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Spring 2010

Trusts & Estates Newsletter

Estate Planning Focus

2010 - A Year Without Estate Taxes?

by Frank Henke: **fhenke@wnj.com**

Most people familiar with estate planning and taxation know 2010 is the year without estate taxes – at least to this point. However, many taxpayers, estate planners, accountants, financial planners and trust departments do not know what to expect for the remainder of the year, in 2011 – or beyond.

As outlined in an Estate Planning e-bulletin sent earlier this year (accessible at www.wnj.com), 2001 legislation substantially changed the estate tax, gift tax and generation-skipping tax systems, which resulted in increased exemptions from estate and generation-skipping transfer taxes and reduced estate, gift and generation-skipping tax rates for the ensuing several years. The 2001 legislation culminated with the following changes for 2010:

- Repeal of the estate and generation-skipping transfer taxes;
- A decrease in the top marginal gift tax rate to 35% (the gift tax exclusion amount for gifts made in 2010 remains at $1 million); and
- Repeal of the step-up in basis rules. In other words, the assets of a person who dies in 2010 will now generally retain the decedent's basis (also called "carryover" basis) instead of receiving a "step up" in basis to fair market value. However, the ability to step up the basis of a portion of the decedent's assets is still available.

Under the existing law, and unless Congress acts otherwise, the 2010 changes will officially expire on January 1, 2011 and we will revert back to the laws as they existed in 2001. This means:

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Avoid Uncapping Forever – Or Not

by Todd Simpson: **tsimpson@wnj.com**

Since Michigan adopted Proposal A in 1994, the annual increase in the value used to determine a parcel's real property taxes is capped at either 5 percent or the rate of inflation, whichever is less. This cap continues so long as there is no "transfer of ownership," a term that has a complex and somewhat opaque statutory definition.

When a transfer of ownership does occur, the property tax value is "uncapped" and is once again based on the fair market value of the parcel. For property that has been held by the same owner for many years, the cap can result in a significant savings in property taxes. Therefore, managing when and if a transfer of ownership will occur is an important consideration.

A pair of unexpected and taxpayer-friendly court decisions suggest that uncapping can potentially be avoided indefinitely. These recent cases, *Klooster v. City of Charlevoix* and *Taylor v. City of Traverse City*, both involved a father who deeded real property to himself and his child as joint tenants shortly before the father's death. This is a common scenario (though sometimes ill-advised, as discussed later in this article).

Prior to these cases, the conventional understanding of transfer of ownership rules was that the property taxes would uncap at the father's death. That's when the child, as surviving joint owner, would take sole ownership of the property. The Michigan Tax Tribunal had followed that approach in its rulings, but, on appeal, the Michigan Court of Appeals reversed the tribunal's decisions and determined that there was no uncapping as a result of the father's death.

The Court of Appeals reached this conclusion because, in its view, the word "conveyance" – as used in the transfer of ownership rule that applies to terminating a joint tenancy – implied a *written instrument* affecting title. Because the property in these cases had passed automatically to the child at the father's death without any further *written instrument,* the transfer of ownership criteria had not been met, the Court of Appeals held.

While the *Klooster* and *Taylor* decisions stop short of stating that uncapping cannot occur unless there is a written instrument of transfer, they do provide a roadmap for avoiding uncapping through joint ownership. If a property owner adds a child or other close relative as a joint tenant, and then, after the death of either joint owner, the survivor does the same, the property taxes could potentially remain capped forever, according to the logic of these cases.

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There are some inherent dangers associated with joint ownership. Those dangers could potentially outweigh any potential property tax benefits.

Should You Use a

No Contest Clause

in Your Will or Trust?

by David L. Skidmore: dskidmore@wnj.com

Are you concerned that a family member might be dissatisfied with how you have chosen to distribute your property after you die? Do you worry about the possibility of litigation over your estate plan? Nobody wants his or her estate to be diminished by litigation expenses. In order to reduce the likelihood of litigation, you may choose to insert a "no contest clause" in your estate-planning documents.

A no contest clause provides that the recipient of a gift from your estate will forfeit the gift if he or she takes action to challenge the validity of the document. A no-contest clause is also known as an "in terrorem clause" because the threat of taking away the gift is intended to instill terror in the recipient. The clause will only be effective if the disappointed family member is deterred from litigation. The clause would have no effect on a family member who is completely disinherited or is to receive only a nominal gift.

