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Temporary Estate, Gift and GST Tax Laws Provide Unprecedented Opportunities in 2012

BY RENEE M. GABBARD, LISA M. LAFOURCADE & MEGAN S. ACOSTA

It appears that the current favorable estate, gift and generation skipping transfer (GST) tax laws may remain in effect until December 31, 2012 -- despite earlier rumors of an accelerated 2011 expiration date. These laws provide significant opportunities for wealth transfer at a reduced tax cost. We are advising our clients to take advantage of these laws in 2012 because there simply may not be another opportunity to transfer up to $5 million per person ($10 million for a couple) in tax-free gifts or to make taxable gifts at the current low 35 percent gift tax rate.

This Paul Hastings Client Alert focuses on year-end planning techniques as well short-term opportunities available under the current state of the gift, estate and GST tax law.

Current Gift, Estate and GST Tax Law

On December 17, 2010, President Obama signed into law a two-year tax compromise for gift, estate and GST taxes as follows. Such law is scheduled to expire on December 31, 2012 without interim Congressional action.

	2011 (Exemption Amount, Tax Rate)	**2012** (Exemption Amount, Tax Rate)	**2013 Without Interim Congressional Action** (Exemption Amount, Tax Rate)
Estate Tax	$5 million, 35%	$5,120,000, 35%	$1 million, 55%
Gift Tax	$5 million, 35%	$5,120,000, 35%	$1 million, 55%
GST Tax	$5 million, 35%	$5,120,000, 35%	$1 million, 55%

The current tax rate for the estate, gift and GST tax is 35%, with an exemption of $5 million per person ($10 million per married couple). On January 1, 2012, the gift, estate tax and GST exemption amounts will be indexed for inflation, for the first time in history, to $5,120,000 per person ($10,240,000 per married couple). Beginning on January 1, 2013, however, without interim congressional action, the gift, estate and GST tax exemption amounts will revert to the previously high tax rate of 55%, with an exemption of $1,000,000 per person ($2,000,000 per married couple). It is unlikely that any significant changes to the estate, gift and GST taxes will be made prior to the 2012 presidential election.

Under the current law, the estate and gift tax exemption amounts are "portable" between spouses. Surviving spouses may use the predeceased spouse's unused estate tax exemption amount to make additional lifetime gifts and estates of decedents may apply the predeceased spouse's unused estate tax exemption amount. This new "portability" law is also set to expire on December 31, 2012 without interim Congressional action.

Gift Tax Exclusions

Certain gifts continue to be excluded from the lifetime gift tax exemption. The current annual gift tax exclusion amount will remain at $13,000 in 2012. Clients seeking to reduce their estates for estate tax purposes could gift $13,000 ($26,000 for married couples) in 2011 and again in 2012 to an unlimited number of donees without such gifts reducing their lifetime gift tax exemption under Internal Revenue Code Section 2053. Annual exclusion gifts can be used in connection with certain advanced estate planning techniques involving irrevocable lifetime insurance trusts and irrevocable "grantor" trusts for children and grandchildren.

Annual exclusion gifting must be completed on or before December 31st each year.

Payments for tuition and medical expenses made directly to educational and medical institutions on behalf of individuals such as children and grandchildren continue to be excluded from the lifetime gift tax exemption. Similarly, gifts to charitable organizations can be made in unlimited amounts without reducing the gift or estate tax exemption amounts.

Remember Crummey Notices

Most clients with Irrevocable Life Insurance Trusts ("ILIT") need to provide a Notice of Gift to Trust to the beneficiaries upon making gifts to the ILIT. The instructions included in the memorandum that clients received at creation of the ILIT should be carefully followed in order to help minimize taxes.

Also keep in mind that the annual gift tax exclusion amount in 2011 is $13,000 per donee. A person making gifts to a beneficiary of an ILIT should keep track of the total gifts to that beneficiary – both gifts made directly to the beneficiary and gifts made to the ILIT. If the total gifts to such beneficiary exceed $13,000 in 2011, the excess gifts may count towards that person's $5,000,000 lifetime gift tax exemption amount and must be reported on a federal gift tax return.

IRS Publishes New Form 8939 for Estates of 2010 Decedents

Under the 2010 Tax Relief Act, executors of estates of individuals who died in 2010 were given a choice between the previous 2010 tax regime of no estate tax with a modified carryover basis (subject to certain adjustments) and the 2011 tax regime of an estate tax at a 35% top rate and a $5 million exemption with a stepped-up (or down) basis for all assets. The 2011 estate tax rules automatically will apply unless the executor elects to apply the alternative 2010 law ("Section 1022 Election"). If the executor has opted to make the Section 1022 Election, the executor must file the recently published Form 8939 for estates of 2010 decedents by January 17, 2012.

