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The 2010 Tax Act, Gifts, and Perpetual Dynasty Trusts - The Perfect Estate Planning Combination

by Richard M. Morgan & Loraine M. DiSalvo

One of the many provisions of the tax law which became effective on December 17, 2010 (the "2010 Tax Act") was a provision which effectively created federal gift and generation-skipping transfer ("GST") tax exemptions[1] of $5,000,000 for each individual U.S. citizen or U.S. permanent resident. Another provision made these exemptions subject to indexing for inflation beginning in 2012, under which they increased to $5,120,000 each as of January 1, 2012. These gift and GST tax exemptions are now significantly higher than they have ever been (for example, as of December 31, 2009, the gift tax exemption was $1,000,000 and the GST tax exemption was $3,500,000, and both the gift tax and GST tax exemptions were even lower in years before 2009). When combined with the generally depressed state of asset values and ultra-low interest rates which exist in the current economy, these historically high exemptions create a wonderful window of opportunity for those who wish to be able to transfer significant wealth to their loved ones without significant wealth transfer taxes. However, this window of opportunity is set to close after December 31, 2012 (a mere eleven months from now), since the rules put into effect by the 2010 Tax Act were only temporary. Under the current law, the wealth transfer tax rules created by the 2010 Tax Act are scheduled to expire, and as of January 1, 2013, the gift and estate tax exemptions are scheduled to drop to $1,000,000 each, with a GST tax exemption rate of somewhere in the neighborhood of $1,120,00, with adjustments for inflation since 2003.

Some of our 2011 newsletters addressed the reasons why 2011 and 2012 would be the "golden gifting years." This newsletter will focus on a relatively unknown estate planning technique which can maximize the benefits of these golden gifting years: the "Perpetual Dynasty Trust."

One of the issues addressed by estate planning is how to move assets from the current owner to the owner's loved ones while reducing negative consequences, including the burden of the "wealth transfer" taxes which can apply when assets move from one person to another (the gift, estate, and GST taxes). Prior to the 2010 Tax Act, the relatively low exemptions associated with the wealth transfer taxes imposed fairly tight limits on the ability to transfer significant wealth without incurring transfer taxes. As stated above, the 2010 Tax Act's changes to the wealth transfer taxes greatly increased the exemptions, which also greatly increased the amount of assets which can be transferred during life or at death without wealth transfer taxes. However, because these changes are temporary, the only way at this time to ensure that a person and his loved ones are able to actually benefit from the increased exemptions without the person having to actually die is for the person to make lifetime gifts, effectively locking in the increased exemptions. If no lifetime gifts are made and the exemptions decrease in the future as scheduled, the opportunity to use the current high transfer tax exemptions could be lost forever.[2] In addition, gifts may become generally less potentially beneficial in the future as the economy recovers and asset values and interest rates rise with the recovery. As a final added incentive to make gifts now, rather than waiting until another year, the government continues to consider making various unfavorable changes to the wealth transfer tax laws, to limit the potential benefits of a

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number of existing strategies. For these reasons, 2012 stands out as potentially the best year ever to consider and make large lifetime gifts.

If you decide to go ahead and make gifts during 2012, there are many strategies to consider, and the strategies you select should be the ones which best fit your particular situation and goals. However, in many situations, one particular strategy, used alone or in combination with other strategies, may offer the best chance for you to maximize the benefits of your gifts for your loved ones. This strategy is the Perpetual Dynasty Trust.

In the past, each state had a law called the “Rule Against Perpetuities.” The Rule Against Perpetuities is based on very old English court cases. The Rules place fairly strict limits on the period of time for which a trust can exist, and effectively mean that a trust has to provide for its own termination every so often (generally, every 90 years or so, under the modern version of the Rule which applies in many states). Beginning in the 1990s, however, a number of states repealed or modified their Rules Against Perpetuities, resulting in the possibility for creating very long term trusts (such as ones lasting for 360 years) or truly perpetual trusts. A “Perpetual Dynasty Trust” generally means a trust which is set up in a state which has either repealed its Rule against perpetuities completely (such as Delaware, Alaska, and South Dakota) or modified its Rule so that trusts can last for hundreds of years (such as Tennessee and Florida with 360 years and Nevada with 365 years). The intent of a Perpetual Dynasty Trust is for the trust to continue as long as the law and its assets allows.

