A Unique Opportunity to Transfer Wealth Without Tax: Taking Advantage of the 2012 Gift Tax Exemption

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Tax provisions enacted in 2010 increased the 2012 lifetime gift tax exemption to $5.12 million and lowered the top gift tax rate to 35%. Beginning in 2013, the estate and lifetime gift tax exemptions are scheduled to return to $1 million and the top gift and estate tax rates are scheduled to increase to 55%. The higher 2012 exemption provides investors with an unprecedented opportunity to transfer wealth to future generations gift and estate tax free, *provided they act quickly.*

Although the higher exemption is scheduled to remain in effect through 2012, *investors are well-advised not to wait until near year-end to prepare to gift assets.* As noted below, most investors will want to place amounts gifted to children or grandchildren in an irrevocable trust, rather than give it to them outright. Using a trust allows the donor to retain control over the assets, preventing the recipients from squandering the gift prematurely. Determining appropriate trust terms—such as when and in what circumstances assets will later be distributed to heirs—requires careful consideration, and preparation of the associated legal documents requires time. If the assets to be transferred are privately held, additional time may be needed to obtain an asset valuation, secure the permission of partners, institute a new capital structure, and draft necessary legal documents. And, the sooner a gift is made, the greater the opportunity for the assets to appreciate outside of the donor's taxable estate.

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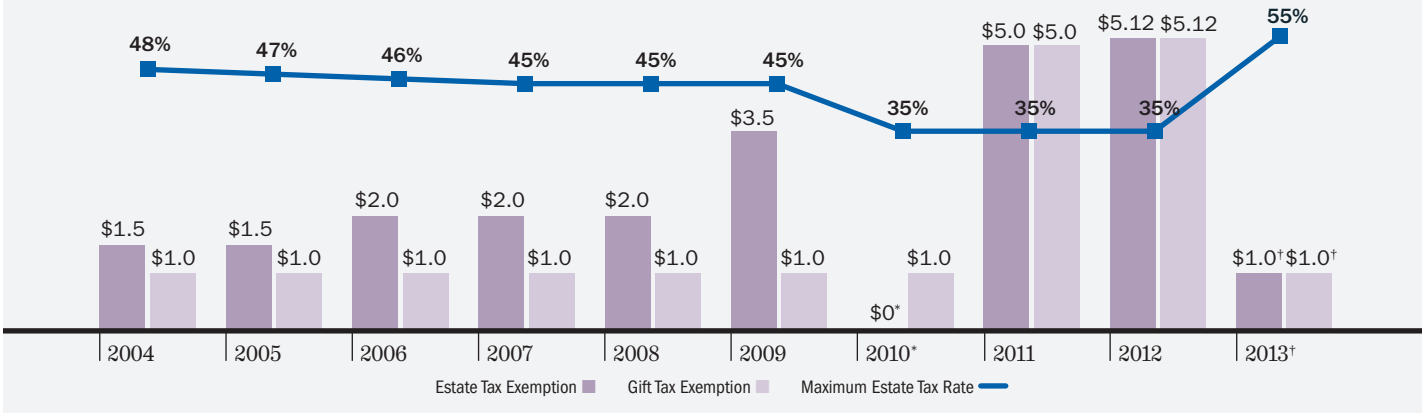
Wealth transfer attorneys already are noting a significant up-tick in demand for their services. By year-end, that

Maximum Gift and Estate Tax Rates and Exemption Amounts ($ millions)



* Executors of the estates of individuals who died in 2010 may elect to have no estate tax apply to the assets held by the decedent (in which case the basis in the assets generally is not stepped up to fair market value in the hands of the heirs) or take advantage of the step-up in tax basis for the benefit of the heirs and pay estate taxes based on the fair market value of the decedent's assets at the time of death (and subject to the applicable exemption amount).

† In the absence of new legislation, the gift and estate tax exemption amounts will revert to $1 million in 2013.

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demand is likely to become a deluge. Thus, investors should initiate discussions with qualified professionals *now* to determine (i) whether a gift makes sense, (ii) which assets should be transferred, (iii) whether conditions must be met to effectuate a transfer of those assets, (iv) whether a trust will be used to hold the gifted assets, and (v) the terms of that trust.

