

Taking Advantage of the Biggest Gift the IRS ever Gave



PARKER | SMITH | FEEK

April 2012

On December 17th, 2010 the President signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010 which contained dramatic, yet temporary, changes to the federal transfer tax system (estate, gift and generation skipping taxes). The most significant provision in the new law is an increase in the amount that may be passed from one individual to another (gifted or bequeathed) free of federal transfer taxes. The “unified credit” was increased to \$5,000,000 which means as of January 1, 2011 high-net-worth individuals may transfer a substantial portion of their assets to their children and grandchildren tax-free. This creates numerous opportunities for families to accomplish their legacy / estate planning goals that weren’t available previously.

Unfortunately, the federal government has had the tendency to use the estate tax as a bargaining chip. In the past 33 years there have been 22 separate changes to the estate tax rates and exemption amounts. These most recent changes are effective for a period of two years and expire on January 1st, 2013. Unless new legislation is passed prior to that date, the exemption amount and tax rate will return to pre-2001 levels - \$1,000,000 and 55%. That applies to the gift tax exemption as well, meaning that affluent families have less than a year now to take advantage of their ability to gift \$5 million (\$10 million for a married couple) free of the federal gift tax.

The following are just a few of the techniques and strategies that are being utilized during this two year window to take advantage of the historically high gift tax exemption amounts:

Gifts to Spousal Lifetime Access Trusts (SLAT) - A SLAT is a trust that one spouse establishes for the benefit of the other spouse and their heirs. The trust contains terms that permit a certain level of distributions to the spouse during their lifetime, with the remaining principal being distributed to their heirs upon their death. When properly drafted the SLAT removes the gifted amount, plus all appreciation, from the couple’s gross estate for estate tax purposes while

providing a degree of access to income from the gifted assets.


Gift to a Beneficiary-Controlled Trust (BCT) - The term beneficiary-controlled trust is a term used to describe trusts that are established to provide a combination of asset protection, retained control of trust assets, and a right to trust income through trust distributions. They may take a number of different forms but they generally contain provisions to accomplish these goals. A BCT is a tremendous tool for transferring interests in closely-held businesses to future generations while minimizing exposure to federal transfer taxes.

Grantor Retained Annuity Trusts (GRAT) - A GRAT is a trust that provides a fixed amount of income to the Grantor (person that contributed funds to the trust), with the remainder passing to a chosen beneficiary after a specific time frame (typically 10 years or less). The advantage of a GRAT is that it removes appreciation from the estate of the Grantor. GRATs work extremely well when interest rates are low (like they are today) and the assets contributed to the trust are expected to appreciate substantially in value.

Life Insurance Trusts - The main problem the estate tax creates for affluent families is that the estate will have insufficient liquidity to pay the tax. The executor is then required to liquidate family assets, possibly even the family business, to come up with the funds to pay the IRS. Gifts made to a life insurance trust may be leveraged to create a substantial amount of death proceeds to solve the liquidity issue. Properly designed, the death benefits will be received free of income and estate taxes. The trust itself may be designed to include some of the benefits of the SLAT and BCT trusts mentioned above, creating a flexible risk management vehicle with lifetime and legacy benefits.

The Future - Flexibility and Risk Management

Two basic concepts should drive planning for the estate tax in the future - flexibility and risk management. If you have concerns over the effect



the estate tax will have on your heirs, you need to take into consideration that this particular tax is a moving target that will be applied at some unknown point in the future. The current law may be extended, amended, modified, or repealed, but there is no such thing as a permanent tax law. So what do you do when there is a future financial threat that is somewhat uncertain - you work with professional advisors to implement strategies to manage the risk. And what do you do when history has proven the threats are uncertain as to their magnitude and timing - you build as much flexibility into your planning as possible.

There are many strategies that are designed to protect families from the risk of a future estate tax while retaining a level of flexibility. Those discussed above are just a few of the strategies available. The most appropriate strategy will depend on your specific facts and circumstances as well as your family's overall wealth transfer goals.

If you would like an analysis of the risks the federal estate tax may pose to you and your family, please contact us. We will work with you and your professional advisors to develop and implement strategies that accomplish your goals, regardless of what the tax laws look like in the future.

By John Frazier. Vice President

Disclaimer: While this article may be used to promote an idea discussed in the publication, it is intended to provide general information about the subject matter covered and is provided with the understanding that Parker Smith & Feek is not rendering legal, accounting or tax advice. It is not a marketed opinion and may not be used to avoid penalties under the Internal Revenue Code. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.