October 2012 Issue | The Competency & Knowledge issue

The Journal Entry

Take Advantage of Gifting Limits Before the End of the Year

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Time is Running Out to Take Advantage of Increased Gifting Limits

BY CLAIR A. ROOD, JR. CPA &
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With the current dearth of "Taxpayer Friendly" provisions coming out of Washington DC, it would be a shame to squander one of these rare opportunities. The time is quickly expiring to take advantage of our current increased Gifting Limits. This is a call to action for every individual who has accumulated an estate in excess of $1,000,000, particularly those with estates well in excess of that amount. There are many ways to take advantage of this opportunity. But, whether you are considering a complicated estate plan or a simple direct gift, the key is to DO SOMETHING NOW!

Perhaps we should pause for a short history lesson. Before year 2000, the federal estate and gift tax was imposed on transfers by individuals (either at death or during life) over $675,000 (this rate was set to increase up to a maximum of $1,000,000), and the tax rate was 55%. Therefore, many people went through complex tax planning to reduce or eliminate taxes that would be due. The so-called "Bush Tax Cuts" increased the estate tax exemption to $3.5 million by 2009 and set the tax rate at 35%. As the estate tax exemption increased, gift taxes continued to be imposed on lifetime transfers over $1,000,000. In 2010, estate taxes were eliminated, but gift taxes continued to be imposed at the 35% rate (again on combined lifetime transfers over $1,000,000). In order to avoid the "sunset" of the law, which would have resulted in a return to the $1,000,000 estate and gift tax exemption and a 55% tax rate, in late 2010, Congress authorized a new, two-year $5 million exemption (with an inflation provision for 2012). This new exemption applies to both transfers during life and at death.

As a result of the changes to the law, currently, each individual may transfer up to $5,120,000 tax-free during life or at their death, avoiding both gift and estate taxes. If your life-time gifts and death transfers exceed this amount, the excess is taxed at a maximum rate of 35%. Unfortunately, these exemption limits are temporary. They expire at midnight on December 31, 2012. Thus, as of January 1, 2013 the exclusion amount for life-time gifts and transfers at death will drop back to the $1,000,000 pre-2010 level and the maximum gift and estate tax rate will jump back up to 55%. In other words, if you have not previously utilized your exclusion, you may gift $5,120,000 during December 2012 and pay zero tax. However, if you

make the same gift on January 1, 2013, it will cost you up to $2,266,000 in tax. That is a significant amount of money which will not be going to your beneficiaries if you do not complete your transfers prior to year-end.

Now, before you enter a mid-December reminder in your iPhone to "make tax free gift to heirs" take a moment to call your CPA and Estate Planning Attorney. Chances are their calendars are already filling up for the 4th quarter of the year, and you will need their help to make sure all i's are dotted and t's are crossed. You would be wise to get the process started now to insure that your transactions can be completed by the December 31st deadline. The window of opportunity is closing and there is no telling whether such an opportunity will exist in the future.

Having established the urgency of the situation, let's move on to how to proceed.

You should be aware that in many instances, taking advantage of this (or other) tax planning opportunities requires some effort. However, you shouldn't be intimidated by the process.

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The Process

Pre-planning

After contacting your professional advisors, you should begin gathering and organizing the information that will be used to create your plan. Here is a basic list of the information that will be useful to your advisors:

1.Updated personal profile for all individuals who may be part of your plan (Often includes spouse, children, grandchildren, etc.):

a. Name
b. Address
c. Birth date
d. Social Security Numbers
e. Relationship

2. List of Significant Assets:

a. Description of property
b. Description of how ownership is held
c. Date initially purchased or acquired
d. Initial purchase price or fair market value on date received, if inherited
e. Estimated current fair market value (any recent appraisals will be helpful)
f. Copies of deeds if available
g. If assets are held in a trust or entity, be prepared to provide a copy of the trust agreement, operating agreement, partnership agreement, etc.
h. List of Items that you would like to eventually give to a specific individual

3. Copies of existing estate planning documents.

4. Copies of any gift tax returns or other information that will help the Advisor know about gifts you may have previously made that may have used up some of your gift tax exemption.

Individuals and married couples also should begin the process of thinking about what they may wish to accomplish with a gift, besides just saving on gift and estate taxes. For instance, do you want to provide for children until they reach a particular age? What about grandchildren or more remote descendants? Do you want to provide money only for limited purposes, such as education, buying a home, etc.? Are you concerned about asset protection for your beneficiaries?

