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Estate Planning Opportunities During 2012 Before the Clock Strikes 2013 – *Use It or Lose It?*



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The year 2012 provides a huge opportunity for estate planning for wealthy individuals that may be lost forever when the clock strikes January 1, 2013.

On Dec. 17, 2010, President Obama signed into law “The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010” (“TRA 2010”). TRA 2010 ushered in sweeping changes to the Federal estate, gift and generation-skipping transfer (“GST”) tax systems. Among other things, TRA 2010 unified the estate, gift and GST lifetime exemption amounts at \$5 million for the years 2011 and 2012, with this amount to be indexed in 2012 – the

2012 indexed amount is \$5,120,000.¹ TRA 2010 also established a maximum tax rate of 35%.² It moreover ushered in the portability of lifetime exemption amounts between spouses for estate and gift tax (but not GST tax) purposes for the years 2011 and 2012.

The critical point here is that TRA 2010 is essentially a “two-year patch” that will expire on December 31, 2012. This means that unless Congress takes further action, then come January 1, 2013 the tax laws that existed back in 2001 – including the \$1 million Federal estate, gift and GST tax exemptions,³ and the 55% top estate, gift and GST

tax rates – will come roaring back into effect.

Because it is impossible to predict when Congress will act and what form such legislation may take, the year 2012 presents a unique opportunity for estate planning that may be lost forever once the clock strikes January 1, 2013.

So what estate planning techniques should be considered for wealthy individuals during 2012?

1. Making Tax-Free Gifts of Up to \$ 5,120,000 per Individual (\$10,240,000 per Married Couple) in 2012

The simplest and most obvious gifting technique for

wealthy individuals during 2012 – but which absolutely should not be overlooked – is to make tax-free gifts of up to \$5,120,000 per individual (up to \$10,240,000 per married couple). Even individuals who previously exhausted their \$1,000,000 gift tax exemption before TRA 2010 was enacted now have the opportunity to gift another \$4,120,000 (or \$8,240,000 in the case of a married couple). These gifts can also be made to grandchildren or more remote descendants (or to trusts for their benefit) without incurring a GST tax, due to the increased GST exemption of \$5,120,000 per individual (\$10,240,000 per couple) now available for multi-generational estate planning.⁴

Taxable gifts are particularly advantageous for residents of states like New York that impose a state estate tax but not a state gift tax, because the gift can remove the property gifted from the New York State estate tax base as well. The way this works is as follows. New Yorkers can now gift \$5,120,000 free of both Federal and New York transfer taxes. If, instead, a New Yorker bequeaths that same \$5,120,000 to children

under a Will, there will be no Federal estate tax, but there will be New York estate tax of \$405,200, because the New York estate tax exemption is only \$1,000,000. By making the lifetime gift an individual will save \$405,200 of New York estate tax, while a married couple will save \$810,400 of New York estate tax.

To the extent that the property gifted is an interest in a closely-held entity or a fractional interest in real property, valuation discounts for lack of control and lack of marketability would generally apply. This would allow an individual to “pack” even more value into the expanded lifetime exemption amount.

In addition, the expanded lifetime gift tax exemption can even be used on a “cashless” basis. One potential use of the increased \$5,120,000 Federal gift tax exemption is for individuals who have outstanding loans to their children (or to trusts or entities for their benefit) to forgive such loans during 2012. However, given the near-historic low rates on intra-family loans (discussed below) it may be desirable to

continue certain loans, or at least refinance them.

2. Grantor Retained Annuity Trusts in 2012

The “grantor retained annuity trust” (“GRAT”) can offer, in certain circumstances, an excellent planning opportunity to transfer the growth potential of assets without paying gift or estate taxes and without incurring any significant tax risks. It would be particularly suitable in 2012 in the case of hard-to-value assets where there is concern that the lifetime \$5,120,000 / \$10,240,000 gift tax exemption amounts may otherwise be exceeded (including in the event of an IRS gift tax audit).

The basic GRAT is essentially simple: the grantor transfers property into an irrevocable trust (the GRAT) for a specified number of years, retaining the right to receive an annuity (a fixed amount payable not less frequently than annually). Upon termination of the GRAT, the trust assets are paid to the remaindermen named by the grantor, typically his or her children, or to a trust of which the grantor’s spouse and issue are beneficiaries.

In essence, the grantor creates a GRAT to transfer its *remainder* at termination. This transfer is a taxable gift that is deemed to occur upon creation of the GRAT. The remainder is valued for tax purposes by subtracting the interest retained by the grantor—the annuity—from the value of the initial transfer into the GRAT. The Internal Revenue Service (“IRS”) requires that the value of the retained annuity be calculated on an actuarial basis using an assumed interest rate published by the IRS under Section 7520 of the Internal Revenue Code that is in effect for the month that the GRAT is funded. For October 2012, the Section 7520 rate is 1.2%.

The tax benefit of the GRAT therefore arises if the investments held in the GRAT *outperform* the assumed interest rate used in the gift tax calculations. In this event there is a tax-free transfer to the extent of that extra performance from grantor to remaindermen because the *actual* value of the remainder at termination will be greater than the value that was calculated for gift tax purposes.

