Schulte Roth & Zabel

Alert

Unique Gifting Opportunities Through the End of 2012

November 4, 2011

Tax legislation passed at the end of 2010 temporarily lowered the federal estate, gift and generation-skipping transfer ("GST") tax rates to 35 percent, increased the federal estate tax exemption from $3.5 million to $5 million, and increased both the federal gift and GST tax exemptions from $1 million to $5 million. The new law presents taxpayers with valuable wealth transfer opportunities, but only until Dec. 31, 2012, which is when this tax legislation is scheduled to expire. In addition, IRS interest rates are currently near all-time lows, making estate planning techniques that benefit from a low interest rate particularly attractive. In order to take advantage of these changes in the tax law, as well as historically low interest rates, you may wish to implement one or more of the planning techniques discussed in this *Alert* before the end of 2012.[1]

Currently, the Congressional Joint Select Committee on Deficit Reduction (commonly known as the "Super Committee") is considering various ways to increase revenue, which may include modifying the current wealth transfer tax laws. There is speculation that these changes might include reducing the federal gift tax exemption amount to $1 million, increasing the current gift and estate tax rates and modifying the grantor retained annuity trust ("GRAT") and intra-family discount rules. These changes could take effect as early as Dec. 31, 2011 (and, while less likely, as early as Nov. 23, 2011, the date on which the Committee is scheduled to announce its proposal). Although these rumored changes are not based on any concrete information, we suggest contacting us as soon as possible should you be interested in hearing more about the gifting opportunities described in this *Alert*.

Tax Law Changes
Consider making gifts in 2011 and 2012, while transfer tax rates are low and transfer tax exemptions are high.

- **Increased Exemption, Lower Tax Rate**
    - Currently, a married couple can make aggregate gifts of up to $10 million (and an individual can make gifts of up to $5 million), reduced by prior taxable gifts, without paying any federal gift tax. Since we do not know what the federal gift tax exemption and the federal gift tax rate will be after 2012, you may wish to consider making substantial gifts in 2011 and 2012 while the lifetime gift tax exemption is $5 million and the federal gift tax rate is only 35 percent. This federal gift tax exemption is in addition to the $13,000 that you can give to an unlimited number of people each year free of federal gift tax.
        - The assets you transfer now, together with the income and appreciation earned on those assets in the future, will not be taxed in your estate.
        - The federal gift tax rate is scheduled to revert to 55 percent in 2013 (from 35 percent now). To the extent that you wish to make gifts in excess of your current $5 million

[1] The tax laws discussed in this *Alert* apply only to persons who are citizens or residents of the United States.

exemption, you should consider making these gifts this year or next year while the federal gift tax rate is only 35 percent. In addition to paying gift tax at a historically low rate, the gift tax paid (assuming you live for at least three years after making the gift) and all of the future appreciation on the gifted asset are removed from your estate.

- **Tax Savings Over Multiple Generations**
  - Now is also a good time to consider transferring assets into a long-term GST-exempt trust (discussed below), to remove them from your estate while preserving them for future generations.
    - A long-term GST-exempt trust will enable you to transfer assets that will benefit your family and ultimately pass to your grandchildren or more remote descendants free of federal GST and estate taxes.
    - Although the trust may provide the trustees with discretion to make distributions to your children and your spouse, the assets are typically preserved for grandchildren and more remote descendants to keep them from being further taxed in your children's estates.
    - However, if your financial situation changes in the future, the trustees will have the authority to distribute trust funds to the spouse-beneficiary, if desirable at that time.
    - A married couple establishing GST-exempt trusts today can shield assets worth up to $10 million (plus all future appreciation) from wealth transfer taxes for approximately 100 years in New York, or in perpetuity in certain other jurisdictions.
    - In addition, the trust can be structured as a "grantor trust" for income tax purposes, so that you (rather than the trust) will pay taxes on trust income and capital gains. Under current law, by paying these taxes you will, in effect, be making additional tax-free gifts to the trust.
- **Potential Clawback?**
  - Because of the uncertainty about whether Congress will allow the federal gift tax exemption to revert back to $1 million in 2013, there is some concern that gifts made in excess of $1 million in 2011 or 2012 could be "clawed back" and taxed in the donor's estate. Whether this "clawback" tax is likely to occur is unknown at this time. However, even with a clawback tax, the donor's estate would likely benefit. Since only the amount of the taxable gift would be included in the donor's estate (as opposed to the value of the gifted property at the time of the donor's death), any appreciation on the gifted property would not be taxed.

Historically Low Interest Rates
With IRS interest rates at near all-time lows, now is a good time to consider estate planning techniques such as intra-family loans, GRATs and sales to irrevocable grantor trusts, which generate the most transfer tax savings when IRS interest rates are low.

- **Intra-Family Loans**
  - An intra-family loan is a simple and effective estate planning tool for transferring wealth to children or grandchildren without gift tax. When you make a loan to a family member, you must charge interest in order to avoid making a gift; however, these loans can be made at interest rates considerably lower than those available for commercial loans. To the extent that the family member earns a higher rate of return on the borrowed funds than the very low interest rate being paid, the excess is transferred to him or her free of gift taxes.
    - For example, if you loan $2 million to your child for nine years beginning in October 2011 at the IRS-required interest rate of 1.19 percent and your child earns an annual rate of return (combined income and appreciation) of five percent on the $2 million during the loan term, you will have essentially transferred $884,000 to your child free of gift tax by the end of the nine-year term.

