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Don't Miss Out: 2012 Offers Real Estate Owners Unique Estate Planning Advantages

Legislation passed in December 2010 created a window of opportunity for real estate owners and investors to take advantage of estate and gift tax exclusions that will likely be legislated away by this year's-end. With real estate valuations still somewhat depressed in many markets as a result of the struggling economy, real estate owners still have a unique opportunity to maximize their opportunity for wealth transfer, which may not exist in years to come.

Understanding the Opportunity

On December 17, 2010, President Obama signed legislation, following Congressional approval, of a tax bill that extends the Bush-era tax cuts through 2012. Not only did the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("the Act") eliminate much of the uncertainty that was being faced regarding what the tax rates and rules would be for 2011 and 2012, but it also included extensions of many expired provisions along with planning opportunities for income, estate, and gift taxes.

Though doubts still exist regarding what will happen after December 31, 2012, the estate tax exclusion amount has for now increased to $5,120,000 per individual and $10, 240,000 per married couple. The top tax rate for estates in excess of the exclusion amount is currently 35 percent.

Also for 2012 (everything may change as of January 1, 2013), the gift tax continues to be reunified with the estate tax, meaning that an individual's exclusion may be used for gifts during life or for assets passing upon death. By example, an individual who has used their $1 million lifetime gift tax exclusion now has an additional $4,120,000 of available exclusion. Lifetime gifts over $5,120,000 are taxed at 35 percent. Further, there is a $5,120,000 generation-skipping tax ("GST") exclusion for 2012.

The technical concept of *portability* must also be considered. It allows a surviving spouse's estate to use any unused Federal estate and gift tax exclusion based on the last deceased spouse. For example, if a husband dies survived by his wife and his estate only needed to use $3.5 million of his exclusion, his wife can combine the unused portion of $1.5 million with her $5 million exclusion (plus indexing), thereby passing an additional $6.5 million estate tax free. The estate will be required to file a return and make an election by the first decedent's executor to transfer the unused portion to the surviving spouse. Portability should not serve as an alternative to proper estate planning. Portability does not take into account appreciation in the assets nor does it offer any asset protection. In addition, the portability provision does not apply to the GST, nor does it assure the intended result. Only the unused exclusion of the last deceased spouse is available to be used.

Absent action by Washington, the above rules sunset back to a $1 million estate/gift tax exclusion and a 55 percent tax rate. Also, the GST exclusion returns to $1 million (indexed for inflation from 1997).

Impact to Real Estate Owners

The past few years have presented real estate owners with a number of challenges including flat or declining lease rates, tenant bankruptcies and financial instability, and decreased occupancy rates. Faced with increased operating expenses and capitalization rates, additional obstacles to development, and maturing mortgages, real estate owners have had their hands full managing cash flow and ensuring their continued survival.

As a result of these challenges, property values in many markets and asset classes remain somewhat depressed. While these conditions limit profitability and growth, they also diminish the worth of the business for valuation purposes, lowering the size of the estate to be transferred to heirs.

At the same time that this valuation phenomenon has occurred, the following economic factors are also present in the market:

- The credit markets are exhibiting historically low interest rates. The applicable Federal rate for a mid-term loan (three to nine years) is currently 1.17 percent. As such, a parent could loan funds to children and be paid interest at a rate of 1.17 percent for a nine-year loan executed in January 2012.
- Discounts for lack of marketability and minority interests currently remain in effect, but face uncertainty as the provision has been discussed in Congress and it is not clear that these provisions will be allowed in the future.
- The previously discussed possibility of the estate tax exclusion of $5,120,000 per person being reduced after December 31, 2012.

All of these combined factors have created a virtual "perfect storm" where there is the ability to have a major impact on a family's estate tax picture if a real estate owner commits to doing something now.

Take the First Step

Discuss your plans with your accountants and attorneys so they can assist you in evaluating your options. It is recommended that, as part of any business transfer or estate planning endeavor, every will and revocable trust be reviewed for conflicting provisions with current intent and the interaction with the new law. State transfer taxes must be carefully considered as they have significant impact on costs and payments. A tax and estate planning advisor should review transfers to grantor trusts and note sales. It is critical to question the continued use of GRATs vs. outright gifts and the elimination or lessening of guarantees on trust obligations by added additional gifts to the trust using the $5,120,000 exclusion. You'll need sound counsel to make optimal decisions.

Take Action Now

Every real estate owner's situation is unique, but given the state of commercial real estate and the current tax environment, most owners owe it to themselves and their family to consider the current state of their succession and estate plans and evaluate what actions, if any, they should take this year to help them achieve their objectives. Under the sunset provisions, delaying action could cost a real estate owner's estate millions.

Summary of Estate and Gift Tax Changes

	2009	2010	2011	2012*
Estate tax exclusion	$3.5 million	May elect $5 million or no Federal estate tax	$5 million	$5,120,000
Lifetime gift tax exclusion	$1 million	$1 million	$5 million	$5,120,000
GST tax exclusion	$3.5 million	$5 million	$5 million	$5,120,000
Maximum estate, gift, and GST tax rates	45 percent	35 percent (but 0 percent GST tax in 2010)	35 percent	55 percent
Basis adjustment upon upon death	For all of the decedent's assets	May elect for (i) all assets or (ii) allocate $3 million increase to spouse and $1.3 million increase to others	For all of the decedent's assets	For all of the decedent's assets

**Note that the provisions are scheduled to sunset December 31, 2012*

Case Study

Everyone's financial position and life circumstances are different, but in the following case study, we are able to demonstrate how implementing today's unique estate and gift tax exclusions saved our client about $37 million.

Background

Our client, John and Mary Smith, retired to Florida after a successful career as real estate developers. They have four children, each with significant interests in real estate, and 10 grandchildren. Most of their net worth ($85 million of assets) is comprised of interests in various LLCs that own real estate.*

Dilemma

For the sake of this case study, we will assume that both John and Mary pass away 10 years from now and that 2012's estate and gift tax exclusions ($5,120,000 per individual) have disappeared. In 10 years, the gift tax exclusions are reduced to $2 million per individual and estate tax rates have increased to 50 percent, from today's rate of 35 percent.

After ten years, the Smith family's taxable estate grows to $118 million, inclusive of applicable discounts and the $2 million exclusion. If we apply a 50 percent tax rate, John and Mary's estate tax would equate to approximately $60 million.

Actions

Our strategy is to utilize today's unique estate and gift tax exclusions and low interest rate environment.

John and Mary structure one grantor trust, established as dynasty trusts in Florida, for each of their four children. Through a strategic series of gifts, valuations, and internal sales, each of the trusts will eventually own 20 percent of the family LLC. (Prior to the gifting, the four children already owned the remaining 20 percent of the family LLC.)

We also implemented additional strategies, including:

- Utilizing the increased exclusion gifts up to $10 million combined;
- Breaking up the holdings into smaller portions which allows for maximum discounting of values;
- Selling a portion of holdings currently generating an 8 percent return in exchange for a note bearing interest at a little over 1 percent, therefore moving most of appreciation to next generations; and
- Structuring a trust that allows for income taxes on income and wealth earned by trust for the next generation to be paid out of John and Mary's other assets.

Results

After nine years, John and Mary will have successfully reduced their estate taxes to approximately $23 million. Still a sizeable amount, but far less than the $60 million tax liability that would have been incurred f they had not taken advantage of today's estate and gift tax exclusions. In addition to saving $37 million, the bulk of the family LLC is held in a trust, which may escape estate taxes for generations to come.

**For simplicity, we have excluded the Smith family's additional financial information from this case study.*

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