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Gift Tax Returns - Who Should File

It is tax season again, and not just for income tax returns. The following are common situations that require the filing of a gift tax return.

1. **Gift Splitting**. Currently, each U.S. citizen or resident can give up to $12,000 per donee per year (the "annual exclusion"). With a spouse's consent, a person can give up to $24,000 to third parties and elect that these gifts are treated as made one-half by each spouse. This is called gift splitting and requires that the non-donor spouse consent on a gift tax return.

2. **Use of $1 Million Gift Tax Exclusion**. In addition to annual exclusion giving, each U.S. citizen or resident alien can gift up to $1 million during his or her lifetime without incurring a gift tax. Examples of gifts that may utilize a donor's gift tax exclusion are a gift of a residence to a Qualified Personal Residence Interest Trust ("QPRIT") or a gift of a life insurance policy to a life insurance trust where the policy has a cash surrender value in excess of the annual exclusion amounts allowed for that trust.

3. **Certain Transfers to Section 529 Plans**. Taxpayers may make gifts to a Section 529 college savings plan and value the gift ratably over five years. For example, in 2007, a taxpayer could gift up to $60,000 to a Section 529 plan gift tax free, but the taxpayer must elect to spread the gift over five years on a gift tax return.

4. **Discounted Gifts**. Gifts of certain assets, such as minority or non-voting interests in a closely held business or fractional interests in real estate, may be subject to discounts. Reporting a discounted gift on a gift tax return starts the three-year statute of limitations and is often recommended even if a gift qualifies for the annual exclusion amount and thus, would not require the filing of a gift tax return. If a gift tax return is not filed, the statute of limitations does not begin to run and therefore, the IRS can challenge the value of the gift at any time in the future.

5. **Gifts Subject to the Generation Skipping Transfer ("GST") Tax**. If a gift requires the filing of a gift tax return and is subject to the GST tax, the transfer must also be reported as a gift subject to GST tax on the return. In addition, certain gifts that may not require the filing of a gift tax return for gift tax purposes may nevertheless require the filing of a gift tax return for GST tax purposes. For example, gifts to life insurance trusts containing trusts for grandchildren may qualify for the gift tax annual exclusion but not for the GST tax annual exclusion. In such a case, the donor should file a gift tax return to allocate a portion of his or her GST tax exemption to the gift. In certain circumstances, the allocation of GST Exemption to certain gifts is automatic and therefore, does not require the filing of a gift tax return. However, these rules are extremely complicated and you should consult a tax attorney to determine whether the automatic rules apply to your situation.

6. **Gifts to a Non-Citizen Spouse**. U.S. citizen spouses can gift unlimited assets to each other under the gift tax marital deduction. However, if the spouse of a donor is not a U.S. citizen, the donor can only gift up to $125,000 per year (indexed each year for inflation) to the non-citizen spouse. This amount increased to $128,000 in 2008.

Like income tax returns, gift tax returns are due on April 15th of the year following the year the assets were gifted. If the donor died during the year, the due date may be earlier. An extension for income tax purposes automatically extends the filing date for a gift tax return. Otherwise, a Form 8892 may be filed to obtain an automatic six-month extension.

Should you have any questions, contact Mary Browning at (201) 525-6247 or mbrowning@coleschotz.com.

Life Settlements: What You Need to Know

A life settlement transaction involves the sale of a life insurance policy by the insured or other policy owner to an unrelated third party for a price in excess of the policy's cash surrender value.

The secondary market for the purchase of life insurance policies is a fairly recent development where sophisticated financial firms are the buyers. This industry is an outgrowth of the "viatical" settlements of the 1980s, when individuals with AIDS sold their life insurance policies, during their lifetimes, to have access to the sale proceeds for medical care and living expenses. A life settlement, as distinguished from a viatical settlement, simply means that the sale is not occurring because of the existence of any terminal or life-threatening illness but rather because of financial judgments about the value of the policy to a buyer.

Before there was a life settlement market for the purchase of life insurance policies, the only viable purchaser of an insured's life insurance policy was the insurance company which issued the policy. These purchases were made for a price equal to the policy's cash surrender value, if the policy had cash surrender value. There was no secondary market for the sale of term life insurance policies, and the only value that could be obtained from the surrender of a term life insurance policy would have been for the unearned premium on the policy.

Today, financial firms as purchasers seek to purchase life insurance policies on individuals and will consider paying prices in excess of a policy's cash surrender value because of certain circumstances. The policy is analyzed as a financial investment. How much will it cost to pay the premiums and what life expectancy is estimated for the insured so that the purchaser can get a good investment return from the ultimate death benefit that will be received?

It is important to note that the sellers of these policies generally are older insureds age 65 or older. To the extent, unfortunately, that the insured has had a deterioration of his or her health since the issuance of the policies, the policies become more valuable to a purchaser. Once again, the purchaser focuses upon the insured's life expectancy as the critical factor. The shorter the life expectancy, the more valuable the policy to the purchaser and the higher the price that would be paid for the policy.

Certain types of policies are more attractive to purchasers - for example, universal life guaranteed death benefit policies and term policies with favorable conversion features. Permanent policies are sometimes attractive but often the existence of substantial cash surrender value makes a policy less attractive to a purchaser, who is trying to invest the least amount of money possible to maintain the policy. Once again, the purchaser will ask whether the cost of the policy is a good investment from a return on investment or cash return standpoint.

