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The Estate and Gift Tax: Congress Inaction May Require Your Action

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We may be facing a “Use it or Lose it” scenario when it comes to year end planning for estate and gift taxes. Yet, because of the uncertainty in the laws, many taxpayers have not taken any action. It is important to understand that this inaction may prove very costly – potentially amounting to additional taxes of several million dollars for many families.

For the remainder of the year, the exemption for the lifetime federal gift tax, generation-skipping transfer (GST) tax and the estate tax is \$5,120,000 per person (\$10,240,000 per married couple) and the tax rate is at a historic low of 35%. That means that a person may give away (during life or at death) \$5,120,000 without paying any federal gift or estate tax and a married couple may give away, gift and estate tax free, a total of \$10,240,000 (in each case, reduced by prior taxable gifts).

Unless Congress acts and passes legislation to extend these exemptions, beginning on January 1, 2013, the law will revert to the 2001 tax regime so that these generous exemptions will drop to \$1 million per person (\$2 million per married couple), indexed for inflation with respect to the GST tax, with the top tax rate at a high 55% (plus a 5% surtax for estates and gifts in the range of \$10,000,000 to approximately \$17,000,000). To illustrate the effect of this change in tax law, for a single person with a taxable estate of \$5 million, the scheduled estate tax changes could mean a federal estate tax bill of over \$2 million next year, compared with a zero federal estate tax under current law.

Based on the exemptions that are now available, individuals and couples who have accumulated sufficient wealth should consider whether to make gifts, in one form or another, before the end of 2012 in order to reduce their taxable estates significantly. It is important to understand that in order to benefit from the current high exemption, the gift made must be greater than what the estate tax exemption is reduced to in the future, which is unknown at this time. Although the law, as currently written, is set to decrease the estate tax exemption to \$1 million in 2013, Obama’s budget has proposed reverting the estate tax regime to the provisions applicable in 2009, which would set the estate tax exemption at \$3.5 million with a 45% tax rate, and Romney would seek a full repeal of the estate and gift tax. Despite this uncertainty, this much is certain – the exemptions in 2012 are historically high and the estate and gift tax rates are at record lows, so that, unless Congress acts to extend the laws currently in effect or repeal the estate tax entirely, engaging in proper planning now could be a once in a lifetime opportunity.

For those who are ready to take action before year-end, making gifts now not only locks in the current estate and gift tax exemptions, but also provides the following advantages: (1) removes future appreciation from the taxable estate, allowing the transferred assets to grow in the hands of the gift recipient; (2) potentially avoids state estate and/or inheritance tax; and (3) for instances where gift tax may be paid, avoids the tax inclusive nature of a later estate tax since the gift tax (unlike the estate tax) is tax exclusive, meaning that there is no tax on the funds used to pay the tax. Before advising clients to make gifts this year, a word of caution - by making gifts, one loses the step-up in basis (for capital gains tax purposes) in the gifted assets that would have occurred if the assets had been retained until death pursuant to Section 1014 of the Internal Revenue Code. For that reason, it is best to gift high basis assets and retain low basis assets to pass at death.

Below are some of the gifting techniques that clients should consider before the end of the year:

1. Outright Gifts - Making an outright gift to family members (or others) is the simplest way to remove those assets from one's taxable estate now without paying gift or GST tax. This could also include forgiving any outstanding loans to family members. However, this does not offer the long-term estate tax planning (since these assets would be includible in the estate of the next generation) nor does it offer any creditor protection.
2. Gift to Dynasty Trusts. A client may also consider making a gift to a dynasty trust (i.e., a trust lasting in perpetuity) in order to remove those assets from his or her taxable estate now, and also remove those assets from the taxable estates of future generations, while protecting the assets from creditors as well. These trusts can be structured as "grantor trusts" for income tax purposes so that all items of income and deduction attributable to the trust assets will be reportable to the settlor of the trust for federal income tax purposes. This is the gift that keeps on giving since paying income tax on the trust assets year after year is another effective way to reduce the assets of one's taxable estate, gift-tax free.
3. Spousal Lifetime Access Trusts ("SLATs"). If a married couple wishes to make use of their gift tax exemptions, but are concerned about relinquishing access to their property and providing for themselves, each can create a Spousal Lifetime Access Trust ("SLAT") for the mutual benefit of each other, and these trusts can also be structured as grantor trusts. Each SLAT must be different in certain respects to avoid triggering estate tax inclusion under the "reciprocal trust" doctrine. Clients need to be mindful that at the first spouse's death, any income that he or she was receiving from the trust created by the other spouse will not continue and, instead, that trust will now benefit the children so that the surviving spouse, in effect, loses access to half of the money in trust. There may be ways to work around this – such as by having the first spouse exercise his or her power of appointment to make the surviving spouse the beneficiary of a trust that the surviving spouse originally created. However, there is a possibility that such an exercise would cause the trust corpus to be included in the surviving spouse's estate since the surviving spouse may then be viewed as the beneficiary of a trust he or she created. No clear authority exists on that issue at this point.

4. Self-Settled Trusts. As a last resort, an individual could create a trust under which he or she is a discretionary beneficiary. In order for this trust to escape estate tax inclusion, the settlor/beneficiary must not hold an enforceable right to a distribution in the trust and a settlor's creditor cannot be able to reach the settlor/beneficiary's interest. These types of asset protection "self-settled" trusts which are free from creditors' claims may be created in limited jurisdictions, such as in Delaware; however, the law is unsettled as to whether or not such a trust created by a Pennsylvania resident would escape the claims of his or her creditors under the full faith and credit clause of the U.S. Constitution.
5. IOU - For clients who are not able to transfer the full amount of the exemption by the end of the year because time is running short or because of liquidity reasons, it is possible to fund a portion of a trust with a Promissory Note to be paid by the settlor to the trust, provided that there is some Pennsylvania nexus. Pennsylvania has adopted the Uniform Written Obligations Act (33 Pa. Cons. Stat. Ann. § 6), which provides that written promises are enforceable, even without consideration, as long as the writing contains the magic words that the signer "intends to be legally bound." Thus, in Pennsylvania, there is a unique opportunity to utilize an IOU to lock in the exemption.

There is always the risk, which most practitioners believe to be minimal, that Congress will attempt to "clawback" the tax savings generated with these types of gift plans; however, even if gifts made in 2012 were subject to such a clawback, the appreciation of the gifted assets would still be removed from the taxable estate and be free of federal estate tax. Thus, this is a "nothing ventured, nothing gained" and, perhaps, once in a lifetime opportunity.

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