The decision to make the Section 1022 Election will depend on the valuation of the decedent's assets as of the date of death and the decedent's basis in such assets. For estates valued at $5 million or less, an executor normally would not make such an election and, instead, would take advantage of the $5 million estate tax exemption and the full step-up in tax basis for the decedent's assets.

For an estate larger than $5 million, however, the analysis is more complex. Under a Section 1022 Election, no estate tax is imposed, however, all property acquired from the decedent acquires a basis equal to the lesser of the decedent's basis or fair market value as of the date of death, with the following exceptions. First, Section 1022(b) allows an executor to allocate up to $1.3 million to increase the basis of assets with unrealized gains. Second, the basis of property which is directed to a spouse outright or in a qualified terminable interest property trust (QTIP trust) can be increased by an additional $3,000,000.

If the estate is comprised mostly of high basis assets, the limited step-up in tax basis allowed under the Section 1022 Election may be sufficient to prevent the recognition of future capital gain income. If the estate is comprised of mostly low basis assets, however, an analysis between estate and capital gains taxes under the 2010 rules and the 2011 rules will be important.

If the executor decides to make the Section 1022 Election, the executor will need to complete and file Form 8939 – including allocating the limited basis increases to the decedent's assets – no later than January 17, 2012. Once the executor's basis allocation is made, it can only be changed with the consent of the IRS.

Low Interest Rates + Low Values = Unique Wealth Transfer Opportunities

The current low interest rate environment presents unique wealth transfer opportunities that allow entrepreneurs, private equity investors, and high net worth individuals the opportunity to pass large amounts of wealth to children, grandchildren and charities, gift and estate tax-free.

Due to the current interest rates and discounting opportunities, 2012 is an ideal time to gift (i) assets which have recently depreciated in value if such assets are expected to experience future appreciation, and (ii) hard-to-value assets including closely held business interests.

Intrafamily loans, family limited partnership planning, short-term grantor retained annuity trust planning and sale to grantor trust transactions continue to provide substantial benefits for our clients.

Intrafamily Loans to Grantor Trusts

The interest rate cuts issued by the Federal Reserve have affected two important interest rates used in estate planning – the "applicable federal rates" ("AFRs") under Internal Revenue Code Section 1274 and the "7520 rate" under Internal Revenue Code Section 7520. AFRs are calculated and published by the IRS every month and represent the minimum rates of interest that must be charged to debt instruments to avoid imputed interest for gift and income tax purposes. The 7520 rate is also calculated and published each month by the IRS and represents the interest rate used to calculate the present value of term interests, life interests, annuities and remainder interests.

The AFR rate for December 2011 for a mid-term note is only 1.27%. The 7520 rate for December 2011 is 1.6%. This is up from a 7520 rate in November of only 1.4%.

The simplest way to take advantage of current low interest rates for estate planning purposes is through the use of intra-family loans. Typically, a parent (or other family member) loans money to a "grantor trust" created for a child or grandchild. Transactions between the parent and a "grantor trust" are ignored for income tax purposes, but a grantor trust is still a separate legal entity for estate and gift tax purposes. Thus, a grantor trust provides an estate planning benefit because the income tax consequences are similar to the grantor making a gift-tax free transfer of the income taxes to the grantor trust each year – thus allowing the assets in the grantor trust to grow undiminished by income

tax payments. In exchange for the loan to the grantor trust, the parent receives a promissory note for the amount loaned, plus interest at the AFR corresponding to the month that the loan was made and for the length of time of the note. The payment terms under the note may be flexible.

For example, a promissory note given in December 2011 for 9 years would carry an interest rate of 1.27% and could require only interest payments until the maturity date at which time the entire note would become due and payable. If the trustee of the grantor trust for the child or grandchild, can invest the borrowed funds and achieve a greater rate of return on the investments over a period of 9 years than the 1.27% interest rate on the note, the grantor trust for the child or grandchild will retain the excess and will have done so gift and estate tax-free.

Because transactions between the grantor trust and the parent are ignored for income tax purposes, the parent does not have to report the interest received on the note as income, nor is there an interest deduction for the grantor trust. Both the grantor trust for the child or grandchild and the promissory note should be adequately documented. There should be a real expectation of repayment to avoid an argument by the IRS that the transaction is really a disguised gift.

Family Limited Liability Company Planning

A family limited liability company is commonly used to transfer wealth for gift, estate and GST tax purposes. Typically, such an LLC is formed and funded with the family's business interests, hard-to-value assets or assets subject to liability risk. Over time, parents can make gifts of a percentage of their ownership interest in the family limited liability company to grantor trusts for their children or grandchildren. Due to the closely held business nature of the LLC, the ownership interests transferred are often subject to a significant discount for gift tax purposes.

