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The Clock Is Ticking on **Rare** Tax Planning **Opportunities**

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ON DEC. 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Act) went into effect and created tremendous wealth transfer opportunities for a narrow window of time. The 2010 Act is scheduled to expire on Dec. 31, 2012, at which time under current law the opportunities afforded under the 2010 Act will be lost. This article explores various tax planning opportunities created under the 2010 Act.

Among the changes implemented through the 2010 Act, there were several substantive changes to gift, estate and generation-skipping transfer (GST) tax law, including the following:

(i) the estate, gift and GST tax rates were decreased from 45 percent in 2009 to 35 percent;

(ii) the estate and GST tax exemptions were increased from \$3.5 million in 2009 to \$5 million, indexed for inflation; and

(iii) the gift tax exemption was increased from \$1 million in 2009 to \$5 million, indexed for inflation.

If no legislation is enacted this year, then as of Jan. 1, 2013, pre-2001 law will return. There will be an estate and gift tax at graduated rates ranging from 37 percent to 55 percent (with a 5 percent surtax in certain cases), and there will be a \$1 million gift and estate tax exemption. The GST tax rate will be reinstated at 55 percent, with a \$1 million GST exemption indexed by inflation following 2001. Even if new legislation is enacted by year-end, there is no guarantee that the currently available opportunities will remain intact. In fact, tax legislation has been proposed in the past two years that would not only reduce the estate tax exemption and increase tax rates, but would also limit the applicability of discounts for lack of control and marketability and diminish the benefits of certain tax planning strategies. Now is the time to take a meaningful look at the opportunities afforded under the tax law and determine whether it makes sense to take advantage of these opportunities for your clients before the window closes at the end of the year.

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Direct Gifts

The increase of the gift tax exemption from \$1 million to the current \$5.12 million inclusive of inflation creates tremendous opportunities for clients to make direct gifts, either outright to designated beneficiaries or to trusts for their benefit. With economic conditions as they have been over the past few years, many assets are at historic lows in terms of value, which has the effect of leveraging any gifts that are made now. Not only will the gifted assets be outside of the donor's taxable estate, but all appreciation and income attributable to the gifted assets will escape estate taxation.

For example, if you make a \$5.12 million gift this year and die 20 years from now, the value of the gifted assets may grow to over \$9 million assuming 3 percent annual growth. To the extent the recipients are in lower income tax brackets, the gifting program may produce income tax savings. In addition, the gifted assets will avoid New York estate tax because there is no gift tax in New York, and under most circumstances the New York estate tax is computed on the basis of assets owned at death without taking gifts into account.

For married clients who are reluctant to lose the benefit of gifted assets, one spouse can make a gift to a trust for the benefit of the other spouse and children. If properly structured, a husband can make a gift to a trust for the benefit of his wife and children and the wife can gift assets to a similar but non-identical trust for the benefit of her husband and children. The trusts cannot be identical in form, as the IRS has held that if two individuals create identical trusts for each other, the trusts are disregarded for tax purposes. With sufficient differences in the two trusts, however, husband and wife can create trusts for each other so as to remove the gifted assets from both of their taxable estates while maintaining access to the trust assets if necessary. This creates substantial flexibility in the use of the gifted assets and the income generated by these assets.

Dynasty Trusts

While direct gifts can be made to children or trusts for their benefit, use of the applicable exclusion can be leveraged further if gifts are made to a dynasty trust for the benefit of children, grandchildren and even future generations. Although New York does not permit a trust to last in perpetuity, multiple generations can benefit from assets transferred to a dynasty trust. The trust can provide for distributions to children for their health, education, maintenance and support, and at a deceased child's death, the assets allocated to that child would pass to the child's issue, again in lifetime trusts. Since the GST tax exemption is currently $5.12 million inclusive of inflation, this amount can be gifted to a dynasty trust and can pass from one generation to the next without any transfer taxes.

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The lifetime trust structure utilized in a dynasty trust as assets pass from generation to generation has an additional advantage of protecting the assets from the claims of the beneficiaries' creditors including a spouse in the event of a divorce. This structure also better ensures that assets remain in the bloodline. A child can become a co-trustee or sole trustee of his or her own trust at a responsible age, and while this may diminish some of the creditor protection planning, it permits the child to have greater access and control over the gifted assets. This is a very powerful approach that should be seriously considered given the enormous potential tax savings and the asset protection advantages.

