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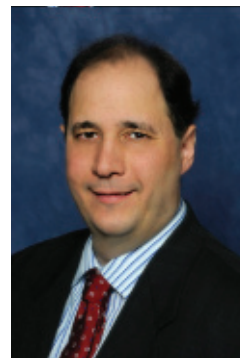
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Planning with the \$5 Million Gift Tax Exemption

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In the last issue of the *Tax Planning E-Newsletter*, we examined the new tax law in effect for 2011 and 2012, outlining the opportunities and challenges that face estate planning professionals.

In this issue, we will look more closely at the powerful planning opportunities that exist for the next two years with the federal \$5 million gift tax exemption. We begin with a quick review of the new law.

Federal Gift, Estate and GST Exemptions and Tax Rates

In 2011 and 2012, the gift, estate and generation-skipping transfer tax exemptions are all \$5 million, and the tax rate is 35%. If Congress does not act again, however, in 2013 the exemption will be \$1 million and the top tax rate will be 55%. This is the current law and must be considered in all planning. The portability of the gift and estate tax exemption between spouses was also introduced, but only for spouses who *both* die between January 1, 2011, and December 31, 2012.

Planning Tip: Note that, unlike a surviving spouse's ability to use a predeceased spouse's unused unified credit, the new law does not allow a surviving spouse to use the unused GST tax exemption of a predeceased spouse. This is just one weakness of the new portability provision.

Planning Tip: Be cautious when deciding how to plan for insurance needs, disclaimers and how to fund the bypass trust, considering whether to plan for a \$5 million exemption or some lower (e.g., \$1 million) exemption. No client will embrace a plan that requires them to die in the next two years. Also, the portability of exemption between spouses may not be around after 2012. Be sure your clients understand the exemption is scheduled to revert to \$1 million in 2013, that these uncertainties exist, and that their planning may need to be updated as the laws change.

New York Gift and Estate Tax

New York (and other states including New Jersey, Connecticut and Massachusetts) has its own tax system, independent of federal rates and credits. There is no longer a New York State Gift Tax, effective January 1, 2000. Therefore, New Yorkers may make unlimited gifts without incurring a gift tax. Nonetheless, gifts made by New Yorkers are relevant to determining whether or not a NY ET-706 Estate Tax Return must be filed. If the NY taxpayer's federal gross estate, when combined with federal *adjusted taxable gifts* is equal to or greater than \$1 million, a NY ET-706 Estate Tax Return is required.

The maximum marginal New York State Estate Tax rate is 16%, which applies to assets in a New York adjusted taxable estate in excess of \$10,040,000. This can be misleading, because the actual tax is computed on the entire New York adjusted taxable estate, even though the first million dollars is exempt from estate tax. To illustrate the point, consider that the marginal tax rate between \$1,000,000 and \$1,200,000 is 6.4%. Nonetheless, a taxpayer with a taxable estate of \$1,200,000 would pay a New York estate tax of \$45,200, because the tax is computed on the entire \$1,200,000 less an adjustment of \$60,000, rather than just on the marginal amount in excess of \$1 million.

Planning Tip: Because the New York Estate Tax is computed based on the federal credit for state death taxes, federal adjusted taxable gifts are not taken into account when computing the New York estate tax. For this reason it is advantageous for New Yorkers to make lifetime gifts to reduce their total New York estate tax bite. For example, a New York taxpayer who gifts \$1 million during lifetime and dies with a taxable estate of \$200,000 would only pay a New York estate tax of \$1,200, as opposed to the taxpayer illustrated above who died with a taxable estate of \$1,200,000 having made no lifetime taxable gifts, and paid a New York estate tax of \$45,200.

The current (and possibly temporary) federal gift tax exemption of \$5 million creates a great planning opportunity for New York estate tax purposes for those taxpayers with the inclination to make large lifetime gifts to their heirs, including "deathbed gifts" made immediately prior to death.

Example: To illustrate the point, a New Yorker with a taxable estate of \$6,000,000 would pay a New York estate tax of **\$510,800**, whereas a New Yorker who makes lifetime gifts of \$5,000,000 and dies with a taxable estate of \$1,000,000 would pay a New York estate tax of only **\$33,200**, a savings of \$477,600.