I. The legislative landscape

The fate of the gift and estate tax exemptions and rates likely will be tied up with Congressional action (or lack of action) on the Bush tax cuts—the lower tax rates in effect for the past decade that are scheduled to expire at the end of 2012. With Congress likely deadlocked until Election Day, the fate of the Bush cuts will be decided by a "lame duck" Congress convening between Thanksgiving and Christmas in 2012. The Congress that returns for that session will be the existing Congress—a Republican-led House and Democratic-led Senate—regardless of the election results. President Obama, too, will still be in office at the end of 2012: either he will have been re-elected—feeling newly-empowered to enact his policies—or he will be a lame-duck president who can do what he believes is right without concern for the consequences.

Republicans believe the Bush tax cuts should be extended for all taxpayers. Democrats believe they should be extended only for the middle and lower classes. President Obama has said he will veto any further extension of the Bush tax cuts for upper income families. If the President carries through on that threat, then the Republicans must either accept a compromise that raises taxes only on the affluent or watch the tax cuts expire for everyone. Under either scenario, affluent taxpayers will face higher taxes in 2013.

The President would like the estate tax regime in 2013 to return to its status of 2009: a $3.5 million estate tax exemption, a $1 million lifetime gift tax exemption, and a top estate tax rate of 45%. If Congress reaches an agreement to extend some or all of the Bush tax cuts, it likely will compromise on an estate tax exemption somewhere at or between $3.5 million and $5.12 million for 2013 and later years. Whether in that case Congress would keep the gift tax exemption at $1 million (the situation for most of the past decade) or would set the gift tax exemption equal to a higher estate tax exemption is unclear. Of course, if Congress fails to act at all, both the gift and estate tax exemptions will fall to $1 million in 2013; in that case the top estate tax rate will be set at 55%.

II. Using the lifetime gift exemption

As noted above, an individual may give away up to $5.12 million before year-end 2012 without imposition of gift tax. A married couple may give away up to $10.24 million. Someone who used his $1 million lifetime exemption before 2012 may give away an additional $4.12 million. These lifetime exemptions are in addition to the annual gift tax exclusion that permits an investor to give away $13,000 each year to as many recipients as he or she wishes.

If an investor uses his $5.12 million lifetime gift tax exemption, he is not permitted to give away an additional $5.12 million estate tax free at his death. Essentially, by making the gift, he is accelerating his estate tax exemption and using it during his life. Doing so can make sense for at least two reasons. First, as noted above, the $5.12 million estate tax exemption is scheduled to expire at the end of 2012. Although Congress might decide to extend the exemption further, there is no assurance it will do so. Thus, an investor who dies after 2012 has no assurance he will be permitted to pass on $5.12 million estate tax free at his death. He might be well-advised to use the exemption now while it is available.

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Second, by giving away $5.12 million now, the gift can appreciate during the remainder of the donor's life. By the time it is finally distributed to heirs, the gift may have increased substantially in value, yet the full amount distributed will be entirely free of estate tax.[1]

In addition to providing for a $5.12 million lifetime gift tax exemption, the 2010 tax compromise provides for a $5.12 million lifetime generation skipping transfer (GST) tax exemption in 2012. The GST tax is an additional tax levied on gifts that "skip" generations (for instance, a gift from a grandparent to a grandchild). By combining these exemptions, an investor can give up to $5.12 million to grandchildren entirely free of estate, gift, and GST taxes. Such a gifting arrangement would permit the $5.12 million to grow not only during the investor's lifetime, but during his children's lifetimes as well.

III. Using trusts to reduce future estate tax

Typically an investor wishing to make a large gift to children or grandchildren will put the gifted amount in an irrevocable trust, rather than giving it to heirs outright. Use of a trust gives the investor control over the later distribution of the assets, keeping them away from heirs who, due to youth or inexperience, might squander them.

An irrevocable trust usually has two classes of beneficiaries: *income beneficiaries*, who may receive the earnings on the assets placed in trust for a specified number of years or for life, and *remainder beneficiaries*, who receive the trust assets at the end of the specified years or upon the income beneficiary's death. Typically, a donor names a spouse as the income beneficiary and children as remainder beneficiaries, or names children as income beneficiaries and grandchildren as remainder beneficiaries, although any individuals may be named for these purposes.

