Historic Tax-Saving Opportunities Set to Expire Soon

The window of opportunity to achieve significant estate and gift tax savings is soon coming to a close. **Join us for a timely 1 hour webinar discussing what steps you should consider before year-end. To register, please visit https://www1.gotomeeting.com/register/800147425.**

As you may recall from our prior communications, the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "2010 Act") postponed the sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") for 2 years and made fundamental changes to the estate, gift and generation-skipping transfer ("GST") tax laws through December 31, 2012.

In particular, the 2010 Act:

- Set the amount exempt from federal estate, gift and GST taxes at $5 million per individual and $10 million for married couples as adjusted for inflation, ($5,120,000/$10,240,000 for 2012).

- Reduced the transfer tax rates from 55% to 35%.

Current law provides the estate and gift tax exemptions will return to $1,000,000 on January 1, 2013, while the GST tax exemption will be lowered to approximately $1,400,000. In addition, the current top estate, gift and GST tax rate of 35% will rise to 55%.

Obama Administration Revenue Proposals

Another impetus for immediate action is the Obama Administration's Fiscal Year 2013 Revenue Proposals ("2013 Revenue Proposals"). The 2013 Revenue Proposals include additional potential changes that could result in increased income, estate, gift and GST taxes. Many of these proposals, if enacted, would severely limit planning opportunities for high net worth taxpayers. The following is a synopsis of the proposals:

- **Minimum GRAT Terms.** The grantor retained annuity trust ("GRAT") is a significant estate planning tool authorized under the Internal Revenue Code. Under the 2013 Revenue Proposals, GRATs funded after January 1, 2013, would be required to have a minimum term of 10 years and a remainder value greater than zero (although there is no stated minimum value). This proposal increases the possibility that the grantor will fail to survive the GRAT term with the effect that the GRAT's assets would be included in the grantor's taxable estate.

- **Limited Duration of GST Exemption.** Effective January 1, 2013, the GST-exempt status of a trust would terminate after 90 years even in states where trusts can last in perpetuity. After that time, transfers from the trust would again be subject to transfer taxation at every generational level.

- **Minimize the Benefits of Grantor Trusts.** Currently, certain irrevocable trusts (including most life insurance trusts) are treated as being owned by the grantor for income tax purposes but are not includible in the grantor's estate for estate tax purposes. This permits the grantor to pay the income tax liability on the income earned by the grantor trust, which is the equivalent of making a tax-free gift to the trust each year. At the same time, the trust assets and all appreciation are removed from the grantor's estate for estate tax purposes. The proposal calls for all grantor trusts to be included in the grantor's estate and for distributions from such trusts to be treated as taxable gifts by the grantor. Grantor trusts in existence prior to January 1, 2013 would be grandfathered. This proposal would make obsolete a powerful estate planning technique that has been utilized by practitioners for decades.

- **Valuation Discounts.** Additional restrictions are proposed that would limit the availability of certain valuation discounts. The result is expected to reduce or eliminate valuation discounts for lack of marketability and for minority interest, resulting in larger taxable gift and estate values.

Action to Take Before It's Too Late

Given the historic and unprecedented opportunities currently available to taxpayers, and that the implementation of an effective gifting strategy can take several months to complete when prepared in a thoughtful and deliberate manner, we recommend that you act as soon as possible. The discussion below highlights what you can do to attain substantial wealth preservation for yourself and your family.

Tax-Free Lifetime Giving

Depending on your circumstances, we strongly recommend that individuals and married couples make tax-free gifts of up to $5,120,000 and $10,240,000, respectively. Furthermore, because of the increased GST exemption, such gifts can be made completely free of federal transfer taxes to grandchildren, or to dynasty trusts for the benefit of children, grandchildren and future generations of descendants.

Please note, for taxpayers who are New York or New Jersey residents, lifetime gifts are doubly efficient because neither New York nor New Jersey impose a gift tax, while they do each impose an estate tax. Accordingly, lifetime gifts within the federal exemption amount reduce the federal <u>and</u> state estate taxes without any adverse gift tax consequences.

Gifting to a Trust

Rather than making outright gifts (which can subject the gifted property to claims in divorce, claims of third-party creditors, and future transfer taxes), we recommend that gifts be made in trust.

Generally, when making a gift in trust, you cannot be a beneficiary of the trust. If properly structured, however, your spouse can be a beneficiary of the trust, which may afford you sufficient comfort in gifting all or a significant amount of your $5,120,000 exemption. Although you are not allowed to control the trust's distributions, (i) your spouse may have limited powers to make distributions to himself or herself and to your other family members, and (ii) you and your spouse may have some control over the identity of an "independent trustee" who could have full power to make discretionary distributions to your spouse and family members. You and your spouse can also retain the right to remove and replace the trustee.

If making a significant gift, even if a spouse is a beneficiary, still causes some concern about your financial security, you might consider establishing a trust where you are a discretionary beneficiary. If the trust is governed under the laws of one of fourteen states it could, under the right circumstances, result in exclusion from your taxable estate even though you may benefit therefrom.

Selection of Assets for Gifting

There is no single type of asset that is best to use in making gifts. Gifts of cash are generally easy to make, are definitive as to value and have no built-in appreciation. However, if you have illiquid or low-basis assets (such as real estate, artwork or family business interests) you might consider the following techniques:

- **Gifting Illiquid Assets.** Illiquid assets such as artwork, a vacation home or investment real estate can be gifted. Gifts of non-income-producing assets may be preferred because they do not affect your current cash flow. In addition, it may be possible to discount the value of gifts of illiquid property due to transferability restrictions and minority discounts. The value of these discounts should be determined by a professional appraiser.

  Potential disadvantages of gifting illiquid assets are that (i) in order to establish the fair market value of the gifted property you will likely need to hire a professional appraiser; (ii) as valuation becomes more subjective, the IRS becomes more likely to challenge the reported value; and (iii) your beneficiaries will take a carryover income tax basis in the gifted property, so potential capital gains on an eventual disposition of the illiquid asset should be considered.

- **Making Intra-family Loans.** Alternatively, family members can make loans to each other at interest rates lower than those available through a bank, and the borrowed funds could be used to make large gifts. For example, for a nine-year loan made in August, an annual interest rate as low as 0.88 percent can be charged without triggering adverse gift tax consequences.

Conclusion

In the current environment of a heated presidential election and a fiscal deficit, we do not know how and when Congress will act, assuming that Congress will act at all. However, given the historic opportunities set to expire on December 31, 2012, as well as the 2013 Revenue Proposals limiting and restricting the effectiveness of current estate planning tools (if enacted), we urge you to act now. Please let us know if you would like to discuss your options.

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