What if the investments held in the GRAT underperform the assumed interest rate? This will cause the actual value of the remainder at termination to be less than the value used for gift tax purposes. The common way to address this threat is to minimize the taxable gift at the creation of the GRAT to close to zero. By adjusting the duration of the GRAT, the payout of the annuity and other provisions (for example, the annuity can increase by up to 20% from year to year), the grantor may be able to create a GRAT where the gift tax value of the retained annuity interest is almost equal to the initial value of the GRAT. In this manner, the grantor makes only a very small gift upon creation of the GRAT. If the investments held in the GRAT prove disappointing, the grantor will have lost little.

The benefits of a GRAT can only be fully realized if the grantor survives the trust term. If the grantor dies during the term of the GRAT, a portion of the GRAT will be included under Section 2036 in the grantor’s gross estate for Federal estate tax purposes.⁵ Although the GRAT will not have achieved its purpose, the tax result

will be no worse than had the grantor done nothing, provided that the GRAT contains appropriate contingent provisions to utilize fully the Federal estate tax marital deduction, if applicable.⁶

It is important to note that the existing rules that make GRATs so attractive in 2012 may change in the future. Various bills requiring that the minimum annuity term of a GRAT be ten years have been introduced in Congress.

3. Intra-Family Loans in 2012

Another technique that works very well in the current low interest rate environment is an intra-family loan. Each month the IRS publishes interest rate tables that establish the lowest rate that can be safely used for loans between family members without producing a taxable gift. The short-term rate for loans of up to three years is 0.28% for May 2012. The mid-term rate for May 2012, for loans of over three years but not over nine years, is 1.30%. The long-term rate for loans exceeding nine years is 2.89%. It will often be possible to consolidate or refinance existing intra-family loans to take

advantage of these near-historic low interest rates.

Making a loan to a trust for one's children may be even more advantageous than making a loan outright if the trust is intentionally structured as a grantor trust for income tax purposes, as further discussed below. Ordinarily, the interest payments on the promissory note must be included in the lender's taxable income. However, if the payments are made by a grantor trust, they will have no income tax consequences whatsoever.

4. Interweaving "Intentionally Defective Grantor Trusts" into the Planning to Utilize the \$5,120,000 / \$10,240,000 Lifetime Gift Tax and GST Tax Exemptions in 2012

Consideration should also be given to interweaving an "intentionally defective grantor trust" ("IDGT") into the estate planning to maximize the leveraging potential of the expanded \$5,120,000 / \$10,240,000 lifetime gift tax and GST tax exemptions available in 2012.

An IDGT is an irrevocable trust for which one of the

"grantor trust" provisions set forth in IRC §§ 671-679 is triggered.⁷ Transfers by the grantor to the IDGT will be complete for gift tax (and estate tax) purposes but incomplete for income tax purposes. Therefore, if the trust is drafted properly, the income and gains of the trust will be taxable to the grantor, but the assets transferred to the trust by the grantor will be excluded from the grantor's gross estate upon death. Further, the grantor's payment of income taxes attributable to the trust will not constitute a gift for Federal gift tax purposes because the grantor is discharging his own legal obligation.⁸ In addition, transactions between the grantor and the grantor trust will not be taxable events.⁹ These tax benefits, of course, are all on top of the wonderful asset protection and property management benefits that trusts can provide.

In addition to making outright gifts to an IDGT, a person can further leverage his or her \$5,120,000 / \$10,240,000 lifetime gift tax and GST tax exemptions by selling property to the IDGT that he or she expects to appreciate substantially in value in exchange for the

trustee's promissory note. To provide additional leverage, this can be structured as a balloon note with interest payable annually but with no payments of principal due until the note matures. This has the important benefit of reducing the use of the grantor's lifetime gift tax exemption. An initial gift of "seed money" to the trust of about 10% to 15% of the amount of the transfer is generally recommended so that the IRS respects the promissory note as debt.

As a result of grantor trust status, (i) the sale transaction will not be a taxable event, and (ii) interest income on the trustee's promissory note will be disregarded for Federal income tax purposes.¹⁰ The full value of the trust would be excluded from the grantor's estate for estate tax purposes, although the outstanding principal amount of the trustee's promissory note (if any) at the time of the grantor's death would generally be included in the grantor's estate for estate tax purposes. The growth in the value of the property sold to the IDGT in excess of the interest rate on the trustee's promissory note (as determined under IRC §

1274(d)) effectively transfers wealth to the trust free of transfer tax. Moreover, the income generated by such property would remain taxed to the grantor for income tax purposes, allowing for the tax-free build-up of wealth within the trust outside of the grantor's taxable estate.

The clock may be ticking, however, on estate planning with grantor trusts as well. President Obama's proposed fiscal year 2013 budget includes a proposal that would dramatically dampen the use of grantor trusts in estate planning. The proposal, if it were to become law, would only apply to trusts created after the date of enactment, so one may proceed to create a grantor trust at this time. However, the proposal, as currently written, would also apply to additions made to existing grantor trusts after the date of enactment. Accordingly, it is very important that the IDGT contain flexible provisions to permit the termination of grantor trust status if warranted.

