The Wealth Advisor

The Door Is Closing - Unique Gift and Estate Planning Opportunities in 2012

Volume 6, Issue 3

2012 is truly an exceptional year to do estate planning. The estate, gift, income and generation skipping transfer (GST) tax laws are the most favorable to taxpayers since the 1940s, or possibly ever, and are scheduled to become far less favorable in 2013. That gives taxpayers like you just five more months to complete making gifts to save tremendous amounts in taxes.

From Michael Wittick

Law Offices of Michael J. Wittick, a Professional Law Corporation

7700 Irvine Center Drive,
Suite 800
Irvine CA 92618
949-753-2829

My practice is exclusively devoted to estate planning, trust and probate law, in which I am certified as a specialist by the State Bar of California, Board of Legal Specialization. This newsletter highlights legal issues which could affect you personally and financially.

Unless tax law changes are enacted (which requires the agreement of the House of Representatives, the Senate and the President), at the end of 2012, the uniquely favorable tax laws we have now will be replaced with tax laws that are drastically less favorable for taxpayers. And, if new tax laws are enacted, we may still lose much of what we have for the next five months as lawmakers search for ways to generate more revenue and lower deficits. Even some planning options that professionals have come to rely upon as "standards" may soon be history. It really is a "use it or lose it" time in estate planning.

In this issue of *The Wealth Advisor*, we will explain some of the wonderful gifting opportunities that are available only for the rest of 2012 and how using these opportunities can help you transfer huge amounts of your wealth tax free to your children and other beneficiaries.

Understanding Estate, Gift and GST Taxes

For you to fully appreciate these opportunities, a brief review of the federal estate, gift, and GST taxes may be helpful.

Estate, gift and GST taxes are excise taxes imposed by the federal government on the value of assets transferred by gift or at death. They are different from and in addition to *probate expenses* and *income taxes*. Some states also have estate taxes. They are beyond the scope of this newsletter, which covers only federal taxes.

Gift taxes apply to transfers made by gift. Estate taxes apply to transfers made when someone dies. GST taxes apply to transfers made both by gift and on death to someone who is treated by the law as being more than one generation younger than the transferor.

Estate, gift and GST tax rates historically have been 35-60% of the value of the assets transferred and they must be paid in cash, usually within a short time after the transfer event (9 months for death and up to 15 1/2 months for gifts).

Whether a tax will be due depends on whether an exclusion can be applied to the transfer. For example, transfers to charities are excluded from these taxes. So are payments made to an educational or health care provided for education or health care expenses of another. Transfers between U.S. citizen spouses may also be 100% excluded.

There are also both annual and lifetime exclusions from these taxes that a taxpayer gets.

On an annual basis, each taxpayer can transfer outright by gift up to $13,000 per recipient to as many people as he or she chooses, and all of the transfers will be excluded from the gift and GST tax. Gifts made in trust may also be excluded, but there are rules to which careful adherence is required and the gift and GST tax rules are different.

Each taxpayer also gets a lifetime exclusion from gift, estate and GST taxes.

If a transfer is not covered by a tax exclusion, the tax is due. Even worse, some transfers can be subject both to the gift or estate tax AND the GST tax!

The starting point to determine if your estate will have to pay estate taxes when you die is its *net* value at that time. To determine the current net value of your estate, add up all of your assets and subtract all of your debts. Include your home, business interests, bank accounts, investments, personal property, IRAs, retirement plans and death benefits from your life insurance policies. Keep in mind that estate taxes are based on the values when you die, and your assets may appreciate between now and then. Then subtract from the net value of your estate your unused lifetime gift tax exemption. If you are planning to die in 2012, that is $5,120,000 minus the sum of gifts you have made during your lifetime that were not subject to a total or annual exclusion. If you are not planning to die in 2012, the safest number to use is what the current law provides: $1,000,000 minus the sum of gifts you have made during your lifetime that were not subject to a total or annual exclusion. The result in both cases is the amount that would be subject to the estate tax.