The fact that the trust is "irrevocable" means the donor cannot later reclaim the assets or make significant changes to their disposition. Thus, a donor must be comfortable with the arrangement at the time assets are placed in the trust. For this reason (and others), it is critical to consult with a qualified estate planning attorney when establishing a trust, gifting assets, or considering any of the techniques described in this paper. Individuals establishing trusts also should retain a qualified professional fiduciary to assist in managing and administering the trust and directing the investment of trust assets.

IV. Income tax treatment of trusts

Although irrevocable trusts are good vehicles to minimize estate taxes, they are notoriously inefficient from an income tax perspective. An irrevocable trust typically is taxed on virtually all of its undistributed income at the highest individual income tax rates. Currently, the top individual tax rate on ordinary income is 35%, and the top rate on dividends and capital gains is 15%. These rates are scheduled to expire at the end of 2012 and could increase in later years.

A trust can reduce income taxes by distributing investment income currently to the income beneficiary. A trust pays no income tax on distributed income. Instead such income is taxed to the recipient at the recipient's tax rate—which typically is lower (and in any event cannot be higher) than the trust's tax rate.

But reducing income tax by distributing income that beneficiaries do not need is inefficient and thwarts the estate planning purpose of the trust. Estate taxes are minimized where the trust retains its investment earnings so the earnings may later pass to the remainder beneficiaries estate tax free. If trust income is distributed currently instead, the income beneficiaries needlessly pay income tax and, later, estate tax when they fail to spend the income during their lives.

This, then, is the conundrum of trust taxation: To keep income taxes low, a trust should distribute its income. But to keep estate taxes low, a trust should retain its income and pass it on later to future generations. The conundrum can be solved only by accumulating earnings in the trust and investing assets wisely to minimize the income tax imposed on those earnings.

To achieve both estate tax and income tax efficiencies a trust should invest in assets that generate income taxed at low rates. For this reason, when investing trust assets, a professional management strategy that seeks to enhance after-tax returns by balancing investment and tax considerations is exceedingly important.

A. Stocks, bonds, and mutual funds

The need to minimize income taxes may make municipal bonds an attractive investment for an irrevocable trust. Similarly, because dividends are subject to a lower tax rate, equities, too, can be an attractive trust investment.[2]

If a trust intends to sell investment assets, it is important that any gain recognized be long-term gain subject to the lower capital gains tax rate. For the same reason, it is important that mutual funds in which the trust invests be managed in a tax-efficient manner. Tax-efficient funds employ a number of techniques to minimize taxes, including purchasing stocks with a long-term perspective to delay recognition of taxable gain, reducing turnover to minimize short-term gain, investing in stocks that pay qualifying dividends, harvesting tax losses, and selectively using tax-advantaged hedging techniques as an alternative to taxable sales.

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B. Life insurance

Irrevocable trusts funded with life insurance are so common they are given a special name: "ILITs", or "irrevocable life insurance trusts." Life insurance can be an optimum trust investment because it can minimize both income and estate taxes while enhancing greatly the amount passed on to heirs. The investment earnings on a life insurance policy are not subject to income tax unless withdrawn during life. When the insured dies, the life insurance typically pays out an amount significantly greater than the amount invested in the policy. And that death benefit is not subject to income tax. Thus, by investing trust assets in a life insurance policy, a donor can transfer significant assets to heirs *entirely income and estate tax free.*

Life insurance also can provide needed liquidity to heirs when an estate holds assets that cannot easily be sold at full value, such as a family-owned business. Without liquidity at death, heirs who otherwise would continue the family business must sell it to pay estate taxes due. The business owner's purchase of life insurance through an ILIT can provide heirs with tax-free funds to offset the tax due on the estate, keeping the business intact.

To provide liquidity in the case of married couples, "second-to-die" life insurance is often used. A second-to-die policy pays at the death of the second spouse, when the estate tax is due. (The first spouse to die can escape estate tax by

transferring assets to the surviving spouse. There is no limit on this "spousal exemption" from estate tax.) Second-to-die insurance is typically less expensive than traditional life insurance.

