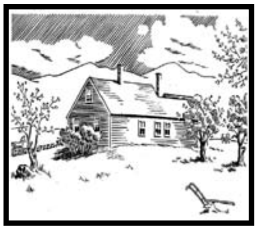

THE FEDERAL ESTATE TAX and GIFT TAX - 2011, 2012 and BEYOND*

A Summary

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WARNING: Estate and gift tax rules are generally highly complex. The rules and concepts discussed below are merely summarized. NO ONE should undertake an estate plan or annual gifting plan without consulting knowledgeable tax counsel.

I. Introduction.

The first version of the federal estate tax was enacted in 1797 to help fund anticipated military conflicts. According to the Congressional Budget Office total revenues raised by the estate and gift tax over the past sixty years have only amounted to 1% to 2% of total federal revenues and are expected to amount to about $420 billion between 2010 and 2019, or about 1.2% of projected revenues for that period.

Federal estate tax was paid by approximately 6,700 decedent's estates in 2010. This represents approximately 0.24% of all decedent's estates in 2010. This low level of exposure to estate tax is doubtless due to the high threshold (the "Exclusion Amount" described in Section IV.C. below) for the payment of the tax applicable to 2010 estates.

By contrast, in 2002 the number of taxable decedent's estates was approximately 33,000 representing approximately 1.[1]4%; nearly 600% higher than in 2010. In 2002 the threshold for the payment of estate tax was $1 million for single persons and, with some estate planning, could be increased to $2 million for a married couple. The top rate of tax was 50% instead of the current top rate of 35%. In addition, in 2002 there was a surcharge of 5% on the value of estates between $10 million and $17 million.

2002 statistics are important because the current estate tax provisions expire at the end of 2012 and the 2002 estate and gift tax rules come back into effect – unless Congress acts. In other words, estate planning for persons of only moderate wealth (in excess of $1 million for single persons and $2 million for married couples) remains important, at least for those hoping to live past 2012.

II. Current Status of the Estate and Gift Tax.

The federal estate tax officially expired at the end of 2009. For a while it appeared that estates of persons dying in 2010 would escape the tax. However, on December 17, 2010 Congress enacted the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312) which re-enacted the federal estate tax, retroactive to January 1, 2010.

However, Congress did provide some relief for the estates of persons dying in 2010. It allowed such estates to make a choice. They could elect an unlimited Exclusion Amount, in which case assets passing through the estate received a modified "carry-over basis" rather than a "stepped-up basis" (see Section IV.J. below for a discussion of basis). In the alternative, such estates could elect to claim a $5 million Exclusion Amount in which case assets passing through the estate would receive a full step-up in basis.

As noted in the Introduction, these new and quite

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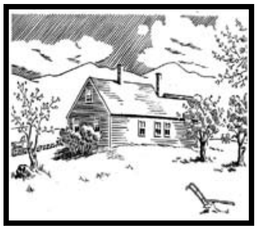
* The purpose of this summary is to, as simply as possible, acquaint the reader with the basics of the federal estate and (to some extent) the gift tax.

** The author thanks Stephen P. Adamson, Jr., Esq. (stephen@wyomingestatelaw.com) for his technical review and assistance in the preparation of this article.



generous estate tax rules expire at the end of 2012. In 2013 the estate tax rates and threshold amount for payment of taxes revert to the rates and unified credit amount that applied in 2002.

As described in Section IV.C. below, current law (2012) excludes up to $10.24 million in assets for a married couple or $5.12 million for a single person from tax so that only a handful of estates are taxable (6,700 in 2010 as noted above). This reflects an increase over the 2011 Exclusion Amount resulting from an inflation adjustment. In 2011 the Exclusion Amount for married couples was $10 million and for single persons it was $5 million.

If Congress fails to act, in 2013 the following will occur:

1. The threshold for payment of tax will drop from $10.24 million for married couples to $2 million for married couples and from $5.12 million for single persons to $1 million for single persons.

2. In order to enjoy the $2 million Exclusion Amount for a married couple estate planning must take place, whereas to enjoy the current $10.24 million Exclusion Amount a couple need do no estate planning. (However, failing to take full advantage of the Exclusion Amount in the estate of the first spouse to die may expose the survivor's estate to estate tax on the inflation in the value of assets passing from the first decedent's estate. This result can be avoided through the use of a by-pass trust (see Section IV.D.(i)) below for a discussion of by-pass trusts.)

3. The top rate of tax will increase from 35% to 50%; plus a 5% surcharge on estates between $10 million and $17 million in value.

4. Similar changes will affect the federal gift tax.

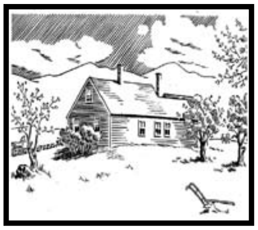
III. The "Unified Estate and Gift Tax" (Code §§2001 – 2801)

The federal estate and gift tax provisions are contained in §§2001 through 2801 of the Internal Revenue Code of 1986, as amended (the "Code" – note that section headings will include, where appropriate, references to relevant sections of the Code); and §§20.0-1 - 26.7701-1 of the U.S. Treasury Regulations (the "Regulations."). The purpose of the Code is to tax transfers of wealth from one person to another whether made at a person's death or during a person's lifetime. Because the tax is imposed both on transfers during life and at death, and because the tax applies cumulatively to both types of transfers, it is called the "Unified Estate and Gift Tax." In other words, tax is due on gifts and on bequests (or on assets passing without a will – by "intestacy") and all such transfers are added together to determine the amount of tax due.

Under the current law (the law re-enacted at the end of 2010) the first $5.12 million of a single person's transfers, whether by gift, will or intestacy, is exempt from both estate and gift tax. This exemption is known as the "Exclusion Amount." The Exclusion Amount covers both life-time gifts and assets passing at death so that only $5.12 million in assets can be transferred exempt from tax. The current tax on anything transferred in excess of the $5.12 million exemption is 35%.

Current law also includes the so-called "portable" Exclusion Amount (see Section IV.C. below). The portable Exclusion Amount provides that if the estate of the first spouse to die fails to take full advantage of the Exclusion Amount the surviving spouse's estate may use that unused portion plus his or her own Exclusion Amount (provided that the estate of the first spouse to die timely filed an estate tax return with the proper election).

Portability expires after 2012. If that occurs, any portion of the Exclusion Amount not used by the estate of the first spouse to die will result in loss of that portion. In the case of married couples full use of the Exclusion Amount, if portability expires



will require some minimal level of estate planning (see Section IV.D.(i) below).

IV. The Gift Tax (Code §§2501 – 2524)

As described in the preceding section the estate tax and the gift tax are unified. However, they are not identical. A person making gifts during his lifetime that do not otherwise qualify as charitable contributions is liable for the payment of tax on the amount of the gift with certain exceptions, discussed below.

A. The Gift Tax and the Exclusion Amount (Code §2505)

As noted, both life-time gifts and property passing by will or intestacy are taxable, subject to the Exclusion Amount. The current Exclusion Amount allows a single person to make life-time gifts up to $5.12 million tax-free, and a couple to make up to $10.24 million in life-time gifts tax-free. Also, as noted, the current Exclusion Amount will revert to $1 million after 2012 under current law.

Because of uncertainty about the future of the Exclusion Amount many wealthy people are making gifts during 2012 to take advantage of the current generous Exclusion Amount.

B. The Annual Exclusion from Gift Tax. (Code §§2503(b) and 2513)

In addition to the one-time Exclusion Amount, life-time gifts are also entitled to an "Annual Exclusion" from gift tax. The Annual Exclusion, like the Exclusion Amount, is indexed for inflation. The amount of the Annual Exclusion for 2012 is $13,000.

The Annual Exclusion is available <u>annually</u> for each gift made to an individual person (or any number of individuals – but only to individuals or to so-called "Crummey Trusts," a discussion of which is beyond the scope of this summary). In addition, the Annual Exclusion is doubled for gifts made jointly by a husband and wife. Such gifts are known as "split gifts." In other words, at current rates, split gifts to an individual (or any number of individuals) are tax-free up to $26,000 annually.

Example: *Don and Jean have three married children and four grand-children. Using the Annual Exclusion, and making split gifts, they can make gifts sheltered by the Annual Exclusion amounting to $260,000 per year. This can be done by making a $26,000 split gift to each child (amounting to $78,000); similar split gifts to the spouse of each child (also amounting to $78,000); and four $26,000 split gifts to each of the four grandchildren (amounting to $104,000).*

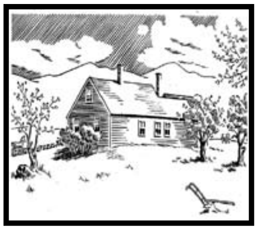
The Annual Exclusion is an important part of many basic estate plans. Annual gifts to children, if started while parents are relatively young can, over the years, effectively transfer very substantial amounts of property tax free. While it is easier to transfer liquid assets (stocks, bonds or cash), it is also possible to transfer land.

Note that assets passing by life-time gifts <u>do not</u> receive a stepped-up basis (see discussion in Sections III.E. and IV.J below), which is one reason to exercise caution in using life-time gifts as part of an estate plan.

<u>(i) Gifts of land or interests in family businesses.</u>

Land and family-owned businesses are not "liquid" like cash or stocks and bonds, and dividing land or family-owned businesses and valuing the resulting interests is difficult. For purposes of this discussion land and family-owned businesses will be referred to as "illiquid assets."

