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Client Alert

Making Hay Before the Sun Sets - 2012 Lifetime Gifting Opportunities

Dear One and All:

This current calendar year without a doubt presents the greatest opportunity to sidestep federal estate and gift taxes that we have seen in our lifetimes. Congress has presented wealthier taxpayers with an opportunity to give away unparalleled dollar amounts, while also announcing that it will close the window on this opportunity at the end of the year. We have no way of knowing whether it will actually shut the window, close it part way, or leave it open. But for folks who can afford to do so, it makes sense to take advantage of the open window while we know it is available.

Executive Summary

- The gift and estate tax "exemption" is to drop in 2013 from $5,120,000 to $1,000,000.
- The tax rate is to increase in 2013 from 35% to graduated rates up to 55%.
- There is a window in 2012 to shift substantial assets at no current tax cost and possibly no tax cost ever.
- Taxpayers whose wealth is (or may grow) above the $1,000,000 mark should consider 2012 gifting.
- The key is determining how much, and what kind, of assets one might comfortably part with.
- Structuring trusts with indirect access "safety valves" can ease the natural qualms of

gifting significant sums.

- Waiting to act until the end of the year is unwise, but one can retain flexibility through a temporarily revocable trust to adjust to any 2012 tax legislation.

- One might even retain flexibility into 2013 through a disclaimer arrangement.

Evolution of Present Gifting Opportunity

The present open window arises out of the strange history of the federal estate and gift taxes over the past decade. The 2001 Bush-era tax cuts had reduced the top estate and gift tax rates and increased the effective "exemption" amounts in stages over the course of the decade. Those reductions were to culminate in a total repeal of the tax in the year 2010, but with a reinstatement in 2011 of the tax at its pre-2001 structure. The latter "sunset" provision was included for some baldly political/budgetary reasons. The 2010 Tax Act preserved the estate and gift tax in its then-current form and deferred the "sunset" of the tax cuts for another couple of years, to 2013.

If one takes federal tax laws as written at face value, the changes slated to take effect from 2012 to 2013 (and thereafter) are drastic. They may be summarized as follows:

	2012	2013
Top gift, estate and GST rate	35%	55%*
Gift and estate tax "exemption"	$5,120,000	$1,000,000
GST tax exemption	$5,120,000	$1,360,000**

*Plus an additional 5% estate tax bump for taxable estates between $10 million and $17.174 million

**Approx. amount, subject to further adjustment based on inflation factor

This is the source of the advice to consider making hay before the sun sets.

Benefits and Detriments for 2012 Gifting

Based on this tax-law background, it may be said that gifting in 2012 presents at least four potential benefits:

- An opportunity to shift substantial assets out of one's taxable estate at no current transfer tax cost.
- A hedge against the possibility that the exemption amount might be reduced later, eliminating such gift opportunity in future years.
- A potential opportunity to permanently avoid any transfer tax on the excess of the gifted amount over any future reduced exemption amount, if Congress abstains from

imposing an estate tax "clawback" (as described further below).

- For Massachusetts taxpayers, an additional benefit of avoiding Massachusetts estate tax on the gifted assets (given the absence of any Massachusetts gift tax).

The advantages of 2012 gifting are amplified in many cases by current low values and, for some strategies, by current low interest rates.

Irrespective of the considerable advantages to gifting in 2012, such gifting cannot be considered a "no-brainer" in all circumstances. One always has to take into account the capital gains effect of the loss of a basis step-up at death, especially for low-basis assets. Even given that detriment, such gifting is almost a no-brainer for very wealthy individuals who can easily afford to give away the full $5.12 million (or $10.24 million for two spouses). Moderately wealthy individuals might wisely give away an amount that continues to leave them feeling financially secure. That might even include certain individuals in the "bubble" between $1 million and $5.12 million, who might make gifts as a hedge against any future decrease in the exemption amount. Individuals below the $1 million mark probably have little tax reason to make gifts, except if they expect significant future increases in their wealth.

Moreover, there remain considerable political uncertainties regarding the dollar amount of the "exemption." It would be unprecedented in the history of the estate tax for Congress to reduce the amount of the exemption, but in principle it could do so. No one knows for sure how the estate tax would work in the face of such a reduction. In particular, no one knows what effect the exemption decrease would have on the computation of the estate tax, given that it is computed cumulatively with essentially all lifetime gifts. Many would consider it politically difficult for Congress, in the calculation of the estate tax, to tax gifts at death that had been tax-free under a higher exemption at the time of the gift. But it is not beyond the realm of possibility. This is the so-called "clawback" issue. From a global tax viewpoint, however, it appears that a taxpayer really has nothing to lose under any clawback. The gifted assets otherwise would have been subject to estate tax anyway, and current gifts would still exclude further appreciation from the tax base.

