July 18, 2012

Estate Planning Update - July 2012

STRATEGIES TO TAKE ADVANTAGE OF 2012 ESTATE PLANNING OPPORTUNITIES

The window of opportunity to make large gifts in a tax-efficient manner is scheduled to close at the end of this year. Perhaps you are already considering making significant gifts this year or are being advised by your friends, family members or advisers to make these gifts before it is "too late" to do so come 2013. The discussion below summarizes why 2012 may provide a special opportunity to make large gifts and planning options that take into account some related issues.

The 2012 opportunity

The current federal estate and gift tax exemption and the generation-skipping transfer ("GST") tax exemption for each individual is $5,120,000 (resulting in up to $10,240,000 of exemption for married couples). Absent congressional action, on January 1, 2013, the estate and gift tax exemptions are scheduled to revert to $1,000,000 and the GST exemption is scheduled to be about $1,400,000. In addition, in 2013 the current top transfer tax rates of 35 percent would increase to 55 percent. Of course, there are other possible legislative outcomes. The bottom line is that if the gift, estate and GST exemptions in future years are, in fact, less than the current $5,120,000, making large gifts before the current law sunsets at the end of the year may provide significant estate tax savings later.

What if you are not sure you want to give away so much of your wealth?

You will want to take many factors into consideration in deciding how much you can afford to give away and, just as important, would be comfortable giving away. Below are several strategies that may increase your level of comfort in making large gifts in 2012.

- Utilize the Exemption of Only One Spouse. Married couples may use their combined gift tax exemption either by both making taxable gifts or by having the nondonor spouse agree to "split" the gift for reporting purposes. A married couple who do not feel comfortable making current gifts of the full $10,240,000 and have not previously made taxable gifts may wish to maximize use of one spouse's $5,120,000 exemption, leaving the other spouse's exemption intact to use in future years. For example, a married couple who have not previously used any of their exemption and who decide to give, say, $3,000,000 in 2012, should consider having one spouse make the entire gift and not "splitting" the gift between them on their gift tax returns. This way, even if the gift tax exemption returns to $1,000,000 come 2013, the donor spouse would have captured a portion of the increased exemption this year. In addition, the nondonor spouse would be able to make an additional $1,000,000 gift at a later time without incurring gift tax. Please note there are circumstances where this strategy may not be appropriate, such as if each spouse has children from prior relationships or if gifts have already been made this year that require gift-splitting.

- Have Your Spouse Be a Trust Beneficiary. In order to take advantage of your gift tax exemption when making a gift in trust, you cannot be a beneficiary of the trust. If properly structured, your spouse may be a beneficiary of the trust (often called a "spousal access trust"), which may be enough to make you comfortable in making a gift of all or a significant amount of your $5,120,000 exemption to such a trust. You may not control the trust's distributions, but (i) your spouse may have limited powers to make distributions to himself or herself and to your other family members, and (ii) you and your spouse may have some control over the identity of an "independent trustee" who could have full power to make discretionary distributions to your spouse and family members. Your spouse could also have the power to redirect (often called a "power to appoint") trust property among your family members or, if you prefer, to a larger class of individuals and entities such as charities. If your spouse does not exercise this power of appointment, on the spouse's death, any remaining trust property would pass as provided in the trust agreement--say, to continuing long-term trusts for your children and other descendants.

- Consider a Qualified Personal Residence Trust ("QPRT"). If you prefer not to make a gift of liquid assets, you may want to consider a QPRT. A QPRT is an irrevocable "house trust" to which you transfer ownership of your primary residence (or vacation home) and retain the right to use your residence for a term of years. If you survive the term, the property passes at the end of the term outright to, or in trust for, your children. Under current law, you can retain the right to live in the residence following the end of the term by renting it for fair market rent. If you die before the end of the QPRT term, your interest in the property would revert to your estate (and its full value at that time would be includable in your estate for estate tax purposes) and then pass in accordance with the terms of your will. Therefore, you must survive the term in order to achieve the tax-planning benefits of the QPRT. The taxable gift of a personal residence transferred to a QPRT is not the fair market value of the property, but such fair market value reduced by the value of your retained use of the property for the desired term of years. Your retained interest is calculated based on your age, the length of the term, the actuarial likelihood you will survive the term and the applicable federal interest rate for the month in which you fund the QPRT. For example, if a 55-year-old transfers her home currently valued at $3,000,000 to a QPRT with a 15-year term this July, her taxable gift would be approximately $2,000,000, a reduction of $1,000,000 for gift tax reporting purposes.

- Note **State Gift Tax Considerations.** If you are a Connecticut resident (or are a resident of another state but considering making a gift of Connecticut real estate), you will need to consider the impact of Connecticut's separate gift tax, which currently has a $2,000,000 exemption for gifts made after January 1, 2005. The Connecticut gift tax on a $5,120,000 gift would be about $240,000 for someone who had made no prior gifts. A Connecticut resident who owns real estate in another state may wish to consider gifting that property in order to avoid the Connecticut tax.

What if your disposable assets are not the "ideal" type to use to make gifts?

There is no single type of asset that is the best to use in making gifts in all contexts. Gifts of cash are easy to make, are easy to value and have no built-in appreciation. But what if your disposable assets consist largely of low-basis stock? Or if your assets are illiquid, as may be the case if a significant portion of your net worth consists of real estate, works of art or a family business? In such a case, you may wish to consider one of the following strategies.