In 2012, a donor may fund the ILIT with an amount up to the lifetime gift tax exemption of $5.12 million. As an alternative, a donor may fund an ILIT with annual gifts within the annual gift tax exclusion amount (currently $13,000). These gifts are then used to pay annual premiums on the policy.

There are other means available to fund an ILIT. For instance, it may be possible to convert existing life insurance policies to a policy more suited to provide liquidity at a lower cost. A comprehensive life insurance review can uncover this potential.

Similarly, an investor might use required minimum distributions from an IRA (or other qualified assets) to pay the premiums on an insurance policy. Combining a life insurance purchase with an annuity might also make sense. An annuity can provide a guaranteed minimum annual cash flow. That cash flow can be used to pay annual premiums on a life insurance policy, without fear that the policy will lapse due to inability to pay the premiums in the future.

An ILIT must be carefully structured with professional assistance to assure that the donor does not retain excessive rights over the life insurance policy. Retention of such rights could cause the life insurance proceeds to be included in the donor's estate.

C. Non-marketable assets

In many cases it makes sense to gift non-marketable assets, such as partial ownership of a private company, interests in a real estate or other partnership, or oil and gas interests. Because privately-held assets often have significant opportunity for appreciation and may qualify for valuation discounts based on lack of marketability or control if a minority interest is transferred, moving them out of the taxable estate may make sense. Privately-held assets also may be efficient from an income tax perspective, as income may be sheltered with tax deductions (in the case, for instance, of many real estate partnerships or oil and gas interests) or derived in the form of future capital appreciation (in the case of private companies).

Not all non-marketable assets are susceptible to gifting, however. Presumably a donor will want to avoid items with emotional attachments or that are not easily divisible. For instance, transferring a vacation home may lead to disagreements over use and even redecorating. Discussions with an experienced advisor can help uncover these latent concerns.

Special care and preparation are needed when a gift involves non-marketable assets. In the case of a gift of a partnership interest, it may be necessary to obtain the permission of the other partners and to revise the partnership documents. In the case of a generational transfer of a private business, it may be advisable to recapitalize the company to separate management control from economic ownership. Again, beginning the transfer process now is important to make sure terms can be set, documents drafted, any required asset valuations are obtained and the gift completed by year-end.

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V. Shifting the income tax burden from the trust

Another way to minimize income taxes imposed on an irrevocable trust is to structure the arrangement so that the donor, rather than the trust itself, pays the income tax imposed on trust earnings. Two types of trusts in particular may be used for this purpose.

A. Intentionally Defective Grantor Trust ("IDGT")

An "intentionally defective grantor trust" ("IDGT") is an irrevocable trust whose assets are outside the donor's estate but the donor—rather than the trust itself—pays tax on the income earned on the trust assets.

An IDGT can provide three advantages:

- Because the donor pays the income tax on trust earnings, income taxes do not deplete the trust assets, permitting more value to be transferred to the beneficiaries. (In essence, the donor is making an additional tax-free gift to the beneficiaries in the amount of the income tax paid.)
- Because individuals often pay income tax at lower rates than trusts do, income tax paid may be less with an IDGT.
- Use of the IDGT reduces administrative costs, as the trust is not required to file annual income tax returns.

An IDGT structure is often combined with an installment sale arrangement. Under this arrangement, a donor sells property to the IDGT in exchange for an installment note payable over a specified term. The installment note bears interest at an IRS-mandated rate (which is based on the Treasury rate). The donor reports on his tax return income generated by the trust assets. However, because the donor is treated as owning the IDGT assets for income tax purposes, the donor does not pay income tax on the initial sale or on the installment note payments received (it's as if he sold the property to himself). Asset appreciation in excess of the installment note interest rate is removed from the donor's estate and passes to heirs free of estate tax. (The IDGT assumes the donor's original cost basis in the trust assets, and so heirs may pay capital gains tax when the assets are later sold.)

Although not necessary, the IDGT may use this excess appreciation to fund the purchase of a life insurance policy also owned by the IDGT. As discussed above, the death

benefit on the life insurance policy is then passed to heirs free of estate and income tax.

The current combination of reduced values for many types of assets (such as real estate) and low interest rates makes this an ideal time for structuring an installment sale arrangement with an IDGT. The low asset values permit more assets to be transferred, and the low interest rate provides a low installment note "hurdle" rate above which asset appreciation may be transferred to heirs, estate tax free.

