LAST MINUTE GIFT AND GST TAX PLANNING IDEAS FOR 2012 AND PITFALLS TO AVOID

Boston Bar Association
Trust & Estates Section
Estate Planning Committee

November 16, 2012

Ideas for Last Minute Gifts

- **Forgive loans to children**
- **Use grantor type trusts whenever possible to maximize reduction in client's taxable estate through payment of trust income taxes**
- **Gift non-income producing assets for clients who cannot afford income loss**
- **Don't forget GRATs; even though a -0- gift, legislation next year may have an adverse impact**
- **Accelerate premium payments for life insurance or prefund trusts holding life insurance**
- **Give income interest in QTIP trust (triggers Section 2519) if not need by surviving spouse**
- **Use QPERTs (even though low interest rate environment) for high value homes; shorten term to minimize risk of survival**
- **Gift cash if available and buy business interests in 2013 or other hard to value assets that need appraisals if it is too late to get them**
- **Gift assets with inherent valuation discounts (business interests; fractional interests)**
- **Use irrevocable trust that includes the spouse as a beneficiary; could consider giving spouse a broad enough power of appointment to create a subsequent trust for donor spouse (beware implied agreement and Section 2036 estate inclusion) (beware of consent to split gift issues discussed later)**
- **Consider self settled trust in asset protection jurisdiction (PLR 200944002 for completed gift to Alaska trust but PLR refused to opine on estate inclusion issue)**

Donna M. White, Esquire
dwhite@davismalm.com
(617) 589-3812
Twitter: @attydonnamwhite

Don't use the most risky strategies unless your client really understands the risk (i.e. gift cash to a trust and client borrows back nearly everything shortly thereafter)

This is obviously not an exhaustive or original list but just some ideas to help you spot opportunities in your specific client situations.

<u>Taking A Step Back: Why are we doing this?</u>

In our haste (or more accurately, our procrastinating clients' haste) to accomplish gifts using the available gift tax exemption before year end, it is easy to get too focused on the client's end goal. We need to take a breath and a step back and remind ourselves what gifting accomplishes in order to look methodically at the proposed gift transaction.

- **Remove appreciation/income on the gifted assets from taxable estate**
- **Remove assets from state estate tax base**
- **Remove \$1.5M from transfer taxes if exemption is reduced to \$3.5 and there is no clawback**
- **Comfort of gifting with less fear of gift tax audit**
- **If using irrevocable trusts, avoid estate tax in multiple generations**

<u>Pitfalls of Gifting (*particularly gifting at an accelerated pace!*)</u>

I. <u>Clawback</u>

If the gift tax exemption is fully utilized and the estate tax exemption is later reduced below the current exemption amount, will an estate tax will need to be paid on the difference. There are technical arguments for and against the existence of the *clawback* under the current calculation of the estate tax. Most estate planners believe this issue will be resolved with technical corrections if the estate tax exemption is reduced.

II. <u>Estate Tax Savings vs. Loss of Basis Step Up</u>

The 35% savings on the asset's appreciation after the gift has to exceed the 15% (20-25%) capital gain tax on the value (after basis) of a low basis asset. For example, consider a \$1M asset with a -0- basis. If the asset does not appreciate after the gift and before the family sells the

asset, the family will net $850,000. The asset would need to appreciate to $1,750,000 to offset the loss of basis step-up.

If the family does not sell the asset or uses a like kind exchange (real estate; art; aircraft; mineral rights), the estate tax savings exceed the basis step up loss.

III. Reciprocal Trusts

Clients who are concerned about potentially needing access to gifted assets or who simply want the comfort of knowing that this is possible, will want to consider two trusts, one created by each spouse with the other spouse as one of the beneficiaries. The danger is that the trusts will be considered reciprocal and "uncrossed" at the death of one or both spouses.

If the two trusts have substantially identical terms and are part of an "interrelated transaction" all of the elements of reciprocal trusts are present.