There are several ways in which illiquid assets may be gifted. With land, the most obvious way is to make the gift outright "in fee simple." The problem with this is that existing parcels of land are unlikely to fit neatly within the Annual Exclusion amount. One way of dealing with this



problem is to divide land into smaller parcels based upon an appraised per-acre value. This is not very practical, and also may violate local land use regulations.

One alternative is to gift an undivided percentage interest in land (typically called a “tenancy in common”). For example, if a ranch is worth $2 million, an undivided 1.3% interest in the ranch would equate to $26,000 (actually less, because there would be a substantial discount in value for such a small minority interest; see the discussion of “discounting” in Section IV.C. below).

Partial interests in family-owned businesses, if owned as sole proprietorships, are also difficult to transfer.

However, by transferring illiquid assets to a so-called “pass-through entity” transferability can be greatly enhanced. Typical entities used for estate planning include family limited partnerships (“FLPs”) and limited liability companies (“LLCs”). These entities allow illiquid assets to be divided fairly simply. Title to the illiquid asset is transferred from the current owners to an FLP or LLC that is wholly owned by the asset owners. Such transfers are not taxable. Once title has transferred the original owners continue to own the formerly illiquid asset, but in the form of limited partnership interests or memberships in an LLC, both of which are easily transferred to others without requiring any division of the underlying asset.

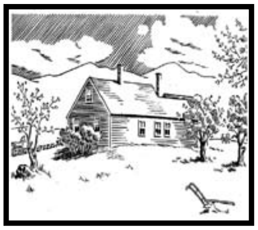
In addition FLPs and LLCs allow a form of centralized decision-making (by the general partner in an FLP or by the managing member in an LLC), so that the parents, for example, may continue to control the use of the assets of the entity regardless of who holds limited partnership interests (FLPs) or memberships (LLCs).

LLCs and FLPs are called “pass-through” entities because they allow the income and deductions generated by the property held by the entity to pass through to the limited partners or members in proportion to their ownership interests, or according to the terms governing the operation of the LLC or FLP. LLCs and FLPs are taxed as partnerships (except single-member LLCs which are ignored for taxation purposes).
Another entity that is sometimes used for estate planning is the “S corporation.” An S corporation is also taxed like a partnership, with some exceptions. An important example of an exception is that charitable deductions by an S corporation are limited to the amount of the shareholder’s adjusted basis in his or her shares.

“C corporations” are not suitable for estate planning. This is due, in part, to the fact that C corporations do not allow a pass-through of income and deductions to shareholders. In addition, C corporations are taxed separately from their shareholders and the transfer of assets or income from a C corporation to its shareholders generates an additional tax. Also, charitable contribution deductions by C corporations are limited to 10% of the corporation’s taxable income and these deductions cannot pass through to shareholders.

(ii) The “present interest” requirement (Code §2503(b)(1))

The Code requires that gifts eligible for the Annual Exclusion must be gifts of “present interests” in property. This requirement does not apply to the Exclusion Amount. As a result of Tax Court decisions in 2002 and 2010, the use of LLCs and FLPs (and possibly S corporations) in connection with the Annual Exclusion has become more complex and, in many cases, impractical. This is because the Tax Court has ruled that gifts that are subject to substantial restrictions on present use fail to comply with the present interest requirement and therefore are not eligible for the Annual Exclusion, unless there are specific provisions in the entity’s controlling documents allowing for the sale of gifted interests back to the partnership or LLC at fair market value (the discussion of such provisions is beyond the scope of this summary).



The Tax Court decisions dealt with gifts made via LLCs and FLPs.

It is still possible to structure gifts via LLCs and FLPs; however, care needs to be taken that these entities are structured to comply with the present interest requirements. However, it is likely that such gifts will not qualify for the discounting treatment described below.

Gifts of partial interests in real property; e.g. the gift of a 10% undivided interest in the family farm to a family member, should be considered gifts of a "present interest" because the recipient of the gift has the immediate right to sell the interest (if anyone would be willing to buy) or to seek partition of the property. Such gifts, because they constitute gifts of a present interest are eligible for the Annual Exclusion. They may also be eligible for discounting.

Gifts to minor children, even if they are not present interests because enjoyment is deferred, are not subject to gift tax provided that they can be enjoyed when the minor reaches age 21.

Note that Tax Court rulings do not preclude gifts using LLCs and FLPs from eligibility for the one-time Exclusion Amount. In any event, the use of an LLC, an FLP or an S corporation should only be undertaken with the guidance of qualified estate tax counsel.

C. Discounting

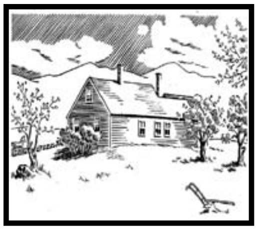
Discounting reduces the value of life-time gifts (or transfers made at death) below their "face value" and is an effective and popular estate planning tool. Discounting applies to transfers of less than the controlling interest in property, particularly assets such as interests in FLPs, LLCs, and S corporations. For example, the face value (technically the "par value") of a one-third interest in an FLP whose assets were worth $1 million would be $333,333. However, the value of the gift of such a one-third interest might be discounted to, say $233,333, when the gift is valued for tax purposes.

Discounting gifts or transfers made at death of (i) property that is not readily marketable (e.g. an interest in an FLP) and that represents (ii) less than a controlling interest in the property gifted is allowed by the Code for two reasons. The first reason is that owning an interest in property that is not readily marketable (as is the case with interests in FLPs, LLCs and S corporations) is worth less than an interest in property that is readily marketable (e.g. shares of stock traded on a recognized exchange). This is sometimes referred to as the "discount for lack of marketability." The second reason is that owning less than a controlling interest in an asset is worth less than owning a controlling interest. This is sometimes referred to as the "discount for lack of control" or "minority discount."

As discussed in the previous section regarding the present interest requirement, it is the very nature of the restrictions on use that make discounting effective that may prevent discounted gifts from qualifying as present interests eligible for the Annual Exclusion. However, discounting can be very important in maximizing the amount of property that can be gifted under the one-time Exclusion Amount, which is not limited to gifts of present interests.

Gifts of partial interests in real property conveyed outright (e.g., by conveying an undivided interest in common) will also result in a discount for both lack of marketability and lack of control. Discounts of as much as 30% have been suggested as appropriate for gifts of partial interests in real property. Such interests, because they can be sold or provide the basis for seeking partition, are likely to be considered present interests, therefore qualifying for the Annual Exclusion as well as a discount.

There are other types of discounts available such as "blockage," applicable where a gift or bequest is made of a very large amount of publicly-traded stock or similar asset), or "market absorption"



where a number of similar assets (e.g. lots in a residential subdivision) are gifted or bequeathed and where it will require a considerable amount of time to sell the lots because of market circumstances.

Determining the actual amount of discount for any given asset is a very complex process and is not infrequently challenged by the IRS if the discounting appears too aggressive. However, as a very general rule, lack of marketability discounts range from 20% to 25% (although they may be much higher or lower depending on circumstances). Lack of control discounts range from 20% to 40% (again, they can be much higher or lower depending on circumstances). As noted, partial interests in real property may generate discounts of up to 30%.

Example 1: The James family owns a 500-acre dairy farm in central Wisconsin. In addition to Mr. and Mrs. James there are three children, all of whom work on the farm. The farm operation, including land, buildings, equipment and livestock, is valued at $17 million. The farm is titled jointly in the names of Mr. and Mrs. James, who decide to create a family limited partnership as a vehicle to begin transferring ownership of the farm to their children. Mr. and Mrs. James become the "general partners" with the sole authority to control the operations of the farm. At the time of the creation of the FLP they are also the sole limited partners holding 100% of the value of the farm.

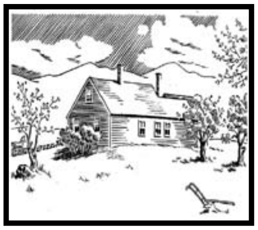
To take advantage of the current $10.24 million Exclusion Amount they transfer limited partnership interests to each of their three children with a face value of $5 million. Without discounting this would amount to $15 million in gifts and would trigger the gift tax. However, their estate tax attorney advises them that they can safely discount the value of these gifts by 35% (10% for lack of marketability and 25% for lack of control). Thus the collective taxable value of the gifts is approximately $9,750,000, an amount that will be completely sheltered by the $10.24 million Exclusion Amount. Note that because the gift of limited partnership interests might not constitute a gift of a "present interest" it is possible that no portion of the gifts will qualify for the Annual Exclusion.

Example 2: The Ball family owns a ranch in southern Montana valued at $4 million, of which the land is worth $3 million. The date is 2013 and the Exclusion Amount has dropped to $1 million per person. The Balls have three married children, all of whom work on the ranch. The Balls decide to make gifts to each child and each child's spouse of undivided interests in the land using the Annual Exclusion to avoid gift tax. Assuming an Annual Exclusion of $13,000, the Balls can make split gifts of $26,000 to each of the three children and three spouses, for a total of $156,000 annually (5.2% of the total current value of the land). If these gifts could be discounted by as much as 30% due to the fact that the gifts are of partial interests in real property, the Balls can actually gift partial interests equal to $222,857 ($156,000/ 0.7) or 7.4% of the current total value of the land, annually. Of course the value of the land remaining in the Balls' ownership may appreciate so that the value remaining in their hands may appreciate faster than they can gift it. This is one drawback to the annual gifting of appreciating assets.

As with the use of LLCs and FLPs, discounting through partial interest transfers is a very complex business and should only be undertaken with qualified estate tax counsel. Any further discussion is beyond the scope of this summary.