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B. Grantor Retained Annuity Trust ("GRAT")

A "grantor retained annuity trust" ("GRAT") is a structure that permits an individual to transfer potential asset appreciation to heirs without incurring gift tax. It works as follows.

A donor transfers assets to an irrevocable trust with a specified term. During each year of the trust term, the trust pays back to the donor a portion of the amount transferred plus interest at an IRS-mandated rate (which is based on the Treasury rate). At the end of the term, the donor has received back the initial amount transferred plus all interest due. The trust distributes (or retains for later distribution) to the beneficiaries the asset appreciation in excess of the mandated interest rate.

This asset appreciation—and any future earnings on that amount—is removed from the donor's estate. Moreover, because the donor received back an amount equivalent to what he initially transferred plus interest, the donor made no net gift and so did not use any portion of his lifetime gift tax exemption. Thus, there is no limit on the asset value that may be transferred to a GRAT.

For instance, suppose a parent establishes a GRAT with a three-year term for the benefit of his children. He transfers $3 million to the GRAT. Assume the IRS-mandated interest rate is 3%, but the assets held in the trust in fact appreciate 5% a year. The trust would pay to the parent about $1,060,000 each year for three years ($3,000,000 principal plus 3% annual interest). At the end of three years, the trust will have $336,000 remaining, which represents the additional investment earnings at a 5% rate over the interest paid at a 3% rate. The trust distributes (or retains for later distribution) to the children this remaining $336,000, which they receive free from gift and estate tax.

If the donor fails to survive the term of the GRAT, the entire value of the transferred property is included in his estate for estate tax purposes. Thus, it usually is beneficial to choose a short term for the GRAT. When that term expires, a new GRAT can be established with another short term. (This structure is referred to as "cascading" or "rolling" GRATs.)

As in the case of an intentionally defective grantor trust, the donor—rather than the trust itself—pays income tax on the trust's earnings. Thus, income taxes do not deplete the trust assets, permitting more value to be transferred to the trust beneficiaries tax free.

A GRAT is best suited for gifts of income-producing assets that are expected to appreciate. If, however, the GRAT is funded with assets that do not generate income, the trust can pay the donor "in kind." For example, if a GRAT is funded with non-income producing stock, the GRAT can pay the donor each year with shares of the stock rather than cash.

The current combination of low values for some asset classes and low interest rates provides an ideal environment for GRATs. The low asset values permit more assets to be transferred to the GRAT, and the low interest rates provide a low "hurdle" rate above which asset appreciation may be transferred to heirs without estate tax.

Investors may wish to take advantage of the current economic environment and laws to establish GRATs quickly.

In recent years, Congress has considered legislation that could curtail some of the benefits of GRATs, perhaps by imposing a minimum GRAT term of ten years or by requiring that the GRAT involve the transfer of some net value to the heirs (or both). These changes likely would not apply to assets transferred to GRATs prior to the effective date specified in the law (although this result cannot be guaranteed). Thus, investors may wish to take advantage of the current economic environment and laws to establish GRATs quickly.

VI. Conclusion

By adopting an effective gifting strategy in preparation for the expiration of the higher gift tax exemption at year-end, individuals can take timely action to reduce their future estate taxes and leave their inheritances intact. Choosing which assets to gift and how to invest gifted assets can enhance this objective.

To assure and maximize tax savings, investors should initiate discussions *now* with a qualified professional. This lead time is necessary to make sure terms are fleshed out, necessary legal documents are prepared, any required asset valuations are obtained and gifts are completed before the current tax exemptions are scheduled to expire.

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[1] Some commentators have suggested that, if the estate tax exemption is reduced after 2012, any gifts made in excess of the post-2012 exemption amount would be "clawed back" and subject to estate tax. For instance, if the estate tax exemption in 2013 reverts to $1 million, then $4.12 million of lifetime gifts made in 2011-2012 could be subject to the estate tax. This interpretation appears at odds with the Congressional intent. Even if the interpretation is correct, it remains worthwhile to use the full lifetime gift exemption, as appreciation in the gifted amount would escape future estate tax under any interpretation.

[2] The lower dividend tax rate is scheduled to expire at the end of 2012.

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