WILLMS, S.C.

▼

LAW FIRM

TO: Clients and Friends of Willms, S.C.

FROM: Attorney Andrew J. Willms

DATE: October 15, 2012

RE: Year-End Tax Planning for 2012

As you are probably well aware, most of the changes to the tax code that were adopted during George W. Bush's presidency are set to expire at the end of this year. If Congress does not act to extend the so called Bush tax cuts, the amount of federal estate taxes that many heirs will be required to pay could increase dramatically. This memorandum offers suggestions on how to take advantage of the Bush tax cuts before year end.

At the present time, gifts during life and transfers at death are currently taxed at a flat rate of 35% unless an exclusion or exemption applies to shelter the transfer from taxation. Currently, all U.S. citizens are entitled to a $5,120,000 "unified credit" which shelters up to $5,120,000 worth of gifts and bequests from transfer taxes. As a result, a married couple can transfer up to $10,240,000 to their heirs tax-free.

If the Bush tax cuts are not extended, as of January 1, 2013 the unified credit and generation skipping transfer tax exemption will be reduced to $1,000,000 per person, indexed for inflation since 2001. This works out to approximately $1,400,000 per person. In addition, the rate of tax on transfers exceeding this amount will increase to 55%. President Obama has called for an estate tax with a $3.5 million exemption and a tax rate of 45%. This would be consistent with the estate tax laws as in effect in 2009.

There are a variety of ways to take advantage of the current rules governing the taxation of gifts and estates before year end. A discussion of some of the available options follows.

1. Utilize the Increased Gift Tax Exemption.

As indicated above, currently every person can gift up to $5,120,000 without incurring gift tax. This means a married couple could give away $10,240,000 tax-free. Because gifts made during life are normally not subject to estate tax when the person who makes the gift

dies, this is a very simple way to take advantage of the current rules.[1]

While an outright gift is the simplest way to use the gift tax exemption, there are a number of other planning techniques that can maximize your gift tax exemption to protect even more assets from transfer taxes. A brief discussion of some of these techniques follows.

a. **Fund a Spousal Gift Trust.** Married couples who wish to take advantage of the current gift tax exemption without significantly changing their current economic situation may want to consider establishing a Spousal Gift Trust. This involves one spouse establishing an irrevocable trust for the benefit of the other spouse. The spouse who creates the Trust would use his or her gift tax exemption to shelter transfers to the Spousal Gift Trust from tax. The other spouse would be the beneficiary of the Spousal Gift Trust, and as such could receive income and principal as needed. When the beneficiary spouse dies, any assets that remain in the Spousal Gift Trust could be given to the couple's descendants, free of the federal estate tax.

b. **Make Gifts that Utilize Valuation Discounts.** In his budget proposal for 2013, President Obama called for changes to the provisions of the Internal Revenue Code that govern the way closely held business interests are valued for estate and gift tax purposes. In many cases his proposal would result in a higher value being assigned to family businesses when gift and estate taxes are calculated, thereby potentially increasing the amount of tax due upon transfer of a family business to the next generation. Accordingly, if you own a closely held business, you may want to consider using the current valuation provisions and the current gift tax exemption amount to transfer a share of the business to younger generations before the end of the year.

c. **Establish an "Intentionally Defective Grantor Trust."** An Intentionally Defective Grantor Trust ("IDGT") is a special type of irrevocable trust whereby trust assets are not included of the Trust's Grantor for estate tax purposes, but are nonetheless regarded as belonging to the Grantor for income tax purposes. Because the Grantor is treated as owning the IDGT's assets for income tax purposes, income earned on those assets are taxed to the Grantor rather than the IDGT. This essentially allows the IDGT to grow on a pre-tax basis for the IDGT's beneficiaries.
Under current tax law, the Grantor can sell assets to the IDGT without triggering capital gains taxes. The effect of such a sale is to transfer future appreciation in the value of what was sold to the beneficiaries of the IDGT tax-free. This can result in significant estate tax savings.

[1] It is worth noting that some commentators speculate that if the Bush tax cuts do expire after the end of this year, then gifts made this year will be "clawed back" (i.e. subject to estate tax) when calculating the estate tax exemption available at death. However, we do not think this will prove to be the case.

The President's tax proposals would require most IDGTs established after 2012 to be included in the taxable estate of the person who creates the trust, thereby eliminating their effectiveness as an estate planning tool. Therefore, individuals who want to take advantage of the tax benefits of an IDGT should look to create this type of trust before the end of this year.

d. **Create a "Grantor Retained Annuity Trust."** A Grantor Retained Annuity Trust ("GRAT") is a special type of gift trust whereby the person establishing the trust is entitled to receive an annuity payment from the GRAT each year for a period of years. The tax code allows the value of this annuity to be deducted when determining the amount of the gift upon funding the GRAT. In fact, if the value of the annuity equals the value of the initial gift, then the funding of the GRAT does not result in a taxable gift, and assets that remain in the GRAT (if any) when the annuity ends will pass to the beneficiaries of the GRAT tax-free. However, if the Grantor dies before the annuity ends, then all of the assets held in the GRAT are estate taxable.