D. Other Gift Tax Exemptions

Following is a list of transfers that are not subject to gift tax. This list is not exhaustive, but does



cover some of the most important exemptions from the tax.

(i) Gifts between spouses (Code §2523)

All gifts between spouses are exempt from the gift tax due to the "Marital Deduction" discussed in Section V.D. below.

(ii) School and Medical Payments (Code §2530(e))

Payments made for tuition (but not room, board, books, etc.) and for medical expenses on behalf of another (regardless of the relationship to the donor) are exempt from the gift tax, regardless of the amount paid, provided that such payments are made directly to the institution providing the service.

(iii) Charitable Contributions (Code §2522)

Contributions to qualified charities and public agencies are not subject to the gift tax. Note however, that "charitable intent" is required. Also note that gifts of partial interests in property, with some exceptions (conservation easements are one of the exceptions) are not considered charitable contributions and may be subject to gift tax.

(iv) Transfers to Political Organizations (Code §2501(a)(4))

Transfers to political organizations are not subject to gift tax, even though they are not considered charitable contributions.

E. Some Cautions about Gifts

It may not always be advisable, as a family matter, to transfer (ultimately) control over the family farm, business, or other significant assets, to children during the parent's lives. This will depend a great deal on family dynamics. In the case of a family farm or other business, how should a family divide the asset where some children are involved in the farm or business and some are not? Where some love the farm or other business, and others would be happy if they never saw the place again? The point is this: tax planning is important, but not always as important as what will happen to the family when the parents begin to shift control of major family assets to other family members.

Another important point is that assets transferred by gift do not receive a "stepped-up basis" (see the discussion of "stepped-up basis" in Section V.J. below). In addition, giving land subject to a conservation easement wastes the 40% estate tax exclusion allowed by §2031(c) of the Code (discussed in Section V.I. below), because this exclusion does not apply to gifts.

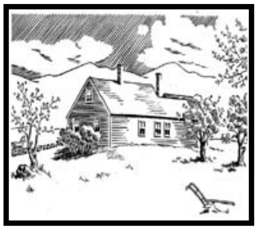
Finally, trying to minimize estate or gift taxes by making annual gifts from parents to children in amounts that don't exceed the Annual Exclusion can take a long time and, if the asset being gifted in this manner is appreciating, it is possible that the annual gifts will not even keep up with the appreciation in value of that portion of the asset remaining in the parents' hands.

V. The Estate Tax (Code §§2001-2210)

A. The Gross Estate (Code §2031)

An important concept in the estate tax law is the "gross estate." The gross estate is to be distinguished from the "taxable estate" discussed in Section V.B. below. The gross estate includes the value of everything titled in the decedent's name, whether solely or jointly with others, as well as any other property over which the decedent had discretionary control for his or her personal benefit.

For example, if the decedent was the trustee of a trust and had the authority to direct the use of the assets of the trust for his or her own benefit, the value of the assets of the trust must be included in the decedent's gross estate. If the decedent owned a bank account jointly with another person and could withdraw the entire sum for his or her own use, the entire value of the account is included in the decedent's estate.



If a decedent owned life insurance and controlled the cash value or the designation of beneficiaries, or other "incidents of ownership" of the policy, the value of that policy will be included in the decedent's estate.

With certain exceptions (see §2040(a) of the Code) if the decedent owned land jointly with another person (except for undivided interests held in common without survivorship rights) the entire value of the land will be included in the estate of the first joint owner to die. In addition, the value of interests in limited liability companies, trusts, corporations, partnerships, limited partnerships, and the like will be included in the decedent's estate to the extent of the decedent's ownership in such entities. The value of property owned by a decedent through a "revocable trust" (one which the decedent had the right to amend or terminate at will) is included in that decedent's gross estate.

Gifts of certain interests made in the three years prior to a person's death, and gift tax paid within that period, may also be included in a person's gross estate (see §2035 of the Code).

In order to insure that the value of property owned by a person is excluded from that person's estate, the person must completely divest himself or herself of all rights to any personal enjoyment of, or control over, the property, except for property placed irrevocably in trust for the benefit of another (in which case some limited control and enjoyment of the trust property may be retained). A person should assume that the value of virtually everything he or she has any control over for personal benefit will be included in his or her gross estate.

The value of property included in a decedent's estate for estate tax purposes is its value measured on the date of the decedent's death or, if the decedent's executor makes a special election to do so, on a date six months after the decedent's death. The six-month deferral of valuation protects the estate from dramatic downward changes in asset values that might occur shortly after a person dies. The valuation of estate property is obviously an extremely important aspect of the estate tax.

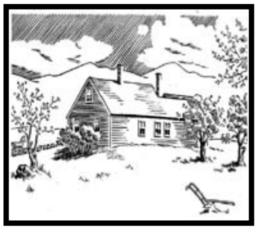
B. The Taxable Estate (Code §2051)

The taxable estate is the gross estate reduced by all allowed estate tax deductions. Deductions are allowed for the following: costs of estate administration, executor's fees, funeral expenses, debts of the decedent including mortgage debt, taxes including state death taxes, contributions to qualified charities and public agencies provided for in the decedent's will, "post-mortem" conservation easement contributions (discussed in Section V.I.(iii) below) and the value of all property passing to the decedent's spouse (whether by the terms of the will, or by operation of law, e.g. survivorship accounts, real property owned jointly with right of survivorship, etc.), unless the spouse is not a U.S. citizen, in which case special rules apply.

C. The Exclusion Amount (Code §2010)

As already noted, the Code excludes a certain amount of every decedent's estate (the Exclusion Amount) from taxation. Technically speaking, the Exclusion Amount does not actually exclude any part of a decedent's estate from taxation. Rather, it is a dollar-for-dollar credit (the "Unified Estate and Gift Tax Credit") against tax. The amount of the credit available in 2012 is $1,772,800 which will shelter $5,120,000 in estate assets. Therefore the Exclusion Amount in 2012 is $5,120,000. This represents an increase over the 2011 credit amount of $1,730,800, which sheltered $5 million in estate assets. The increase is the result of the indexing for inflation of the Exclusion Amount provided for by current law.

The credit against tax is called "unified" because it applies to the estate tax <u>and</u> the gift tax. The unified credit can only be used once against either estate or gift tax, or a mixture of both, and the total value sheltered by the credit



cannot exceed the Exclusion Amount. Calculating the amount of estate and gift tax due requires that the amount of all taxable gifts (i.e. those in excess of the Annual Exclusion, or otherwise exempt from gift tax) be combined and added to the taxable estate. The total is the amount subject to tax and to which the Exclusion Amount applies. If the total amount of taxable gifts made exceeds the Exclusion Amount, gift tax must be paid at that time the gift is made, and none of the Exclusion Amount will remain to shelter estate assets. A credit equal to the amount of gift tax previously paid is allowed against the estate tax due, if any.

Example: Suppose that Mr. Jones made taxable gifts during his lifetime amounting to $800,000 (over and above the Annual Exclusion of $13,000). Because this amount does not exceed the Exclusion Amount which, due to the Unified Credit applies to both gift and estate tax, no tax is due. When Mr. Jones died his taxable estate amounted to $5 million. However, because taxable gifts must be added to the gross estate to determine total tax due, his gross estate will be $5.8 million for taxation purposes. Assuming Mr. Jones died in 2012 the Exclusion Amount would only shelter $5.12 million of this amount leaving $680,000 subject to tax. The rate of tax on everything in excess of $5.12 million is 35%. In this example Mr. Jones's estate would be liable for $238,000 in tax [($5,800,000 - $5,120,000) x 35%].

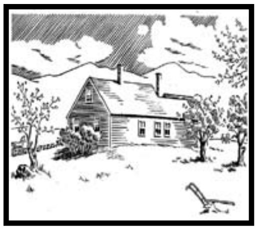
Example: Assume the same facts as in the preceding example except assume that Mr. Jones made a $5.8 million dollar lifetime gift and had assets of $5 million at the time of his death. Under these circumstances gift tax would be payable at the time of the gift on the amount in excess of the Exclusion Amount or, in this case, $238,000 [($5,800,000 - $5,120,000) x 35%]. At the time of his death Mr. Jones's executor would be required to add the total of taxable gifts made during Mr. Jones's lifetime to his estate to determine total tax due. The executor would figure the tax due on this total of $10.8 million ($5,800,000 + $5,000,000), which would be $1,988,000 [($10,800,000 - $5,120,000) x 35%)]. From this amount he would subtract the $238,000 of gift tax previously paid (or Mr. Jones would be paying the same tax twice) to determine the net tax due ($1,988,000 - $238,000 = $1,750,000).

As already noted, unless Congress acts the Unified Credit reverts to the level existing in 2002, which was $345,800 which translates into an Exclusion Amount of $1 million.

(i) "Portability" of the Exclusion Amount (Code §2010(c)(2))

When Congress reinstated the estate tax at the end of 2010 it added a new provision allowing a person to use his or her predeceased spouse's unused marital deduction. In other words, if John dies and only uses $2 million of the $5 million Exclusion Amount, his wife Susan may use the remaining $3 million of John's Exclusion Amount plus her own $5 million Exclusion Amount, provided that John's estate timely filed an estate tax return.