- **GRATs**
    - A GRAT is a trust which pays the grantor an annuity amount for a term of years which is calculated based on the value of the property initially transferred to the trust plus the IRS-prescribed interest rate. After the term of years, any property remaining in the GRAT is distributed to, or held in trust for, one or more designated beneficiaries. The taxable gift is equal to the fair market value of the property transferred to the GRAT, less the present value of the annuity payments that the grantor will receive from the GRAT. Lower interest rates increase the present value of the annuity payments, which reduces the value of the taxable gift of the remainder interest. Any appreciation of the GRAT's assets in excess of the IRS interest rate (1.4 percent in October 2011) will pass to the GRAT's beneficiaries free of gift or estate tax.
        - For example, if you create and fund a five-year GRAT in October 2011 with $2 million of non-discounted assets, you will make a taxable gift of $0.59 and receive an annuity payment of $416,953 for five years. Assuming the assets grow at eight percent per year and you outlive the five-year term, almost $500,000 will be transferred to the GRAT beneficiaries with no additional gift tax. If the assets are discountable, even more wealth can be transferred to the beneficiaries tax efficiently.
        - As has been the case in recent years, Congress is considering enacting legislation which would impose a mandatory minimum 10-year GRAT term and prohibit so-called "zeroed out" GRATs in which the value of a grantor's retained interest is equal to the value of the property transferred to the trust, resulting in a zero gift tax. To date, Congress has not adopted any legislation which imposes such limitations on new GRATs. However, there is some concern that if restrictive GRAT legislation were adopted, it might apply retroactively to any GRATs created on or after Jan. 1, 2011. Since GRATs have historically been one of the most attractive estate planning tools, if you are considering this technique, please communicate with us so that we can discuss whether GRATs would still be appropriate in your particular situation.
- **Sales to Irrevocable Grantor Trusts**
    - A sale to a grantor trust involves creating and funding an irrevocable trust and then lending it money to buy one or more of your assets — such as securities, real estate or a business interest — that you expect to appreciate significantly. In return for lending money to the trust, you receive interest payments for a set number of years at the IRS-prescribed interest rate. Once the assets are sold to the trust, all future appreciation on those assets is removed from your estate and shielded from future estate or gift taxation.
        - For example, assume that you use your increased federal gift tax exemption to transfer $5 million to an irrevocable grantor trust for the benefit of your descendants. (The trust must be funded with sufficient assets to make it a credit-worthy borrower.)
            - Assume you then sell $50 million of your assets to the trust in return for a nine-year note with a balloon payment of the principal at the end of the nine-year term and interest payable annually at the rate of 1.19 percent (annual mid-term rate for October 2011).
            - Assuming the trust assets appreciate at a rate of five percent per year, approximately $28.7 million would remain in the trust for the benefit of your descendants at the end of the nine-year term.
            - In addition, since the trust is structured as a "grantor trust" for income tax purposes, you will not pay income taxes on the interest payments you receive from the trust. Also, as discussed above, you will in effect be making additional tax-free gifts to the trust by paying income and capital gains taxes on the trust's behalf.

Review Estate Plan

- Many wills and revocable trusts include a provision creating a trust (an "exemption trust") that will be funded with the <u>maximum</u> amount that can pass free of federal estate or GST tax at the person's death. Given the new estate and GST tax regime with the increased federal estate and GST tax exemption amounts for 2011 and 2012 (i.e., $5 million), you should review your estate plan and your finances to determine whether it is appropriate for you and your spouse to fund your respective exemption trusts with the maximum exemption amount (or possibly a lesser amount), if the exemption remains at a high level.

- Funding an exemption trust with the maximum amount available can result in unintended consequences as follows:
    - The "residuary beneficiaries" under your will or revocable trust are the persons or entities who will receive the property in your estate in excess of the amount that is needed to fund your exemption trust. Therefore, if you maximize the exemption trust under your will, you might leave your residuary beneficiaries with little, if any, property, depending upon the value of the property passing under your will. For example, if a husband dies (survived by a wife) with an estate worth $6 million and his will provides for the maximum funding of his exemption trust and for the remainder of his estate to be distributed to his wife, the wife will receive only $1 million in her own name and the balance of the husband's estate will pass to the exemption trust, of which the wife may only be a permissible beneficiary (or may not benefit at all).
    - In addition, by maximizing the funding of your exemption trust, your estate might incur a significant state estate tax if you live in a state which has a state estate tax exemption amount which is less than the federal estate tax exemption amount. For example, the New York estate tax exemption is currently $1 million, which means that if a New York resident elects to fund his or her exemption trust with the full $5 million federal exemption amount, the estate will incur a New York estate tax of approximately $444,000. The current Connecticut and New Jersey estate tax exemption amounts are $2,000,000 and $675,000, respectively. In many estates, the benefit of sheltering an additional $4 million from federal estate tax will still be tax efficient. However, this should be examined in light of your particular personal and financial situation.

Please contact your attorney at Schulte Roth & Zabel at your earliest convenience if you wish to discuss these or other gifting opportunities as they may apply to your specific financial and personal situation since these valuable transfer tax opportunities will expire at the end of 2012 and, in some instances, may be very beneficial to implement well in advance of that deadline.

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