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Trusts & Estates Advisory

Making the Most of 2012: Unique Planning Opportunities Under Current Transfer Tax Laws

Lifetime Gifting Report

Under legislation passed at the end of 2010, Congress increased the federal estate, gift, and generation-skipping transfer ("GST") tax exemptions to $5,000,000 per person (indexed for inflation) with a 35% maximum tax rate. On January 1, 2013, absent any action from Congress, these exemptions will decrease drastically to $1,000,000 and the maximum tax rate will increase to 55%.

Although most commentators feel that the exemptions will not fall to the 2001 levels, it is certainly possible that the exemptions will be significantly lower than they are today. In fact, President Obama's 2013 budget proposes a $3,500,000 estate tax and GST-tax exemption, $1,000,000 gift tax exemption, and 45% maximum estate and gift tax rate. Although we do not know with certainty what 2013 will bring, we do know that 2012 offers the potential for significant lifetime gifting opportunities.

The following table shows the tremendous growth in the exemption amounts that play a critical role in many estate planning techniques.

Year	Estate Tax Exemption	Max Estate Tax Rate	Gift Tax Exemption	Max Gift Tax Rate
2008	$2,000,000	45%	$1,000,000	45%
2009	$3,500,000	45%	$1,000,000	45%
2010	$5,000,000*	35%*	$1,000,000	35%
2011	$5,000,000	35%	$5,000,000	35%
2012	$5,120,000	35%	$5,120,000	35%
2013	$1,000,000	55%	$1,000,000	55%

* Estates of decedents dying in 2010 could "elect-out" of the federal estate tax and into a modified carry-over basis regime.

Opportunity for Lifetime Gifts

Estate planning is a highly personal process. The best use of the increased 2012 exemptions will vary from one person to another. You should therefore structure your gifting to account for your particular financial needs and resources, the nature of your assets, maintaining sufficient assets for retirement, and other personal goals. Here are some techniques that may not have been nearly as effective with the lower exemption amounts but may provide significant transfer tax benefits in the current tax environment.

Outright Gifts

The simplest way to transfer wealth is to make outright gifts. This may be done by transferring cash, securities, or real property to your beneficiaries on an outright basis. The advantage of this approach is that it is the simplest way to remove any income earned on the asset and any future appreciation from your estate. It also allows the recipient to enjoy immediate ownership. You may also use the increased gift tax exemption to forgive loans previously made to children and other family members.

Many states, such as New York, New Jersey, and Massachusetts, impose an estate tax, but not a gift tax. Consequently, residents of these states, or nonresidents owning real property in such states, have a great incentive to make lifetime gifts to reduce, or eliminate, potential state estate tax liabilities.

Family Trusts

If you are not comfortable making outright gifts, you may consider the advantages of making gifts to a trust for the benefit of your descendants. This would allow a trustee to maintain some level of control over when distributions are made to your descendants through the trust terms. Any appreciation and future income on the gifted property is not included in your estate at death. In addition, a Family Trust may be classified as a grantor trust for income tax purposes so that all income and capital gains would be taxable to you on your personal income tax return during your lifetime, without the payment of taxes being considered an additional gift to the trusts.

The trust may also provide your descendants with some protection from the claims of marital, medical, financial, or other creditors.

Dynasty Trusts

For those interested in benefitting multiple generations, gifting to a multigenerational trust, or "Dynasty Trust," allows you to remove assets not only from your estate but also from the estates of your children and grandchildren. Similar to a Family Trust, such trusts may also provide your descendants with protection from the claims of creditors, and may also be classified as grantor trusts for income tax purposes.

Given the increased GST-tax exemption, this may be an ideal time to create a Dynasty Trust. It would be necessary to allocate all or a portion of your GST-tax exemption to your contributions to the Dynasty Trust. In this way, the trust's assets would be shielded from transfer taxes for the longest period permitted by law.

An important consideration when creating a Dynasty Trust is selecting the governing state law. It may be desirable to establish the trust under the laws of a state which allows for the trust to continue in perpetuity, such as Delaware, Rhode Island, and New Hampshire.

Currently, there are no federal restrictions on the duration of GST-Exempt trusts (many states, including Connecticut, limit the duration of trusts). However, President Obama has proposed to limit the duration of GST-Exempt trusts to 90 years from the date the trust is created. This rule would have a significant impact on a Dynasty Trust. GST-Exempt trusts created before the enactment of this legislation would not be subject to the limitation. Consequently, if GST planning is something you are considering, there is a strong incentive to create a GST-Exempt trust in the near future.