Many folks have wills that provide that everything in their estate goes to their surviving spouse when they die, or to their children if there is no surviving spouse. Under this approach all of the first decedent's estate is sheltered by the Marital Deduction and none of the Exclusion Amount is used. Under the law that existed prior to 2010 (the law that may come back into effect after 2012) the entire Exclusion Amount available to the first decedent's estate would be lost. With portability, the unused Exclusion Amount from the spouse to die first is not lost but can be used by the surviving spouse.



The portability provisions eliminate the need for special estate planning to avoid losing the Exclusion Amount (see Section V.D.(i) below). However, some planning may still be needed to avoid the potential estate tax resulting from the inflation in the value of assets passed from the first decedent's estate to the surviving spouse. In other words, if a by-pass trust is used (discussed in Section V.D.(i) below), assets qualifying for the Exclusion Amount may "by-pass" the survivor's estate (while providing benefits to the survivor) and go directly to the children thereby avoiding appreciation of those assets in the survivor's estate that will increase the estate tax due when the survivor dies.

The generation-skipping tax credit (discussed in Section V.G below) is not portable. Also, as previously noted, the estate of the first spouse to die must timely file an estate tax return on which the proper election is made to allow portability of its unused portion of the Exclusion Amount.

D. The Marital Deduction (Code §2056)

As already noted, the Code allows a decedent's estate to deduct the total value of all assets passing to a decedent's spouse upon the decedent's death, provided that the surviving spouse is a U.S. citizen. This is known as the "marital deduction." The amount of this deduction is unlimited. In other words, Bill Gates could leave his entire estate to his wife Melinda and the estate would pass to her estate tax free. The marital deduction also applies to life-time gifts made to a spouse, regardless of amount.

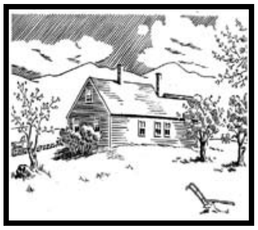
<u>(i) "Over-qualifying" for the marital deduction and "by-pass trusts"</u>

The following discussion is not currently relevant because of the "portability" of the Exclusion Amount (discussed in Section V.C.(i) above), which (provided the estate of the first spouse to die timely files an estate tax return) automatically transfers any unused portion of the exclusion amount remaining after the death of the first spouse to die to the surviving spouse. However, under prior law, and the law that may come back into effect in 2013, any unused portion of the Exclusion Amount will be lost to a surviving spouse's estate. Under this law, if all of a decedent's assets passed outright to the surviving spouse the Exclusion Amount would be lost. This is because all of the assets passing to the surviving spouse would qualify for the marital deduction rather than the Exclusion Amount and the Exclusion Amount would be lost. In other words, if portability is not renewed after 2012 it will be important to maximize use of the Exclusion Amount before using the marital deduction.

Maximizing the Exclusion Amount in the absence of portability requires that assets up to the amount of the Exclusion Amount do not pass into the control of a surviving spouse so that they will be sheltered by the Exclusion Amount rather than the marital deduction. Of course, most people want to provide for their spouses in the event of death. This can be accomplished, while still taking advantage of the Exclusion Amount, through the use of a type of trust known as a "by-pass trust."

A by-pass trust provides income and as much of the principal of the trust as may be needed to maintain the surviving spouse in the "style and manner to which he or she is accustomed" (or some other ascertainable standard), with all of the principal of the trust existing on the death of the surviving spouse payable to children, or other persons or entities. The name of the trust comes from the fact that the trust assets "by-pass" the estate of the surviving spouse while still providing substantial benefits to the surviving spouse. In by-passing the estate of the surviving spouse assets will qualify for the Exclusion Amount rather than the marital deduction and will not be included in the surviving spouse's estate (therefore appreciation of those assets in the surviving spouse's estate will also be avoided).

A by-pass trust may not be suitable for certain assets, such as a principal residence, automobiles



or other assets that are required by surviving spouse for everyday living. However, stocks, bonds, cash, and other relatively liquid assets that generate income or are easily liquidated may fit very well in a by-pass trust.

Many assets are titled in the joint names of husband and wife, in which case the assets automatically pass by operation of law to the survivor, regardless of the provisions of the decedent's will. To effectively avoid "over-qualifying" it is often necessary to re-title some (or all) jointly owned property so that such property passes according to the terms of the owner's will or revocable trust, rather than automatically as a matter of title.

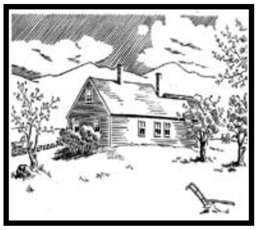
The following example illustrates the problem of over-qualifying and the use of a by-pass trust:

> *Example: Assume it is 2013 and that "portability" is no longer available.*
>
> *Suppose that George and Mary jointly own $2 million in assets. When George dies everything passes to Mary (as it will regardless of the provisions of George's will because the title dictates the disposition of jointly held assets – not the joint owner's will). There is no estate tax due because George's entire estate is sheltered by the marital deduction. When Mary dies everything goes to the couple's two children, according to the terms of her will. The tax (assuming that Mary dies in 2013 with a taxable estate of $2 million and taking into account the $1 million Exclusion Amount that may then be in effect) will be $435,000 (reflecting tax rates and the Unified Credit that may apply in 2013).*
>
> *Now, let's assume that George and Mary divide their joint property so that each owns $1 million outright in their own names without any survivorship provisions. They each have wills that provide that their estate will be placed in a trust at their death. Each trust provides that the trust income be paid entirely to the surviving spouse together with as much of the principal as the trustee agrees is needed to maintain the surviving spouse. Upon the survivor's death what is left in the trust is to be distributed outright to the two children. (Note that if the surviving spouse is the trustee restrictions must be carefully imposed on the trustee's discretion to avoid having the trust assets included in the surviving spouse's estate.)*

When George dies his entire estate goes into the trust, and the entire estate of $1 million is covered by the Exclusion Amount so there is no tax. When Mary dies her entire estate of $1 million will go directly to the two children because the trust provided for by her will was only required if she died survived by George. Again, Mary's estate is entirely sheltered by the Exclusion Amount, so there is no tax on it either. The end result is that, rather than having to pay $435,000 in estate tax, the children receive the entire $2 million tax-free.

<u>(ii) Under-qualifying for the Marital Deduction and "Qualified Terminable Interest Property Trusts" (Code §2056(b)(7)(B))</u>

In attempting to avoid "over-qualifying" for the marital deduction it is important not to fail to take advantage of the marital deduction. Remember that the Exclusion Amount is limited to $10 million for married couples (through 2012). Passing more than $10 million in a manner that fails to qualify for the marital deduction will result in estate tax on the first decedent's estate. Therefore, to minimize tax both in the first decedent's estate and in the surviving spouse's estate, consideration should be given to insuring that all assets in excess of the Exclusion Amount pass to the surviving spouse either directly or through a qualified terminable interest trust ("QTIP" trust).



A QTIP trust is very like a by-pass trust in that the income from the assets of the trust is to be paid to the surviving spouse together with as much principal as the trustee determines necessary to support the surviving spouse (and the trust must be explicit that none of the income or assets of the trust may be paid to or used for the benefit of anyone other than the surviving spouse during his or her lifetime). The provisions of a QTIP trust must allow the decedent's executor to make an election to have the trust treated as a QTIP trust on the decedent's estate tax return. Failure by the executor to make the election on time will result in denial of the marital deduction and taxation of the trust's assets in the decedent's estate.

Example: Assume that Max and Minnie own property worth $15 million. They divide their ownership to eliminate any survivorship joint ownerships so that their wills or revocable trusts control the disposition of their property when either of them dies. They then create by-pass trusts and provide that all of the assets owned by the first decedent are transferred to that person's by-pass trust. Assume Minnie dies first in 2012. Her gross estate will include $7.5 million. All of it goes to a by-pass trust, none goes to Max. The Exclusion Amount shelters the first $5.12 million of assets in her estate. However, that leaves $2.38 million of assets subject to tax. That tax will be $833,000. Had Minnie left everything in excess of the Exclusion Amount to Max (or to a QTIP trust) there would have been no tax because of the marital deduction.

In considering the foregoing example it should be recognized that the portability of the Exclusion Amount only allows portions of the Exclusion Amount unused by the first spouse to die to pass to the survivor. It does not allow the estate of the first spouse to die to use more than the $5 million Exclusion Amount.

(iii) Don't Forget to Be Practical

It is important to keep the avoidance of estate taxes in perspective. It is possible to come up with a perfect estate plan that saves lots of tax but that is completely unworkable for a family. For example, it rarely makes sense to put a personal residence in a by-pass trust because the surviving spouse should not have to work with a trustee and a trust structure for his or her day-to-day living arrangements. The same can be said for other basic assets necessary for the normal conduct of the surviving spouse's life.

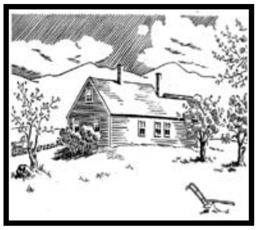
E. Credit for Prior Transfers (Code §2013)

If the decedent received property from someone who died either within ten years prior to the decedent's death, or two years after the decedent's death, a credit is allowed for some or all of the federal estate tax paid by the estate of the person who provided for the transfer to the decedent.

F. Special Valuation for "Qualified Real Property" (Code §2032A)

The estate tax is particularly troublesome for farmers, ranchers and others whose small businesses may include substantial real property. This is because it is often the case that such persons may have very valuable estates due to the value of the real property that is part of the farm, ranch or other small business. However, these folks may have little in the way of cash or other liquid assets, such as stocks and bonds that can easily be converted to cash to pay estate taxes.