In 2012, the tax rate is 35%. This means that every dollar that is taxable will be taxed at 35%. Unless the law is changed, starting January 1, 2013, the estate tax rate will begin at more than 40% and the top estate tax rate will be 55%.

Will the estate, gift, and GST laws be changed? Probably. They have been changed many times before and will likely be changed many times in the future. Today’s laws, however, are the most favorable they have been in decades. Also, a deadlock between the President and at least one of the houses of the Congress is a distinct possibility. If that happens, starting on January 1, many more estates of decedents will be subject to estate taxes and those families who failed to plan in 2012 and lose a loved one after December 31, 2012, may also lose huge amounts of their inheritances to taxes.

How to Use Your $5.12 Million Exclusion Without Dying in 2012
There are lots of people who have been lulled into inaction. They may think that because their net estate is below $5.12 million, there is no reason to do any estate planning this year. Or they may think that they can delay the cost and bother of planning because they are very unlikely to die in 2012.

If they have an estate that would be taxed under current law on a 2013 death, they really need to do planning now, while there is still time, because the $5.12 million gift tax exclusion is very likely not to be available after this year. As the saying goes, "use it or lose it." Then, when the estate tax calculation is made on a death, if the estate tax exclusion is then lower, excluded gifts in excess of that estate tax exclusion will not be considered.

There is also a benefit to being married here. Married taxpayers can elect to have all their gifts split, so one half is counted against each spouse's exclusions. In other words, if you are married, through the end of December the amount that you and your spouse can give away together during life without paying gift tax is $10.24 million!

To use all or some of that lifetime gift and GST tax exclusion this year, start giving some assets to the people who will eventually inherit from you. With such large gifts, careful planning is necessary. The rest of this newsletter will focus on some ways to do that gifting that will take full advantage of the exceptional exclusions we currently have.

Planning Tip: Never give away more than you can afford to be without. Also, any kind of substantial giving program must be done under careful professional guidance and supervision to be sure everything is done correctly and really will be excluded from taxation.

Use Annual Exclusion Gifts in a Lifetime Giving Program and Avoid the Gift Tax
Only gifts in excess of the annual gift and GST tax exclusions deplete the lifetime GST, gift and estate tax exclusion. Federal law currently lets you give up to $13,000 per year to as many people as you wish without incurring a gift or GST tax. A married couple can give twice this amount, or $26,000 per year per person. (This amount is currently tied to inflation and may increase to $14,000 next year.) Gifts made in trust have special rules that must be carefully followed to be eligible for the annual gift and GST tax exclusions.

With a lifetime giving program, you can transfer $13,000 annually to the individuals of your choice, typically children, grandchildren and other close family members. For example, if you give $13,000 per year to two beneficiaries for five years, you will have removed nearly $150,000 from your estate for estate tax purposes (assuming these assets would have grown by 6%). After 10 years, you will have removed more than $365,000 and $1.5 million after 25 years. The amount removed from your estate is increased significantly with each additional $13,000 annual gift recipient.

Planning Tip*:* Gifting programs involving gifts to young people need to be carefully planned. Accumulated gifts not made in trust will have to be turned over to the young person at age 18 or 21, depending on the state of their residence. Many are the families who have suffered from the consequences of an irresponsible youth receiving a large sum of money.

Planning Tip*:* When you give more than the annual tax exclusion amount, the excess will reduce your remaining available lifetime gift, GST and estate tax exclusions.

Planning Tip: Prior to 2011, the lifetime gift and GST tax exclusions were never more than $1 million. For the remainder of 2012, those who have already exhausted their old $1 million gift and GST tax lifetime exclusions are not "tapped out." During these 5 months, they have an additional $4.12 million of lifetime gift and GST tax exclusion to use. Again, married couples who plan ahead can double those amounts.

Give More Using Structured Assets

The gift, estate and GST taxes are all based on the value of the asset transferred to the recipient. Careful planning may be able to reduce the "value" of gifted assets substantially. Such reductions are popularly called "discounts." Here's how it works.