Initial Meeting

After gathering at least a portion of the preplanning information, your advisors will want to meet to discuss with you some of your objectives and the various gift planning options available. Of course, planning to minimize estate and gift taxes is a given, but, as noted above, you likely have other objectives that may be fulfilled by properly structuring a gift. At an initial meeting, your advisors will be able to help you to identify and prioritize your objectives and to begin suggesting tools for achieving them. An initial meeting also allows your advisors to explore any questions raised by the materials you have provided and to identify any items that may be missing. Depending upon your circumstances, they and you can then lay out a game plan for completing a gift by year end.

Plan Development

In certain instances, a plan can be developed in an initial meeting. More common is to have one or more follow up meetings or calls to further discuss planning objectives and options. Your advisors likely will present you with several options and the pros and cons of each. Good planners will work to make sure you understand the consequences of implementing a plan and what it will take to complete the plan. Even in complex planning situations, they will want you to be comfortable with moving forward. They will not impose their idea of a "good" plan upon you, but instead will work with you to make sure the plan is yours — that it fits you and your circumstances (not the other way around). Far too often, it seems that some advisors try to fit their clients into a particular (and often prepackaged) plan. Just like you tell your kids, you should be wary of utilizing a particular planning strategy just because "everyone is doing it."

Be aware that in some instances, particular planning strategies may require that you identify a fiduciary, such as a trustee, to be involved. This person may have an ongoing role in carrying out your objectives, and therefore should be selected with some care. Your advisor will work to ensure that the plan has a mechanism for replacing a fiduciary who later becomes unwilling or incapable of fulfilling his duties.

Plan Implementation

After developing a plan, it is time to implement. This ordinarily involves several steps. Your estate planning attorney will begin drafting the documents necessary to accomplish your objectives. This could include trust agreements, organizational documents (to form one or more entities), deeds, assignments, promissory notes, and other similar instruments. During this phase, you will have time to resolve any lingering concerns and to make any changes to the plan.

Once finalized, it becomes necessary to execute the plan documents. It often is important to make sure that this is done properly. That is, certain documents may require specific formalities (such as deeds of real property, which require a notary) and still others may simply need to be executed in a particular order (such as in the case of funding an entity for subsequent gifting of interests in the entity). Depending upon the nature of the gifted assets, it may be necessary to obtain appraisals for such assets. This is particularly important for any asset that the IRS may reasonably question as to its value. You will need to attach copies of such appraisals to any gift tax returns.

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Reporting and Follow Up

In most instances, taking advantage of this 2011-12 gift exemption opportunity will mean filing a gift tax return (IRS Form 709). Ordinarily, the gift tax return is due on April 15 of the year following the year of the gift. Your CPA will help to ensure all necessary and appropriate elections are made, that any ancillary documents are included with the form, and that it is timely filed.

Certain gifting structures require ongoing maintenance and follow up. Your planning strategy should include such procedures to ensure that the plan accomplishes the desired objectives and that it continues to comply with applicable laws. For instance, certain entities and/or trusts may require annual state filings and income tax returns.

Types of Gifts

Outright Gifts

The simplest gift is a gift of cash or a marketable asset (such as publicly trades stock) to a beneficiary. In some instances, outright gifts may involve other assets (such as closely held stock, limited liability company interests, artwork, etc.) which can be gifted with appropriate title transfers.

Such gifts, although still "simple" may involve a certain amount of diligence and work to maximize their benefit.

For instance, gifts of assets other than cash and marketable securities will require some type of valuation appraisal (as of the date of the gift). As noted above, the appraisal will be filed with the gift tax return. You would be wise to obtain appraisals from reputable appraisers who have experience valuing the type of asset that will be gifted. Likewise, an appraiser should have experience preparing appraisals used to support the values reported on gift and estate tax returns.

"IT IS IMPORTANT TO NOTE THAT SIGNIFICANT BENEFITS MAY BE DERIVED FROM EVEN AN OUT-RIGHT GIFT, IF IT IS PROPERLY STRUCTERED."

It is important to note that significant benefits may be derived from even an outright gift, if it is properly structured. For instance, in one case we had an elderly client who approached us with a desire to minimize taxes that would be due upon the client's death and to minimize issues between the client's three children. The client had several assets including several parcels of real property, certain promissory notes, cash and marketable securities. The combined value of these assets totaled approximately $7 million. The client desired to pass these assets (or their value) to the client's children, but was unsure of whether to divide the assets among them, transfer them in equal shares or take some other direction.

