Taking a Fresh Look at Lifetime Gift Planning Opportunities

Identify and implement strategies to take maximum advantage of the two-year increase, portability, and unification of the estate and gift tax exemption amounts.

The Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010 (the "2010 Act") provides exceptional opportunities for lifetime gift planning during 2011 and 2012, even though it has extended the uncertainty for long-term estate planning. The 2010 Act generally extended all of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) for two years, moving EGTRRA's sunset date from 12/31/2010 to 12/31/2012. In addition, the 2010 Act made changes to the estate, generation-skipping transfer (GST), and gift taxes.

The increased exemption is not only an opportunity to increase family wealth transfer; in many instances, the increased exemption makes tax effective a technique that was inefficient when the exemption was limited to $1 million. This article explores the benefits and risks of lifetime gifts under the 2010 Act and takes a fresh look at some strategies that create attractive opportunities under the new law.

**2010 Act provisions**

Below is a summary of the relevant changes made by the 2010 Act.

**Gift tax provisions.** Effective 1/1/2011, the 2010 Act increased the gift tax exemption to $5 million, matching the increased exemption of $5 million that became effective in 2010 for the estate and GST exemption. Also, effective 1/1/2012, all three exemptions are indexed for inflation, from a baseline of 2010. The gift tax maximum rate of 35% is applied to 2010, is extended through 2012, and is now the same rate as the estate and GST taxes. For the first time since EGTRRA was enacted, the transfer tax system is unified.

Importantly, the full increased exemption is also available to taxpayers who had previously made taxable gifts, whether they were above or below the $1 million exemption. The 2010 Act amends Section 2505(a) to provide that the calculation of the gift tax credit for prior gifts is based on the rates in effect for the current calendar year, rather than the calendar year when the gifts were made, so that the full unused exemption is available regardless of the exemption amounts and rates applicable when prior gifts were made.

**GST tax provisions.** As noted above, the 2010 Act increased the GST tax exemption to $5 million
and reinstated the entire GST system for all of 2010, although temporarily providing for a 0% rate in 2010 only. The GST tax rate for 2011 and 2012 is a flat rate of 35%. The 2010 Act also deferred by two years EGTRRA’s sunset provision, which states that “The Internal Revenue Code ... shall be applied and administered to years, estates, gifts, and transfers as if the provisions and amendments ... of EGTRRA] had never been enacted.” The “never been enacted” language creates some technical issues for GST planning, as it is not clear what the impact of EGTRRA section 901 (i.e., the sunset provision) would be on future distributions after the sunset date from GST trusts that were created and funded in reliance on exemption amounts and other GST provisions enacted under EGTRRA.

Portability of the estate and gift exemptions. One of the reforms ushered in by the 2010 Act is the “portability” of the estate tax exemption. Effective 1/1/2011, the unused exemption amount of a predeceased spouse may be used by the surviving spouse. Like all other provisions of the 2010 Act, however, new Section 2010(c)(4) is scheduled to expire on 12/31/2012. It is well beyond the scope of this article to discuss the impact of the new portability rules on estate planning generally. In the context of lifetime gift planning, however, the new portability rules have two important aspects:

1. Any unused exemption of a predeceased spouse, defined as the deceased spousal unused exclusion amount (DSUEA), may be used by a surviving spouse for lifetime gifts, as well as for testamentary transfers. For a surviving spouse of a decedent who dies in 2011 or 2012, the portability provision may significantly increase the available lifetime gift exemption. Note that the computation of the DSUEA can be complex in the case of multiple marriages. In particular, in March 2011 the Joint Committee on Taxation suggested that a technical correction to the 2010 Act might be required in order to compute the DSUEA as provided in an illustration in the Committee Report to the 2010 Act.

2. The GST tax exemption has no analogous portability provision, so any unused GST tax exemption of a deceased spouse will “disappear” permanently as it did under prior law.

Sunset provisions. Absent further congressional action, the changes made by the 2010 Act will sunset on 12/31/2012, with all three exemptions scheduled to revert to the law in effect before enactment of EGTRRA. While Congress is highly likely to act before the end of 2012 to avoid a reversion to pre-EGTRRA law, the congressional inaction at the end of 2009 and the late adoption of the 2010 Act are reminders of the impossibility of predicting when and how Congress will act to avoid the reinstatement of pre-EGTRRA law. Thus, 2011 and 2012 provide a true “window of opportunity” for individuals and couples with the means to make substantial lifetime gifts.

Administration’s budget proposals
On 2/14/2011, the Administration released its 2012 revenue proposals, several of which would significantly affect planning strategies for federal estate, gift, and GST taxes. While these are only proposals and must be enacted by Congress in order to take effect, they provide insight into the Administration’s position on a variety of tax issues.

Return to 2009 rates and exemptions. The baseline revenue assumptions for the budget assume that the 2009 estate tax exemption of $3.5 million and rate of 45% would be permanently extended starting in 2013.

Portability rules made permanent.
A proposal would make permanent the portability rules discussed above, which are currently effective for 2011 and 2012 only.

