

May 24, 2012

Planning Opportunities Set to Expire

Shifting Tax Laws

Tax legislation enacted in 2010 greatly expanded the estate, gift and generation-skipping transfer (or GST) tax exemption amounts and significantly reduced transfer tax rates. Absent Congressional action, the expanded exemptions and reduced rates are scheduled to sunset on December 31, 2012. While there have been proposals for permanent tax rules, ranging from ushering in higher rates and lower exemptions to transfer tax repeal, it is quite possible that Congress simply will not act (or that the President may veto proposed tax legislation). Accordingly, those who wish to take advantage of the current favorable tax rules should consider acting now and utilizing their remaining gift tax exemption.

Gift Tax

Exemption Amount. Currently, the gift tax exemption amount is \$5.12 million. A married couple therefore may shield up to \$10.24 million from gift tax, after taking into account any prior use of the gift tax exemption. (A decedent's estate tax exemption is reduced by the amount of any gift tax exemption used during his or her lifetime.) If Congress fails to act, the gift tax exemption amount will return to \$1 million on January 1, 2013.

Applicable Rate. Gifts in excess of a transferor's exemption amount currently are taxed at a rate of 35%. Beginning in 2013, such gifts will be subject to tax that can reach a rate as high as 55%.

GST Tax

Exemption Amount. The GST tax generally applies when property rights devolve to someone who is two or more generations below the transferor. The tax law permits the transferor to shield assets from the GST tax to the extent GST exemption is allocated to the transfer. The GST exemption amount currently is \$5.12 million. Beginning January 1, 2013, absent Congressional action, the exemption amount will fall to approximately \$1.4 million.

Applicable Rate. The current GST tax rate of 35% for GST transfers in 2012 is set to increase to 55% for GST transfers in 2013 and beyond.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter that is contained in this document.

Planning Opportunities

What Does the Future Hold For Estate Planning? With respect to gift and estate tax laws, Congress has proven itself unpredictable. For example, estates of decedents dying in 2010 could have opted out of the estate tax regime, while estates of decedents dying in 2013 could be exposed to estate tax at a rate of 55%. These disparate results suggest that those individuals who have the wealth to make gifts should consider acting now before the increased exemptions and reduced rates might expire.

I Want To Make a Gift, Now What? For those who are interested in pursuing this planning opportunity that may expire soon, there are several items to consider.

It may be important to leverage the gift and GST tax exemption amounts. Leveraging the exemptions can be achieved in a variety of ways, including sales or loans, both of which are particularly effective now given current low interest rates. Another technique to consider is making a gift of assets with respect to which one can justify valuation discounts.

For those who wish to utilize their gift tax exemption amount but are concerned they may need access to the funds in the future, we could explore the merits of a gift to a trust of which the spouse is a permissible beneficiary. So long as the spouse is living and the marital unit remains intact, if funds are needed, the Trustee could distribute trust property to the spouse, thereby providing a safety net. However, one drawback of including the spouse as a permissible beneficiary is that the donee spouse's gift tax exemption amount generally cannot be applied to the gift. We also could explore the possibility of each spouse creating a trust; however, the trusts should be sufficiently different to avoid the so-called "reciprocal trust" rules.

We often recommend gifts to a trust that is a grantor trust for income tax purposes. Using a so-called "grantor trust" as the receptacle for the gift provides an additional planning opportunity: because the grantor (and not the trust or the beneficiaries) will be responsible for the income tax on any income generated by the trust, the trust assets will grow unencumbered by the income tax, while the grantor's tax payments further will reduce the estate. Furthermore, a sale to a grantor trust will not trigger an income tax. This technique has caught the attention of the current Administration, which has proposed to limit its effectiveness in the future; however, the proposed limitation has yet to gain traction. As an alternative to the grantor trust, it may be important to consider state income tax, which (in some cases) may be avoided with non-grantor trusts.

In all events, it bears mentioning that there are some risks associated with utilizing the full amount of the current gift tax exemption. First, there is a chance that a portion of the date-of-gift value of lifetime gifts will be subject to estate tax upon the donor's death if the estate tax exemption amount at death is lower than the current gift tax exemption amount. However, even if lifetime gifts are "clawed back" into the estate, the donor will have removed all post-gift appreciation of the assets from the estate. Another possibility, albeit remote, is that Congress will lower the exemption amount and make the change retroactive, affecting gifts made prior to the change in the law. These risks should be considered in determining whether to make a gift and the size of the gift.

There are several other techniques available that we can tailor to the individual circumstances of each client. We welcome the opportunity to discuss these issues with you.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

John J. O'Neil
212-373-3379
joneil@paulweiss.com

Alan S. Halperin
212-373-3313
ahalperin@paulweiss.com

NEW YORK

1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING

Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG

12th Fl., Hong Kong Club Building
3A Chater Road Central
Hong Kong
+852-2846-0300

LONDON

Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO

Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

TORONTO

Toronto-Dominion Centre
77 King Street West, Suite 3100
P.O. Box 226
Toronto, ON M5K 1J3
Canada
+1-416-504-0520

WASHINGTON, D.C.

2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON

500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410