Put yourself in the shoes of a buyer of assets. Would you pay the same thing for, say 100 shares of IBM that you could sell tomorrow for cash that you would for the same 100 shares that someone else had all the power to decide to sell and what to do with the proceeds? Of course not! That is the heart of asset discounting. Make the shares less attractive.

The way discounting is commonly done is to contribute the assets to a family limited partnership (FLP) or family limited liability company (FLLC) that has been formed for valid non-tax reasons. Later, when interests in the FLP or FLLC are given away, the value of the interests given is often found to be significantly (like maybe 40%) less than the value of the assets inside the FLP or FLLC! Such valuation is a matter of expert professional opinion and the FLP or FLLC has to be formed and governed, so there are significant legal and other costs involved in implementing such a gifting program. However, the tax savings for a family with a taxable estate will far outweigh those costs.

Depending on your goals, the FLP or FLLC can be structured so that the recipients of the gifts have absolutely no say in how the investments are used or managed, and so that the gifted interests cannot be easily sold or transferred without your approval.

Here is an example. $216,670 worth of stock is put into an FLLC. Later, a 10% nonvoting interest is given away. If the professional valuation expert determines that a 40% asset to market discount is appropriate, the amount of the gift, for gift and GST tax purposes, is $13,000 instead of $21,667. With that level of discounts, a married couple will be able to transfer approximately $43,000 per beneficiary per year, or $430,000 over ten years, excluding growth without using any of their lifetime gift and GST tax exclusions.

Planning Tip: Discounts are one of those widely used and accepted estate planning methods that may not be around much longer. The IRS has made it clear it hates them. With the Congress looking to close tax "loopholes," we suspect that the days of using discounts are numbered.

Use Annual Exclusion Gifts to Fund an Irrevocable Life Insurance Trust (ILIT)
Life insurance can be used to provide income for a family, to provide the cash needed to pay estate taxes, and as an income tax shelter. If set up properly using an ILIT so that you do not have any incidents of ownership in the policy, the policy death benefits will not be included in your taxable estate, making them free of estate taxes.

The general concept is that the ILIT is the owner and beneficiary of an insurance policy on your life. You make gifts to the trust to cover the insurance premiums, and the trustee makes the premium payments. If you make annual gifts for this, the gifts will be shielded from the gift tax up to the annual exclusion per beneficiary but probably will not be eligible to the annual GST tax exclusion and so will use some of your lifetime GST tax exclusion. For the gifts to be qualified for the annual gift tax exclusion, the beneficiary must have the right to withdraw up to $13,000 of the transferred funds for at least a period of time. However, if that right is not exercised, the gifted funds can be used to pay life insurance premiums or for other investments.

At your death, the death benefit proceeds are paid to the trustee who can use the funds to purchase assets from your estate and provide the liquidity needed to pay estate taxes and other expenses. The trustee can even make discretionary distributions of income and principal during your lifetime to the ILIT's beneficiaries, which can include your spouse, children and future generations. Assets that remain in the ILIT are not included in its beneficiaries' estates (exempting them from estate taxes for generations) and are protected from your and the beneficiaries' creditors. The trust can become a "family bank" for education, business acquisitions, home purchases and other ventures for generations to come.

Planning Tip: You can also use some or all of your $5.12 million lifetime gift and GST tax exclusions to fund an ILIT to purchase *substantial* amounts of life insurance for which the future required premiums will exceed the annual gift tax exclusions for gifts to the beneficiaries. That money can then be invested by the trustee and the investments liquidated as needed to pay policy premiums.

Dynasty Trusts

Generally, a dynasty trust is one that benefits multiple generations and none of the assets are included in your or your beneficiaries' taxable estates. Getting this benefit to your grandchildren and beyond requires allocation of GST tax exclusion to the trust. Not being estate taxed at every generation allows the trust assets to grow tremendously over the years.