New York Generation-Skipping Transfer Tax

The New York State GST tax applies to taxable distributions and taxable terminations from a trust to a skip person. Generally, a skip person is an individual who is two or more generations below the Grantor's generation (i.e. grandchildren). For the New York GST tax to apply, the distribution or termination has to occur at the same time as, and as a result of, the death of an individual. For example, if one creates a trust for his child for life, with the remainder to be held in further trust for his grandchildren, there will be a GST taxable event at the death of his child. The New York GST tax would not apply to specific distributions to grandchildren or to trusts created only for grandchildren. Also, the New York GST tax would not apply to lifetime distributions to grandchildren from a trust created for the child for their life that allows discretionary distributions to the grandchildren during the child's life, if the distribution was not a result of a death.

Federal Income Tax Rates

We also have lower income tax rates for the next two years, but President Obama has made it clear he wants higher tax rates in 2013. Unless there are changes in the next two years, in 2013 the long-term capital gains rate will increase to 20%, the maximum tax on qualified dividends will go back to 39.6%, and the additional

3.8% surtax will be introduced.

Planning Tip: Take advantage of the lower income tax rates that we have for the next two years, and look for opportunities to accelerate income into 2012. Choose an 11/30 year-end for any estates currently being administered to maximize the lower income tax rates for as long as possible.

Tax Planning Opportunities in 2011 and 2012

With the gift tax exemption at \$5 million per person and \$10 million for a married couple, we can expect a huge transfer of wealth over the next two years. Those who have already used their \$1 million exemption now have an additional \$4 million to use for gifts! And while we cannot be absolutely certain that the \$5 million gift tax exemption will be honored if it returns to \$1 million in 2013, it would certainly make sense for Congress to do so. Let's look at some of the planning opportunities that will immediately maximize these transfers.

Planning Tip: Start meeting with your wealthier clients now to discover which properties they could give away now that will be relatively painless for them. For residents of New York State and the other states with an independent estate tax and no gift tax, locking in tax savings now presents an even greater opportunity.

Spousal Access Trusts

The general concept of a Spousal Access Trust is that one spouse can transfer up to \$5 million in trust for the benefit of his/her spouse, children and future generations. Benefits include asset protection, estate tax protection, direct descendent protection (property stays within the bloodline) and income shifting. The trust may be structured to revert back to the transferring spouse if the beneficiary dies. Risks are the reciprocal trust doctrine if both spouses set up trusts that mirror each other, and grantor trust rules.

In *U.S. vs. Estate of Grace*, 395 US 316 (1969), the Supreme Court developed a two-part test to determine whether trusts will be ignored because they are "reciprocal": a) the trusts must be inter-related and b) the trust creation and funding must leave the grantors of the trusts in essentially the same economic position as they would have been in if they had created the trusts naming themselves as life beneficiaries. If both parts are met, the IRS and/or the courts will uncross the trusts and include the value in each of the grantor's gross estate, nullifying their careful planning.

Planning Tip: To avoid the reciprocal trust doctrine, the lawyer on the planning team must take care to draft outside of the *Grace* doctrine and not make the trusts identical. Be sure to file the gift tax return and allocate the GST exemption if desired rather than rely on the automatic allocation rules.

Gifts to an Irrevocable Life Insurance Trust

Life insurance can be used to provide income for a family, pay estate taxes, and as an income tax shelter. If structured properly so that the trust maker does not have any incidents of ownership, none of the assets (policy proceeds) of an irrevocable life insurance trust (ILIT) will be included in the trust maker's taxable estate, making them free of both income and estate taxes. ILITs will become more popular as income tax rates increase, in 2013, from the current 35% rate to 39.6% or even to 43.4% for clients subject to the 3.8% surcharge.