Grantor Trusts

To obtain further tax advantages through the gifts, the dynasty trust can be structured as a grantor trust that is treated as owned by the grantor for income, but not estate, tax purposes. This permits the grantor to pay income taxes associated with trust income, thereby allowing all of the trust's income to grow on a compounded basis within the trust.

A commonly used technique in estate planning is the sale of discounted assets to a grantor trust. This sale is disregarded for income tax purposes generally and permits a donor to freeze the value of the assets sold for transfer tax purposes. To insure that the sale will be respected, assets with a fair market value of at least 10 percent of the amount sold to the trust must first be gifted to the trust as seed money. When the gift tax exemption was $1 million, no more than $10 million of assets could be sold to a grantor trust. With a $5.12 million gift tax exemption in 2012, the opportunity to transfer assets through a combined gift and sale of assets is significantly magnified.

Fractional Interest Transfers

One of the most powerful tax planning strategies involves the transfer of fractional interests in closely held businesses, real estate entities and investment partnerships. As an example, real estate owned by a limited liability company can be transferred through gifts of non-voting membership interests in the entity and the value of these gifts can be discounted to reflect the lack of control and lack of marketability inherent in the gifted interests. Discounts typically range from 20 percent to 35 percent depending on the assets owned by the entity and other factors. Assuming a 30 percent valuation discount, a nonvoting LLC interest with an underlying value of $7.31 million can be gifted to children or trusts for their benefit utilizing the $5.12 million applicable exclusion.

This approach can be used to leverage both the applicable exclusion amount and the GST exemption amount, thereby transferring more wealth than would otherwise be possible. It is possible, however, that the use of discounts will be restricted under new legislation so that this strategy should be seriously considered before year-end.

Life Insurance

Life insurance policies can be utilized to deliver significant wealth transfer tax savings. This may be even more appropriate under the 2010 Act. Clients can use a portion of the increased exemption by gifting cash to an irrevocable insurance trust, which then acquires life insurance that would then pass estate and GST tax-free. Given the uncertainty of future estate tax legislation, it may make sense to purchase insurance to create liquidity to pay potential estate taxes at death. Utilizing gifted assets to fund the purchase of insurance may be a good investment by the recipient and a powerful way to achieve significant estate and GST tax leveraging.

Gifts That Generate Gift Tax

In addition to considering gifts that take advantage of the $5 million applicable exclusion, gifts in excess of the exemption should be considered where appropriate to take advantage of the historically low 35 percent gift tax rate that applies in 2012. In 2013, the gift tax rate is scheduled to revert to 2001 rates ranging from 37 percent to 55 percent for gifts over $3 million. In addition to lower rates, paying gift taxes now has the additional advantage of removing the gift tax dollars from the taxable estate provided that the donor lives for three years after the date of the gift. Further, all appreciation and income attributable to the gifted assets will be removed from the client's taxable estate.

In 2013, the gift tax rate is scheduled to **revert** to 2001 rates ranging from **37 percent to 55 percent** for gifts over $3 million.

Potential Risks

In considering and making gifts, there are several potential issues to consider. First, the recipient will have a basis in the gifted asset equal to the donor's basis. This is generally less attractive than the "step-up" in basis, which provides the recipient of an inherited asset with a basis equal to date of death value. As an example, if an asset with a basis of $50,000 is gifted to a trust and is sold after the donor's death for $100,000, the recipient will have to pay capital gains tax on the $50,000 difference between the $50,000 basis and the $100,000 sales price.

If instead that same asset had been inherited by the recipient, and the asset was valued at $90,000 at the decedent's death, the capital gains tax would only be imposed on the $10,000 difference between the $90,000 stepped up basis and the $100,000 sales price. Therefore, to the extent possible, it makes sense to gift high basis assets.

One other issue to consider is the possible "claw back" concept. There is some concern that if a donor uses the increased exemption of $5 million (indexed for inflation) during 2011 or 2012 and the exemption is reduced to $1 million or some lesser amount in the future, the difference between the amount previously gifted and the exemption at the time of death will be brought back into the donor's taxable estate. Although it is unclear whether this "claw back" would apply, the donor in this scenario achieves the benefit of removing income and appreciation of the gifted asset, so is theoretically in a better tax position even with the "claw back."

As this article demonstrates, clearly the time is right to address rare planning options for clients. The 2010 Act has created significant tax planning opportunities that may disappear after Dec. 31, 2012.