To address this problem the Code provides that estates meeting certain criteria may value their "qualified real property" based upon the income the farm, ranch or other business generates as farm, ranch or other small business rather than upon the development value of such real property. The criteria include: (1) the farm or ranch must make up at least 50% of the value of the gross estate; (2) the real property included in the value



of the farm, ranch or other small business must make up at least 25% of the value of the gross estate; (3) the decedent or members of the decedent's family must have operated the farm, ranch or other small business for at least five of the eight years preceding the decedent's death; (4) the "qualified heir" receiving the real property cannot dispose of it, or any portion of it (other than by conservation easement) for at least ten years after the decedent's death; and (5) the qualified heir must continue to use the real property as a farm, ranch or small business for at least ten years after the date of the decedent's death.

The maximum amount by which the value of qualified real property may be reduced under this provision is currently $1 million, although this amount is indexed for inflation.

<u>The foregoing are summaries of only some of the requirements of §2032A.</u>

Example: John has been divorced for many years. He owns Two-Rivers Ranch which he has operated with his son, Bill, for over 20 years. John dies in 2012 leaving the entire ranch to Bill. The appraised value of the ranch, taking into consideration its development potential (it has over two miles of scenic frontage on a nationally recognized trout stream) is $6 million. John also had $200,000 in equipment and $50,000 in cash, and no debt at his death. Therefore John's gross estate amounts to $6,250,000.

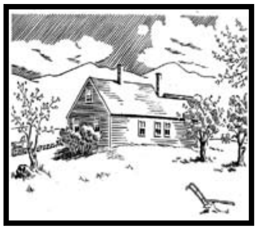
The first $5.12 million of John's estate is covered by the Exclusion Amount. John's executor elects the special valuation treatment for the ranch allowed by §2032A. The value of the ranch, as a ranch, using the valuation method provided in the tax code, is $1.5 million. However, the maximum reduction in value allowed in 2011 by §2032A is $1 million. Therefore, combining the $5.12 million Exclusion Amount and the $1,000,000 reduction under §2032A, John's taxable estate is $130,000 ($6,250,000 - $5,120,000 - $1,000,000). The estate tax in 2012 on $130,000 is $45,500. The 2032A election has saved John's estate $350,000 in estate tax.

G. Generation-skipping Transfer Tax (Code §§2601-2664)

Generation-skipping transfers (GSTs) are subject to special estate tax rules. A generation-skipping transfer is one in which a person transfers property, by lifetime gift or by will, to a generation at least twice-removed from his or her own generation; that is, to a grandchild, great-grandchild, grandniece, grandnephew, etc. The tax law assumes that the normal way to transfer property from one generation to another is one generation at a time, without skipping over intervening generations. In other words, generation 1 passes property on to generation 2 for its use, generation 2 passes on what is left of the property to generation 3, and so forth. A generation-skipping transfer, by contrast, is one in which generation 1 passes property directly, or in trust, to generation 3 or 4, etc. skipping over generation 2, while allowing some benefits of the property to be enjoyed by generation 2. Prior to the imposition of the GST tax this was a good way to minimize estate taxes.

From a tax standpoint, the normal (in the eyes of the tax law) transfer from one generation to the next, to the next, and so on, generates a tax at each step. However, the GST skips one or more generations thereby eliminating the tax for the generations that have been skipped.

The tax on GSTs is intended to generate, more or less, what would have been the tax if property passed from one generation to the next without any skips. There is an exemption from the GST tax equivalent to the $5.12 million Exclusion Amount. The exclusion from the GST replicates the exclusion that would have been applicable



to the second generation's transfer to the third, had the second generation not been skipped. The tax on the GST is also equivalent to the "unified estate and gift tax" amount, currently 35%.

Example: Mary is a widower with two children and four grandchildren. Her gross estate at the time of her death amounts to $10 million. Her will provides for the creation of four trusts, one for each of her grandchildren. Each trust receives one-quarter of her estate. The trust provides that the income from each trust and so much of the principal as necessary to maintain her children is to be paid to her children quarterly during their lifetimes. Upon the death of each child the trusts established for that child's children is to be distributed outright, and free of trust, to those children (depending on state law a later distribution date may be chosen which would defer the time when estate tax comes due). Each of these four trusts constitutes a generation-skipping transfer trust. An explanation of the application of the tax in this situation is beyond the scope of this summary. Note that for the exclusion from generation-skipping transfer tax to be available Mary's executor must allocate that exclusion to the trusts.

H. Installment Payment of Tax (Code §6166)

An important tool for lessening the burden of the estate tax on family ranches or farms operated as a business (and any small business owned by a decedent) is the Code's provision allowing the deferral and installment payment of estate tax. The deferral and installment payment provisions only apply to that part of a decedent's estate tax imposed on the family ranching or farming business or other small business, and only if the family ranch, farm, or small business makes up more than 35% of the value of the decedent's adjusted gross estate.

If a decedent's estate qualifies for the deferral and installment payment benefits the decedent's executor is required to make a special election on the estate tax return (Form 706). Payment of tax can then be deferred for up to five years and installment payments can be spread over a maximum of ten years thereafter. In other words, a decedent's estate can spread the payment of that portion of the estate tax applicable to the family farm or ranch business or other small business over a total of fourteen years.

Interest on the first $598,500 of tax eligible for the deferral and installment payment is 2% per year. Any eligible tax over that amount is subject to interest at 45% of the short-term federal rate plus 3%. For example, if the short-term federal rate is 0.26% the interest rate on eligible estate tax amounts in excess of $598,500 would be 1.47% [45% x (0.26% + 3%)].

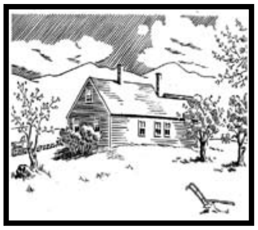
In the event of the disposition of more than 50% of the family farming or ranching business or other small business prior to the end of the deferral and installment period the entire amount of the unpaid tax becomes due and payable at that time.

I. Conservation Easement Estate Tax Benefits (Code §2055(f); 2031(c))

One tool that is particularly well-suited to family owning valuable land, if the family wants to keep the land, is a conservation easement. Conservation easements are not for everyone, and should be carefully considered because of the permanent restrictions they impose on land. However, in the right circumstances they can be the easiest and quickest way to avoid estate tax.

(i) What is a Conservation Easement?

Conservation easements are voluntary agreements entered into between landowners and either a governmental agency, or a private charity whose purpose is land conservation (typically called "land trusts"). A conservation easement imposes permanent restrictions on the future use of land to protect the land's agricultural, open space, natural habitat, historic, and/or scenic values. A conservation easement can



allow continued ranching or farming, recreational (for example, hunting and fishing), and limited residential use – depending upon the size and character of the land. Unlike most "easements" conservation easements do not give anyone the right to use the property that is subject to the conservation easement. A conservation easement necessarily gives the agency or land trust that "holds" (has the right to enforce) the easement the right to come on the easement property to monitor compliance with the easement.

(ii) Two Types of Estate Tax Benefits for Conservation Easements

Conservation easements can result in substantial income and, most importantly for this summary, estate tax benefits. There are two kinds of estate tax benefits that arise from the grant of a conservation easement. First, when land subject to a conservation easement is included in a decedent's estate the land is valued taking into account the restrictions imposed by the easement (what we will refer to as the "reduction in value" due to the easement). Second, under §2031(c) of the Code, the decedent's executor may elect to exclude a certain amount of the value of the land remaining after the grant of the easement.

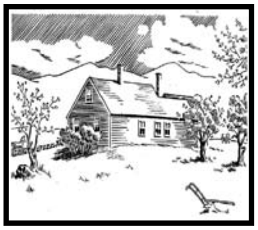
The "reduction in value" is simple: so long as a conservation easement is in place at the time of the decedent's death the land is valued taking into account the restrictions imposed by the easement. It is also possible for a landowner to provide for the contribution of a conservation easement by will. Such a contribution is deductible from the decedent's gross estate as a charitable contribution under §2055(f) of the Code (see Section V.I. (iv) below).

In addition, §2031(c) of the Code allows a decedent's executor to exclude up to 40% of the value of any land in the decedent's estate that is subject to a conservation easement. This 40% exclusion applies to the value of easement land as already reduced by the conservation easement. The maximum amount that may be excluded from a decedent's estate under this provision is $500,000.

However, the exclusion is allowed per estate; not per easement. For example, the estates of four brothers, each owning an undivided one-quarter interest in land over which they had granted a conservation easement, could each claim up to the $500,000 exclusion so that the conservation easement on their land actually generated an exclusion of $2 million. It is relatively easy for the estates of a husband and wife to each claim the $500,000 exclusion, provided that the easement land is properly titled (e.g., as tenants in common rather than as a survivorship interest).

§2031(c) is complex in terms of the requirements that must be met and the limitations that are imposed. For example, in order to claim the full amount of the exclusion the conservation easement must reduce the value of land by at least 30%. In addition, if residential development rights are reserved in the conservation easement the value of such rights must be subtracted from the exclusion. Land with respect to which §2031(c) is applied must have been owned by the decedent or a member of the decedent's family for at least three years prior to the decedent's death. The use of §2032(c) must be affirmatively elected by the decedent's executor. To the extent of the §2031(c) election land will not receive a "stepped-up" basis. There are other conditions and requirements as well.