Limit GST exemption to 90-year period. A proposal would affect long-term or perpetual trusts, such as a Delaware Dynasty Trust, discussed below, by limiting the duration of the GST exemption, so that distributions from the trust after 90 years would be subject to the GST tax. This provision would apply to trusts that were funded after the date of enactment, and to contributions after the date of

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1 Sections 2505(a), 2010(c), and 2631(c).
2 Sections 2010(c)(1)(A), 2505(a), and 2631(c).
3 Sections 2641(a), 2502(a), and 2010(c).
4 2010 Act section 302(c).
5 EGTRRA section 901.
6 See McCaffrey and Schneider, “The Generation-Skipping Transfer Tax: Time Traveling with the GST Tax in 2011 and Beyond,” 150 Tr. & Est. 30 (Feb. 2011); Worthington and Mielnicki, “Planning for Multi-generational Trusts,” 150 Tr. & Est. 34 (May 2011).
7 Section 2010(c)(4).
8 Section 2010(c)(4)(B)(ii).
9 General Explanation of Tax Legislation Enacted in the 111th Congress, Joint Committee on Taxation, 3/29/2011. The Committee Report illustration suggests that the DSUE of a husband surviving a deceased wife who herself had DSUE from a deceased husband includes all of such unused exemption, a result that does not appear to follow from the language of Section 2010(c)(4).
11 Greenbook 2012, Table 2, page 149.
12 Greenbook 2012, page 123.
enactment to trusts formed before enactment.\textsuperscript{13}

\textbf{Modify valuation discount rules for family-controlled entities.} As proposed last year,\textsuperscript{14} this proposal would create a category of "disregarded restrictions," to be developed by regulation, that would not result in valuation discounts. The proposal would apply to transfers, after the date of enactment, of property subject to restrictions created after 10/8/1990.\textsuperscript{15}

\textbf{Modify GRAT requirements.} Also proposed last year,\textsuperscript{16} a ten-year term would be required for grantor remainder annuity trusts (GRATs). Furthermore, the value of the GRAT remainder interest would need to exceed $0, and decreasing annuity payments would be prohibited. These requirements would apply to trusts created after the date of enactment.\textsuperscript{17} These GRAT restrictions were passed by the House three times during 2010, but were never adopted by the Senate.\textsuperscript{18}

\textbf{Use increased exemption.} With the gift and GST exemptions scheduled to drop dramatically in 2013, a gift allows clients to remove assets from their estates. As discussed below, a potential risk exists that an estate will lose the benefit of the larger gift tax exemption if there is a "clawback" of the exemption at death. Using the current gift exemption, rather than relying on portability, however, makes sense for a variety of reasons. Most importantly, portability is scheduled to expire in two years. Furthermore, the ability to use a deceased spouse’s unused exemption depends on multiple factors, including the surviving spouse’s subsequent remarriage.

\textbf{Remove future appreciation from the estate.} Regardless of whether the clawback applies, a lifetime gift permits clients to remove future appreciation of assets from their estates, a benefit that can significantly multiply the estate tax savings over and above the tax savings from the initial gift.

\textbf{Take advantage of valuation discounts.} With the possibility of future change to the valuation rules for family-controlled entities, lifetime gifts today can maximize the advantages of the current exemption through gifts of family limited partnership (FLP) or limited liability company (LLC) interests that are appropriately valued considering lack of control and marketability.

\textbf{Benefits of making gifts} Clients who are financially able to take advantage of the increased exemption can achieve many benefits by making gifts during the two-year window.

\textbf{Endnote:}

\textsuperscript{13} Greenbook 2012, page 129.
\textsuperscript{14} General Explanations of the Administration’s Fiscal Year 2011 Revenue Proposals, Department of the Treasury, February 2010 (“Greenbook 2011”), page 124.
\textsuperscript{15} Greenbook 2012, page 127.
\textsuperscript{16} Greenook 2011, page 126.
\textsuperscript{17} Greenbook 2012, page 128.
\textsuperscript{19} Greenbook 2011, page 122.
\textsuperscript{20} Greenbook 2012, pages 125-126.
**EXHIBIT 2**
Benefits of Dynasty Trust in a Clawback Scenario

<table>
<thead>
<tr>
<th>Benefits of Dynasty Trust in a Clawback Scenario</th>
<th>$5 million of assets contributed to dynasty trust; $10 million of assets retained outside the trust</th>
<th>$15 million of assets retained outside of a dynasty trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross estate after 25 years (6% rate of return)</td>
<td>$42,918,707</td>
<td>$64,378,061</td>
</tr>
<tr>
<td>Value of dynasty trust after 25 years (6% rate of return), excluded from estate tax</td>
<td>$21,459,354</td>
<td>$0</td>
</tr>
<tr>
<td>Estate tax (assuming a 55% maximum rate and $1 million exemption, and clawback of prior gift)</td>
<td>($26,009,489)</td>
<td>($35,062,133)</td>
</tr>
<tr>
<td>Net transfer to heirs (i.e., full value of dynasty trust plus after-tax estate value)</td>
<td>$38,368,572</td>
<td>$29,315,927</td>
</tr>
</tbody>
</table>

**Take advantage of current GST exemption.** As noted above, the Administration’s revenue proposals would limit the duration of the GST exemption to 90 years, but would not apply to trusts created or contributions made before enactment. Because the GST exemption is not portable, a surviving spouse cannot rely on portability of the GST exemption for testamentary planning.

**State estate tax benefits.** With the federal exemption substantially increased, lifetime gifts using the exemption also provide a state estate tax savings opportunity in most states. Only Connecticut, Tennessee, and Puerto Rico impose a gift tax. Some states also impose a GST tax, but the applicability of these taxes is beyond the scope of this article.

