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Estate Planning for Your Family's Future: The Time to Act Is Now

By Russell J. Ressler and Tara M. Walsh

I. Introduction

With significant tax law changes scheduled to take effect on Jan. 1, 2013, time is running out for individuals to take advantage of unprecedented opportunities to transfer up to $5.12 million ($10.24 million for married couples) to family members (or others) free of federal gift tax and federal generation-skipping transfer tax. Individuals wanting to take advantage of what could be once-in-a-lifetime estate planning opportunities should consult with their estate planning lawyers before it is too late – the sooner, the better, so there is sufficient time before year-end to put the appropriate strategy in place for you, your family and your business.

II. The Current State of the Law

The Economic Growth Tax Reconciliation and Relief Act (EGTRRA) is scheduled to sunset on Dec. 31, 2012, ending Bush-era tax cuts. EGTRRA was originally scheduled to expire on Dec. 31, 2010; however, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Tax Relief Act) extended EGTRRA. In addition, the Tax Relief Act increased the Applicable Exclusion Amount for the federal gift and estate tax and the exemption amount for the federal generation-skipping transfer tax.

Pursuant to the Tax Relief Act, the Applicable Exclusion Amount for federal gift and estate tax purposes is $5.12 million ($10.24 million for married individuals) for the remainder of 2012, and amounts transferred in excess of the Applicable Exclusion Amount are subject to a 35 percent tax rate. Absent any intervening legislation between now and January 2013, the Applicable Exclusion Amount for federal gift and estate tax purposes will fall to $1 million, and amounts transferred in excess of such exclusion amount will be subject to a top tax rate of 55 percent (estates of more than $10 million are subject to a surcharge of 5 percent, making the top tax rate technically 60 percent).

In addition to the expected changes to the federal gift and estate tax law, the generation-skipping transfer tax law, which assesses a tax on transfers to grandchildren and more remote generations, is also scheduled to revert to pre-Bush era law. Pursuant to the Tax Relief Act, for the remainder of 2012, the generation-skipping transfer tax exemption amount is $5.12 million, and amounts transferred in excess of such exemption amount are subject to a 35 percent tax rate. Absent any intervening legislation between now and January 2013, the generation-skipping transfer tax exemption amount will fall

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to $1.43 million ($1 million indexed for inflation), and amounts transferred in excess of such exemption amount will be subject to a top tax rate of 55 percent.

In light of these looming changes in the tax law, these last two months of 2012 present a limited window of opportunity (perhaps to be closed forever) for individuals to make large lifetime gifts to anyone, including skip persons (i.e., grandchildren, great-grandchildren, etc.), completely free of any federal gift tax and federal generation-skipping transfer tax. Gifts may be made outright; however, there are also various estate planning strategies that can be used to maximize the significant tax savings opportunities. Some of the more frequently used strategies are discussed below.

III. Strategies to Leverage the Gifting Opportunity

The following highlights some of the estate planning strategies that can be used to leverage the opportunities available under the current federal gift, estate and generation-skipping transfer tax law.

Irrevocable Life Insurance Trusts (ILITs)

An ILIT is a trust formed for the purpose of acquiring life insurance on the grantor's life. Because the ILIT (not the grantor) is the owner of the life insurance policy, for federal estate tax purposes, the death benefit of the life insurance will be outside the grantor's estate at the time of his or her death.

During the grantor's lifetime, he or she may make gifts to the ILIT that, in turn, the trustee will use to pay the premiums on the life insurance policy. The ILIT will be structured so that gifts to it qualify for the Annual Gift Tax Exclusion (currently $13,000 per donee for a single person and $26,000 per donee for a married couple). Gifts to the ILIT in excess of the Annual Gift Tax Exclusion will use part of the grantor's $5.12 million Applicable Exclusion Amount for federal gift tax purposes to offset any gift tax. At the time of the grantor's death, the death benefit (typically many times greater than the premiums paid), will pass to the beneficiaries designated in the ILIT and will not be included in the grantor's estate for federal estate tax purposes.

As a result of the $5.12 million Applicable Exclusion Amount for federal gift tax purposes and the $5.12 million generation-skipping transfer tax exemption amount ($10.24 million for married individuals), individuals have a significant opportunity to make large premium payments upfront (i.e., perhaps even a single premium to pay up the policy) to the ILIT, free of federal gift tax and generation-skipping transfer tax.