Example: Susan and Bill own Red Apple Farm containing about 500 acres and located on the Old Mission Peninsula extending into Grand Traverse Bay outside of Traverse City, Michigan. The farm has tremendous resource values, beautiful views over Grand Traverse Bay, spring creeks and a great trout stream. Susan and Bill operate substantial commercial orchards on the farm. Their two children, Susan and Doug, live on the farm with their families and help in the operation of the orchards. The farm, because of its high "amenity



values," is worth $15 million for large lot "trophy home" development.

In addition to the farm, Susan and Bill have about $500,000 in investments and another $250,000 in equipment. Therefore, their gross estate amounts to $15,750,000. Susan and Bill have done some basic estate planning: the farm is titled 50% in Susan's name and 50% in Bill's name as tenants in common (not a "survivorship" interest). Each has a will providing that no more than $5.12 million (or whatever amount is equivalent to the Exclusion Amount allowed for the year of death) in the value of the farm owned by the first to die will go to a "by-pass trust" for the benefit of the survivor, then to the children. Thus, they have each maximized use of the Exclusion Amount. All of the assets of the first to die, other than the assets passing to the by-pass trust, pass outright to the surviving spouse. In the event there is no surviving spouse, all of the assets go directly to the Susan and Doug.

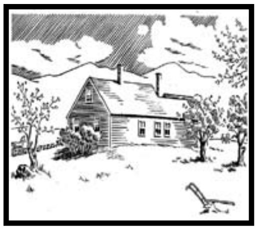
Bill dies in January of 2012, the first to die. Bill's gross estate is valued at $8,750,000. This is one-half of the value of the farm, plus all of the other assets (which are owned jointly with survivorship rights). However, there is no tax payable on Bill's estate because the entire estate is sheltered by the combination of the Exclusion Amount and the marital deduction.

Susan dies in November of 2012. Her estate is valued at $10,750,000. This is all but $5.12 million of the value of the farm (remember that $5.12 million was transferred by Bill's will to a by-pass trust to insure use of the Exclusion Amount), plus the value of the rest of the assets, which automatically passed to Susan's ownership on Bill's death because they were jointly titled. After subtracting debts, administrative expenses, etc. Susan's taxable estate amounts to $10.5 million. Taking into account the $5.12 million Exclusion Amount, the estate tax that will be due on Susan's estate is $1,883,000 [($10,500,000 - $5,120,000) x 35%].

However, let's assume that Susan and Bill donated a conservation easement on the farm before Bill died. The easement allowed continued operation of the orchards and other agricultural uses. In addition, the easement allowed the farm to be divided into four parcels, each with one home site, guesthouse, barns, etc. The easement reduced the value of the farm from $15 million to $11 million. The easement changes the estate tax liability as follows:

Bill's gross estate now amounts to $6,750,000 (because the easement removed $2 million in value from Bill's estate). In addition, Bill's executor elects the 40% exclusion allowed under §2031(c) of the Code. That removes $500,000 from the gross estate, bringing it down to $6,250,000. $5.12 million goes into the by-pass trust (to insure maximum use of the Exclusion Amount) and the remaining $1,130,000 goes directly to Susan. There is no tax due on Bill's estate because of the combination of the Exclusion Amount and the marital deduction.

When Susan dies her gross estate amounts to $6,630,000. This reflects her one-half interest in the farm as reduced by the easement ($5.5 million) plus what she received from Bill's estate ($1.13 million) Susan's executor also elects the 40% exclusion, reducing the gross estate by $500,000 to $6,130,000. After payment of debts, administration expenses, charitable bequests, etc. Susan's taxable estate amounts to $5,500,000. Taking the



$5.12 million Exclusion Amount into account, the estate tax that will be due on Susan's estate is $133,000 [($5,500,000 - $5,120,000) x 35%]. The conservation easement saved Bill's and Susan's estates $1,750,000 in estate taxes, allowing their children to keep the farm instead of selling it to pay estate taxes.

(iii) The "Post-mortem Election" (Code §§2031(c)(8)(A)(iii) and (C) and §2031(c)(9).

"Post-mortem" estate planning is estate tax planning that is still possible after a person dies. There are very few ways in which this can be done. One is the renunciation by a surviving spouse of some or all of the assets passing to him or her from a deceased spouse (further discussion is beyond the scope of this summary). Another is the special use valuation provision of §2032A discussed above which a landowner's executor may elect after the landowner dies.

Another important estate planning tool is provided by §2031(c) of the Code; the same section that provides the 40% exclusion.

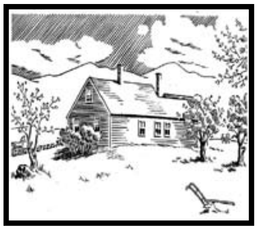
The combined effect of §§2031(c)(8)(A)(iii) and (C) and §2031(c)(9) of the Code allows the heirs of a decedent to elect to contribute a conservation easement over property included in a decedent's estate, thereby qualifying it for the reduction in value due to the easement (treated as a formal deduction in this case) and for the 40% exclusion – just as though the decedent had donated an easement before his or her death. This is known as the "post-mortem easement election." In certain situations this post-mortem election can make a big difference for heirs who want to keep land in the family.

Example: Let's assume that George, who is divorced, dies in 2012 leaving to his only child, Sam, an estate containing a $7 million farm and $250,000 in other assets. Sam lives on the farm but works in town as a schoolteacher. The estate tax on George's estate will be $745,500 [($7,250,000 - $5,120,000) x 35%)]. Sam can't pay this tax without selling the farm, which he does not want to do. He decides to direct George's executor to contribute a conservation easement on the farm, allowing continued residential use of the two houses on the farm, one division for each house, as well as agricultural and recreational uses. The contribution of the conservation easement reduces the value of the farm from $7 million to $5.5 million. George's executor also elects to use the §2031(c) 40% exclusion, thereby excluding an additional $500,000 of the farm's value (already reduced by the conservation easement) from George's estate. Due to the conservation easement the value of George's estate is now $5.25 million. Taking into consideration the $5.12 million Exclusion Amount, the taxable estate is $130,000 and the tax is $45,500. The conservation easement has saved George's estate $700,000 in estate taxes allowing Sam to stay on the farm.

(iv) Tax Requirements for Conservation Easements

In order to be eligible for federal estate tax benefits, and for income tax benefits as well, conservation easements must meet the requirements of §170(h) of the Code and §1.170A-14 of the Regulations, as well as state law requirements governing the creation of conservation easements. In addition, there are extensive requirements imposed by the Code and Regulations to substantiate any income tax deduction claimed in connection with the charitable contribution of a conservation easement (§170(f)(11) of the Code and §1.170A-13 of the Regulations).

To qualify for any federal tax benefits conservation easements must be contributed to "qualified organizations" (as defined in §170(h)(3) of the



Code and §1.170A-14(c) of the Regulations); they must be enforceable under state law; they must be for a "qualified conservation purpose" (as defined in §170(h)(4) of the Code and in §1.170A-14(d) of the Regulations); and they must be granted exclusively for conservation purposes (§170(h)(5) of the Code and §170A-14(e) of the Regulations).

The Code limits the amount of any income tax deduction that may be claimed for the charitable contribution of a conservation easement to 30% of the donor's "contribution base" (essentially, adjusted gross income) and allows any portion of the deduction that cannot be used in the year of the contribution to be carried forward for five years.

All of these requirements, a detailed discussion of which is beyond the scope of this summary (see A Tax Guide to Conservation Easements by the author, available from Island Press or at amazon.com, for a detailed discussion of these requirements), must be met for conservation easements contributed during a person's lifetime. However, §2055(f) of the Code allows a charitable deduction for conservation easements contributed by the provisions of a person's will without regard to whether the conservation purposes requirements of §170(h)(4) of the Code and §1.170A-14(d) of the Regulations have been met. This exception from the conservation purposes requirement is also applicable to post-mortem conservation easements (see Section IV.I.(iii)).

In addition, there is no limitation on the amount of deduction against estate taxes allowed for the charitable contribution of a conservation easement by the provisions of a decedent's will. Note also that, although there is a limit on the amount of the income tax deduction available for life-time contributions of conservation easements as discussed above in this Section, the reduction in estate tax and the estate tax exclusion are not similarly limited, even though the easement was granted during the decedent's life-time.

H. The Use of Conservation Easements in Estate Plans

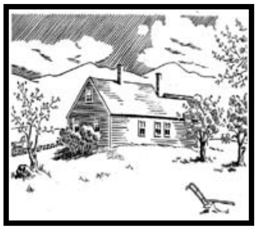
Following are some examples of the role that conservation easements can play in typical estate plans.

(i) Use with the Annual $13,000 Gift Tax Exclusion

Conservation easements can facilitate an estate plan by increasing the amount of land that can be transferred and sheltered by the Annual Exclusion from gift tax. As discussed in Section IV.B. above, current law allows up to $13,000 per donee in value to be gifted without incurring the gift tax. A couple can make "split gifts" of up to $26,000 per donee without incurring gift tax (also discussed in Section IV.B).

By reducing the economic value of land, conservation easements allow more land to be transferred under the Annual Exclusion. For example, if a conservation easement reduces the value of a farm by 50%, that farm can be transferred twice as fast as were there no conservation easement. Of course, if the principal goal is to maximize the financial value of assets passing to the next generation, a conservation easement would not be a good choice. However, where the principal goal is to transfer the maximum amount of land and minimize estate or gift tax, a conservation easement may be the best choice.

