ARNOLD & PORTER LLP

ADVISORY

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No Time Like the Present for Gifting: Final Year of the Tax Relief Act[1] Provides Planning Opportunities for 2012

In 2010, Congress enacted legislation creating the highest gift tax exemption in US history. That legislation, however, expires at the end of 2012. Unless Congress acts, the gift tax exemption will return to its significantly lower 2001 level. As a result, this year presents the perfect planning opportunity for those interested in making significant gifts in a tax-efficient manner.

Consider the current gift tax landscape: Under current law, the 2012 lifetime exemption amount is a record US$5.12 million[2] for individuals and US$10.24 million for couples filing jointly, with any gifts over the exemption amount taxed at a historically low rate of 35 percent. If Congress does not act by the end of this year, the Tax Relief Act will sunset, causing the exemption to return to only US$1 million, with gifts in excess of the exemption amount taxed at graduated rates with the maximum rate reaching 55 percent in 2013.

Smart Gifting: No Strings Attached

Many clients may be uncomfortable with making significant gifts, especially in times of economic uncertainty. Tax law, however, prevents a donor from retaining control over the gift or maintaining an interest in the transferred property. If a donor gives a gift with any sort of a retained interest, the gift is treated as incomplete, causing the transferred property to be drawn back into the donor's estate for estate tax purposes.

One exception to the "no strings attached" rule is the gift of assets to a trust for the benefit of the intended recipients, with the donor's spouse named as an additional trust beneficiary. During the spouse's life, the trustee of the trust has the discretion to distribute trust assets to the spouse, as well as to the other trust beneficiaries. The benefit of this arrangement is that the trust funds can be distributed to the donor's spouse if the need should arise.[3] Although the donor, through his or her spouse, still has some access to

1 Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Dec. 17, 2010).

2 US$5 million in 2011 indexed for inflation in 2012.

3 The amounts distributed to the spouse are includible in the spouse's estate and subject to estate tax, and thus distributions to the spouse should only be made if necessary.

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the trust funds, such an arrangement is not considered an offending retained interest. The gift in trust is deemed complete, and the lifetime exemption can be applied to the assets transferred in trust.

Both spouses may execute trusts like the one described above. Although the trusts may be structured similarly, in that each trust allows the trustee to make discretionary distributions to one's spouse, for gift tax purposes, the trusts cannot be identical or "reciprocal."

Making the Most of Your Gift

Gifts of fractional interests in closely held businesses can be used to leverage valuation discounts, thereby increasing the underlying value of assets that can be transferred gift tax-free. Discounts for lack of control and lack of marketability, among others, can sometimes yield a total discount of 25 percent or higher. Thus, for example, an interest in a closely held business with an underlying value of US$6.8 million, if subject to a 25 percent valuation discount, can be gifted tax-free using the US$5.12 million lifetime exemption amount.

If a gift is made in trust, another way to maximize the value of the gift is to structure the trust as a so-called "grantor" trust. Under the tax laws, the transfer to the trust is respected for estate tax purposes (meaning that assets in the grantor trust are outside the grantor's estate and therefore not subject to estate tax at the grantor's death) but is ignored for income tax purposes. As a result of these rules, all income on trust assets is taxed to the grantor. By paying the income tax on the trust assets, the grantor is, in essence, making additional gifts to the trust beneficiaries by paying taxes that would otherwise be payable out of trust assets. For tax purposes, this is not treated as an additional gift. In addition, transactions between an individual and his or her grantor trust do not trigger gains, losses, or deductions. Best of all, the trust can be structured so that the grantor can toggle off the grantor trust status at any future time,[4] thereby eliminating the grantor's obligation to pay future income taxes on the trust assets if the grantor no longer desires to do so.

4 If the spouse is a permissible beneficiary of the trust, grantor trust status can only be toggled off if the spouse's rights as a trust beneficiary also terminate when the grantor trust powers are released.

If you wish to discuss the gifting options that may be available to you, or if you would like to review your current estate planning documents, please contact your Arnold & Porter attorney or:

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