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Re: <u>Donor's Remorse – Reversing 2012 Gifts</u>

Dear One and All:

Like Wile E. Coyote chasing the Road Runner through the Badlands, Congress launched us all over the fiscal cliff at the end of 2012 and then scrambled us back from mid-air to the safety of the plateau, seemingly in defiance of the laws of gravity. The American Taxpayer Relief Act of 2012, passed by Congress on January 1, 2013 (but retaining "2012" in the title), was made retroactive, putting us back in a position as if we had never gone over the cliff at all.

General Retention of 2012 Status Quo for Estate and Gift Taxes

In particular, the 2012 Act left the estate and gift tax laws virtually unchanged. The only substantive change to the 2012 status quo was to set a maximum tax rate of 40%, as opposed to the maximum rate of 35% that had been in effect in 2012 (and as opposed to a top 55% rate that otherwise was supposed to go in effect on January 1). The new maximum rate of 40% applies to amounts in excess of $1 million. Significantly, the unified credit "exemption" amount, which had been slated to drop from $5 million to $1 million, was fixed back at $5 million. Adjusted by an inflation factor, that exemption amount is set at an actual amount of $5.25 million for 2013. Since that amount exceeds the $1 million bracket for the 40% tax rate (by a lot), we essentially have a flat 40% gift and estate tax rate for any transfers that will actually be subject to tax.

Possible Undermining of Impetus for 2012 Gifts

The possibility of a steep decline in the exemption amount had prompted a lot of wealthier citizens to make substantial gifts in 2012. Like many tax planners, I had suggested that making such a gift could be a good idea for wealthier individuals, as a hedge against a possible detrimental "sunsetting" of the favorable Bush-era tax cuts. Many of you may recall a client alert that I sent out last June captioned "Making Hay Before the Sun Sets – 2012 Lifetime Gifting Opportunities."

For many wealthier individuals, their 2012 gifts still make a lot of sense, for the reasons that lifetime gifts have always often made sense, most notably as a way to eliminate future appreciation in value from the transfer tax base. Some individuals, however, may now suffer from a sense of donor's remorse, especially individuals who now might feel that their estates are unlikely to ever surpass the $5 million federal tax threshold ($10 million for married couples). The remorse might be particularly acute when one factors in the loss of a potential step-up in tax basis that might otherwise apply to low-basis assets upon the death of an owner.

Invocation of "Safety Valves" for Gifts

Like many estate planners, I had consistently suggested that any individuals making 2012 gifts seriously consider incorporation of one or more "safety valves" in the planning to permit an easy exit, should that later seem desirable. To be effective for estate and gift tax purposes, any 2012 gift would have to have been irrevocable, but as any good estate planner appreciates, "irrevocable" is not always as absolute as it seems. Even if the planning did not include an explicit "safety valve," there still may be legitimate ways to exit from the gift.

For a lot of reasons, anyone thinking about reversing a 2012 gift should look to act upon that thought as soon as possible. As time elapses, reversing a gift can become more difficult to accomplish, and at some point it may become impossible to accomplish. So I thought that I might now recap some of the ways in which a 2012 gift might be undone.

1. Self-Settled Trusts. Some gifts might have been structured as a transfer to a so-called "self-settled" trust, under which the donor had written himself in as a permissible beneficiary. For some complicated reasons related to the interaction of federal tax laws and state creditor laws, such a transfer would constitute a completed gift only in a limited number of states (and certain foreign jurisdictions). Massachusetts is not one of these so-called "domestic asset protection trust" states, but a trust could have been written invoking the law of a more permissive state or jurisdiction. In that case, the donor might now go hat-in-hand to the disinterested trustee to request a distribution of the trust assets back to himself. The trustee would not be under any obligation to comply with such a request, but perhaps the trustee might be sympathetic if the trust is no longer serving its intended purpose.

2. Spousal Limited Access Trusts. A close relative of a self-settled trust would have been a spousal limited access trust (SLAT), under which the donor's *spouse* is the permissible beneficiary. The transfer to such a trust should have constituted a completed gift in *any* state. In this case, it is the spouse who could issue a request to the disinterested trustee to distribute out the trust assets.

3. Disclaimers. Substantive law has long held that no person is required to accept a gift that he or she does not want. Think of the proverbial gift of a white elephant. Because acceptance is an essential element of the gift, if the recipient does not accept the gifted property, there is no gift. This rule of substantive law has been incorporated into federal tax law. A transfer of gifted assets back to a donor is *not* treated as a gift again from the intended recipient, if the re-transfer is made pursuant to a "qualified disclaimer." The most important requirement for a qualified disclaimer is that it be made within nine months of the date of the original transfer. (Though federal law provides a possible extension for a recipient under age 21, the disclaimer would still need to satisfy state requirements, and Massachusetts law provides no such extension.) Other requirements: the disclaimer must be in writing, the recipient must not have accepted the property or any of its benefits, and the disclaimed property must then pass to a person other than the intended recipient without any direction on the part of such intended recipient.

In the case of a gift which was made to a trust, the question arises whether a disclaimer is properly made by the beneficiaries or by the trustee (or trustees). A 1988 decision of the Massachusetts Supreme Judicial Court, *McClintock v. Scahill*, explicitly held that the trustees had a power to disclaim a gift to the trust, without the involvement of the beneficiaries. This should be good law for any Massachusetts trust. The *McClintock* case, however, does not give the trustees carte blanche to execute disclaimers. The Court stipulated that general fiduciary requirements – that the trustees act in good faith with the best interests of the trust's beneficiaries in mind – still applied. This raises the issue of when a disclaimer would ever be in the best interests of the beneficiaries (assuming that the gift is not one of environmentally-tainted property or of a white elephant). In *McClintock* the Court was persuaded that family would enjoy superior estate tax results, taking into account both the husband's and the wife's estate plans, if a gift upon the husband's death was disclaimed. That tax-saving argument might not hold water in all cases, though it might be supportable if a 2012 gift to a trust is not providing its intended tax benefits and the trust meanwhile may be incurring otherwise avoidable administrative expenses. In a less clear-cut case, the trustees might be well advised to obtain the consents of the beneficiaries.

Given the strict conditions which apply to making any qualified disclaimer for tax purposes, the longer the period of time that elapses, the greater the chance that some disqualifying event may intervene. So if the parties decide to go the disclaimer route, they should embark upon it as soon as possible.

4. Repurchase of Gifted Assets. In some cases, the donor might not be able to totally undo the gift. She might be able to obtain some of the desired results, however, by repurchasing the gifted assets. Such a repurchase might be made either for cash or for a promissory note, or for some combination of both. Obviously this would not remove the value that had been given to the recipient (or recipients). However, it could be useful if the donor decides that the gifted asset is a desirable one that she now prefers to retain. More pointedly, she might decide that it is important to retain the gifted asset to obtain a step-up in basis upon death. As a tax matter, however, such a repurchase works only if the recipient is a grantor trust with respect to the donor. If the trust is so classified, then the repurchase is treated as a non-event for income tax purposes, eliminating the triggering of any capital gain upon the trust's sale back to the donor. A repurchase from any other kind of third-party would be treated as a taxable sale.

This letter is intended to provide you with general guidance. 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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