- Making Gifts of Illiquid Assets. For example, illiquid assets such as artwork, a vacation home or investment real estate can be used to make gifts. Gifts of non-income-producing assets may be attractive because they do not affect your cash flow. In addition, because of their illiquid nature, it may be possible to discount the value of gifts of illiquid property due to the fact that the person receiving the gift may lack the ability to freely transfer the property or may lack control over it (for example, if a donee receives an interest in a nonmarketable asset or a fractional interest in real estate). These discounts should be determined by a professional appraiser. Potential downsides to making gifts of illiquid assets are that (i) in order to establish the fair market value of the property you are giving to your children, you will likely need to hire a professional appraiser; (ii) as valuation may be more subjective, the IRS may scrutinize the valuation of such a gift more than it would a gift of cash or publicly traded securities; and (iii) for certain assets such as art, you may be called on to prove you have actually given up control and enjoyment of the property. In addition, your beneficiaries will take your income tax basis in such property, so potential capital gains on a subsequent sale of the illiquid asset should be considered.

- Using Your Low-Basis or Illiquid Assets as Collateral for Loans. Instead of making a gift of an illiquid asset or a low-basis asset with built-in capital gains, you may be able to borrow funds using your illiquid or low-basis assets as collateral and then use the loan proceeds to make gifts. For low-basis assets that you retain rather than gift, this would preserve the "step up" in basis for income tax purposes on those assets at your death. While doing so will add some cost to the transaction, interest rates on loans are currently at historically low levels and offer an attractive planning opportunity.

- Making Intra-family Loans. Alternatively, family members can make loans to each other at interest rates lower than those available through a bank, and the borrowed funds could be used to make large gifts in certain circumstances. For example, for a nine-year loan made in July, an annual interest rate as low as 0.92 percent can be charged on a loan between family members without triggering gift tax consequences.

What if you are afraid of having "too much" end up in the hands of your children?

For any number of reasons, you may feel inheriting more than a certain amount of property could be detrimental to your children and their own families, and you may have qualms about making gifts of the full 2012 gift tax exemption amount of $5,120,000 (or $10,240,000 for married couples). While you need to decide what will be right for your family, there are several ways to address this concern using a trust.

- Making Gifts in Trust. If you make gifts outright to your children or more remote descendants, you have no say over how they use the property (although how they do so may affect your future decisions on whether to give them additional property during your life or at your death). If you make gifts in trust, you would still be giving up direct control over the use and distribution of the property, but you have many options on how to structure an irrevocable trust. Your trust can be as flexible or restrictive as you like. For example, you could:
- Give your spouse the power to appoint the trust property among your descendants in a different manner than you initially provide, or among a broader class of extended family members, other individuals and charities. Giving your spouse this power permits the spouse to take a second look at your decisions in light of later developments, such as any change in circumstances or behavior of your descendants or the extent to which the property you contributed to the trust has grown. You can also provide your children with a similar power to make adjustments as needed for their own family members down the road.
- Give the trustee the power to make distributions to one or more charities, either at the trustee's discretion or automatically if the trust assets reach a certain level, in addition to the power to make distributions to your spouse and/or descendants. You can specify such charitable beneficiaries, including a family foundation, so long as you are excluded from exercising any control over assets contributed to the foundation from the trust you created or you make a nonbinding, general request that the trustee select charities you support.

Please let us know if you would like to discuss making gifts before the end of the year.

Legislative developments

President Obama's budget plan for fiscal year 2013, released in February of this year, proposes a number of changes to the estate, gift and generation-skipping transfer ("GST") tax laws. Although many of the changes have been proposed in the past without being enacted, these proposals are likely to be among the items under consideration as Congress contemplates the looming increase in federal transfer taxes next year. The following summarizes the key proposals in the budget plan:

- Return to 2009 Transfer Tax Levels. The federal estate and GST exemptions would be lowered to $3,500,000, and the gift tax exemption would be lowered to $1,000,000. (As noted above, all three exemptions are currently $5,120,000.) In addition, the tax rate would be increased to 45 percent from the current 35 percent. These changes would be effective January 1, 2013, meaning that currently pending transactions are unaffected. Significantly, the proposal would make permanent the "portability" of a deceased spouse's unused federal estate tax exemption, which was first introduced in 2011 but is currently slated to expire at the end of this year.

- Minimum GRAT Terms. Grantor retained annuity trusts (or "GRATs") funded after January 1, 2013, would be required to have a minimum term of 10 years and a remainder value greater than zero (although there is no stated minimum value). This proposal increases the possibility that the grantor would not survive the GRAT term and therefore may make mortality risk a more important consideration to weigh in deciding whether to use GRATs in the future.

- Limited Duration of GST Exemption. For transfers on or after January 1, 2013, the GST-exempt status of a trust would terminate after 90 years. After that time, transfers from the trust would again be subject to transfer taxation.

- Coordinate Income and Transfer Tax Rules Applicable to Grantor Trusts. Currently, certain irrevocable trusts (including most insurance trusts and many other gift trusts) are treated as being owned by the grantor for income tax purposes but are not included in the grantor's estate at death. This effectively permits the grantor to continue to pay the income tax liability on the income earned by the grantor trust, which is the equivalent of an additional tax-free gift to the trust each year. At the same time, the trust assets and all appreciation are removed from the grantor's estate. The proposal calls for all such trusts to be included in the grantor's estate and for distributions from such trusts to be treated as taxable gifts by the grantor. Transition rules would apply to grantor trusts in existence prior to January 1, 2013.

- Valuation. Additional restrictions are proposed that would limit the availability of certain valuation discounts. While the specific restrictions are not spelled out, the result is expected to be lower (or in some cases eliminated) valuation discounts for lack of marketability and for minority interest.

These proposals have not yet been introduced as legislation and would not take effect until next year, so no immediate action is necessary. However, if you have not updated your estate planning documents in the past few years, this may be an appropriate time for a more comprehensive review of your estate plan to ensure that it still meets your estate planning needs and objectives.