**Risks of making lifetime gifts**
While lifetime gifts can be a very efficient strategy for transfer tax purposes, the risks of making lifetime gifts also need to be carefully considered with clients.

**Can donor afford it?** The most important planning question, of course, is whether the donor can afford to lose the benefit of the income and the principal of the property given as a lifetime gift. As discussed below, some gift strategies can provide income for the donor or spouse, but at the end of the day, the donor must be able to afford to make the gift.

**Will the asset make good use of the exemption?** Assets for lifetime gifts must be carefully selected. While appreciated assets leverage use of the exemption, gifts of assets that end up losing value waste the exemption.

**Consider the basis consequences.** Lifetime gifts lose the potential benefit of the basis step up at death, so it is important to assess the estate tax savings from the gift relative to the income tax cost of the future capital gains on the gifted assets that have a carryover basis.

**Potential clawback.** The scheduled decrease of each of the GST in 2013 presents the possibility that a decedent could die in a year in which the estate tax exemption is lower than the gift tax exemption used for an earlier gift. This possible reduction in the exemption, coupled with the wording of the Form 706 instructions on the calculation of the estate tax, has raised the question of whether the benefits of the earlier larger gift exemption would be “clawed back” by virtue of the estate tax computation required in the year of death.

A detailed consideration of the clawback issue is beyond the scope of this article. While it is important to advise clients contemplating gifts of the uncertainty of the clawback, there are several reasons to believe that this uncertainty will be resolved favorably. First, the ambiguity is created by instructions that were written prior to the enactment of the 2010 Act. Second, congressional staff has indicated that the clawback was not intended and have even suggested the possibility of a technical correction to the 2010 Act.

Even if the clawback does apply, the gift will still have successfully removed from the taxable estate any appreciation in the value of the gifted assets from the time of the gift until the decedent’s death. A clawback could, however, produce liquidity issues with regard to the estate tax, and in some extreme cases, if the decedent had given away the bulk of his or her assets, the estate might not have sufficient resources to pay the tax. Some

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22 Akers, "Estate Planning Effects and Strategiess under the "Tax Relief... Act of 2010" (Feb. 2011), Texas Tax Lawyer (Winter 2011) page 34.
commentators have suggested that a gift agreement may be a possible solution, but such agreements may also result in estate tax inclusion of the amount subject to reimbursement. In some states, apportionment statutes may address the issue of donee liability, but many states do not have legislative or judicial guidance.\(^{23}\)

Despite the ongoing uncertainty, for donors with substantial net worth holding assets likely to appreciate, the benefits of making large lifetime gifts would appear to outweigh the uncertainties created by the clawback possibility. Most importantly, the gift will remove all future appreciation from the estate, and in the worst case, will create additional tax equal only to what the estate would have owed if the gift were not made and had not increased in value. Most clients are unlikely to make such substantial gifts relative to their total net worth as to create the likelihood of leaving the estate unable to pay any estate tax due.

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**EXHIBIT 3**

Seed Money Gift Followed by Installment Sale

Assumptions:
- Amount of loan: $45 million.
- Amount of gift: $5 million.
- Applicable federal rate: 4.05%.
- Total rate of return: 6.00%.
- Number of years of loan: 20.
- Interest is computed semi-annually.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning amount</th>
<th>Investment return</th>
<th>Interest expense</th>
<th>Balloon payment</th>
<th>Ending balance</th>
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<tr>
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<td>$3,000,000</td>
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<td>$51,159,047</td>
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<tr>
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<td>$3,069,543</td>
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<tr>
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<td>$1,840,953</td>
<td>$45,000,000</td>
<td>$47,636,236</td>
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</tbody>
</table>

Could distributions from exempt GST trusts be subject to tax if pre-EGTRRA law returns? By deferring EGTRRA section 901 for two years, the 2010 Act defers, but does not eliminate, the uncertainty on the future applicability of GST distributions from many GST trusts that to date are fully exempt. The range of issues raised by section 901’s “never been enacted” rule is well beyond the scope of this article. If section 901 becomes effective in

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23 Id. at pages 31 and 36.
2013 or at a later date, it could affect not only trusts funded in 2011 and 2012, but all GST trusts funded under the increased exemption provided under EGTRRA. Further, trusts that had relied on a variety of provisions permitting qualified severances, late allocations, and automatic allocations, might also need to recalculate their inclusion ratios. The planning issues related to funding new trusts are considered briefly below in the context of funding a dynasty trust.

**Establishing a perpetual or dynasty trust**

Perhaps the most attractive use of the enhanced exemption, for families who can afford to make such a gift, is to use the exemption to fund a perpetual or dynasty trust primarily for the benefit of grandchildren and future generations. Many states now permit perpetual trusts, but for purposes of this example, we will refer to the benefits of establishing a dynasty trust in Delaware. Of particular significance in planning for a large lifetime gift of such long duration, is that a dynasty trust in Delaware can take advantage of state law provisions that permit a trust to be established with advisors who may advise the trustee regarding the investment of and distributions from the trust. Further, the trustee and advisors may be given guidelines in the trust as to the types of expenditures that the donors would expect to be considered. Because the trustee, which is usually a corporation, may be expected to get to know the family well, if in the future advisors are no longer serving, the trustee will have guidance and experience in distributing money from the dynasty trust.

