2012: Estate Planning Opportunity of a Lifetime

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the Act) set the stage for a once in a lifetime opportunity to pass wealth to future generations.

Under the Act, the exemption amounts or amounts that can pass free from estate, gift, and generation-skipping transfer (GST) taxes are at the highest that they have ever been. At the same time, the Act reduced the gift, estate and GST tax rates to the lowest that they have ever been. This combination of exemption amounts and low rates creates a fantastic estate planning opportunity.

Time is running out because these historically high exemptions and low rates are set to expire on December 31, 2012 unless congressional action is taken soon. If and when they expire, the exemption amounts and tax rates will return to those in existence in 2001.

Since it is impossible to predict whether Congress will act in time to prevent the return of lower exemption amounts and higher rates, individuals who desire to pass maximum wealth to future generations should act now to take advantage of the current exemption and rate situation.

Gift Taxes

Under the Act, the current gift tax exemption amount is $5.12 million. Thus, a husband and wife can make gifts of up to $10.24 million without paying gift tax, depending upon whether or not they had previously made taxable gifts. Moreover, gifts in excess of those amounts would only incur gift tax at a 35 percent rate.

Without congressional action before the end of the year, the gift tax exemption amount will revert to $1 million on January 1, 2013. This means that beginning next year, a husband and wife will only be able to make gifts of up to $2 million without incurring gift tax. Gifts in excess of those amounts would incur gift tax at rates as high as 55 percent.

The price of waiting. Under the present exemption amount, an individual is able to make a gift of $5.12 million (assuming the individual had not previously made taxable gifts) without triggering any gift tax. However, beginning on January 1, 2013, reverted gift tax rates will trigger $2,111,000 in gift tax for that same gift amount if the current, lower rates are all let to expire.

GST Tax

The GST tax is designed to prevent individuals from avoiding gift and estate taxes by either (1) making gifts directly to their grandchildren and more remote descendants or, (2) establishing trusts for their children that are structured so that the trusts' assets are not subject to estate tax when a child dies.

The GST tax exemption amount is the maximum amount that can be transferred to future generations without triggering the GST tax. Under the Act, the GST tax exemption amount for 2012 matches the gift tax exemption amount, or $5.12 million. The GST tax rate is also the same as the gift tax rate, 35 percent.

As with the gift tax, the GST tax exemption amount is set to expire at the end of the year, reverting to the exemption amount in existence in 2001, which was $1 million adjusted for inflation. As a result of the inflation adjustment, it is predicted that the GST tax exemption amount in 2013 will be $1.4 million if today's amounts expire on December 31, 2012. Likewise, the GST tax rate will return to that which was in existence in 2001—55 percent.

The price of waiting. Under the present rules, a grandparent who had not previously used any gift or GST exemption is able to give $5.12 million outright to a grandchild without incurring gift or GST tax. After December 31, 2012 and without renewal of the current rules, that same gift would cost $3,236,000 in gift tax and $2,046,000 in GST taxes for a total tax of $5,282,300. In other words, the combined tax would exceed the amount of the gift.

Estate Tax

For individuals who are or become deceased in 2012, the estate tax exempt amounts and rates match those for the gift and GST taxes, a $5.12 million exempt amount and a 35 percent rate. Note that the gift and estate tax exemptions are "unified," which means that using a gift tax exemption will reduce the available estate tax exemption. In other words, if an individual makes a $1 million taxable gift, the estate tax exempt amount upon that person's death in 2012 would be $4.12 million.

What to Do

Act Now

Amid the uncertainty in congressional, one thing we do know is that without any movement to extend the exemptions, today's favorable exemption amounts and rates will disappear on January 1, 2013. Given this indecision, individuals should consider acting now to take advantage of the historic exemptions and rates.

How to Make a Gift

There are many ways to make a gift. In some cases, for example, outright gifts of cash or securities to family members may make sense. However, in most cases, the use of trusts and other techniques can maximize the benefit that is passed to future generations. Trusts can also be used to mitigate any concerns that might otherwise arise if the cash or securities were gifted outright.