Currently, GRATs can be drafted to have a term as short as 2 years. For the last several years there has been considerable discussion in Congress about amending the rules governing GRATs so as to require GRATs to have a minimum term of 10 years. Such a change would increase the odds that the Grantor could die during the term and thereby undo the estate and gift tax savings created by using a GRAT. In addition, the President and others have proposed a requirement that the creation of a GRAT result in a taxable gift upon formation.

e. **Make Gifts to a Charitable Lead Annuity Trust.** A Charitable Lead Annuity Trust ("CLAT") can be a particularly attractive way for individuals who are charitably inclined to take advantage of today's large gift tax exemption. This type of trust is similar to a GRAT, except that annuity payments are made to charitable organizations, rather than the Grantor, for a specified term of years. Because the annuity payments qualify for the gift tax charitable deduction, the value of those payments is deducted from the value of the assets transferred to the trust. Whatever is left in the trust when the charitable payments end can be given to non-charitable beneficiaries tax-free. Additionally, unlike a GRAT, the person who creates a CLAT does not need to outlive the term period for the tax savings to be realized.

CLATs are particularly attractive at the present time because today's low interest rates increase the value of the annuity going to charity, thereby decreasing the amount of the taxable gift. Another attractive aspect of CLATs is that the annuity payment can take the place of annual charitable donations the Grantor is in the habit of making in any event.

2. Make a Donative Promise.

If you would like to make a lifetime gift to lock in the current unified credit amount but are not in a position to currently part with the gifted assets, you may want to consider promising to make the gift or bequest at some point in the future. A "donative promise" is a promise to give or bequeath money to another at some future point in time. If the donative promise is legally enforceable, then it would seem to constitute a gift that can utilize the gift tax exemption available in 2012, and should not be subject to estate tax at your death.[2]

In order for a donative promise to be legally enforceable, the person making the promise must receive something in exchange for the promise (known as "consideration"). However, there is legal authority for the proposition that it is not necessary for the consideration given to have monetary value. For example, the donee could promise to send their children to a certain school, allow their children to spend a certain number of days at your home per year, or something similar.

The law surrounding the use of a donative promise to make a gift is not settled. Therefore, it is important that precautions be taken to improve the likelihood the technique will provide the desired results. One such precaution is to make the donative promise to a trust established for the benefit of the donee instead of making the promise directly to the donee. In addition, the promise should be properly documented and a gift tax return should be filed to report the gift. Finally, the more significant the consideration for the promise, the greater the likelihood of success.

3. Fund a Dynasty Trust.

A Dynasty Trust is a special type of trust designed to continue in perpetuity. Currently, Wisconsin law has no limit on the duration of these trusts. As a result, a trust funded now that is exempt from transfer taxes under current law theoretically could escape transfer taxes forever.

Lawmakers are considering imposing a limit on the length of time a trust can be sheltered from transfer taxes. President Obama has proposed the limit be 90 years. As a result, it would be prudent for persons who are interested in creating a Dynasty Trust to do so before year end.

4. Convert Traditional IRAs to Roth IRAs.

Roth IRAs offer substantial tax benefits as compared to traditional IRAs because (1) distributions from Roth IRAs are never subject to the federal income tax, and (2) the minimum distribution rules mandating the commencement of distributions from an IRA

[2] This assumes Congress does not "claw back" 2012 gifts as mentioned in the previous footnote.

when the account owner turns 70 ½ do not apply to Roth IRAs while the account owner is alive. These benefits could be lost if the legislation permitting Roth IRAs is repealed.

Furthermore, owners of a traditional IRA are permitted to convert the traditional IRA to a Roth IRA. Such a conversion in 2012 could lock in the tax benefits of Roth IRAs. However, this will result in all amounts transferred to the Roth IRA being subject to immediate income taxation. While this is normally considered a drawback, it may actually be a significant advantage if the Bush tax cuts are not extended. That is because today's lower tax rates will apply when determining the amount of tax payable as a result of the conversion, and future distributions will avoid both income taxes and the 3.8% heath care reform surtax on net investment income that takes effect on January 1, 2013. Therefore, conversion from a traditional IRA to a Roth IRA before the end of the year may be a very attractive tax-saving strategy.

****

If the possible repeal of the Bush tax cuts is a concern relative to your estate planning, then please schedule an appointment with us at your earliest convenience to discuss whether you ought to take action now before these changes are given a chance to take effect. We would welcome the opportunity to meet with you to review your estate plan.

END OF MEMO