A married couple who has not yet used any of the $5 million per spouse gift exemption can fund such a trust with $10 million in 2011 or 2012. In addition, in order to maximize the benefits for future generations, the full GST exemption of $5 million per spouse may be allocated to the trust. Because future growth of the trust is not subject to estate, gift, or GST tax, subject to the risk of future GST tax discussed below, the trust can in effect become a "family endowment fund" for future generations. Over time, the estate tax savings from establishment of a dynasty trust can be substantial.

Exhibits 1 and 2 show the benefits of establishing a $5 million dynasty trust by a married couple with a total net worth of $15 million, assuming an annual growth rate of 6%. The exhibits illustrate different scenarios regarding the applicability of a clawback provision:

- Exhibit 1 assumes that the estate tax reverts to the pre-EGTRRA maximum rate of 55%, with a $1 million exemption, and further assumes no clawback of the earlier gift in computing the estate tax.
- Exhibit 2 also assumes that the estate tax rate reverts to a maximum rate of 55%, with a $1 million exemption, but assumes that the additional gift above the $1 million exemption is fully clawed back, although for the reasons noted above, we believe this is an unlikely scenario.

**Could future distributions be subject to the GST tax?** One of the most attractive features of the dynasty trust has been that future distributions are not subject to the GST tax, provided that the amount funding the trust was fully covered by GST exemption at the time of funding so that the trust had an inclusion ratio of zero. As noted above, EGTRRA section 901 creates a risk that future distributions from a trust that was fully exempt when funded, could nevertheless be subject to the GST tax if distributions are made at a time when section 901 is in effect and is interpreted literally. Among other consequences, it is possible that section 901 could be interpreted to require a recalculation of the trust's inclusion ratio based on the exemption in effect at the time of distribution.

Some commentators have suggested a conservative planning approach to mitigate this risk. Rather than funding a single dynasty trust, instead three trusts could be created, funded respectively with $1 million, $2.5 million, and $1.5 million. The multiple trusts would provide more flexibility if in the future, the GST exemption amount is reduced, and there is no protection for amounts funded during the period of higher exemptions. The second and third trusts might give beneficiaries a general power of appointment, under certain circumstances, so as to avoid distributions subject to the GST tax.

In addition, as previously discussed, the Administration’s revenue proposals would limit the duration of the GST exemption to 90 years. At that time, the GST exclusion allocated to the trust would end, increasing the inclusion ratio under Section 2642 to one, so that distributions after 90 years would be fully taxable. This proposal is yet another reason to consider acting sooner rather than later to fund a Delaware dynasty trust with the expanded $5 million exemption available for 2011 and 2012.
Grantor trust planning with a dynasty trust. Another significant advantage of establishing a Delaware dynasty trust is that the trust may be drafted as a “grantor trust” for federal income tax purposes, so that the donor is required to pay the trust’s federal income tax liability. Grantor trust status is often accomplished by providing that the donor may substitute assets in the trust for other assets of equivalent value, or sometimes by giving a third party the ability to add a charitable beneficiary. The donor’s payment of the tax is not treated as a taxable gift to the trust each year, and since the trust will not pay any income or capital gains taxes, the trust can continue to grow income-tax free until the donor’s death.

If a dynasty trust is structured as a grantor trust, it may also be an effective vehicle for a freeze transaction. Through this transaction, often referred to as a sale to an intentionally defective grantor trust (IDGT), the donor makes a gift of seed money to the trust, followed by a sale of assets to the trust, taking back an installment note. Generally the trust is funded with a seed money gift of at least 10% of the total sale so as to assure that the note is respected as bona fide debt. Because of the grantor trust status, the sale is not treated as such for federal income tax purposes and, therefore, no capital gain tax will be due. This technique freezes the value of the assets for estate planning purposes, so the only asset taxed in the donor’s estate is any outstanding value of the note. The appreciation on the assets transferred escapes taxation in the donor’s estate.

The increased exemption makes possible very large sales, because the seed money gift may now be increased to $5 million without incurring any gift tax. In addition the increased exemption may provide an opportunity to address outstanding installment notes. For example, if as part of a sale to an IDGT some years ago, guarantees were used to provide more equity around the seed gift, the donor could make an additional gift to the trust with the newly increased exemption, in order to terminate the guarantee agreements.

Establishing lifetime credit shelter trust for spouse

Although a Delaware dynasty trust is highly tax-efficient, many clients cannot afford to lose the benefit of $5 million or $10 million (for a married couple) in assets during lifetime. In the current environment, with the federal exemption scheduled to decrease, and most state estate tax exemptions substantially below the federal level, establishing a lifetime credit shelter trust to take advantage of the increased exemption may be an attractive alternative.

A lifetime credit shelter trust could be structured with provisions similar to a more typical testamentary credit shelter trust. Such a trust could allow the trustee various levels of discretionary payments to or on behalf of the spouse. Because no marital deduction would be elected, the asset transfer would be a completed gift, using some or all of the increased $5 million exemption available in 2011 and 2012. A lifetime credit shelter trust could be very attractive to a married couple since the donor’s spouse could serve as trustee, be one of the discretionary beneficiaries (along with the donor’s issue, if desired), and could hold a limited power of appointment.