Grantor-Retained Annuity Trusts (GRATs) and Qualified Personal Residence Trusts (QPRTs)

A GRAT is a particularly effective estate planning tool in the current economic climate where interest rates and asset values are generally low. When creating a GRAT, the grantor makes a gift to the GRAT in exchange for an annuity for a set term of years. The value of the grantor's gift is equal to the value of the remainder interest in the GRAT when the GRAT is funded. Ideally, the gift of the remainder interest should be as small as possible so that the grantor uses the smallest amount of his or her federal gift tax Applicable Exclusion Amount. At the conclusion of the GRAT term, leveraging of the Applicable Exclusion Amount is realized when the appreciation of the assets in the GRAT (i.e., the amount in excess of the IRS "hurdle rate" set at the time of the creation of the GRAT) passes to the beneficiaries, free of any additional federal estate or gift tax. For the GRAT to be effective, the grantor must survive the term of the GRAT. If the grantor dies during the term, the assets in the GRAT are includable in the grantor's estate for federal estate tax purposes.

It is important to note that the Obama administration proposed certain limitations on GRATs that may significantly reduce the effectiveness of this estate planning strategy. For instance, the administration proposed introducing a law that would require all GRATs to have at least a 10-year minimum term, which would prevent the use of short-term rolling GRATs (short-term GRATs lessen the risk of the grantor dying during the term and can be very effective in moving highly appreciating assets to the next generation). The Obama administration also proposed introducing a law that would disallow

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zeroed-out GRATs, where the value of the remainder interest (the measure of the gift) at the time of the creation of the GRAT is zero. This change in the law would result in a gift at the time the GRAT is created and, thus, the grantor would most likely be forced to use part of his or her Applicable Exclusion Amount. The administration also proposed limiting the ability to use valuation discounts for lack of marketability and minority interest when making transfers between family members, which would limit the availability of these discounts in valuing assets transferred to GRATs (as well as other planning strategies).

Somewhat similar in operation to GRATs, QPRTs may be an attractive option for individuals owning a high-value personal residence or vacation home. The QPRT involves the individual-grantor transferring his or her personal residence or vacation home to the QPRT and retaining a right to live in the property for a term of years. Upon the expiration of the term of years, the personal residence or vacation home passes outright to the children or is held in further trust for their benefit. The grantor may then turn around and lease the property back from the children or their trust (as the case may be). QPRTs may be used in conjunction with other planning strategies, but are particularly appealing for individuals who might not have other high-value assets they are willing or able to gift at this time.

Intentionally Defective Grantor Trusts (IDGTs)
Like the GRAT and the QPRT, an IDGT is an "estate freeze" strategy allowing the grantor to freeze the value of the contributed assets (often business interests or other assets likely to substantially appreciate) and thereby take advantage of low asset values in this economic climate. Through a combination of gifting and selling assets to the IDGT, the grantor may remove assets from his or her estate for federal estate tax purposes yet continue to be treated as the owner of the transferred assets for federal income tax purposes. As a result of this contrast in treatment between the income tax regime and transfer tax regime, the grantor (and not the IDGT) recognizes the IDGT's taxable income during the grantor's lifetime (essentially, making additional tax-free gifts to the trust beneficiaries); however, at the grantor's death, the assets in the IDGT pass to the IDGT beneficiaries free of any federal estate tax. The grantor trust feature also eliminates capital gains tax when the assets are initially sold to the IDGT because the grantor is effectively treated as selling assets to himself or herself.

The mechanics of the IDGT involve the grantor prefunding it with "seed money" (typically, 10 percent of the amount to be sold) and, thereafter, selling business interests (or other assets likely to substantially appreciate) to the IDGT in exchange for a promissory note. After the sale, the value of the remaining balance, if any, on the promissory note is included in the grantor's estate for federal estate tax purposes; however, the business interests (or other assets), as well as any appreciation thereon above the IRS "hurtle rate" (stated on the

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promissory note), is not included in the grantor's estate for federal estate tax purposes. Such assets will instead pass to the remainder beneficiaries of the IDGT, free of any additional federal gift or estate tax.

As with GRATs, the Obama administration proposed certain limitations that would diminish the effectiveness of IDGTs and other grantor trusts. Specifically, the administration's proposal would (i) include the assets of a grantor trust in the grantor's gross estate for federal estate tax purposes; (ii) subject to federal gift tax any distribution from the grantor trust to beneficiaries during the grantor's lifetime; and (iii) subject to federal gift tax the assets remaining in the grantor trust if at any time during the grantor's lifetime the grantor ceases to be treated as an owner of the trust for federal income tax purposes.

Also, the Obama administration's proposal to limit the use of valuation discounts for lack of marketability and minority interest when making transfers between family members would limit the availability of these discounts in valuing assets gifted and sold to an IDGT.

Dynasty Trusts
A dynasty trust is a trust formed for the purpose of existing for multiple generations and, in some instances, in perpetuity. This type of trust can exist in the form of, inter alia, an ILIT or an IDGT. A dynasty trust is a very powerful tool in that it leverages not only the federal gift tax Applicable Exclusion Amount, but also the federal generation-skipping transfer tax exemption amount.