The general concept is that the ILIT is the owner and beneficiary of the policy on the trust maker's life. The trust maker makes gifts to the trust to cover the insurance premiums, and the trustee makes the premium payments. At the trust maker's death, the proceeds are paid to the trustee who can use the funds to purchase assets from the estate and provide liquidity for estate taxes and other expenses. The trustee can make discretionary distributions of income and principal during the lifetime of the trust's beneficiaries, which can include the trust maker's spouse, children and future generations. Assets that remain in the trust are not included in the beneficiaries' estates and are protected from

creditors.

Planning Tip: Using the \$5 million gift and GST exemption amounts can provide substantial amounts of life insurance (think single or 2-pay premium) and benefit the grantor's children without future estate, gift and/or GST tax.

Planning Tip: Be very cautious about canceling existing insurance policies now. If possible, wait until 2013 nears, when we will know what the exemption will be at that time.

Dynasty Trusts

Generally, a dynasty trust is one that benefits multiple generations, and none of the trust assets are included in the trust maker's or any of the beneficiaries' taxable estates. Not being taxed at each generation (historically at 45-55%) allows the assets to grow tremendously over the years.

However, there is a generation-skipping transfer tax that applies when a transfer is made by the grantor to a "skip person" (grandchild, great-grandchild, or other person more than 37.5 years younger than the grantor). Currently, each grantor is allowed a lifetime GST exemption on the first \$5 million of taxable transfers directly to a skip person or to a trust that could benefit a skip person. A husband and wife can combine their GST exemptions. This perhaps temporary GST exemption increase will make dynasty trusts even more popular over the next two years.

The dynasty trust established in the right jurisdiction can theoretically go on forever, with the trustee making discretionary distributions for the lifetime of each beneficiary in each generation. Advantages include creditor protection, divorce protection, estate tax protection, direct descendent protection, spendthrift protection and consolidation of capital, which typically results in higher returns and better management options.

Planning Tip: The choice of situs is critical. Choose a state with no income tax, good creditor and divorce protection, and no Rule against Perpetuities such as Delaware, South Dakota or Alaska. Make sure you file a gift tax return. If the trust maker allocates enough GST exemption to cover the entire gift, neither the gift nor any distribution from the trust will ever be subject to the GST tax.

Planning Tip: Be aware of the President's budget proposal to limit GSTT-exempt trusts to 90 years, regardless of the applicable rule against perpetuities. While this was introduced in 2011 and will not likely gain support in the current Congress, this may gain support in the future.

Income-Shifting Trusts

The concept here is to shift income to younger family members to reduce income taxes. Parents can move up to \$10 million (\$5 million each) in income-producing assets gift tax-free to their children who can then use the income to invest or purchase insurance.

Example: A husband and wife gift \$10 million of non-voting S-Corporation stock to their four children (15% each) using Qualified Sub-Chapter S Trusts. There is no gift tax because the parents use both of their \$5 million gift tax exemptions. After the gift, 15% of the income generated by the S-Corporation will pass through to each child.

Benefits include creditor protection on the assets; estate tax savings because the assets are being transferred to the children and out of the parents' estates; and income tax savings because the children will pay income taxes at a lower rate than their parents. Over time, this can save a tremendous amount in income taxes.

Long-Term Tax Planning Opportunities:

Lifetime Gifting

After the \$5 million exemption has been used, it may be advantageous to give away more and pay the gift tax at the current 35% gift tax rate. Also, the gift tax is "tax-exclusive" while the estate tax is "tax-inclusive." A taxable gift of \$1.00 makes the donor liable for a \$0.35 gift tax, for a total of \$1.35. On the other hand, \$1.35 in a decedent's estate taxed at 35% nets only \$0.88 to the heirs.

Planning Tip: As was the case in 2010, gifting can be a wait and see scenario. As we get closer to 2013, we hope to know what the 2013 gift tax rate will be. If the rate is moving to 55%, it would be advantageous to make additional gifts and pay the 35% gift tax in 2012 rather than wait and pay a 55% gift or estate tax in 2013.

Intentionally Defective Grantor Trusts (IDGT)

An IDGT is a trust that is a "grantor trust" for income tax purposes, but not for gift, estate, and GST tax purposes, such that income from gifted assets continues to be reported back to the grantor. IDGTs are especially powerful right now for wealthy clients because of the \$5 million gift and GST tax exemptions and historically low interest rates.

