Client Alert.

June 2012

GIFT TAX PLANNING OPPORTUNITIES: THE WINDOW IS CLOSING

As our clients know from our prior alerts, the last few years have seen unprecedented changes in the federal tax on gifts and bequests. One element of this was the unexpected increase in the federal gift and estate tax exemption (the "applicable exclusion amount") in 2011 to $5,000,000 per person. Another element was the reduction in the maximum tax rate—to 35%—for gifts or bequests in excess of that exemption. These were temporary two-year features applicable to 2011 and 2012 and are scheduled to "sunset" at the end of 2012, at which point the estate and gift tax exemption and rates will revert to levels from more than a decade ago, namely: a $1,000,000 per person exemption and a top tax rate of 55%.

WHAT THIS MEANS.

Since the two-year $5,000,000 gift tax exemption was indexed for inflation, it rose to $5,120,000 in 2012. This means that for the rest of this year, a person who has not yet used any of his or her exemption can give away money or other property having a fair market value of up to $5,120,000 and pay no gift tax, and a married couple can make a tax-free gift of twice this amount. Moreover, gifts in excess of these amounts are subject to a relatively low gift tax rate of 35% before the maximum rate rises to 55% next January.[1] For wealthy individuals, making significant gifts this year is an attractive way to reduce gift and/or estate taxes that would otherwise almost certainly be payable in future years.[2] The opportunity becomes more attractive given current depressed asset values and historically low interest rates. Here are a few ways in which to take advantage of this situation:

OUTRIGHT GIFTS.

The simplest way, of course, is an outright gift of cash to a donee. This can be accomplished with a check or wire transfer, and would be reported on a gift tax return filed by April 15, 2013. (All gifts discussed in this article will require a gift tax return to be filed by next April.)

[1] Changes are possible before January 2013 but only through legislative compromise that would most likely occur, if at all, after the November elections.

[2] There is always the possibility that Congress could reduce or eliminate the federal estate tax, but making gifts this year within one's available exemption amount will not subject the donor to any tax that might otherwise be avoided later on repeal of the estate tax.

Alternatively, gifts of other assets (*e.g.*, stocks, artwork and real property) can be made with appropriate title transfers. Gifts of anything but cash or marketable securities will require some type of valuation appraisal as of the date of the gift, and the appraisal will be filed with the gift tax return.

SPLIT-INTEREST TRUSTS.

Certain types of irrevocable trusts are particularly attractive now because they depend on current low applicable interest rates and discount factors published by the IRS each month. The following three types of trusts operate on similar principles that depress the value of the gifted interest for gift tax purposes:

- **GRATs.** In a grantor retained annuity trust (GRAT), a grantor transfers assets to a trust while retaining the right to receive an annuity from the trust for a period of years. The property remaining in the trust at the end of the period passes to other beneficiaries, for example the grantor's children. The amount of the gift is the actuarial value of the remainder interest, though GRATs are often structured with a grantor-retained annuity amount that leaves an actuarial remainder interest of $0, so that there is no taxable gift. If the assets transferred to the GRAT outperform the applicable federal interest rate (relatively easy to do at June's low 1.2% rate), the excess growth is then transferred to the remainder beneficiaries, free of gift tax.

- **QPRTs**. A qualified personal residence trust (QPRT) can accomplish a similar result if a grantor wishes to retain the right to rent-free use of a primary home or a vacation residence for a period of years, but gift a remainder interest in the property to children or others at the end of the period. A transfer of a 50-year-old grantor's $2 million home to a 20-year QPRT in June 2012 would produce a taxable gift of only $1,259,080, well within the gift tax exemption amount. As with the GRAT, the period of years should be something the grantor is reasonably expected to survive, because the assets (and any appreciation) generally will escape tax in the grantor's estate only if he or she survives the period.

- **CLATs.** For a grantor with philanthropic desires and no current need for income from the gifted property, a charitable lead annuity trust (CLAT) can provide a favorite charity with the right to an annuity for a period of years, with the remainder passing to the grantor's children or others at the end of the trust period. A transfer of $5,120,000 to a 20-year CLAT paying a 5% annual annuity in June 2012 would produce a taxable gift of only $592,051 at June's 1.2% applicable federal rate, well within the gift tax exemption amount.

GIFTS OF BUSINESS INTERESTS.

This year's historic low applicable federal interest rates and large gift tax exemption provide incentive for more comprehensive planning. Many of our clients are using their exemptions to shift interests in closely held businesses, family investment companies or other assets to future generations of beneficiaries. These gifts are often structured using "intentionally defective grantor trusts" (IDGTs). An IDGT is an irrevocable trust that a grantor establishes for the benefit of others, *e.g.*, children and grandchildren, retaining no beneficial interest in the trust property and thereby removing the entire value of the property (including appreciation) from the grantor's estate. From an income tax perspective, though, the grantor retains certain limited powers that cause the trust's property to be treated as though it continues to be owned by the grantor, instead of by the trust, for income tax purposes. The grantor's payment of the trust's tax liabilities allows the trust assets to grow in value without reduction for income tax payments, resulting in more value being passed to trust beneficiaries.

COMBINE GIFTS WITH SALES.

Structured estate planning often involves bargain sales as well, by which children, grandchildren, or IDGTs purchase interests in the family business or other assets. Not only are minority or fractional interests in an asset or entity discounted for lack of control and marketability (reducing the gift tax cost), but the purchases can take advantage of current low interest rates that make the cost to the purchaser more manageable. For example, the annual interest rate for a 9-year intra-family installment note issued in June 2012 would be 1.07%; a note with a term over 9 years would only require a 2.64% annual interest rate. This makes it more possible for the purchasers of family assets to finance their purchases. Also, purchases by IDGTs are disregarded for income tax purposes if properly structured, providing added tax savings. With careful planning and ongoing respect for the business structures that are employed, these comprehensive plans can represent very significant long-range gift and estate tax savings.

OTHER PLANNING CONSIDERATIONS.

The more complicated the structure, the more time it will take to put in place – months in some cases. We are accustomed to working with our clients' accountants, other professional advisors, and appraisers to streamline the process of making major gifts. As part of the process we also advise clients on related issues, such as income tax basis considerations in choosing assets for gifting, the effect of the federal generation-skipping transfer ("GST") tax, and the effect of state property taxes on gifts of real estate interests.

LEGISLATIVE CHANGES?

We also can advise on the status of potential legislative changes that might impact the ability to make certain gifts, *e.g.,* gifts to GRATs, gifts of minority interests in certain assets to family members, and the use of IDGTs, all of which have received some attention from Congress in recent years. Also, there is a possibility that Congress could act this year to reduce the generous gift and estate tax exemptions, or that Congress could act in future years to recapture (or "clawback") the benefits taxpayers obtained in 2011 and 2012 by utilizing the increased gift tax exemption. Most experts believe this attempt would fail for reasons of fairness.

FINAL THOUGHTS.

The financial condition of the donor is paramount. The ability to transfer significant wealth at low (or no) transfer tax cost this year does not necessarily mean that it is the right decision in every case. As with any large gift, a donor should carefully consider his or her cash flow needs well into the future. Minimizing taxes can be beneficial, but not if it leaves the donor with financial worries or a lack of financial security in future years.

Despite this caveat, for the right donors with sufficient wealth and donative intent, it is worth considering making gifts this year while the gift tax rates and exemptions are so favorable and acting sooner rather than later before interest rates and property values rise. We invite you to call us if you wish to discuss any of these options.

If you have questions about gifting possibilities or about your specific estate plan, please call us.

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