Upon creation of a dynasty trust, the grantor may gift assets to the trust and use part or all of his or her federal gift tax Applicable Exclusion Amount to offset gift tax. The grantor will also allocate part or all of his or her generation-skipping transfer tax exemption to the gifted assets because, pursuant to the dynasty provisions in the trust, such assets will benefit multiple generations. After the exemption is allocated to the gifted assets, all such assets, including any appreciation thereon, will be forever sheltered from generation-skipping transfer tax. In addition to the tax advantages, assets held in a dynasty trust can be protected from beneficiaries' creditors for multiple generations.

The Obama administration proposed limiting the use of the generation-skipping transfer tax exemption amount to 90 years.

Spousal Lifetime Access Trusts (SLATs)
A SLAT is a trust designed to address the concern individuals might have regarding the loss of future access to assets gifted to an irrevocable trust. To establish a SLAT, the grantor-spouse creates an irrevocable trust for the benefit of the beneficiary-spouse, typically also naming their descendants as additional beneficiaries. The terms of the SLAT will provide the beneficiary-spouse with access to the gifted assets pursuant to certain distribution standards; the beneficiary-spouse may then use those assets for his or her benefit or for the benefit of the grantor-spouse. The assets are contributed to the SLAT utilizing the federal gift tax Applicable Exclusion Amount, and the assets remaining in the SLAT would not be subject to federal estate tax in either spouse's estate at the time of death. Moreover, each spouse may allocate his or her generation-skipping transfer tax exemption to the contributed assets to protect such property for future generations.

Each spouse could create a SLAT for the benefit of the other spouse. However, at least one issue to be aware of in this instance is the "reciprocal trust doctrine," which prohibits individuals from creating identical or nearly identical trusts for the benefit of each other with the effect of escaping taxation under the literal language of the tax law. To avoid the reciprocal trust doctrine, the SLATs must be drafted with sufficiently distinguishable terms.

If you would like more information about estate planning opportunities, please contact Russell J. Ressler at 484.323.1346 or rressler@stradley.com.

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IV. Claw-back: Is It a Concern?

The manner in which the federal estate tax is calculated creates the potential for what has been referred to as "claw-back." Specifically, upon death, to calculate the federal estate tax, all lifetime gifts are pulled back into the donor's estate for federal estate tax purposes; however, only the Applicable Exclusion Amount for federal estate tax purposes in effect at the time of death (and not the prior Applicable Exclusion Amount for federal gift tax purposes) is used to offset any tax generated.

> Example: An individual owning $1 million in assets dies in 2013 when the federal gift and estate tax Applicable Exclusion Amount returns to $1 million. However, the year before his death (2012), he gifted $5 million qualifying for the federal gift tax exclusion. For federal estate tax purposes, the value of his estate equals the sum of the $1 million he owned at death plus the $5 million of prior lifetime gifts, creating a taxable estate of $6 million. If claw-back applies, the federal estate tax will be calculated on $5 million – i.e., the value of the taxable estate reduced by the available federal gift and estate tax Applicable Exclusion Amount at death. The net result is that the gifted assets would not avoid federal estate tax.

Many commentators believe that claw-back is an unintended result of the legislation, and they predict that a technical correction will be made to the law to eliminate it. In any event, even if claw-back applies, clients may still benefit by making large gifts in 2012 because the value of the gift would be frozen at its 2012 value (i.e., any increase in the value of the gifted assets after the date of the gift would avoid federal estate tax in the donor's estate). Had the gift not been made and the asset later appreciated in value (quite possible, given the current economic climate), the increased value at death would be subject to federal estate tax.

V. Conclusion

The time to act is now. The remainder of 2012 presents what might be a once-in-a-lifetime opportunity for individuals to transfer up to $5.12 million ($10.24 million for married couples) before Jan. 1, 2013, completely free of any federal gift and generation-skipping transfer tax. Also, a number of estate planning strategies are at risk of soon losing some or all of their effectiveness if the Obama administration's proposals become law. Although there has been no clear pronouncement to date, many commentators believe that claw-back will not apply to 2012 gifts, in which case gifts of up to $5.12 million ($10.24 million for married couples) will forever escape federal gift, estate and generation-skipping transfer tax.

As we rapidly approach year-end, individuals should also remember to make their Annual Gift Tax Exclusion gifts for 2012. In 2012, the Annual Gift Tax Exclusion allows each individual to give $13,000 ($26,000 for married couples) to an unlimited number of individuals without triggering federal gift and generation-skipping transfer tax consequences. The Annual Gift Tax Exclusion is noncumulative, meaning that any unused exclusion does not roll over to following years. For 2013, the Annual Gift Tax Exclusion is scheduled to increase to $14,000/donee ($28,000 for married couples).

We look forward to hearing from you, before it is too late, to discuss which of these time-sensitive estate planning opportunities might be appropriate for you, your family and/or your business. ▪

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