The limited power could even be drafted broadly enough to allow the donor to be a discretionary beneficiary if the donor survived the donee spouse. To avoid the possible argument by the IRS that the donor has retained the possession or enjoyment of, or the right to the income from the property, resulting in inclusion in the original.

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28 Section 675(4)(c).
29 Section 675(c). See Ltr. Rul. 2007-47001.
31 Ltr. Rul. 9535026.
32 Section 677(a); Rev. Rul. 85-13, 1985-1 CB 184; Rev. Rul. 2004-64, supra note 30.
33 Section 2038(a)(1).
nal donor’s estate, the conservative approach might instead be to purchase life insurance in an irrevocable life insurance trust to cover the assets lost on an early death of the donee spouse. Another advantage of a lifetime credit shelter trust is that it may be drafted to provide that the definition of “spouse” includes any person to whom the donor is married, from time to time, for the rest of his or her life.

Because few states have a gift tax, removing assets from the donor’s estate in 2011 and 2012, while providing benefits for the marital unit, should successfully protect the assets from state estate tax, which may have a much lower exemption amount than the federal exemption at the time of the donor’s death.

If the donor is concerned that the donee spouse might exercise the power of appointment in a manner that is inconsistent with the donor’s overall plan, the trust could provide that the exercise requires the consent of a non-adverse third party, such as the donor’s sibling.

Under Section 677, the trust would be treated as a grantor trust for income tax purposes unless there were an adverse party who had to consent to distributions to the donee spouse.

If a client and his or her spouse each wish to create a credit shelter trust, in order to obtain the maximum benefit from this technique, great care will be needed in structuring the two trusts, in order to avoid the reciprocal trust doctrine.

If the doctrine applied, because the trusts were held to be substantially identical, and “interrelated,” the trusts would be “uncrossed,” and each trust would be taxable to the estate of the original donor, as the doctrine holds that the donor would be treated as having set the trust up for the donor’s own benefit.

If the trusts are created and funded at different times, or with different benefits for the spouse, then the trusts should not be found to be substantially identical, and it should be possible for each spouse to create a credit shelter trust.

Completed gift with a self-settled asset protection trust

As noted above, many clients may be reluctant to make large lifetime gifts out of a concern that they might need some of the income or principal in the future. For some individuals, funding an asset protection trust (APT) as a completed gift may be an effective alternative to funding a credit shelter trust for the benefit of a spouse. In the past, a client could do little when making a gift in order to retain the possibility of benefiting from the gifted property in the future. A trust set up by a donor that also benefited the donor, often called a “self-settled trust,” did not provide completed gift treatment for a transfer into the trust, because creditors could reach the assets. Thus, the assets were taxable in the donor’s estate.

Thirteen states now allow self-settled trusts that in varying degrees protect the assets from the donor’s creditors, while allowing the donor to be a permissible beneficiary:

1. Alaska
2. Colorado
3. Delaware
4. Hawaii
5. Missouri
6. Nevada
7. New Hampshire
8. Oklahoma
9. Rhode Island
10. South Dakota
11. Tennessee
12. Utah
13. Wyoming

For purposes of describing the gift vehicle in more detail, the discussion that follows refers to Delaware law. Many asset protection trusts are created primarily for protection from future creditors, including a future spouse, and are not structured as completed gift vehicles. With a lifetime gift exemption of $5 million for 2011 and 2012, however, individuals structuring an APT as a completed gift can provide a “rainy day fund” for themselves, rather than funding a trust that benefits only future generations.

The Delaware Qualified Dispositions in Trust Act (“the Delaware Act”) was originally enacted in 1997 and imposes certain requirements in order to obtain its protection, regardless of whether

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38 12 Del. C. §§ 3836(c), 3570-3576 (1997).
40 RSMo § 456.5-505 (2005).
48 Wyo. Stat. Ann. §§ 4-10-103, 4-10-506(b), 4-10-510--4-10-523 (2007).
transfers are intended to be completed gifts. The trust must:

- Be irrevocable.
- Specify that Delaware law will apply.
- Contain a spendthrift provision.
- Provide for a qualified Delaware trustee.\(^{50}\)

If a client wants to make a completed gift to a Delaware APT, the trust must be drafted to allow only certain benefits, in order to avoid inclusion in the donor's estate under Sections 2038(a)(1) and 2036(a)(1) and (2). The donor may receive income and principal in the independent trustee's sole discretion, and discretionary reimbursement for income taxes if it is a grantor trust.\(^{51}\)

An actual pattern of distributions, however, may increase the risk of estate tax inclusion. There may be an argument under Section 2036(a)(1) that there was an implied agreement with the trustee for continued enjoyment of the assets.