One of the problems inherent in transferring land to children using the Annual Exclusion is that the value of land remaining in the hands of the parents may continue to appreciate at a rate that is greater than the value that can be transferred sheltered by the Annual Exclusion. By



eliminating all or most of the development value of land, a conservation easement can significantly reduce the rate of appreciation of land remaining in the parents' hands so that annual gifting is more effective.

Another problem is that outright gifts of land (as interests in common, for example) transfers control over the gifted land to the person receiving the gift. Outright gifts or gifts of interests in common, the kind of gifts most likely to constitute "present interests" as required for the Annual Exclusion, vest in the recipients the rights to sell their interests or to seek partition or, with outright fee interest gifts, the right to use the land in the recipient's discretion. By placing a conservation easement on the land prior to making outright gifts or gifts of interests in common, the future use of the land is controlled by the terms of the conservation easement regardless of the desires of the recipients.

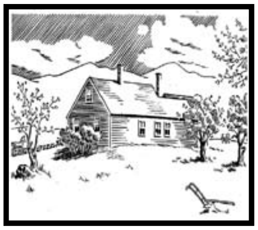
Here are two examples of how a conservation easement can increase the rate at which land can be transferred using the Annual Exclusion.

Example 1: The Browns own Green Farm located in Northern Virginia. The farm consists of 700 acres and is valued at $25,000 per acre, for a total land value of $17,500,000. The Browns have four married children. They can make split gifts amounting to $208,000 (2x8x$13,000) annually sheltered by the Annual Exclusion. Assuming no appreciation, and without regard to discounting rules (considered below), it would take the Browns over 84 years ($17,500,000/$208,000) to completely transfer Green Farm to their children using the Annual Exclusion (and assuming that the value of the farm in the parents' hands does not appreciate).

Of course, there are several caveats. If the Exclusion Amount for a married couple remains at $10.24 million (assuming portability) the Browns can eliminate the estate tax by gifting $10.24 million in assets in 2012, leaving $7.26 million remaining to transfer using the Annual Exclusion. It would take only 36 years to transfer $7.26 million at the rate of $208,000 per year. In fact, the Browns <u>should</u> gift $10.24 million of the farm in 2012 just in case the Exclusion Amount is lowered to $1 million after 2012.

As noted in Section IV.C, gifts of land made outright, even as a tenancy in common interest, may be discounted by as much as 30%. Assuming no appreciation and not considering discounting, each annual set of gifts of $208,000 represents approximately 2.9% ($208,000/ $7,260,000) of the entire value of Green Farm remaining in the parents' hands. However, if a 30% discount were to be applied to these fractional interest gifts, each annual set of gifts could convey 4% ($208,000/70%/$7,260,000) of Green Farm, reducing the number of years necessary to transfer $7,500,000 of value to just over 25 years.

Example 2: Suppose that before the Browns began their annual gifting program they placed a conservation easement over Green Farm allowing it to be divided into four parcels, one for each child, with each parcel entitled to one single-family residence, guest house and agricultural structures. Much of Green Farm's $25,000 per acre value derived from its development potential. The conservation easement strips most of this value away, reducing the value of the land from $25,000 per acre to $10,000 per acre. This generates a significant income tax deduction ($10,500,000) which could be used in a "value replacement" program to provide substantial liquidity to the children when their parents die (see Section V.H.(iv) below). It also allows transfer of the farm much more quickly to the Browns' four



children.

The value of the land has been reduced to $7,000,000 by the conservation easement. This amount can be entirely gifted to the children using the existing Exclusion Amount. However, let's assume that the Browns don't take advantage of the 2012 Exclusion Amount and that the Exclusion Amount reverts to $1 million ($2 million for a married couple using a simple estate plan). The Browns would need to gift $5,000,000 of the value of the land to pass it to their children estate-tax free.

Taking into account a possible 30% discount for gifts of fractional interests in land, the Browns could (again, assuming no appreciation, which will be reduced by the conservation easement in any event) entirely gift the land using the Annual Exclusion in about 17 years.

In summary, here are the principal ways in which a conservation easement can help in an estate plan that relies on the Annual Exclusion:

1. It increases, in some cases dramatically, the amount of land that can be successfully transferred by life-time gifts sheltered by the Annual Exclusion.

2. It reduces the rate of appreciation of the land remaining to be gifted.

3. It insures how the land will be used regardless of who owns the land.

(ii) Use with §2032A Special Valuation

By reducing overall land values, conservation easements can also effectively increase the amount of land that can pass through a decedent's estate under the special use valuation rules of §2032A discussed in Section IV.E above.

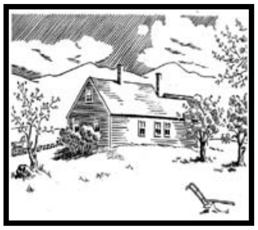
By reducing the value of land through the grant of a conservation easement, more land will be sheltered by the $1 million limit currently imposed on special valuation reductions.

Example: John's estate amounts to $7 million. Of this amount the family ranch makes up $5 million, most all of which is in the value of the land. John's son, Paul, operates the ranch and, when John dies, Paul agrees to continue to operate the ranch for ten years and elects to have the ranch valued under §2032A. The value of the ranch and the land making up most of the value of the ranch exceeds the 50% and 25% levels as required by the Code.

Paul election of §2032A treatment allows a reduction in the value of the ranch by up to $1 million, reducing the estate to $6 million. Taking into account the $5.12 million Exclusion Amount, the estate tax due is $308,000 [($6,000,000 – $5,120,000) x 35%].

If John had contributed a conservation easement on the ranch (or if Paul had directed John's executor to make a post-mortem easement contribution as described in Section V.I.(iii) above) and if the easement had reduced the value of the ranch to $4 million, the ranch would still qualify for special valuation under §2032A, and the easement would eliminate an additional $1 million from the estate, plus an additional $500,000 excluded under §2031(c), as discussed in Section IV.I. (ii) below. In this case there would have been no tax.

One caution: §2032A requires that the value of the family ranch or farm make up at least 50% of the value of the decedent's estate in order to qualify for the special valuation benefits, and that the value of the real property included in the farm or ranch must make up at least 25% of the value of the estate. Therefore, if a family plans



to use this provision coupled with a conservation easement, it needs to be careful that the grant of a conservation easement does not cause the total value of the farm or ranch to fall below these levels.

(iii) Use with the Exclusion Amount

Because a conservation easement reduces the value of land, it also allows the transfer of more land under the current $5.12 million/ $10.24 million Exclusion Amounts.

Example: John wants his farm to go to his son Paul. The farm is valued at $8 million. The tax on the farm, after subtracting the $5.12 million Exclusion Amount, will be $1,008,000 ($2,880,000 x 35%). However, assume that John places a conservation easement on the farm before he dies. The easement reduces the value of the ranch to $4 million. This value is entirely sheltered by the Exclusion Amount making it possible for the farm to pass to Paul estate-tax free.

If John failed to grant the conservation easement before he died, Paul could direct John's executor to grant the easement pursuant to the post-mortem easement election provisions described in Section V.I.(iii)above, thereby reducing the value of the land and the estate tax just as though John had done so during his lifetime.

(iv) Conservation Easements and Value Replacement

Value replacement is an estate planning technique whereby a person converts the income tax savings resulting from a charitable contribution (or cash from a bargain sale) into additional cash for his or her estate. This works particularly well where the income tax savings or cash results from the contribution or bargain sale of a conservation easement, because such tax savings represent "new money" to the donors (as opposed to the contribution of a liquid asset, such as cash, stocks or bonds).

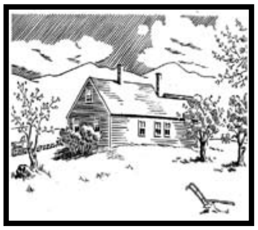
Example: Assume that John and Joan are aged 51 and 43 respectively. Assume that they donate a conservation easement worth $1,800,000 and that the income tax deduction resulting from this donation saves them $738,000 in income tax. They spend $58,000 on a new car and buy a "second to die" insurance policy (such a policy pays out when the surviving spouse dies, and premiums are generally lower than on a single-life policy) with the remaining $680,000 of their income tax savings. They place the policy into an "inter-vivos" trust (a trust created during their lifetimes) for the benefit of their children and transfer all of the "incidents of ownership" to the trust.

A premium payment of $680,000 for a second to die policy on a couple John's and Joan's ages will buy approximately $12,500,000 in coverage. Properly placed in an inter-vivos trust there will be neither income tax nor estate tax on the policy proceeds. Thus, John and Joan have replaced $1,800,000 in land value lost due to the conservation easement with $11,820,000 (face value of the policy less the premium) in tax-free cash payable directly to their children, a ten-fold increase!

Note that investing the $680,000 in stocks or mutual funds transferred to an inter-vivos trust could generate substantial results as well. There are many variations.

I. Other types of Restrictions

Restrictions on the use of land other than conservation easements (such as restrictive covenants in a subdivision) can also reduce land values for estate tax purposes. However, to do so the restriction must be the result of a "bona fide business arrangement" not merely intended



to transfer property to family members for less than fair market value. The business arrangement must be typical of similar arrangements entered into by people in arm's length transactions in order to reduce value for estate tax purposes. See §§25-2703 – 1(b)(1) and (2) of the Regulations.

Of course, governmental regulations such as local planning controls or federal endangered species restrictions, can also reduce the value of property included in a decedent's estate and must be taken into account in appraising estate assets.