Spousal Lifetime Access Trusts (SLATs)

The trusts discussed up to this point require that you will no longer have access to the gifted assets once they are transferred to the trust. A married person who desires to use the increased federal gift exemption, but wants to retain some level of control and access to the gifted property, may create an irrevocable trust for the benefit of his or her spouse and descendants, a so-called Spousal Lifetime Access Trust (SLAT). The transfer to a SLAT is a completed gift, and any remaining assets of the SLAT should not be included in either spouse's estate for estate tax purposes. Each spouse could create a SLAT for the benefit of his or her spouse so long as the terms of each trust are not identical.

Irrevocable Life Insurance Trusts (ILITs)

Creating an Irrevocable Life Insurance Trust (ILIT) may make a great deal of sense in the current transfer tax environment if you already own a significant amount of life insurance, particularly life insurance policies with large cash values, or you are thinking of purchasing a large policy at this time. The contribution of an existing life insurance policy is a gift for tax purposes roughly equal to its cash value as of the date the policy is transferred to an ILIT. Therefore, the current increased gift tax exemption gives you the opportunity to transfer a policy with a significant cash value without the payment of a federal gift tax. An ILIT can also create liquidity to pay potential federal and state estate taxes at death.

Charitable Lead Annuity Trusts (CLATs)

For those who are philanthropic, this technique involves transferring assets to an irrevocable trust, which then pays an annuity to a designated charity for a specified number of years (the "Annuity Period"). Once the Annuity Period is complete, the remaining assets of the Charitable Lead Annuity Trust (CLAT) would pass to your family. In calculating the value of your taxable gift, the charity's interest is subtracted from the value of the assets transferred to the CLAT. Under present law, it is possible to draft a CLAT so that the value of the remainder interest passing to your descendants is calculated at inception to be zero. Consequently, a CLAT offers you the opportunity to pass assets to your family in a tax-efficient manner.

A CLAT is especially effective in the current low interest rate environment. Each month, the Internal Revenue Service issues an interest rate (the "hurdle rate") that must be used in calculating the value of your taxable gift. The rate for the month of June, 2012, is 1.2%. If during the Annuity Period, the CLAT's assets appreciate at a higher rate than the hurdle rate, such excess will pass to your remainder beneficiaries.

Grantor Retained Annuity Trusts (GRATs)

As we have discussed in the past, the Grantor Retained Annuity Trust (GRAT) has been an effective method of transferring assets to descendants. A GRAT allows you to transfer property (i.e., stock, bonds, closely held business interests, etc.) to a trust while retaining the right to receive an annuity for a specified term of years. Currently, a GRAT can be drafted so that the value of the property you are transferring is equal to the value of your annuity payments, with the result that there is no taxable gift. This is commonly referred to as a "zeroed out" GRAT. The benefits of the low hurdle rate, discussed above in the CLAT section, are equally powerful with GRATs. Proposed legislation seeks to place significant restrictions on GRATs by setting the minimum term for GRATs at 10 years and mandating that remainder interests of GRATs have a value greater than zero. Consequently, 2012 may be the last year to create a GRAT with little or no negative tax consequences.

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Additional Promising Techniques

Other techniques that you may find attractive include intra-family loans, Qualified Personal Residence Trusts (QPRTs), and sales to Intentionally Defective Grantor Trusts (IDGTs). We would be happy to discuss these techniques with you.

It is also worth noting that valuation discounts are still available this year. Minority and lack of marketability discounts have historically been used when valuing transfers of real property and business interests. However, legislation has been proposed that would limit or eliminate these discounts.

Other Considerations

It is important to note the potential impact of state gift tax and the loss of the basis step-up when considering large gifts. In Connecticut, the gift tax exemption is currently $2,000,000. As a result, by fully utilizing the higher federal exemption amount, a Connecticut tax would be payable. It is therefore important to consider the tax and financial impact of paying such a tax at the time of the gift. In addition, it is important to be aware that there is the potential that if the federal gift tax exemption is lowered in 2013, prior gifts made in excess of the new amount may be "clawed back" and included in a donor's taxable estate at death. Many commentators have suggested that making taxable gifts may still be advantageous given that any future appreciation would not be subject to estate tax, even in the event of a claw back.

Given the possibility of Congressional action that could cause many types of gifting techniques to be less attractive, and notwithstanding the above considerations, 2012 may be the perfect time for you to implement these planning opportunities. We would be happy to discuss these techniques in further detail to determine if they might work well as part of your own estate plan.

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