The Delaware APT may provide for the appointment of advisors to remove and replace qualified trustees; direct, consent to, or disapprove distributions from the trust; or serve as investment advisors (even the donor may serve in this capacity).\(^{52}\)

Because a Delaware APT benefits the donor or the donor's spouse, it is generally a grantor trust for income tax purposes.\(^{53}\) From a wealth transfer perspective, having the grantor, rather than the trust, pay the income tax is advantageous. Alternatively, the trust could be structured as a non-grantor trust. The Service has ruled repeatedly that a domestic APT may qualify as a non-grantor trust if distributions to the trustor must be approved by adverse parties.\(^{54}\) Most donors, however, prefer not to involve adverse parties, such as their adult children, in the management of the trust. The Delaware Act also allows the donor the ability to replace the trustee or advisors with "unrelated and non-subordinate parties".\(^{55}\)

Where the trust permits distributions to the donor, even when limited to the sole discretion of an independent trustee, a question arises whether this trust provision is enough by itself to cause estate tax inclusion. Cases and rulings support the view that it is not enough to cause inclusion.\(^{56}\) The Delaware Act specifically states that any understanding between the donor and the trustee to obtain future benefits is invalid.\(^{57}\) Alternatively, some advisors suggest that as long as the donor-spouse is married, the Delaware APT should provide no benefits at all for the donor, but could still benefit the spouse.\(^{58}\)

The Service has twice ruled, in Ltr. Ruls. 9837007 and 200944002, that transfers to an Alaska APT were completed gifts, even though the donor was a discretionary beneficiary. However, neither ruling confirmed that transferred assets would definitely be excluded from the donor's estate. The Service clarified that the discretionary authority to benefit the donor, combined with events during the rest of the donor's lifetime, could result in the Service arguing for inclusion at the time of the donor's death. However, the mere ability of the donor to receive distributions in an independent party's discretion was not enough, per se, to cause the assets to be included in the donor's estate. Although this ruling addressed the estate tax treatment of an Alaska APT, a similar analysis should apply to self-settled trusts formed under the laws of other states.

Perhaps the most serious challenge to a completed gift APT is the question of the rights of creditors to reach the assets. Because self-settled trusts are enforceable under the Delaware Act, and Delaware law should control even if the donor lives in another jurisdiction, creditors are prohibited from reaching the Delaware APT trust assets, so a completed gift APT should be possible, with a corresponding exclusion from the donor's estate.\(^{59}\)

Some commentators have questioned whether a divorced spouse's alimony rights, or rights of children under a support agreement, provide limited creditor's rights that would prevent treatment of a Delaware APT as a completed gift for federal transfer tax purposes.\(^{60}\) However, because these limited rights arise only due to the donor's divorce, which is an "act of independent significance," those limited rights should not be rejected on this basis itself.
acts of independent significance, including divorce or separation, in order to regain control over trust property.\footnote{See Estate of Tully, 528 F.2d 1401, 37 AFTR2d 76-1529 (Ct. Cl., 1976); Outwin, 76 TC 153 (1981); Ltr. Rul. 9141027; TAM 8819001.}

A donor should file a timely gift tax return for a transfer to a Delaware APT that is intended to exclude its assets from the donor’s estate. This will commence the running of the period of limitations for assessment of the gift tax, even if the assets are ultimately included in the donor’s estate based on the facts and circumstances during the rest of the donor’s life.

If the donor is confident that no pattern of distributions will occur, then the donor may decide to allocate GST exemption on the gift tax return to the transfers made to the Delaware APT. If the donor is unsure of the extent of his or her future need for the assets, it would probably be preferable to transfer a smaller amount into a completed gift Delaware APT with a larger amount into a more traditional Delaware APT.

Reconsider creation of a qualified personal residence trust

When the federal estate tax exemption amount was only $1 million, the creation of a qualified personal resident trust (QPRT)\footnote{Section 7520. The Applicable Federal Rate (AFR) is set monthly by the IRS and tends to follow market interest rates. AFRs are set for short-term loans (up to three years), mid-term loans (three to nine years), and long-term loans (more than nine years). The Section 7520 rate is the rate used to value the right to live in the residence for the term of years. The Section 7520 rate follows the AFR; it is set at 120% of the mid-term AFR.} for a valuable residence may not have been possible without paying gift tax. Even though a QPRT is a way of leveraging the exemption amount, real estate values were historically high. Those inflated values and the rapid decline in them were central to the market decline and financial crisis of the last few years.\footnote{See generally, Choate, The QPRT Manual: The Estate Planner’s Guide to Qualified Personal Residence Trusts (A tabplan Publications, 2004).} The lower values now allow for even more efficient use of the increased exemption amount.

A QPRT is basically a delayed gift of a personal residence. The residence is transferred to a trust for a term of years, after which it may remain in trust for the beneficiaries or be transferred to them outright. Because the QPRT is not effective for removing the residence from the donor’s estate for estate tax purposes if death occurs within the QPRT term, it is advisable to use a term of years that the donor is likely to survive.\footnote{www. Standardandpoors.com/Case-Shiller Home Prices Indices.} The value of the gift at the creation of the QPRT is the value of the residence minus the value of the right to occupy the residence for the term of years. That right is calculated using the Section 7520 rate.\footnote{Section 2702; Reg. 25.2702-5.}

One of the major benefits of the QPRT is the certainty provided by the Code and Regulations, unlike the litigation risk of transfers that take advantage of valuation discounts for FLP or LLC interests. Likewise, the value of the asset given, the residence itself, does not have to outperform any hurdle rate, as with a GRAT or a sale to an

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IDGT, in order to achieve some transfer tax benefit, although of course, the QPRT will be more tax-effective if the property value increases after the transfer.

Because interest rates and thus the Section 7520 rate recently have been at close to historic lows, the amount of the retained interest subtracted from the value of the gifted residence has been lower than in higher-interest-rate environments; for that reason the QPRT may have been out of favor as the strategy of choice to use the limited exemption amounts. However, in many cases the savings can still be substantial and the Section 7520 rates have increased considerably since their historic low of 1.8% in December 2010. With a temporarily higher exemption amount, the QPRT may be a transfer strategy to reconsider.