***United States v. Grace* 395 US 316 (1969) defines a reciprocal trust arrangement as an "*arrangement, to the extent of mutual value, that leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries*."**

In the *Grace* case, the trusts were signed 15 days apart, were identical and the same value was transferred to each. The trusts were found to be reciprocal and uncrossed. In a more recent case, the trusts were found not to be reciprocal where one trust has a broad lifetime special power of appointment and one did not. See *Estate of Levy v. Commissioner* 46 T.C.M. 910 (1983)

There have also been distinctions made between the "interests" that the beneficiaries retain and the "powers" that the beneficiaries retain although the best approach is to focus on both. See *Estate of Green v. United States* 68 F.3rd 151 (6th Cir. 1995) (Jones, J. dissenting)

Some distinctions to consider include:

- **Create the trusts at different times (more than 15 days apart)**
- **Fund the trusts with different assets and with different values**
- **Use HEMs standard for one and make the other fully discretionary**
- **Give an independent party the power to add the spouse**
- **Lifetime/testamentary power of appointment in one and not the other**
- **Use different classes of appointees for powers of appointment**
- **Different remainder beneficiaries**
- **Different trustees (don't have spouse as co-trustees or sole trustees on each trust)**
- **Different removal powers**
- **Essentially anything you can do to make the trusts different**

IV. Gift Splitting

Under Section 2513 of the Code, both spouses must consent to treat all gifts to third parties as having been made one-half by each spouse. A spouse cannot consent to a transfer to a trust under which he or she has an interest unless and to the extent the interest of the other third party beneficiaries are ascertainable at the time of the gift. Under the *Falk* case, (T.C. Memo. 1965-22) February 9, 1965, the spouse's interest, and therefore the interests of the non-spouse beneficiaries, was ascertainable because it was subject to an ascertainable standard. Therefore if you are creating a trust with one spouse as grantor and one spouse as a potential beneficiary, it is critical that the discretionary standard be subject to an ascertainable standard or otherwise ascertainable. See Diana S.C. Zeydel's article, *Gift-Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, Journal of Taxation June, 2007 for a full treatment of the topic.

V. Defined Value Clauses

Defined value clauses help to minimize the risk of taxable gifts when gift values are close to the exemption amount or the client wants to utilize all of the exemption amount with an asset that is difficult to value.

At this point the clauses have fallen into two general buckets. One type, the *Petter* type clause is a defined value clause that allocates assets first to a "taxable" trust up to the value of the gift tax exemption with the balance to charity or other non-taxable entity with values "as finally determined for gift tax purposes". The initial split is done based on the appraisal and reported gift tax value and then redistributed if values change after audit. Many planners like this approach as the formula is very similar to the basic marital deduction formula we have all been using for decades and perhaps is less likely to be challenged. *Petter* (T.C. Memo 2009-280) December 7, 2009

Under the *McCord/Hendrix* approach, the allocation between the "taxable" trust and the non-taxable entity is by agreement between the parties under a willing buyer/willing seller test. It depends on a factual "arm's length negotiation" between the trust and the non-taxable entity (separate counsel, appraisals etc). *Hendrix* (T.C. Memo. 2011-133) June 5, 2011 and *McCord* 461 F. 3d 614 (5^{th} Cir. 2006)

It has always been appropriate to use a provision that says, "I give $XM of XYZ stock to the trust at the per share value determined by Acme Appraisal Co." if the issue is merely that there is insufficient time to obtain an appraisal.

VI. State Law Issues

If you are creating irrevocable trusts, you should be considering which state law should apply from the perspective of the Rule Against Perpetuity, the beneficiary's right to information about the trust, and the income tax "residency" of the trust both now and potentially in the future. Pay particular attention to the identity of trustees and the impact they may have on the income taxation of the trust (California for example).

Beware also of real estate transfer tax issues (this is a particular problem in NH); and states that have their own gift tax scheme.