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Time is Running Out for Those Who Want to Save Taxes and Provide Huge Benefits to Their Loved Ones!

by Richard M. Morgan & Loraine M. DiSalvo

As readers of our newsletter should already be aware, the 2010 Tax Act is set to expire, or "sunset," at the end of 2012. This means that the laws regarding the federal wealth transfer taxes, which are the gift, estate and generation-skipping transfer or "GST" taxes, will all revert to pre-2001 law, including significantly lower tax exclusion amounts and significantly higher tax rates. Two of the biggest benefits of the 2010 Tax Act – the current federal gift tax exclusion of $5,120,000 and the current federal GST tax exemption of the same amount – will be part of the sunset. Under pre-2001 law, the gift tax exclusion will drop to $1,000,000, and the GST tax exemption will drop to $1,000,000, subject to indexing for inflation in the intervening years. However, if you act before year-end 2012, you may be able to preserve a large portion or all of the benefits of the current federal gift tax exclusion, even if the 2010 Tax Act sunsets as scheduled. **In order to help bring attention to this important but short-lived opportunity, we have placed a real time countdown clock on our website's home page. The clock shows exactly how much time is left before the 2010 Tax Act sunsets.**

Although we have addressed these issues before, as a refresher, here are the benefits available to those who make gifts in 2012 under the current federal gift tax exclusion and GST tax exemption:

1. Overall wealth transfer tax savings – potentially **millions** of dollars.

2. Assets given away in 2012 in a properly structured transfer may be removed from the giver's future estate for estate tax purposes. In addition, a well-designed gift can remove all of the future income from the gifted assets and the future appreciation in their value from the giver's future estate. The giver who uses a properly-structured grantor trust as a recipient can also effectively make additional, tax-free gifts by paying the annual income taxes on the earnings on the gifted assets.

   If a properly-structured trust is used as the recipient of gifts, the gifted assets may be sheltered from unwanted outsiders, including your beneficiaries' creditors, their spouses in the case of divorce, and potential predators.

3. If a properly-structured trust is used as the recipient of gifts, the giver may also be able to protect the gifted assets from his or her own potential future creditors, but also retain practical access to (and possibly control over) the gifted assets. This practical access to gifted assets can help ensure that the gift giver does not feel financially insecure after the gifts are made.

4. Properly-structured perpetual or "dynasty" trusts (those which are designed to last for hundreds of years or longer) can help ensure that the above benefits are available to many generations of the giver's beneficiaries, and to the extent the trust is GST-exempt, it may avoid having additional wealth transfer taxes become payable each time assets move from generation to generation.

5. The current economic environment, in which many asset values are depressed and interest rates are at historic lows, actually makes this a perfect time to make gifts, since these factors can really help maximize the benefits of gifting.

While the chance to take advantage of the great benefits of making gifts exists through the end of 2012, there is no guarantee that the current opportunities will exist beyond December 31, 2012. Not only is the 2010 Tax Act set to sunset, but President Obama, Congress and the Treasury Department (IRS) have been considering potential major changes to the federal wealth transfer tax laws. The latest example of these considerations can be found in the President's 2013 Budget and the Administration's explanations of its provisions, which are spelled out in the so-called "Green Book." The proposals found in the Green Book for 2013 include changing the federal wealth transfer tax exclusion amounts back to their 2009 levels (a \$3,500,000 million estate tax exclusion, a \$3,500,000 GST tax exclusion, and a \$1,000,000 gift tax exclusion, each with a flat 45% tax rate) and making permanent the rules which allow "portability" of the federal estate tax exclusion (the transfer of a deceased person's estate tax exclusion to his or her surviving spouse). However, some of the other proposals include major changes to many of the rules that most estate planners rely upon, including, among others, the "grantor trust" rules. One of the Green Book proposals which estate planners find most frightening is the one which would cause a grantor trust to be included in the estate of its grantor for federal estate tax purposes, and would cause distributions made from the trust during the grantor's lifetime to be subject to federal gift taxes. This proposed change, as described in the Green Book, will only affect (1) trusts created after the effective date of the change and (2) the portion of trusts created before the effective date which are attributable to contributions made after that date. Another change proposed by the Green Book would limit the benefits of the GST tax exemption for trusts created after the effective date of the change, so that federal GST taxes would apply to the trust again after about 90 years. We do not expect that either of these proposed changes would be enacted before the end of 2012, but after that, who knows?

The grantor trust rules and the federal GST tax rules are technical in nature, and we won't try to explain them here. However, please note that the grantor trust rules have long been used by estate planners because they allow the creation of trusts which exist and have legal significance for wealth transfer tax and state law asset protection purposes, but which are effectively non-existent for income tax purposes. In the hands of experienced estate planners, the dual nature of a grantor trust helps make their use incredibly beneficial from both a tax and non-tax perspective. The income of a grantor trust is taxed to the trust's creator (the grantor), and the grantor's payment of the taxes is not considered an additional gift to the trust. This effectively allows the assets inside the trust to accumulate on an income-tax-free basis during the grantor's lifetime. In addition, because the grantor trust is effectively the grantor for income tax purposes, the grantor can borrow from or loan to the trust without the need for the grantor or the trust to report taxable interest income (although the loan should carry interest), and a the grantor can sell to or purchase assets from the trust without triggering capital gain or loss reporting. For income tax purposes, it is as if the grantor is transacting with himself. The key is for such transactions to be structured at arms-length, full fair market value basis. Grantor trust status is the key component to enabling gifts to be structured as legally effective but practically invisible. For example, most standard irrevocable life insurance trusts ("ILITs") are set up to be "grantor" trusts. A properly-structured ILIT can allow its creator to remove the death benefits on his or her life insurance policies from the estate tax system while using the gift tax annual exclusion to pay the policy premiums on a gift tax free basis. A properly-structured ILIT can also be used to engage in other transactions, as discussed above, while still providing impressive wealth transfer tax savings and the many significant state law asset protection benefits of a trust. The GST tax exemption adds another layer of benefit if it is properly applied to a grantor trust, since it can allow the trust to last for a very long time or, under current federal law and the laws of some states, potentially forever, and for the trust's assets to be exempt from future federal wealth transfer taxes during its entire existence.

Trusts set up, fully funded, and made GST tax exempt prior to the sunset of the 2010 Tax Act at the end of 2012 and the enactment of any future changes to the grantor trust and GST tax laws are likely to be shielded from the impact of these changes. As we mentioned earlier, however, the clock is ticking and the time to take advantage of these great opportunities is running out. If you have considered taking advantage of these opportunities, you need to start moving **now**. You can make a gift to a flexibly structured trust using just about any asset– cash, marketable securities, business interests, land or otherwise, but you **must** get the trust set up and the gift completed **before the end of 2012**. Those who do so can then worry about changing the trust's investment profile later, even potentially using the grantor trust rules to exchange trust assets for other types of assets of equivalent value. But if you fail to get the gift done now and lock in the benefits of the current laws, the opportunity to do so may be lost forever.

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