As discussed above, the GST tax exemption amount is presently historically high. Rather than making an outright gift, gifting to a trust structured to last for multiple generations would allow that same $5.12 million (or $10,240,000 for a married couple) to potentially avoid any future estate, gift or GST taxes.

To take further advantage of the exemption amounts, individuals should consider gifting assets such as closely-held stock or limited liability company interests whose values are subject to minority and lack of marketability discounts. If an individual has interests in a business that is expected to have a liquidity event (whether due to a sale or IPO) even in the next couple of years, making a gift now may be a tremendous opportunity. This makes 2012 an ideal year to make gifts of interests in the family business.

To pass even more wealth, and after funding a trust, the donor may agree to sell additional assets to the trust worth as much as nine times the value of the assets in the trust at the time of the sale. Thus, a trust funded with $5 million could purchase up to an additional $45 million in assets. Not only would the sale of the asset not trigger gift or GST taxes, but the transaction may also be structured so as not to trigger income taxes through the sale of the assets—which would allow donors to take advantage of today's historically low interest rates. For example, for a transaction closing in June 2012, the annual interest rate on a 20 or thirty 30-year promissory note would only be 2.64 percent.

Finally, a trust's performance can be further enhanced by structuring the trust as a "grantor trust." As a grantor trust, the donor of the gift is treated as the owner of the trust's assets for income tax purposes and as such, is responsible for the income taxes attributable on the trust's income. Under current rules, the payment of the income taxes on the trust's income is not considered an additional gift. Thus, from the trust's perspective, the trust's assets grow on a tax-free basis. Of course, it is not truly tax-free growth as the donor still pays the income taxes. For this reason, grantor trusts are typically structured so that the "grantor trust" status can be "turned off" if the tax burden on the donor becomes too high, or the donor becomes unwilling to pay the taxes.

What if I need the assets in the future?

Generally, a person should only make a gift if he or she is certain that they will not need the assets in the future to maintain his or her lifestyle, because gifts are irrevocable. However, if an individual with sufficient assets makes a gift, is able to maintain his or her lifestyle, but is still concerned about what would happen if there was a significant downturn in his or her financial affairs, it is still possible for a married person to make a gift in a manner to mitigate those concerns.

For a married couple, it is possible to take advantage of certain gifting techniques while retaining the ability to use the gifted assets if necessary. To do so, trusts should be structured so that it is possible for the trust to make distributions to the donor's spouse. That way, if there is a downturn in family fortune, distributions may be made from the trust to the spouse in order to weather the downturn. Of course, this only works as long as the spouse is alive and cooperative. Also, it is possible for husband and wife to establish trusts that allow distributions to each other; however, in that event it is necessary to structure the trusts so that they do not violate the reciprocal trust rules. Another technique that could be considered in certain situations is the use of a beneficiary intentionally defective irrevocable trust, which is essentially a third-party settled trust that combines the benefits of a traditional intentionally defective grantor trust and also gives the beneficiary (who is both trustee and the initial primary beneficiary of the trust) control and enjoyment over the trust property without sacrificing the trust's ability to avoid estate and GST taxes at the beneficiary's death.

Risks

Aside from the aforementioned advantages, individuals should likewise be aware of the handful of risks associated with making gifts now.

One possible risk is the possibility that Congress could retroactively lower the exemption amount or increase the tax rates for gifts made in 2012. It should be noted that such a retroactive change seems unlikely in an election year and would almost certainly face a constitutional challenge.

There are also specific risks related to some of the more advanced gifting techniques discussed above, although, those risks are beyond the scope of this article.

If you are interested in discussing whether or not this historic opportunity to pass wealth to future generations makes sense in your circumstances, please contact **Robert P. Tiplady** at 734-214-7644, **Michael G. Cumming** at 248-203-0740, **Frederick H. Hoops** at 616-776-7556, or one of the listed Dykema estate planning attorneys.

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