5. Interweaving Interests in Closely-Held Entities into the Estate Plan

Finally, the ability to leverage

the \$5,120,000 /\$10,240,000 lifetime gift and GST tax exemptions available in 2012 can be even further enhanced by transferring interests in a family limited partnership or a family limited liability company to junior family members or to an IDGT established for their benefit.

A family limited partnership (a "FLP"),¹¹ if properly structured and administered, can provide significant tax and nontax benefits to senior and junior family members in appropriate circumstances.¹² These transfer tax savings are attributable to discounts in the value of limited partnership interests, or limited liability company membership interests, that are transferred to junior family members or to trusts (generally IDGTs) established for their benefit. These valuation discounts reflect the relative lack of marketability and lack of control associated with such interests.

Where, however, the decedent has retained too much control over the FLP's operations (particularly with respect to the ability to direct entity distributions), or has retained the possession or enjoyment of,

or the right to the income from, the entity's property, the property transferred to the FLP may be subject to inclusion in the decedent's gross estate without any discounts under Section 2036 of the Internal Revenue Code. Accordingly, the advice of counsel experienced with FLPs should be obtained (1) before embarking on establishing such entity, or (2) if the entity has already been established, to provide recommendations on how the FLP's structure or administration may be improved.¹³

Conclusion

The combination of the expanded Federal gift and GST tax exemptions, together with low property values and near-historic low interest rates, makes 2012 a watershed year for estate planning. Like all good things in life though, it will not last forever – in this case, it may all come to a screeching halt come January 1, 2013. Accordingly, wealthy individuals would be well advised to consider the various estate planning techniques discussed in this article well in advance of the year end to allow sufficient time to implement them.

¹ TRA 2010 also retroactively restored the estate and GST tax systems as of January 1, 2010 (although subject to an “opt out” for 2010 decedents for purposes of the estate tax). In addition, under TRA 2010, the lifetime gift tax exemption amount was maintained at \$1 million in 2010 before being raised to \$5 million in 2011.

² A notable exception to this is that GSTs occurring during 2010 were instead subject to a *zero percent* tax rate.

³ The GST exemption amount is subject to indexing and would actually be closer to approximately \$1,400,000.

⁴ The annual exclusion gifting amount remains at \$13,000 (or \$26,000 if spouses elect to split gifts) in 2012. This is in addition to the exclusion for direct payments of tuition and medical expenses for gift tax and GST tax purposes. See IRC §§ 2503(e), 2611(b).

It should be noted that, although highly unlikely as a practical matter, there is a school of thought that gifts of the entire increased lifetime gift tax exemption amount could potentially pose a risk of recapture or “clawback” if the estate tax applicable exclusion amount is subsequently reduced below \$5,120,000 in the case of a decedent who has gifted away \$5,120,000 or more during his or her lifetime.

⁵ See Treas. Reg. § 20.2036-1(c)(2) (the portion of the GRAT that is includible in the decedent’s gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to yield the decedent’s retained annuity, taking into account the Section 7520 rate in effect at the date of death).

⁶ This may be done by requiring that, following the grantor’s death survived by a spouse, the trustee shall pay annually to the holder of the annuity interest (*e.g.*, which may be the trustee of the QTIP trust pursuant to the grantor’s estate plan) the *greater of* the amount of the GRAT annuity or the income of the GRAT.

⁷ For example, grantor trust status may be triggered under IRC § 675(4)(C) if the trust agreement provides that any person acting in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity, may exercise the power to reacquire the trust corpus by substituting other property of an equivalent value. The IRS confirmed in Rev. Rul. 2008-22 that the grantor’s retention of this substitution power does not constitute a retained interest for estate tax purposes under Sections 2036 or 2038 provided that adequate fiduciary safeguards are in place to ensure the grantor’s compliance with the terms of this power. See also Rev. Rul. 2011-28 (extending this safe harbor to life insurance for purposes of IRC § 2042).

⁸ See Rev. Rul. 2004-64.

⁹ See Rev. Rul. 85-13.

¹⁰ See Rev. Rul. 85-13.

¹¹ References to “family limited partnerships” are intended to include both limited partnerships and limited liability companies (as well as other similar entities) in which family members hold the partnership or membership interests.

¹² There should be a substantial nontax purpose for establishing the FLP. This can include any of the following: (1) a joint investment vehicle for partners or members; (2) the centralized and active management of assets; (3) asset protection; (4) facilitating an investment strategy that expressly permits the retention of portfolios that are heavily concentrated in particular assets or classes of assets; (5) facilitating the establishment of a voting block through the pooling of partners’ or members’ voting securities of a particular issuer; (6) facilitating the raising of capital from third parties; and (7) providing a mechanism to ensure the submission to arbitration of any intra-family disputes subject to strict confidentiality provisions.

¹³ See Kevin Matz, *Special Concerns in FLP Planning Where Both Spouses Are Living*, 34 Estate Planning 1, at 16 (Jan. 2007).

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