A brief example demonstrates the value of a QPRT in the current environment. A donor aged 60 could have transferred a residence valued at $2.5 million in April 2011 to a 15-year QPRT, and the gift tax value would have been $1,182,700. That would have exceeded the maximum exemption of $1 million available amount prior to 2011, but now represents only a fraction of the increased $5 million exemption. If the donor survives the 15-year term, the value of the residence, including any appreciation in it, will be removed from the donor’s estate.

A married couple could use both spouses’ exemption amounts on a larger QPRT gift by making an election to split the gift on a gift tax return. Another way to fit the gift within the exemption amount has been to transfer the residence one-half to each spouse of a married couple and have each one of them give his or her 50% interest in the residence to a separate QPRT. That strategy had the added benefits of minimizing the mortality risk and reducing the starting value of each gift by a discount factor to take into account the fractional interest. This strategy, however, reduces the benefit of certainty of the QPRT, because the discount would have to be defended and an argument might be made under the step-transaction doctrine to treat the gift as made solely by the donor who originally owned the residence.6 The fractional interest discount itself may be in danger when the entire residence is owned by members of the same family. With the increased exemption amount available, such a fractionalization strategy may no longer be necessary.

Life Insurance Planning
The additional exemption amount also provides an opportunity to clean up or enhance some life insurance arrangements without incurring gift tax. Some individually owned policies have grown over the years such that the value of the policy, if transferred to a child or an irrevocable life insurance trust (ILIT), could not be covered by annual exclusions or the prior exemption of $1 million. Especially useful for the donor who is not willing to make a gift of assets that provide him or her with support or cash flow, the increased exemption offers an opportunity to transfer a policy without incurring gift tax.

Other insurance arrangements that should be reviewed include the following:

- The terms of an ILIT may have ceased to be in line with the donor’s wishes, but prior to this year the tax cost (in terms of annual exclusions or exemption used) of creating a new ILIT to purchase the policy from the old ILIT was not the most efficient use of the smaller exemption.
- The performance of a policy in a trust may be dragged down by an outstanding loan, but repayment of the loan would require a transfer not covered by the exemption until now.
- As with loans to family members discussed below, the increased exemption may provide an opportunity to terminate a split-dollar arrangement or pay off third-party premium financing.
- Variable life or universal life policies that have not performed well may be shored up through additional premium payments that take advantage of the increased exemption. Premiums for traditional universal life and variable universal life products rely heavily on interest rates or market returns. As a result of the extended low interest rates and equities volatility, many of these policies are now underfunded and need additional premium amounts. Many insureds, however, hold coverage in an ILIT, with premiums structured to match annual gift tax exclusions. Assuming they have used their prior $1 million lifetime exemption elsewhere, additional “catch up” premiums to keep the coverage in force would have resulted in a gift tax liability. The higher exemptions create a window of opportunity.
- The increased exemption could also present an opportunity to pre-fund an ILIT with a side fund of income-producing assets that can pay premiums, thus freeing up the annual exclusion amounts normally

used up by the withdrawal powers granted to the beneficiaries in the ILIT.

**Loan forgiveness**

One of the simplest strategies for using the increased federal gift tax exemption amount is for a client to forgive an outstanding loan made to a family member. This strategy can be especially attractive for clients who may be reluctant to give away assets, but are willing to forego the interest payments on a loan. Debt forgiveness has both transfer and income tax ramifications.

**Gift tax implications.** From a gift tax perspective, when the lender/donor gratuitously cancels or forgives a loan, assuming the note was bona fide and not deemed a gift at the time of its issuance, he or she is treated as having made a taxable gift of the fair market value of the note to the borrower/donee in the year the debt is forgiven. Loan forgiveness of up to $26,000 per married couple could qualify for the annual exclusion under Section 2503(b). However, the real opportunity in 2011 and 2012, with the dramatically increased exemption, is for a family member to forgive a significant loan. Indeed, a married lender may forgive up to $10 million of debt.

If instead of forgiving the entire loan, the lender chooses simply not to enforce the interest payments from time to time, the lender will likely be deemed to have made gifts of the forgone interest in the year the interest should have been paid. This too would qualify for the annual exclusion to the extent available or otherwise use some of the taxpayer’s available gift tax exemption. If the lender has a consistent pattern of not enforcing the borrower’s obligation to make payments, however, the entire loan may be deemed to be a gift. If the donor does not intend to forgive the loan balance, the borrower should make occasional payments to avoid an argument that the gift consists of more than just periodic interest.

The donor makes a gift of seed money to the trust, followed by a sale of assets to the trust, taking back an installment note.

As noted above, because most states do not impose a gift tax, forgiving a note should also provide a state transfer tax benefit. The state income taxation issues of note forgiveness are beyond the scope of this article.