This penalty provision is activated by a challenge to the validity of the will or trust. So the no contest clause could be triggered by several types of claims, including:

- the author lacked mental capacity
- the author was unduly influenced
- the document is defective, or
- the document is a forgery

But not *all* Probate Court disputes would trigger the no-contest clause. Some examples of disputes that would not trigger the clause include:

- litigation over whether the fiduciary administering the estate or trust has breached a fiduciary duty
- litigation to compel a fiduciary to prepare and serve accountings
- litigation to have the Probate Court interpret an ambiguity in the document

Ten years ago, the Michigan Legislature passed a law that a no contest clause shall not take effect if, and only if, the gift recipient had good reason (or "probable cause") for challenging the validity of the will. It says:

"A provision in a will purporting to penalize an interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings." (MCL 700.2518)

After some confusion in the courts about whether this statute applied to trust agreements as well as wills, the Legislature recently enacted a new statute applying a similar rule to trusts. (MCL 700.7113)

On one hand, the Legislature has weakened the effectiveness of the no contest clause. On the other hand, if there is probable cause to believe that your documents are tainted by mental incapacity or undue influence, then those concerns probably should be brought to the attention of the Probate Court.

Ultimately, you can't stop your family from challenging your will or trust, but you can draft your estate planning documents in a way that reduces the risk of litigation.

No Better Time for Making Taxable Gifts

by Karen L. Kayes: **kkayes@wnj.com**

The tax benefits of making taxable gifts during your lifetime – and paying the gift tax – can be significantly better than being subject to estate tax at your death. This strategy may be even more beneficial this year because the current top gift tax marginal rate should remain at 35%, while the tax rate increases scheduled to take effect January 1, 2011 will result in estate and gift tax maximum rates of 55%.

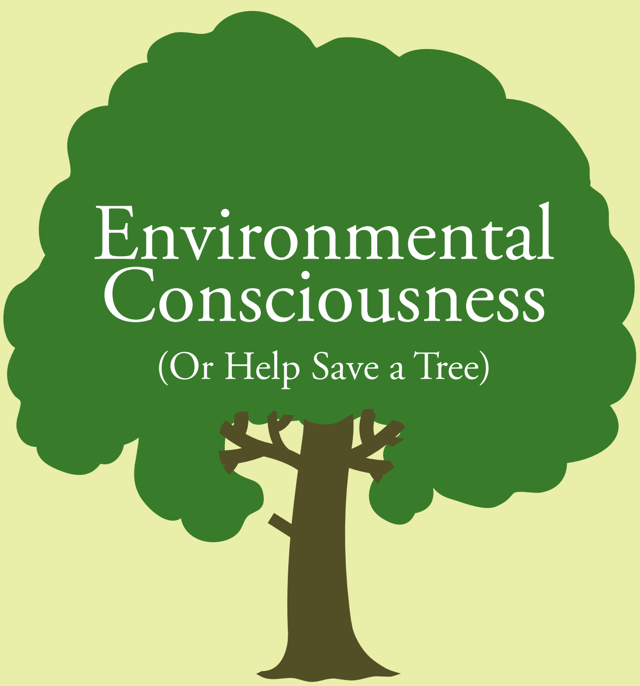
The benefits of this strategy can be seen in this example:

- Assume Don, who is single, has a $5 million estate and has not used any of his gift tax exemption (currently $1 million). If he were to gift $2 million of those assets in 2010, he would pay a 35% gift tax, amounting to $350,000. In addition to removing the appreciation on the gifted assets from Don's estate, the amount of gift tax paid will also be excluded from estate taxation, provided Don lives for three more years. So if Don lives at least three more years, his estate tax owing would be $1,427,750, assuming no asset appreciation. The total taxes paid would be $1,777,750.
- Alternatively, if Don makes this gift in 2011, the gift tax on $2 million of assets would be $560,250. If he then dies more than three years later, the estate tax owing would be $1,312,113. The total taxes paid would be $1,872,363.

Essentially, taxable gifts made in 2011 may be subject to a 20% higher tax rate than those made in 2010.

As outlined in Frank Henke's article (see Page 1), we cannot be certain these laws won't be changed, either for the balance of this year or retroactively to the beginning of the year. Nor do we know what changes may take place next year. There are strategies available to protect you from paying higher taxes as a result of retroactive tax law changes.

Regardless of what changes are made, it is almost certain that gift tax rates will never be any lower than they are this year. Contact your Warner estate planning attorney to take advantage of these opportunities.



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Take Care when Making Tax-Free Gifts of Business Interests

by Susan Gell Meyers: **smeyers@wnj.com**

Business owners often will gift interests in the family business to their children, grandchildren, and perhaps spouses of children. Many family businesses also have "buy-sell" or other restrictive agreements that set forth rules as to who can be an owner of the business, and specify the situations that trigger options or obligations to purchase the interests.

A recent tax court case held that partnership interests given under those circumstances did not qualify as "present" interests, and thus the gifts did not qualify for the donor's $13,000 annual gift tax free amount. (*Walter M. Price v. Commissioner*, TCM 2010-2, Jan. 4, 2010).