Why would you want to set up a trust which may last for hundreds of years or longer, well beyond the period of time when you will be alive? A trust can be an incredibly beneficial and protective way to transfer assets to your loved ones. A trust can allow beneficiaries to have fairly extensive control over their assets; such as holding powers of appointment, which can let the beneficiaries direct the way the assets benefit their own loved ones. At the same time, a trust can still provide protection for the assets which pass to the beneficiary - protecting the assets from a beneficiary’s creditors, the beneficiary’s spouse in the event of a divorce, predatory persons who may want to take advantage of the beneficiary, and future wealth transfer taxes. To maximize these benefits, you want the trust to have significant assets at its creation, and you want the trust to be fully exempt from the GST tax, so that there are no transfer tax consequences as the assets move from generation to generation. The current high gift and GST tax exemptions, along with the availability of very long term or truly perpetual trusts, offer an unprecedented opportunity for the creation of well-funded, fully GST tax exempt, Perpetual Dynasty Trusts.

One concern, which prevents many people from taking advantage of the ability to make tax-free wealth transfers, is this: “What if I need the money later?” Proper planned and structured Perpetual Dynasty Trusts, along with other estate planning techniques and good financial advice, can go a long way toward reducing this concern. This type of estate planning should generally include “safety valve” provisions, of which there are a number of different types. When used correctly, these safety valves can help you get assets back if and when you need them, while not preventing you from realizing the transfer tax and other benefits of making the gifts if you don’t need the assets. Your advisor should be able to explain these safety valves to you, and to

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help you set up a plan which lets you give assets away without feeling any significant economic or emotional discomfort as a result of the gifts.

A word of caution: since Perpetual Dynasty Trusts can last for extreme periods of time, they need to be very carefully drafted, to help ensure that they have maximum flexibility and can allow your wishes to be best carried out and potential future problems to be fixed or avoided most easily. You should include very clear statements describing your intent and desire as to how the trust should be used and managed, and as to the kind of benefits you want it to provide for your loved ones. These are not "off-the-shelf" documents, and should only be prepared by sophisticated, experienced, estate planning attorneys after extensive consultation.

At Morgan & DiSalvo, we have focused for many years on helping our clients transfer their wealth to their loved ones efficiently and effectively, with flexible and sophisticated planning and lots of safety valves. If you would like to learn more about the opportunities presented by the remainder of the golden gifting year 2012, and how you may be able to take advantage of a Perpetual Dynasty Trust or other planning, please contact us at (678) 720-0750 or sollila@morgandisalvo.com to schedule an appointment to talk to either Richard Morgan or Loraine DiSalvo. Remember, time is limited, and the sooner you begin planning, the better.

Disclaimer: This material has been prepared as a tool to assist in a general discussion of the matters discussed herein. These materials should not be relied upon without an attorney being consulted with regard to your particular situation. The interpretation of any laws and rulings should be independently verified by local counsel.

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[1] The gift and estate taxes actually do not have an exemption. Instead, a "unified credit" exists against gift and estate taxes. This unified credit is a tax credit which applies against gift and estate taxes which would otherwise be due on lifetime gifts and transfers at death. The credit effectively exempts an amount of assets from gift and estate taxes: currently, the effectively exempted amount is $5,120,000. The effective exemption is referred to in the gift and estate tax statutes as the "basic exclusion amount." The GST tax does have an "exemption." For 2012, the GST tax exemption is set at the value of the gift and estate tax basic exclusion amount. For purposes of convenience, this newsletter will generally refer to both the gift and estate tax basic exclusion amount and the GST tax exemption as "exemptions."

[2] After the 2010 Tax Act, many people raised the question of whether there could be a "recapture" or "clawback" at death of taxable gifts made during life under a high exemption if the gift and estate tax exemptions do drop in the future. However, this should not happen. The gift and estate tax "exemption" (referred to by the statutes as the "basic exclusion amount") is actually not a true exemption or exclusion, but is actually the result of a credit against gift or estate taxes which is given to U.S. citizens and U.S. permanent residents under the wealth transfer tax laws. Gift taxes, which were actually paid by the deceased person during his lifetime, are added to the value of the estate tax credit applied on the person's estate tax return. The fear of a "clawback" arose because taxable gifts made during a person's lifetime are added to the value of the person's gross estate for estate tax purposes at the person's death. The thought was that, if gifts made under a larger gift tax exemption were added to an estate, and the smaller estate tax exemption were then applied, there would be no offset for the value of the gifts transferred under the lifetime gift tax exemption. However, the actual result should be as follows: if the credit against gift taxes was higher at the time taxable gifts were made than the estate tax credit which exists at the time of the person's death, the "excess" credit (the amount by which the gift tax credit at the time of the taxable gifts exceeds the value of the estate tax credit at death) will be effectively treated for estate tax purposes as if the person actually paid the gift taxes. This resulting in the person's estate taxes effectively being calculated as payable only on the amount actually being transferred at death, with no additional amount generated by the past "excess" taxable gifts.