**Gift tax valuation of notes.** The fair market value of a promissory note (secured or unsecured) for gift tax purposes is presumed to be the unpaid principal plus accrued interest on the date of the gift. In certain circumstances, a note may be valued below its unpaid balance, but the applicable regulations require the taxpayer to submit satisfactory evidence that the value is less than the unpaid amount or that the note is uncollectible in part and that any security is insufficient. The Service takes into consideration all relevant data and factual circumstances. Factors justifying a lower value include:

- The presence or lack of protective covenants in the note.
- The nature of the default provisions and the default risk.
- The market for purchase and resale of the note.
- The financial strength of the issuer.
- The value of the security.
- The interest rate and term of the note, comparable market yields, payment history, and the size of the note.

The relationship to the donor generally should be irrelevant in valuing a promissory note (other than an installment obligation, as discussed below) for federal gift tax purposes. Accordingly, when a lender/donor gives a note to the borrower/donee, effectively canceling the note, the donor may be able to value the note for transfer tax purposes at a discounted value. The burden of proving that a note has a value of less than the face amount, however, is on the taxpayer. Absent a factual basis to substantiate the discount, the note, even if it is non-negotiable, will be treated at face value.

**Income tax implications.** From a federal income tax perspective, the borrower/donee under a promissory note forgiven by the donor will not recognize income because the forgiveness is in the nature of a gift and not of a discharge of debt.

**Forgiveness of an installment note.** The federal income tax consequences of the forgiveness of an installment note are different from the forgiveness of a promissory note. Special rules govern the satisfaction of an installment obligation for an amount other than its face value, or its sale or exchange or other disposition. A disposition of an installment obligation is a transaction that is separate from the installment sale that produced the obligation, whether the disposition occurs in the year of the sale or a later year.
If an installment obligation is sold or exchanged, gain or loss on the sale or exchange is measured by the difference between (1) the amount realized for the obligation, and (2) the basis of the sold or exchanged obligation. In the case of a disposition of an installment obligation in a transaction other than a sale or exchange (such as a gift or cancellation), gain or loss on the disposition is the difference between (1) the fair market value of the obligation at its disposition, and (2) the basis of the obligation. If the seller and buyer are related persons, the fair market value of the obligation cannot be less than its face value as of the date of disposition.78

The basis of an installment obligation is determined by multiplying the unpaid balance on the obligation by the gross profit percentage and subtracting that amount from the unpaid balance.79 For example, assume that a taxpayer sold property several years ago in an arm’s-length transaction on the installment method. Assume further that the gross profit percentage (cost basis of property sold / sale amount) in the original transaction was 60%. If the buyer still owed the taxpayer $1 million of the sales price under the obligation at the time of a gift or cancellation of the obligation, the taxpayer’s basis would be $400,000, resulting in the recognition of $600,000 in gain. Any gain or loss on its sale or disposition would be the same character (i.e., capital gain or ordinary income) as was produced by the sale of the property on account of which it was received.77

If the note is given away as a gift, rather than cancelled, the carryover basis in the hands of the recipient/donee would be effectively “stepped up” to fair market value as a result of the gain recognition by the original seller/donor on the disposition. Any subsequent disposition by the recipient/donee could, therefore, avoid capital gain recognition.

Gift of installment note to grantor trust. Because the disposition of an installment obligation generally causes the deferred capital gain to be accelerated under Section 453B, the lender/donor may find it undesirable to give or cancel the obligation. One potential solution to this problem is for the lender/donor to transfer the note to an irrevocable grantor trust of which he or she is treated as the owner for income tax purposes.79 The gift of the note to the trust would be an effective transfer for federal transfer tax purposes, but would be ignored for federal income tax purposes.80

Furthermore, when the donor dies, a “transmission at death” exception to the installment sale rules is available so that the installment method is available until all payments have been received by the trust.81 One further planning possibility is to fractionalize the ownership of the obligation between the donor and a grantor trust and take advantage of potential discounts for lack of marketability.82

General clean-up

Over time, some originally good estate plans have backfired or become unnecessary. Gifts that were intended to treat children equally may have failed to do so because the assets given have performed in dramatically different ways. The increased exemption may provide a way to “re-equalize” the beneficiaries.

Planning to use both spouse’s exemption amounts regardless of who died first, especially in relatively smaller estates, may have caused titling of assets in a way that is no longer necessary and may even have detrimental nontax results. For example, real estate ownership may have been changed from tenancy by the entirety to tenants in common. If that is no longer important in order to make sure that both credits are used, the asset protection benefits of tenancy by the entirety have been given up for no good tax purpose. Financial assets may have been divided between spouses in such a way that increased fees or limited investment opportunities.

FLPs and LLCs may have been created with a view towards eventually gifting all of the interests to the next generation. Such plans are not always carried out by the donor after he or she has left the attorney’s office, and the increased exemption may provide an opportunity to reinstate the planning strategy without tax cost or start statutes of limitation running on discounted gifts.

Conclusion

Although the 2010 Tax Act has left long-term estate planning in the same uncertain state it was for the past decade, it has created a two-year window of opportunity for gift planning with the increased exemption. For clients able to make large lifetime transfers, there are many effective ways to make gifts in trust. Further, some techniques that were not attractive with the lower gift tax exemption may now be tax-efficient, and for many clients the two-year window may provide a chance to take a look at existing plans and clean up problems without incurring a tax cost.

78 Section 453B(I).
79 Section 453B(b); see also IRS Publication, Installment Sales, 537.
77 Sections 453(a) and (b); Regs. 1.1453-9(a) and (b).
75 Section 1015; See Rev. Rul. 79-371, 1979-2 CB 294.
81 Section 453B(B).