It used to be, because of a rule of law called "the rule against perpetuities," that trusts could only last about 120 years. However, many states have eliminated that rule or made it apply only after hundreds of years. As a result, a dynasty trust established in the right jurisdiction can theoretically go on forever, and the trustee (usually a corporate trustee, like a bank or trust company) can make discretionary distributions for the lifetime of each beneficiary in each generation. Assets in the trust are protected against the beneficiaries' creditors, divorces, estate taxes, and irresponsible spending.

Planning Tip: It is important to establish the trust in a state that has no income tax, good creditor protection and divorce protection, and no rule against perpetuities (or a very long allowance of years). You must allocate enough GST tax exclusion to cover the entire gift so that no distribution from the trust will ever be subject to the GST tax.

Making Gifts Beyond Your Exclusions

If you have a substantial estate and use your entire $5.12 million exclusion in 2012, it might be wise to give away more this year and pay the gift tax at the current 35% gift tax rate. Remember that the estate tax rate is scheduled to increase to a maximum of 55% on January 1, 2013. You can wait until late in 2012 to make your decision; perhaps by then we will know for sure what Congress will or will not do.

Planning Tip: If there is a gift or estate tax to pay, it will cost you less to pay the gift tax. The reason is that the gift tax is paid on the amount of the gift, and the amount an estate beneficiary gets is what is left after the estate tax is applied to the entire bequest. For example, a taxable gift of $1.00 makes you liable for a $.35 gift tax and depletes your estate by a total of $1.35. On the other hand, that same $1.35 in your estate, after being taxed at 35%, nets just $.88 to your heirs.

What to Expect in 2013

The only honest answer is that no one knows. What we do know is that the estate, gift, and GST tax exemptions are set to be reduced dramatically at midnight on December 31, 2012, and at the same instant, interest rates on those and income taxes are scheduled to increase substantially.

Will the President, the House of Representative and the Senate all agree to make the future different? Maybe. They have in the past. Exactly what they might agree to is unknown, but we know of no one who expects the estate, gift and GST tax exclusions to be higher or the rates lower than they are now. Remember, capital gain and dividend rates are also scheduled to increase on January 1, 2013. Plus, there is a new 3.8% investment tax (it is a part of the Patient Protection and Affordable Care Act recently upheld by the

Supreme Court) that will go into effect on January 1. While much depends on the election in November, the current and projected future budget deficits do not bode well for deceased tax rates or increased tax exclusions.

Conclusion
In this newsletter we have presented only some of the unique gifting opportunities available in 2012 that we most likely will not have in 2013. There are many more, including giving through charitable and other trusts, that are also very attractive this year due to other reasons.

We can help you evaluate all the opportunities and implement those that will work best for you and your family. The time to plan is now. You and your family do not want to miss out on this historic opportunity. Don't say you weren't warned.

TEST YOUR KNOWLEDGE

1. There are exceptional estate planning opportunities in 2012 that may not last. T F

2. The only way to use your $5.12 million federal unified gift and estate tax exemption is to die in 2012. T F

3. Annual tax-free gifts can only be made to those in your immediate family. T F

4. A gift tax must be paid immediately on any gifts over the annual tax-free limit. T F

5. Married couples must share one gift/estate tax exemption. T F

6. Gifts for medical care and tuition expenses are unlimited but only for people who are related to you. T F

7. Discounts can only be applied to annual tax-free gifts. T F

8. Dynasty trusts can only last for 20 years. T F

9. There is no exemption from the generation-skipping transfer tax. T F

10. If Congress does not act before the end of 2012, all of the existing tax laws will simply remain as they are for another year. T F

Answers: Only #1 is true; the rest are false.

avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

You have received this newsletter because I believe you will find its content valuable. Please feel free to Contact Me if you have any questions about this or any matters relating to estate planning.

Law Offices of Michael J. Wittick, a Professional Law Corporation 7700 Irvine Center Drive, Suite 800 Irvine CA 92618 Website

The Advisors Forum
A WEALTHCOUNSEL COMPANY