Income tax consequences to the seller of a policy in a life settlement transaction are as follows. The price, to the extent of premiums paid on the policy, is non taxable as return of basis. That portion of the purchase price equal to the amount of the policy's cash surrender value in excess of the premiums paid, if any, is ordinary income. Any portion of the purchase price in excess of the premiums paid and cash surrender value amount is reported as capital gains.

When entering into a life settlement, the insured must agree to provide his or her medical records to a potential purchaser and must also provide access to future medical examinations. Thus, privacy issues related to medical and health matters must be understood as a precondition to such a sale.

For an individual who is not uncomfortable with a third party owning polices on his or her life, and for whom access to medical records by the purchaser would not be a problem, the life settlement should be considered very carefully. If anyone over the age of 65 is considering terminating a policy, he or she should have that policy brought to the life settlement community to determine if a life settlement would be financially advantageous.

Should you have any questions, contact Michael Forman or Gary Phillips at (201) 525-6333 and (201) 525-6328, or mforman@coleschotz.com and gphillips@coleschotz.com.

Advantages of Multigenerational Trusts

Multigenerational trusts have become increasingly popular in recent years. Multigenerational trusts, sometimes referred to as "dynasty trusts," are trusts that last for children's lifetimes, and for the lifetimes of grandchildren or more remote descendants. Multigenerational trusts can have significant tax and non-tax benefits.

I. Tax Benefits
Multigenerational trusts can be structured to apply or leverage the GST exemption at the parents' generation, and retain assets in trust for subsequent generations. While it is certainly advantageous to reduce the estate taxes that will be imposed when parents' assets pass down to children, even more dramatic tax savings can be achieved by structuring estate plans to allow assets to pass to grandchildren and even younger generations, without the imposition of estate or generation-skipping transfer ("GST") taxes.

Making sure that clients are taking full advantage of the GST exemption is an important planning objective. This can involve direct transfers of the GST-exempt amounts to grandchildren or trusts for their benefit. This approach, however, deprives the children of access to the assets. Therefore, a popular alternative is to create trusts for the benefit of each child for his or her lifetime and then on to younger generations.

If a client desires to shelter additional assets from the GST tax, the GST exemption can be leveraged using life insurance. The leveraging in the life insurance context is achieved through the allocation of the client's GST exemptions to the premium payments, rather than to the death benefit.

Multigenerational trusts can also be used to reduce state income taxes on trust assets over multiple generations.

II. Non-Tax Benefits
There are a number of non-tax reasons why clients may choose to create lifetime trusts for multiple generations. First, by leaving assets in lifetime trusts for children, rather than outright distributions, clients can maximize the likelihood that their assets will remain in the bloodline and do not pass to a child's spouse at the child's death. The trust structure also lessens the risk that assets are dissipated due to a spouse's remarriage or mismanagement of trust assets. Second, if a client lacks confidence in a child's financial experience, spending habits or good judgment, a lifetime trust can be used to permit one or more individuals designated as trustee by the client to control the monies, alone or together with the child for whom the trust was created. Another advantage of lifetime trusts is that they can be used to encourage children to maintain certain lifestyles, or to discourage negative behavior. Certain criteria, such as completion of educational levels or refraining from substance abuse, etc., can be set forth as incentives, with either cash rewards for satisfying the criteria or instructions to withhold distributions to a beneficiary who fails to satisfy the criteria.

In sum, there are numerous reasons why clients should consider the use of multigenerational trusts.

Should you have any questions, contact Steven Leipzig or Lori Wolf at (201) 525-6340 and (201) 525-6291, or sleipzig@coleschotz.com and loriwolf@coleschotz.com.

Evaluate Your Inheritance Rights

In the last year, we have observed an increase in estate litigation. The facts of each case are variations on a theme - abuse of trust, entitlement and often, greed. We have seen adult children take advantage of one or both of their parents by causing them to draft a new will when the parent no longer has testamentary capacity. We have also seen a spouse in a second marriage cause his wife to disinherit her birth children. Though it is difficult to pinpoint the reason for the increasing abuses of trust, it is important to be acutely aware of your inheritance rights.

A will contest is a challenge to a will, usually initiated by a family member or a beneficiary. Common grounds for a will contest include claims that it was improperly executed, the testator lacked testamentary capacity or it is the result of fraud, undue influence or duress.

Any person who has a legal interest in an estate of the person whose will is in question can contest the will. Generally, spouses, children, grandchildren and other family members and heirs may have standing to challenge a will. If the will is found to be invalid because it does not conform to New Jersey's requirements or because the testator was incapacitated and/or unduly influenced when it was made, it is possible that a previous will may be revived. If there is no previous will, the estate assets will pass under the laws of intestacy.

"No-contest" or "in terrorem" clauses are enforceable in New Jersey. Such penalty clauses may cause a beneficiary to forfeit his or her bequest if he or she challenges the will. New Jersey, however, allows a beneficiary to challenge a will that contains a no-contest clause and retain his or her bequest if the court determines that the challenge is based on probable cause.

If you would like us to evaluate your inheritance rights, it is important that you not delay as there are short limitation periods for contesting a will. Consequently, we will assist you in evaluating your claims and determining if an action is warranted.

Should you have any questions, contact Glenn Kazlow or Susan Usatine at (201) 525-6320 and (201) 525-6219, or gkazlow@coleschotz.com and susatine@coleschotz.com.

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