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ESTATE PLANNING UPDATE

Two Important Tax Planning Techniques That Everyone Should Consider

Our practice has seen two tax planning techniques grow in popularity over the past six months – Exemption Gift Trusts (EGTs) and Grantor Retained Annuity Trusts (GRATs). Each one is discussed in turn below.

Exemption Gift Trusts (EGTs)

The purpose an EGT is to take advantage of the current $5 million federal estate/gift/GST tax exemption.[1] This exemption was implemented by the passage of the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" on December 17, 2010 (the "2010 Act"). Importantly, the provisions of the 2010 Act expire as of January 1, 2013. In the absence of additional legislation, the Federal gift, estate and GST tax system will be restored to the 2001 status, which provides for only a $1 million federal estate tax exemption, indexed for inflation. In light of the foregoing, and the fact that no one can predict whether the estate/gift/GST exemption will ever again be $5 million (or more), it is important that high net worth individuals and families take advantage of the current provisions of the tax law; this may turn out to be a "use it or lose it" situation.

Terms of the Trust

The permissible beneficiaries of an EGT can be anyone, including, but not limited to, your spouse, your children, your grandchildren and/or, perhaps, your more remote descendants (*i.e.*, great-grandchildren). The specific terms for how the income and principal will be distributed to your beneficiaries (i) during your lifetime, and (ii) during their lifetimes after you have died, is entirely up to you.

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[1] In 2012 the exemption is indexed for inflation; therefore, the exemption amount is actually $5,120,000.

The most flexible method for providing support is to leave it entirely in the discretion of the trustee to distribute for the beneficiary's "health, education, maintenance and support." However, you can choose a more restrictive method if you prefer. Also, the trust can be "generation-skipping," meaning it is later distributed to your grandchildren or more remote descendants.

Trustees

For tax reasons, you cannot serve as trustee of your own EGT. However, you can select any individual or entity or more than one individual or entity, or a combination of both, to serve as the trustee of the EGT. The trustee can be your spouse, parents, adult children, siblings, etc. We also recommend that you name both a successor trustee(s) and a second successor trustee(s), in the event the initial trustee named cannot serve or ceases to serve.

If you prefer, you can retain the power to (i) remove any then acting trustee and appoint a new trustee to serve, (ii) add another individual or entity to serve as a co-trustee, and (iii) eliminate or change the order of succession of any successor trustee or co-trustee designated in the document. In addition, the last acting trustee for whom no designated successor shall be available to act for any reason whatsoever may appoint any one or more individuals and/or entity as his, her or its co-trustee or successor trustee.

Taxation of the Trust Assets

The EGT will be a "grantor" trust, meaning that you may continue to be the taxpayer for income tax purposes. This allows the trust to grow free of income taxation and thus compound more rapidly than it otherwise would. Significantly, there is no gift tax consequence to your paying the taxes on the trust's income and gains. Upon your death, your spouse will be treated as the owner of the trust for income tax purposes and upon your spouse's death, the beneficiaries of the trust will be treated as the owner(s).

Ability to Borrow from the Trust

During your lifetime, the trustee may permit you to borrow the income or principal of the trust, directly or indirectly, without requiring you to provide adequate security. Following your death, your spouse will have the ability to exercise this power and upon your spouse's death, the beneficiaries of the trust will have the ability to exercise this power.

Short Window of Opportunity

Given that the Federal exemption is slated to diminish from the current $5 million to only $1 million at the end of this year, there is a relatively short period of time to take advantage of the significant transfer tax benefits afforded by EGTs. The time to act is now.

Grantor Retained Annuity Trusts (GRATs)

A GRAT is created by transferring one or more high-yield assets, or assets with significant potential for appreciation, into an irrevocable trust and retaining the right to an annuity interest for a fixed term of years. When the retention period ends, assets in the trust (including all appreciation in excess of the "hurdle rate") pass to the named "remainder" beneficiaries tax free. Thus, a GRAT is an effective way for you (the Grantor) to transfer any appreciation in the assets transferred to the GRAT to your family members with minimal to no gift or estate tax consequences.

One of the advantages of a GRAT is that the assets contributed to the GRAT are valued at today's value and the annuity paid to the Grantor is based on that value. Therefore, the GRAT freezes the value of the assets to be paid to the grantor and passes to the appreciation on the property the GRAT beneficiary. (That is why we often recommend that clients transfer to the GRAT assets that have significant potential for appreciation.)

In addition, the GRAT is a "grantor" trust for income tax purposes. This means you (the Grantor) continue to be taxed on income and realized gains on trust assets even if these amounts are greater than the trust's annuity payments. This further enhances the GRAT's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence, you are effectively allowed to make tax-free gifts of the income taxes.

The use of a GRAT is particularly effective now as the aforementioned "hurdle rate" is at a historic low. For June 2012, the rate is 1.2%. Accordingly, any asset that has the potential to realize a total return of more than 1.2% in the near future should be considered to fund a GRAT.

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The above summarizes the salient aspects of the EGT and GRAT. If you have any specific questions, or would like to discuss implementing either or both of the above-referenced tax planning techniques, please do not hesitate to contact us. We would be pleased to meet with you and discuss your options.

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