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Year-End Gift Tax Planning for 2012¹

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I. Reasons to Make Gifts in 2012

There are three principal tax reasons to make substantial gifts before the end of the year.

1. The gift tax credit for 2012 is at an historic high, \$5,120,000 . It is scheduled to drop to \$1,000,000 on January 1, 2013. If there is no “claw back” in the year of the 2012 donor’s death, and if the credit amount is then lower than it is in 2012, the 2012 gift is likely to save substantial estate taxes because the 2012 gift will have locked in the advantage of the higher credit.

2. The donor will be able to use the \$5,120,000 GST exemption to protect the gifted property from future generation-skipping transfer taxes. A claw back of the gift tax credit will not affect the level of GST exemption allocated to gifted property although the IRS could apply section 901 of the 2001 Economic Growth and Tax Relief Reconciliation Act of 2001 (the sunset provision) in a way that would significantly reduce the level of GST exemption allocated to a 2012 gift.

3. The income and appreciation earned on the gifted property will be removed from the donor’s transfer tax base. If the gifted property is given to a grantor trust, the income and appreciation earned on the gifted property will be enhanced by the donor’s payment of gift taxes.

2. The Claw Back Issue

The term “claw back” refers to the apparent requirement in the current estate tax law as that the estate of a donor of a \$5,120,000 gift in 2012 who dies in a year in which the applicable credit amount under section 2010 of the Code,² must calculate her estate tax by including the 2012 gift in her estate tax base as an adjusted taxable gift and by reducing the tax due, not by the credit allowed against the gift in 2012 but only by the smaller credit allowable in the year of death.

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² References to the “Code” are to the Internal Revenue Code of 1986, as amended. References to “section” are to sections of the Code.

If claw back applies, the only advantage of the 2012 \$5,120,000 gift will be the prospect of removing the income and appreciation earned on the gifted property from the estate tax base and the use of the GST exemption.

For some estates, claw back, if not properly planned for, could cause a significant distortion in the estate plan.

Consider, for example, the estate of a 2012 donor who makes a 2012 gift of \$5,120,000 and dies with an estate of \$5,000,000 all of which is given to her husband. If claw back applies, and if the burden of paying the estate tax falls on the estate rather than on the 2012 gift, most of the assets in her estate will be required to pay estate taxes. Little will be available for her husband.

III. Overcoming Reluctance to Make 2012 Gifts

Many clients are reluctant to make 2012 gifts because of uncertainty about their own economic futures. In some cases, the concern of a client can be overcome by making the gifted property available to her husband. This can be accomplished in various ways, including by naming the husband as a discretionary beneficiary of a discretionary trust or by selling a term interest in the family home to him (the term of which is measured by the joint lives of the donor and her husband) for full value while simultaneously gifting the remainder interest in the home to a trust for the children.³

Clients who would not be willing to make substantial gifts without having access to the gifted property for themselves, might want to consider the techniques described below.

IV. The Gift of the Donor's Obligation

A promise to make a gift, if enforceable, is a completed gift for gift tax purposes. This is so despite the fact that the donor retains full control over all of her assets after the gift has been made. The donor's estate will not receive a deduction under section 2053 for the amount of the debt if it is in existence at her death because the promise was not based on adequate and full consideration in money or money's worth. Because there is no deduction, Rev. Rul. 84-25 will entitle the estate to reduce the amount of the decedent's adjusted taxable gifts by the amount of the debt. As a result, her estate tax base will be the same as if a section 2053 deduction had been allowed.

If there is no claw back, the estate of the donor who dies with the \$5,120,000 note outstanding will have achieved the savings described on Schedule I.

The difficulty with this technique is that most states will not enforce a promise to make a gift. As a substitute, consider the following.

Step # 1 – Donor establishes a trust for the benefit of her husband and issue and makes a gift of \$120,000 to it.

³ In order to avoid application of section 2702's joint purchase rules to the husband, this technique should be implemented in the form of a qualified personal residence trust.

Step #2 – The trustee forms an LLC and contributes the \$120,000 to the LLC. The trustee is the manager.

Step #3 – Donor contributes her personal note for \$5,000,000 in exchange for a 97.66% membership interest in the LLC.

Step #4 – Donor gives her interest in the LLC to the trust or to another trust.

The donor has accomplished the economic equivalent of a promise to make a gift. In addition, because she has retained all of her assets, all of her assets will receive a basis adjustment under section 1014.

VI. The Intentionally Busted 2701 Transaction (the “IBT”)

The donor who makes a gift of a junior equity interest in a partnership or limited liability company while retaining a preferred equity interest with a fixed economic value and a zero value for section 2701 purposes will have made a gift with a value equal to her entire interest in the company while retaining complete control over the retained preferred. When she dies, the value of the preferred will be included in her gross estate under section 2033, but its value will be eliminated from her adjusted taxable gifts under Treas. Reg. 25.2701-5. As a result, if there is no claw back, the donor will have achieved the savings described on Schedule II.

Consider the following example:

Step #1 – Donor transfers \$5,120,000 worth of assets to a limited liability company (“Newco”). Newco’s operating agreement creates two classes of membership interests, Class A and Class B. Class A entitles its holder to a 1% annual, non-cumulative return on a redemption value of \$5,000,000 and gives her the right to put her interest to Newco at any time for \$5,000,000. Class B consists of all other economic rights in Newco.

Step #2 – Donor gifts her Class B interests in Newco to a discretionary trust for the benefit of her husband and issue.⁴

Because section 2701 will treat the Class A interests in Newco as having a zero value, she will be treated as having made a gift of \$5,120,000.

The IBT has the following advantages over the conventional gift.

1. The donor retains full control over \$5,000,000 worth of her assets despite the fact that she is treated for gift tax purposes as having made a gift.
2. If the property the donor contributed to Newco is appreciated property, on death it will receive a basis step up under section 1014 to \$5,000,000.

For many donors the IBT may be preferable to making the debt arrangement described above for the following reasons:

⁴ The use of a grantor trust as the donee of this technique will reduce the income tax complications that could be caused by the creation of a partnership for income tax purposes.

1. The IBT will remove the income and appreciation earned on the \$5,120,000 from the transfer tax base to the extent the income and appreciation exceeds any return paid to the donor. If the excess return on the assets held by Newco exceeds the interest that would have been paid on the debt described above, the donees will be better off with the IBT than with the debt arrangement.

2. For a client who may be interested in future borrowings, the depletion in net worth that would result from the debt arrangement may not be acceptable. The IBT will have only a minimal impact on a client's balance sheet.