In addition to outright gifting of family limited liability company interests, such interests are transferred to future generations through certain advanced estate planning transactions, discussed below.

Grantor Retained Annuity Trust ("GRAT") Planning

A GRAT is a trust codified by Internal Revenue Code Section 2702 commonly used to transfer the appreciation on assets from parents to children without incurring federal gift or estate tax.

A GRAT involves transferring property that is expected to appreciate significantly over time – such as a closely held business, pre-IPO stock or a private equity investment – to a GRAT trust instrument. In return, the individual who established the trust (the "Grantor") receives an annual annuity payment for each year the GRAT is in existence. The amount of the annuity payment is based on the value of the assets transferred to the GRAT, the number of years the GRAT will exist, and the applicable interest rate mandated by the IRS (known as the Section 7520 rate). At the end of the GRAT term, the assets remaining in the GRAT may be transferred to trusts for the children.

Many GRATs are limited to a term of 3-7 years because the success of a GRAT depends on two risk factors: (1) whether the Grantor survives the term of the GRAT (the "mortality risk"); and (2) whether the assets transferred to the GRAT outperform the 7520 rate (the "investment risk"). If the Grantor dies during the term of the GRAT, some value of the GRAT assets may be included in the Grantor's estate for estate tax purposes – thus reducing the tax benefits of the GRAT. As a result, GRATs are often structured with certain terms in order to minimize the mortality risk.

A shorter 3-7 year GRAT is also used to overcome the investment risk. For example, if a parent owns pre-IPO stock or other investment which is likely to increase rapidly in 3-7 years, the appreciation, through the GRAT trust, can be transferred from the parent to the children. For a longer term GRAT, however, the investment risk increases. If the assets contributed to the GRAT lose value or do not outperform the Section 7520 rate over a longer period of time, such as a 10-year term, there will be no assets remaining in the GRAT at the end of the term to transfer to the children.

Sale of Assets to Grantor Trusts

A very similar estate planning technique that works well in an environment of low interest rates is a sale of assets to a grantor trust. Closely held business owners, including family limited liability company owners, and private equity investors are typical clients for sales to grantor trusts. In a typical sale transaction, the parent/grantor "sells" an asset that is expected to appreciate over time to a grantor trust for a child or grandchild in exchange for a promissory note.

Ideally, the asset is an income-producing asset and the income on the asset is used to pay off the note during the term. The promissory note is usually structured as a 9 year interest-only note with a balloon payment at the end of the 9th year. Thus, the interest rate that would apply to such a note would be the mid-term AFR for the month of the sale. If the assets of the grantor trust allow for the payoff of the note and further appreciation, then the appreciation of the asset in the grantor trust for the benefit of the children or grandchildren at the end of the note's term is transferred free of gift tax.

There is also no capital gain recognized by the parent/grantor when the assets are sold to the grantor trust (for income tax purposes, the sale is treated as being made between the parent and himself or herself). Because of the fairly long term of the note, it is reasonable to expect that the investment return of assets sold to the grantor trust will be greater than the note's low interest rate.

There are several potential pitfalls to be aware of when utilizing this sale technique. First, if the parent/grantor dies during the term of the promissory note, the unpaid portion of the note will be included in the estate of the parent/grantor. Also, it is important that the grantor trust is adequately capitalized before the sale in order for the transaction to be respected by the IRS. This must often be done through a "seed" gift by the grantor to fund the trust (if the trust does not already have adequate assets). There is also more cost for sales to grantor trusts rather than a straight loan of cash to a grantor trust. The asset sold must be professionally appraised to establish the sale price. The documentation for the sale is similar to the sale of a business and will require a purchase and sale agreement, a pledge of security, title transfers and other documentation.

To access prior Paul Hastings Client Alerts regarding additional wealth transfer opportunities, please visit: http://www.paulhastings.com/publicationslist.aspx.

Conclusion

We strongly recommend that our clients review their existing estate plans and contact us to discuss the impact of the current transfer tax laws on their planning and the significant wealth transfer opportunities for them and their families in 2012.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Orange County

Renee M. Gabbard
1.714.668.6214
reneegabbard@paulhastings.com

Lisa M. LaFourcade
1.714.668.6203
lisalafourcade@paulhastings.com

Douglas A. Schaaf
1.714.668.6221
dougschaaf@paulhastings.com

Megan S. Acosta
1.714.668.6288
meganacosta@paulhastings.com

New York

Edward Peck
1.212.318.6840
edwardpeck@paulhastings.com