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Extraordinary Estate and Gift Tax Planning Window Might Close Before the End of the Year

The very favorable estate and gift tax planning environment that currently exists could be nearing an end. This Client Alert will have special interest to anyone who has a sizable estate and wants to minimize their family's exposure to estate, gift and generation-skipping transfer taxes.

The media has made it well known that "Taxmageddon" (aka the "fiscal cliff") will occur at the end of this year unless Congress extends the Bush-era tax cuts that expire on December 31. The expiring provisions include many significant estate, gift and generation-skipping transfer tax laws. For example, unless Congress takes action:

- The estate and gift tax exemption will go down from its current $5.12 million to $1.0 million.
- The generation-skipping transfer tax exemption will go down from its current $5.12 million to $1.36 million (i.e., $1.0 million adjusted for inflation).
- The estate, gift and generation-skipping transfer tax rates will increase from their current 35% to 55%.

In addition, the Obama Administration has floated proposals that, if implemented as law, would restrict the use of some of the more commonly-used advanced estate planning strategies, such as short term grantor retained annuity trusts (or "GRATs"), discount planning with family limited partnerships and LLCs, and intentionally defective grantor trusts.

What Congress will do, and when they will do it, is anybody's guess. It is possible that Congress will simply extend the current laws for a year or two, in which case there is nothing special to do by the end of this year. But it is also possible that Congress will do nothing this year. In that case, on January 1, 2013, the tax laws will revert to what was in effect pre-2001, and any later Congressional action – which could include a complete rewrite of the Internal Revenue Code – might (or might not) be effective retroactively to January 1, 2013. If that happens, a review of a client's estate plan, and some special planning actions this year, would have been very important.

But in any event, the current estate and gift tax climate, coupled with exceptionally low interest rates and the possibility that investment values (particularly in real estate) might currently be depressed, makes right now a great time to consider implementing some advanced estate planning strategies. Here is a brief (though incomplete) shopping list of some possible actions.

Use your $5.12 million lifetime exemption to make non-taxable gifts. In addition to the $13,000 annual gift tax exclusion that is available to everyone, a married couple can give away $10.24 million this year with no gift tax liability. (Next year that number could drop to $2 million.) Clients who have already used part of their lifetime exemption can use the rest of it now. Clients who have loaned money to their children or grandchildren can forgive their intra-family loans now, and the amount of the forgiven loan will be applied against the unused exemption amount. If gifts are made with appreciating assets, post-transfer appreciation – while owned by the recipient of the gift -- will escape both gift and estate tax and the value of the appreciation will not be charged against their unused exemption amount.

Leverage gifts with discount planning. With proper planning, clients can increase their non-taxable gifts by 40% or more. The values of interests in LLCs, limited partnerships and closely-held corporations, and partial interests in real estate and certain personal property, can be discounted for lack of marketability and lack of control. If a 30% discount is applied, the $5.12 million exemption effectively increases to about $7.31 million. Many clients who have established family limited partnerships and LLCs to hold real estate, business interests and even investment assets have later made gifts of the partnership or LLC interests to their children, grandchildren and other beneficiaries at discounted values.

Pre-fund an irrevocable life insurance trust to cover the payment of large insurance policy premiums. It is often difficult to transfer to a life insurance trust enough money to pay the insurance premiums without incurring a gift tax liability. Crummey withdrawal powers can be a way around this problem but are often an administrative nuisance, and even then the amount of the premium may be too large for this to be a total solution. By pre-funding the premiums with a large non-taxable gift, the trust will have the money to pay the premiums in the future (assuming the insurance company forecasts of cost are accurate). A collateral benefit is that most insurance trusts, which generally use independent trustees, can provide creditor protection for the funds placed in trust.

Establish an intentionally defective grantor trust. This type of trust is not, in fact, truly defective. While treated as separate from the grantor's estate for estate tax purposes, it is disregarded as an entity for income tax purposes, meaning that the trust's income is treated as the grantor's income for income tax purposes. This allows the grantor to engage in transactions with the trust with no income tax consequences. For example, the grantor could give the trust a $1 million non-taxable gift, the trust could purchase $10 million of income producing assets from the grantor for a promissory note bearing interest at the very low current Applicable Federal Rate, and by the time the note is paid, the appreciation in the asset's value over the principal and interest paid on the note by the trust will stay in the trust and will not be subject to estate or gift tax. And, if the asset purchased is an interest in an LLC or a similarly discountable interest, the underlying proportionate value of the assets in the LLC should be greater than the discounted purchase price for the LLC interest, giving a head start to the need for the purchased asset to appreciate faster than the AFR.

Establish a qualified personal residence trust (or "QPRT"). A QPRT allows a homeowner to give away a remainder interest in a personal residence or vacation home. The owner retains the right to live in the residence for a period of years. At the end of that period, the owner's children become the owners of the house. If the QPRT is structured properly, the value of the retained right to live in the house, which will be a potentially taxable gift, will be very small, meaning the owner can pass much of the value of the house, plus appreciation, to the owner's children at a no or low gift tax cost. Of course there is one big caveat: at the end of the term the owner is no longer the owner of the house, so the owner will be required to pay fair market rent to the children if the owner wants to continue to live in the house.

Establish a grantor retained annuity trust (or "GRAT"). In a standard GRAT, a person contributes assets to a trust and the trust pays the grantor an annuity amount for a period of years. At the end of that period, the assets pass to the grantor's beneficiaries, or to a trust for their benefit. If the GRAT is structured properly, the grantor can pass future appreciation in the assets to the beneficiaries at little or no gift tax cost. The GRAT works when the appreciation in the assets is greater than the Applicable Federal Rate, which is currently below 2%. Clients can use interests in family limited partnerships or LLCs, or shares of closely-held corporations, when establishing a GRAT.

There are other planning strategies that might be better for some people, but given the legislative environment, no matter what, they should consider doing something before the end of the year. Any clients who want to see how these and other planning opportunities might work for them should contact a member of our firm's Tax Group.

This document is intended to provide you with general information about trust and estates planning. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed below or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

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