This case highlights the importance of carefully drafting gift documents and reviewing any agreements restricting ownership rights. In *Price*, the Tax Court stated that to qualify as present interest gifts, the gifts must include the right to *the immediate use, possession or enjoyment of* 1) the transferred *interests* or 2) the income from the interests.

Restrictions that precluded immediate use, possession or enjoyment included:

- If partners were prevented from withdrawing contributions.
- If partners were restricted from transferring and assigning partnership interests to third parties without the written consent of all partners.
- If an assignment gave the assignee the right to profits/losses and capital account, but not the rights of a full limited partner with a vote.
- If a partner assigned his or her interests, the partnership and remaining partners had the option to purchase the interests at fair market value.
- If there were no mandated distributions, but distributions could be made in the discretion of the general partner or, if directed, by a majority of all partners.

The court found these contingencies stood in the way of the children receiving economic value from the gifted interests. The fact that the children possessed the right to income generated by the interests was insufficient for the court to find a present interest because no income had historically been generated by the interests, nor did the partnership have a record of paying any distributions to the partners.

All hope is not lost, however. Properly drafted gift documents can create a present interest without disturbing transfer restrictions in buy-sells or operating agreements. We are well versed in this case and can assist you in qualifying intra-family gifts as annual exclusion gifts.

This case highlights the importance of carefully drafting gift documents and reviewing any agreements restricting ownership rights.

- The estate tax exclusion amount will be $1 million;
- The generation-skipping tax exemption amount will be $1.34 million (which has been adjusted for inflation);
- A top marginal rate of 55 percent for estate taxes, gift taxes and generation-skipping taxes; and
- The step up in income tax basis rules would go back into effect.

So what are the possible next steps? Below are three courses of action that Congress could take:

- **Pass legislation retroactively**. Congress could choose to retroactively reinstate both the estate tax and the generation-skipping tax and modify the gift tax. This reinstatement could be either a continuation of the 2009 laws, or it could be completely different from what we have previously seen. This course of action could result in the filing of a number of lawsuits that would question the constitutionality of the retroactive legislation. In looking at this possible course of action, Congress would have to weigh the constitutionality of the retroactive change and the number of lawsuits it could potentially generate.
- **Pass legislation prospectively**. Congress could choose to pass a law that would only be effective from the date of enactment forward. Making a change prospectively may not warrant quite as many lawsuits; however there is an ethical question as to how a single person who passed away on December 31, 2009 with a $10 million estate can owe approximately $3 million in estate taxes, while a person in that same exact situation who died one day later on January 1, 2010 would owe no estate taxes whatsoever. If a prospective change is made, a debate will certainly arise as to the fairness of having a window of time when the estates of persons who die aren't taxed.
- **Do nothing**. Congress could do nothing, which is exactly what it has done to this point. If Congress does nothing in 2010, then on January 1, 2011 we will simply revert back to the law as it existed in 2001. For those acting as a trustee or personal representative for someone who died in 2010, caution and consideration of these possibilities should be contemplated before making distributions.

This is a critical time for people to review their estate planning documents and determine if their current plans are still operating properly. It is also an excellent time to discuss "doing more," such as shifting wealth to younger generations, increasing charitable giving or transferring a business to the next generation.

Under the existing law, and unless Congress acts otherwise, the 2010 changes will officially expire on January 1, 2011 and we will revert back to the laws as they existed in 2001.

So everyone should start adding children as joint owners of their real property, right? Not so fast. It is important to note that this issue is now being appealed to the Michigan Supreme Court, which could reverse these taxpayer-friendly decisions. Even if the decisions are ultimately upheld, the legislature will likely attempt to amend the property tax statute to close this loophole.

When a transfer of ownership does occur, the property tax value is "uncapped" and is once again based on the fair market value of the parcel.

More importantly, there are some inherent dangers associated with joint ownership. Those dangers could potentially outweigh any potential property tax benefits suggested by the *Klooster* and *Taylor* cases. Adding a joint owner subjects the property to the claims of the new joint owner's creditors. Do you want a lawsuit against your child to result in the loss of your residence? Adding a joint owner on your property also constitutes a gift for federal tax purposes. Depending on the value of the property and the number of joint owners, this likely imposes an obligation to file a federal gift tax return and could potentially result in gift tax liability. Finally, adding a joint owner can skew the distributions provided in your estate planning documents because jointly-owned assets will pass without regard to the terms of your will or trust. Far too often, joint ownership arrangements are created without considering these potential traps.

The *Klooster* and *Taylor* decisions are an unexpected development in Michigan property tax law, but caution should be exercised, and competent counsel consulted, whenever creating or terminating joint ownership arrangements. If you have questions about these cases, property tax uncapping or other tax issues, contact a member of Warner's Trusts and Estates group.

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