The one issue that one does need to address is to make sure that the tax on any clawback is borne by the proper party. It is possible that the lifetime gift triggering the clawback was given to one party, but another party (or parties) is receiving the estate assets and therefore will be bearing the burden of the estate tax. In the case of such divergent gifts, the burden of the tax should be managed through appropriate tax apportionment provisions or, perhaps, through a net gift arrangement (making the donee contractually liable for transfer taxes on the lifetime gift).

Mitigating the "Pain" of Parting with Assets - Safety Valves

Aside from any such tax risks, in all cases a taxpayer needs to determine how much he or she can comfortably part with. In many cases, it will be easier to part with non-income-producing and/or illiquid assets. Such assets might not be missed as much as, say, income-generating securities.

Many of us would be more comfortable in parting with assets if the arrangement includes an appropriate "safety valve," permitting some kind of back door access to the gifted assets, if one really needs them. There are indeed some legitimate ways to include such a safety valve through a trust arrangement.

Traditionally, in Massachusetts and in most states, a gift to a trust would not be treated as "completed" for tax purposes if the trustees had any discretion to make distributions back to the donor. Rather than being treated as a completed gift, the assets would remain includable in the donor's taxable estate. That is because under state law the donor's creditors might have access to such a self-settled trust to the maximum extent of such trustee discretion. In principle, the donor might run up debts freely, knowing that his creditors could be satisfied from the trust assets. So the donor himself would have retained indirect access to those assets. Although there is some tax authority (cases and rulings) suggesting that this result does not always apply, it does not seem wise to rely upon this contrary tax authority for planning purposes. However, it might be possible to give a party other than the trustees a power to add the donor to the list of eligible beneficiaries at some time after the inception of the trust.

A more reliable way to effect a completed gift to a self-settled trust would be to create the trust under the laws of a state which expressly exempts such a trust from creditor claims. These states include Delaware, Rhode Island, and New Hampshire. For this purpose, one probably needs a connection with that state, such as a trustee located there.

We should note that payments back to the donor would work against all the tax planning, by re-including the gifted assets in the donor's taxable estate, but the safety valve aspect can be reassuring.

A married couple might obtain benefits similar to a self settled trust, without the bother of trekking to another state, by writing in the donor's spouse as a permissible beneficiary, instead of the donor. This is the so-called "spousal limited access trust" (or "SLAT"). If need be, trustees could make distributions to the spouse, who would be free to return these assets to the donor without income or transfer tax consequences, provided that the donor is a U.S. citizen.

A SLAT, like any estate-planning arrangement, carries with it certain risks. The obvious risk is of marital disharmony or even divorce. The tax laws present another, subtler risk if each spouse creates a trust for the other. This risk resides in the so-called reciprocal trust doctrine, which provides for cross trusts to be uncrossed, treating the spouse as if he or she had created a self-settled trust for his or her own benefit. Reciprocal trust status can be avoided by varying the trusts as much as possible. Variations can include:

- Different powers of appointment
- Different standards of payment
- Allowance or prohibition of use trust conversions
- Different trustee appointment and removal provisions
- Different assets
- Different dates of trust creation

Under a SLAT, without more, the donor would lose even indirect access to the trust assets upon his or her spouse's death. As frosting on the cake, it may be possible to add the donor as a permissible beneficiary after the spouse's death. Of course, including the donor as a permissible beneficiary under the terms of the original trust document, even on a deferred basis, still presents the tax risks of any self-settled trust. However, as before, the donor might later be introduced as a permissible beneficiary through the action of some non-trustee party. That action might include a spouse's exercise of a limited testamentary power of appointment. Though there are issues even here, there is authority which suggests that this arrangement should be effective.

Getting It Done in Time, but with an Escape Hatch

Planning for 2012 gifts remains subject to all of the uncertainties of Washington politics. These uncertainties suggest the desirability of playing for as much time as possible. Waiting until December to decide whether to make gifts, however, is ill-advised. Planners will be busy, and some plans take some time to construct and implement. A better idea would be to make a present gift into a trust which is revocable until the end of December 31. The planning than could easily be reversed should Congress act by the end of the year to make it moot. Of course there is a considerable likelihood that Congress will not act until 2013, when it may fix the law on some retroactive basis. Donors desiring extended flexibility might make gifts to trusts which are expressly disclaimable (e.g., by the trustees) at any time within nine months of the trust's creation. Although the trustees would have to act very carefully to avoid any action which would undercut their ability to disclaim, the disclaimer provision could extend planning flexibility well into 2013.

This letter is intended to provide you with general guidance regarding the current opportunities of gifting in 2012. It is not intended to provide you with specific advice. If you have any questions or concerns about your own situation, we would urge you to call us. We would be happy to review your situation with you.

Very truly yours,

Ken

Kenneth P. Brier

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