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Client Tax Alert

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You "Built" It, So Don't Lose It!
Estate Tax Laws to Change Dramatically on December 31, 2012
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At the end of 2010, Congress passed, and President Obama signed into law, significant changes in the estate, gift and generation-skipping transfer ("GST") tax regime. The 2010 tax legislation extended the so-called "Bush Tax Cuts," but only temporarily through 2012. Beginning January 1, 2013, these tax cuts will expire and the Internal Revenue Code will revert to its 2001 status, unless there is further legislative action to make the 2010 tax changes permanent. **Absent such legislation, on January 1, 2013 the gift and estate tax exemptions are both scheduled to decrease to $1,000,000 from $5,000,000, and the maximum gift and estate tax rates will increase from 35 percent to 55 percent.**

Clients should consider whether and how best to take advantage of the 2010 tax legislation (lock in the $5,000,000 gift exemption before it is lost—**use it before you lose it**—and not wait until 2013 when it may be too late. This Client Tax Alert discusses strategies that a client can embrace to lock in the use of their $5,000,000 gift exemption before it is lost. Depending upon your financial circumstances, the nature of your assets and your intended beneficiaries, one or more of the techniques listed below may be an appropriate way to utilize this expiring gifting opportunity.

Estate, Gift and GST Rates and Exemptions Under the 2010 Tax Legislation

Under the 2010 tax legislation, the estate, gift and GST tax rates all were set at a maximum rate of 35 percent. This is a significant decrease from the 2001 rates of 55 percent. Furthermore, the 2010 tax legislation increased the amounts exempt from these taxes to $5,000,000, indexed for inflation. In addition, the IRS increased the gift tax exemption to the same amount as the estate tax exemption of $5,000,000. The amount for married couples is $10,000,000. **Under current law, until December 31, 2012, a client can make a gift of $5,000,000 without incurring any tax whatsoever. This creates several very attractive strategies for clients**.

Also worthy of note is the fact that both the Gift Tax and Estate Tax Exemptions increased to **$5,120,000** on January 1, 2012, based on the inflation index.

For those clients who have not yet used their lifetime gift exemption of $5,000,000, this a good time to consider making lifetime transfers and lock in the use of all or part of that exemption <u>before it expires on December 31, 2012</u>. This is especially attractive to clients who have real estate that has depreciated in value, or who have seen a decline in the value of their portfolios and bank accounts.

There are a number of ways to take advantage of the increased Gift and GST Tax Exemptions (and lower tax rates) before they are lost:

1. Gifts to "Spousal Gift Trust" for Spouse and/or Other Family Members

A Spousal Gift Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members. Gifting assets to such a trust removes the assets and their future appreciation from your taxable estate. If you are married, a gift to such a trust can be particularly attractive because your spouse can be the primary beneficiary of the trust. **This allows the assets to be removed from your taxable estate while still being available to your spouse**. With careful planning and some restrictions, each spouse can create and fund his or her own Spousal Gift Trust so that each can use their respective $5,000,000 gift exemption. In addition, if you choose to allocate the GST exemption to the gifts to a Spousal Gift Trust, the trust assets and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that the assets will pass free of estate taxes for two or more generations (children and grandchildren). **This Trust may also offer significant asset protection for a client and his or her family**.

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2. Gifts to "Dynasty (Legacy) Trust" for Children and Grandchildren

A Dynasty Trust is a trust that is designed to benefit multiple generations (children, grandchildren and great grandchildren) by continuing to hold property in trust for each generation with the assets in the trust not being subject to Estate Tax or GST Tax. The increased Gift Tax Exemption and GST exemption under the 2010 tax legislation present an excellent opportunity to fund a Dynasty Trust using your increased Gift Tax Exemption and allocating the GST Exemption to such gift for the benefit of your descendants. **These Trusts may also be asset protection devices.**

Most states still have statutes that require a trust to terminate within a specified period. Some states, such as Arizona, have modified or repealed these "rules against perpetuities" to allow a trust to continue either for a period significantly longer than the traditional time (21 years after the death of the last member in a named class of then living individuals) or even continue in perpetuity with no required termination. Establishing a Dynasty Trust in Arizona potentially enables three or more generations to enjoy the use and enjoyment of these assets without any Estate Tax consequences at any level, and may afford major asset protection.

3. Qualified Personal Residence Trusts ("QPRT")

A Qualified Personal Residence Trust is designed to be a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust, but retains the right to live rent-free in the residence for a specified number of years. At the end of that period, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries for a fair rental rate if he or she wishes to remain in the house. Additionally, during the term of the QPRT, as trustee of the QPRT, the owner will always have the control and decision-making authority as to whether to sell the residence in the future in exchange for another residence or otherwise.

The tax advantage of the QPRT comes primarily from the way in which the value of the residence is calculated for Gift Tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather the gift is valued based on the beneficiaries' right to receive the residence only after the specified number of years. The value is calculated based on a number of factors including the age of the donor, the number of years the donor can remain in the house rent-free, the value of the residence at the time of the gift and the IRS prescribed discount rate required for the calculation. A higher IRS discount rate produces a lower gift tax value. Although the IRS rates have been at historic lows, suppressed property values may still produce favorable outcomes. Additionally, for clients over age 65, a low IRS rate has less of an impact on the Gift Tax value.

However, no matter how a QPRT is structured to reduce the gift, the gift will still be substantial. With the increased gift exemptions ($5,000,000), QPRTs may be an appropriate gifting opportunity for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption on such a gift but now find themselves with "extra" exemption to spare.

4. Grantor Retained Annuity Trusts ("GRAT")

Because of low interest rates, the use of Grantor Retained Annuity Trusts, has become very popular. **GRATs allow you to transfer certain assets to your beneficiaries at a discounted gift tax value**. This is because you retain the right to receive payments from the GRAT for a certain number of years before the GRAT terminates in favor of your beneficiaries. The amount of the payments you can receive can be calculated so that you will be deemed to have made a "zero gift" upon funding of the GRAT. With the increased gift exemptions, clients may design a GRAT with a relatively low annual payment, while using the gift tax exemption to cover the value of the remainder interest for your beneficiaries and avoid gift tax.

In essence, the GRAT works similarly to the QPRT in that the client makes a gift of a family asset (in this case either marketable securities, bank accounts, or income producing real estate) to a trust for the benefit of their children rather than in the case of a QPRT where you make a gift of your primary residence or a vacation home. Similar to your ability to remain in your residence for specified period of time in the case of the QPRT, with the

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GRAT you will be able to enjoy much of the income that is produced from the investment securities, bank deposits and/or real estate so that your lifestyle cash flow needs will not be impacted. However, the good news is that at your death the appreciated value of those assets gifted to the GRAT will pass tax free to your heirs. During the GRAT term, as trustee of the GRAT, the client will maintain the investment decision-making authority and can sell the underlying securities for other investments.

In sum, as of the date of this alert we do not yet know what Congress will do with regard to the tax law for 2013 and beyond, but there is a strong likelihood that the exemptions for Gift and/or Estate Tax will either drop significantly as mentioned above or certainly be reduced; and, therefore the use of the Gift Tax Exemption is a **use it in 2012 or lose it** scenario.

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