Keeping More of Your Family's Money After Estate and Gift Taxes

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With the ever-changing landscape in tax, a number of planning and reporting ideas should be given consideration. Current combination of low interest rates and asset valuations provide an ideal circumstance to plan and execute gift, estate and succession plans. While each circumstance is different and must be viewed within the context of the total picture, we are offering some suggestions that you may want to explore before year-end 2012.

Inflation Adjustment for Estate Tax Exemption

Commencing in 2012, the $5 million per person exemption for gift, estate tax and generation skipping transfer taxes has been adjusted for inflation to $5,120,000. This allows for additional tax-free gifting of $120,000 per person or $240,000 per married couple during 2012. If you have fully utilized your $5 million gift tax exemptions during 2011, you have the opportunity to gift an additional $120,000 (or $240,000 for couples) during 2012. As there is uncertainty to the continuation of the current level of estate and gift tax exemption beyond this year, it is strongly recommended utilizing eligible exemptions through planned gifting during the current year. Selecting assets with low valuations, such as real estate or stocks that are at discounted value, can further increase the amount that's being transferred.

Default Elections on Gift Tax Returns

A gift tax return is required to be filed for any gifts other than direct gifts to an individual in the amount of $13,000 and below. An area of concern is gifting to trusts as they generally have the possibility of becoming a gift to grandchildren or other beneficiaries more than one generation removed from the grantor. Such transfers are potentially subject to an additional "generation skipping transfer tax" (GST), which is a tax equal to the estate tax (set at 35% for 2012). A gift that is subject to both GST and gift or estate tax could be subject to a tax as high as 70% of its value at current rates (or more if rates go back up to prior levels that were as high as 55%). As with gifts and transfers on death, an exemption, in the amount of $5,1200,000 per person or $10,240,000 per married couple exists for "GST" transfers.

Commencing in 2001, where a gift tax return reporting the gift potentially subject to GST is not filed by the due date, IRS makes a "deemed election" irrevocably allocating the GST exemption to such trust transfers as of the date the gift tax return should have been filed. To avoid inadvertent depletion of this critical exemption amount or worse, imposition of the GST, it is important to properly disclose, evaluate, and report on Form 709 all prior year gifting, especially gifts into trusts, regardless of the amount.

Dynasty Trusts

Dating back to our earliest laws, trusts have been limited to terms not to exceed a lifetime and twenty-one years. This limitation, or some version of it, was ultimately adopted by statute in all the states. In more recent times, an increasing number of states such as Delaware, Alaska, New Jersey, Rhode Island and South Dakota have repealed this rule so as to allow trusts to exist in perpetuity. Other states, such

as Florida, extended the period to terms that achieve practically the result where the limit is now set at 360 years. IF GST-free, from a tax perspective, the advantage of such trusts is that its corpus, or trust property, will not not subject to additional estate taxation which would otherwise deplete the balance in the amount of the estate tax rate when beneficiaries pass on. It is important to note that some of the states that offer more favorable terms for the trusts do not require that you be a resident to set up a trust in their state.

For high net worth individuals interested in establishing multi-generational trusts that potentially can carry on into multiple future generations, such trusts can be established utilizing (1) application of the GST exemption (in 2012 set at $5,120,000 for single and $10,240,00 for married couples) and (2) further leveraging this amount by installment sales of family property in exchange for promissory note set at current low interest rates.

Grantor Retained Annuity Trusts (GRATs)

This wealth planning technique involves transferring assets to a trust in return for an annuity with the balance at the end of the trust term becoming a gift. With low valuations, discounting and application of low interest rates on the annuity, a significant amount of income-producing assets can be transferred to the next generation with little or no gift tax incurred.

The drawback of this technique is that if the grantor dies during the trust term, the property is included in his or her estate. To avoid or minimize this problem, GRATs have generally been structured over shorter terms, cascading, upon the end of the short term, to a new short-term GRAT. However, pursuant to a proposal by the Obama administration, Congress is contemplating creating a minimum GRAT term of ten years. It is recommended that those contemplating utilizing GRATs, execute these strategies as soon as possible to avoid potential legislative change limitations.

Sale to Intentionally Defective Grantor Trusts

This wealth planning technique involves utilizing a trust that is “invisible” for income tax purposes, but recognized for gift and estate tax purposes. The transfer mechanism that’s used involves a deemed sale in exchange for a promissory note of income-producing assets. Given current low interest rates, discounting and low asset valuations, such mechanisms work well because they afford greater flexibility to generate sufficient income to meet promissory note payments.

Self- Cancelling Installment Notes

In general, exemption amounts and trust corpus can be increased through leveraging. For example, let’s assume rental property managed through a separate company, with a currently depressed value of $6.5 million is gifted into a trust. A 15-year note of $1,380,000 at 2.23% APR is issued by the donor. The donor utilizes the current gift tax exemption of $5,120,000 as to the balance. Rentals are used to repay the loan. In 15 years, the trust would own the property free and clear and at a foreseeably higher value. Significantly more than $5,120,000 has passed to the next generation free and clear of estate or gift tax.

If the donor takes the additional step of adding a provision that the loan that would cancel or terminate upon his or her death, both the note and the gifted property, in effect, would pass to the trust free of gift or estate tax. Promissory notes with these types of provisions are known as self-cancelling installment notes or “scins.” As long as the underlying transaction creating the note is viable, the Service only requires a premium for this provision based on life expectancy of the holder and rates in existence when the note is issued. Given the current low interest rate environment and depending on the life expectancy of the holder, reasonably interest rates could be achieved with this type of note that carries with it a guarantee that (1) any unpaid balance on death won’t be included in the estate of holder and (2) no further payments are owed on death of the holder.

In addition to the strategies discussed above, there are quite a number of other strategies and techniques that can be employed to minimize estate tax liabilities and maximize the amount that is being transferred to the next generation or generations. This area is complex, but the benefits of taking an in-depth look can make a substantial difference in effective planning. We encourage you to contact the tax professionals at Perelson Weiner to discuss such opportunities.