The gift/ sale of assets to an IDGT can produce truly remarkable results under the current tax law. Using an IDGT, a married couple can currently gift up to \$10 million to the trust in undivided interests in highly appreciating assets. The Grantors then sell additional interests in the same or other assets to the IDGT. The value of both the donated and the sold assets can be discounted if the assets are "wrapped" in an LLC or limited partnership, as their value may be adjusted for minority interests, lack of marketability and lack of control. The trust issues an installment note back to the trust maker based on the discounted value of the LLC or FLP. Assuming the growth rate on the assets sold to the IDGT is higher than the interest rate on the installment note, the difference is passed on to the trust beneficiaries free of any gift, estate and/or GST tax.

Example: An ultra high net worth family wishes to transfer a minority interest in the family business to next generations, where the total value of the company is \$500 million. If 30% of the company is to be transferred, or \$150 million, assume that minority and marketability discounts totaling 33% apply, reducing the taxable value to \$100 million. Husband and wife gift \$10 million of discounted shares to an IDGT, filing a gift tax return which results in \$0 gift or GST tax. They then sell \$90 million of stock to the trust for a balloon note, payable as interest only for 30 years at 4%. The net result is that \$150 million of company stock, plus all growth and income which accumulates tax free (any gains or ordinary income are taxed back to the grantor) will pass to the children and future generations, with only the \$90 million note at 4% remaining in the estate. The tax free growth of the gifted stock will substantially amplify the gift.

Also, because the IDGT is a grantor trust (i.e., "defective" trust for income tax purposes), no capital gains tax is due on the installment sale, the interest income on the installment note is not taxable to the grantor, and all income earned by the trust is taxed to the grantor, effectively allowing for a tax-free gift to the trust's beneficiaries equal to the tax burden borne by the grantor. Discretionary distributions of income and principal are made to the trust beneficiaries during their lifetimes, and all assets in the IDGT remain outside of their taxable estates.

Planning Tip: The grantor should make an initial gift of at least 10% of the total transfer value to the IDGT or have other security for the financed sale so that the IDGT has sufficient capital to make its purchase of assets from the grantor commercially reasonable.

Planning Tip: Not everyone has \$500 million; many clients may be reluctant to lock in the federal and state tax savings without the security of having access to the gifted funds if other assets are diminished. Through trusts created in favorable jurisdictions such as Delaware and Alaska, it is possible for a Grantor to make a

gift to a trust, achieve the tax savings, yet still be a beneficiary of the trust. Contact Lou Pierro at lpierro@pierrolaw.com for more information on this technique.

Grantor Retained Annuity Trusts (GRATs)

The creator of a GRAT retains an annuity payout for a fixed term. At the end of the annuity term, any residual assets remaining in the trust pass to the remainder beneficiaries, such as the trust creator's children, free of any gift and estate tax (but not free of GST tax exposure).

The tax treatment of a GRAT is based on the assumption that the GRAT assets will grow at exactly the Section 7520 rate in effect at the time the GRAT was established (2.44% in March, 2011). If the GRAT assets outperform the 7520 rate, there will be a larger than anticipated (for tax purposes) balance to transfer to the trust's remainder beneficiaries at the end of the annuity term. In addition, all income earned by the GRAT during its term is taxed to the trust's creator because the trust is "defective" for income tax purposes, allowing for an enhanced probability of having a tax-free gift to the remainder beneficiaries.

Planning Tip: GRATs are currently most effective for property that is extremely volatile or is difficult to value, or for large estates that have already used their \$5 million exemption. Unlike a dynasty trust, a GRAT can only create a one-generation transfer unless GST exemption is allocated to it based on the actual value of the trust assets at the end of the annuity term.

Conclusion

Estate planning professionals have an exceptional window for transfer opportunities in 2011 and 2012 with the \$5 million estate, gift, and GST tax exemptions; lower income and estate tax rates; and still-depressed property values. And, as is often the case, these opportunities provide an excellent chance to work with a team of advisors to provide the best possible results for mutual clients.

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