J. "Stepped-up Basis" for Estate Assets (Code §1014)

There are few silver linings to the estate tax. However, there is one important one. Assets passing through a decedent's estate receive a "stepped-up" basis. Basis is important when a person sells property because it has a significant effect upon the amount of tax paid on the sales proceeds. Essentially, basis is what a person pays for property, plus expenditures for improvements. When the property is sold a tax is imposed on the difference between the sales price and the basis.

> *Example: Susan buys 50 acres for $100,000 and builds a barn on it for $20,000; her basis in that property is $120,000. If Susan sells the property several years later for $200,000, she will pay tax on the difference between what she is paid for the property and her basis in the property. This difference is her "taxable gain" and in this example it is $80,000 ($200,000 - $120,000 = $80,000).*

When property passes through a decedent's estate its basis is "adjusted" to the value that it had on the date of the decedent's death (or alternate valuation date, if such a date is elected). This means that when heirs sell such property they only pay tax on the difference between the adjusted, or "stepped-up" basis, and the selling price; rather than on the difference between the selling price and the decedent's original basis.

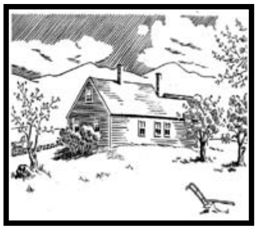
> *Example: Using the preceding example, if Susan died before she sold the property, assuming it was worth $200,000 when she died, her heirs could sell the property for $200,000 and realize no taxable gain. This is because the basis was stepped up to its value on the date of Susan's death.*

It is important to note that if a person makes a gift of property during their lifetime, the gifted property <u>does not receive a stepped-up basis</u>. Instead of a "stepped-up basis" property that is gifted during the owner's life-time has a "carry-over basis" in the hands of the person receiving the gift. A carry-over basis is identical to the basis in the hands of the person making the gift. This is a draw-back to making lifetime gifts, although there are also many advantages to life-time giving.

> *Example: If Susan had given the property to her son before she died, and her son had sold the property for $200,000, he would have the same taxable gain as Susan: $80,000. On the other hand, if Susan had devised the property to her son in her will and he had sold it for $200,000, assuming it was valued in Susan's estate at $200,000, there would be no taxable gain on the sale. Therefore, the life-time gift cost $12,000 in capital gains tax over the tax that would have been due had the property passed to Susan's son at her death. On the other hand, by making a gift of the land during her life-time, Susan may have transferred appreciation in that land away from her estate thereby potentially saving estate taxes, which are higher than capital gains taxes that would be due on the sale of the property.*

K. Estate Tax Returns and Tax Payment

An estate tax return (Form 706) is required to be filed with the IRS within nine months of a



decedent's death. Extensions of the return date are allowed on a discretionary basis for up to six months. Six-month extensions are automatic if the extension application is (1) filed before the normal due date for the return; (2) the application is filed with the proper IRS office; and (3) the application includes payment of the estimated amount of estate tax due.

Returns are only required to be filed by estates whose value exceeds the Exclusion Amount.

Unless the election to defer tax and pay in installments (described in Section IV.H above) is made, the entire estate tax must be paid nine months after the decedent's death, even if an extension for filing is granted, unless the extension expressly extends the time for payment. After that date interest will begin to accrue and penalties for late payment may apply.

In addition to the right to pay estate tax in installments where family-owned farming and ranching businesses and other small businesses are involved, the IRS has the discretion to enter into installment payment agreements with all decedent's estates. Such agreements are not uncommon and are allowed in any case in which the IRS determines that the agreement will facilitate the payment of tax. Such agreements can be for payment of the entire amount of tax due, or a portion of the tax due.

L. Life Insurance (Code §2042)

Life insurance is a particularly useful tool for payment of the estate tax. This is because life insurance provides a payment of cash at the time when estate tax liability occurs. Furthermore, properly handled, life insurance is subject to neither income tax nor estate tax. If the policy holder places the insurance policy in a trust created during his or her lifetime, and relinquishes all of the "incidents of ownership" (that is, the right to change beneficiaries, borrow against the policy, terminate the policy, draw down the cash value of the policy, etc.), the proceeds of the policy will be excluded from the decedent's gross estate. However, the face value of insurance policies transferred by a person within three years of their death will be included in their estate for estate tax purposes (§2035(a)(2) of the Code).

N. Charitable Giving and Estate Taxes

In addition to gifts of cash or conservation easements by will already described, there are a number of other charitable giving methods that can generate income and estate tax savings. This summary is not intended to provide an exhaustive description of gifting techniques.

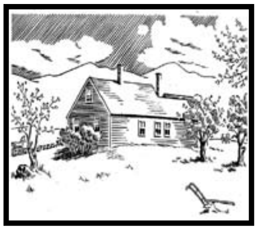
(i) Charitable bequests (Code §2106(a)(2))

Outright bequests to charity are deductible from the gross estate, provided that they are qualified under §170(h) of the Code as charitable contributions.

(ii) Charitable Remainder Trusts (Code §664)

A charitable remainder trust (CRT) is a vehicle for selling appreciated assets (such as stocks or bonds) tax free, generating lifetime income from the sales proceeds, and claiming a charitable contribution for the remainder value of the assets in the hands of the charity that is the ultimate beneficiary of the trust. Such assets are also removed from the donor's estate for estate tax purposes. This is a tool that works particularly well for wealthy people who can leverage the benefits of the transaction on the ability to use tax deductions.

> *Example: Frank owns 500 shares of highly appreciated Microsoft stock. If he sells it himself he will pay 15% of the gain in federal income taxes (that assumes he has held the stock for more than one year, qualifying the sale for capital gains tax rates). Frank really would like to convert this stock to an asset that pays regular income. He also has a substantial income*



already and could use a tax deduction. Finally, Frank is a great fan of his alma mater and wants to provide for it when he dies. By using a charitable remainder trust Frank can accomplish all of his goals, including avoiding paying tax on the sale of the Microsoft stock. Here is how it works:

1. Frank's lawyer sets up a charitable remainder trust. Note that there are two types of CRTs, Charitable Remainder Unitrusts ("CRUTs") and Charitable Remainder Annuity Trusts ("CRATs"), the difference primarily having to do with the way in which income is paid to the trust beneficiary. The trust provides that it will pay income to Frank for so long as he lives, and when he dies it will pay the amount remaining in trust to his alma mater. The trust is irrevocable, that is, Frank cannot change the trust, except in limited ways, and he cannot revoke it. Also, once Frank puts assets in the trust he cannot get them back.

2. Frank contributes the highly appreciated Microsoft stock to the CRT.

3. The trust sells the stock (there can be no agreement to sell the stock prior to the contribution in order for all of the tax benefits of this arrangement to be available). Because the trust is a charitable entity it pays no income tax on the sales proceeds.

4. Frank is entitled to a federal income tax deduction (and a state income tax deduction if he is a resident of a state that imposes an income tax and recognizes and allows charitable contribution deductions). The tax deduction is equal to the value of the remainder interest in the stock, based upon Frank's age at the time of the gift and the value of the stock when Frank transferred it to the trust.

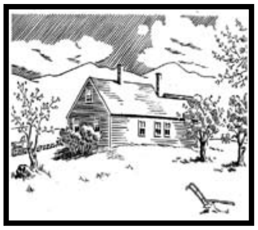
5. Frank receives income for his lifetime from the trust, based upon the terms of the CRT. This income will be greater than if Frank had sold the stock himself and invested the proceeds because the sales proceeds will not have been reduced by any income tax.

6. The value of the stock will be excluded from Frank's estate for estate tax purposes.

VI. The Use of Trusts

Trusts can be a very valuable tool for estate planning. They have income tax, estate tax, and gift tax implications. Among the lists of trusts that are commonly used in estate planning strategies are "grantor trusts" (trusts ignored for taxation purposes because the creator of the trust controls the trust; however such trusts may remove assets from a decedent's estate for purposes of probate); CRTs (charitable remainder trusts, discussed in Section IV.N(ii)); QPRTs (qualified personal residence trusts); GRATs (grantor retained annuity trusts); and GRUTs (grantor retained unitrusts). The structure and tax aspects of these trusts are beyond the scope of this summary. Suffice it to say that they are all used to facilitate the transfer of property from one person to another while retaining some rights in the grantor of the trust to use or enjoy the trust property while minimizing either gift or estate taxes.

In addition to estate planning benefits, trusts have the very practical benefit of controlling how property given to children is used until children are old enough to have developed the judgment to manage the property for themselves. Without a trust, property transferred to children becomes theirs to manage and use upon their 18th birthday (the actual age may vary according to state law).



Note however, that if a trust is irrevocable, charitable contributions must be expressly allowed by the trust instrument for a deduction to be available, and some types of contributions will generate no deductions, such as the contribution of conservation easement on land owned by the trust.

VII. Conclusion

There are opportunities available this year (2012) to transfer substantial assets estate and gift-tax free. Anyone with a substantial estate (practically speaking, any single person with an estate in excess of $1 million and any married couple with an estate in excess of $2 million) should consider acting this year to capitalize on the generous Exclusion Amount. The thresholds of $1 million and $2 million recognize that if Congress fails to act, the Exclusion Amount available after this year will drop from $5.12 million and $10.24 million to $1 million and $2 million.

Families with substantial illiquid assets, such as farms, ranches, family-owned businesses, need to be pro-active about estate planning if they desire to keep the farm, ranch, or family-owned business in the family. The intra-family transfer of illiquid assets the value of which exceeds the Exclusion Amount must be carefully and aggressively planned; the sooner the better.

Conservation easements remain one of the simplest and most effective estate planning tools for families owning substantial land assets who want to keep those assets in the family.