We determined that the most effective strategy to accomplish the client's objectives was to transfer most of the assets to a limited liability company. The client then transferred a 1/3 interest in the LLC to each of the children. The LLC provided an effective tool, so that the children can collectively manage the assets. It also created a structure that will allow for the orderly liquidation of the assets at the appropriate time. With appropriate succession planning built into the LLC's operating agreement, the LLC also created a mechanism for dealing with the possible death of one of the children prior to liquidation of the LLC.

Additionally, certain tax benefits were made available as a result of this planning strategy. Because each child received 1/3 of the LLC, the value of what he or she received was not 1/3 of the approximately $6 million of assets held by the LLC. Instead, upon appraisal, each 1/3 interest was subject to valuation discounts due to the lack of control and a lack of marketability of the LLC interests. Subjected to such limitations, the value was reduced by approximately 30%. Thus, the total value gifted to all three children fell below the $5,120,000 gift tax exemption (e.g. the combined value of the gifted 1/3 LLC interests was around $4,000,000). As a result of such planning, the client will largely avoid paying any transfer taxes upon the client's death.

Other Gifting Techniques

There are myriad other gifting structures available to take advantage of the current high gift exemption. Certain strategies involve the use of trusts. Others may include the use of sales and loans to trusts or other entities. Many of these planning strategies have acronyms associated with them. As you meet with your advisors, you will become at least partially familiar with terms such as GRAT's, QPRT's, IDGT's, ILIT's, CLAT's, CLUT's, CRUT's, and CRAT's. Most of the strategies represented by these acronyms are especially beneficial in economic conditions when interest rates are low, and when assets are expected to experience substantial future appreciation.

For instance, let's examine the IDGT. The term IDGT is short for "Intentionally Defective Grantor Trust." Now, you may be thinking, why would anyone want to use an "intentionally defective" trust? An IDGT is a trust that is structured in such way so it is effective for gift and estate tax purposes, but "defective" for income tax purposes. That is, the IDGT is treated as not existing for income tax purposes. A gift and/or sale of assets to an IDGT provides a significant opportunity to reduce transfer taxes.

Let's look at two planning options with an IDGT. The most common strategy is to sell assets to an IDGT. In such a case, the IDGT purchases assets from the client, usually in the form of an LLC or limited partnership interest. To ensure that the sale transaction to the IDGT is respected by the IRS, certain attributes of the transaction must exist. The IDGT must have assets that provide economic substance prior to the sale. The general rule of thumb is that the IDGT should have assets worth at least 10% of the value of those that are being sold to it. The best way to explain the benefits of a sale to IDGT is with an example.

Assume Mr. Client transfers a mixed portfolio of investments (stocks, bonds, and cash) worth $1 million to a family LLC. Typical LLC discounts reduce the value of that $1 million to about $650,000 (a 35% discount). Then Mr. Client creates an IDGT and sells the LLC interests (now valued at $650,000) to the IDGT in exchange for an installment note.

If Mr. Client sells the LLC interest to the IDGT in exchange for future payments, those future payments will be based on the lower value of the LLC interest (vs the actual value of the assets in the LLC), thereby reducing the size of the required installment note payments to Mr. Client.

Because the IDGT is disregarded for income tax purposes, that is, it is treated as if it were Mr. Client, there is no recognition of capital gains on the sale of the LLC interest to the trust. Also, since the IDGT would be purchasing the LLC interests from Mr. Client at a market value determined by a qualified appraiser, there would be no gift being made and no gift taxes due on the sale.

The IDGT would issue an installment note to Mr. Client and give him a security interest in the LLC interests. The note would bear interest at the IRS minimum required rate (the "applicable federal rate"), and could be structured as a self-amortizing note, a level principal payment note, or an interest-only with balloon payment note. The type of note used will largely depend on the cash flow being generated by the assets being sold to the IDGT. Because Mr. Client and the IDGT are not considered separate taxpayers for income tax purposes, Mr. Client will not recognize income when the interest on the note is received.

Similarly, Mr. Client could simply gift assets to the IDGT. In such a case, the obvious benefit to incorporating an LLC is the fact that Mr. Client only uses $650,000 of his $1,000,000 gift tax exemption. Additionally, as the assets continue to appreciate in value, and as Mr. Client pays the income taxes on the IDGT income, the amount that will pass to the beneficiaries of the IDGT continues to increase in value, without the imposition of additional transfer taxes. When combined with dynastic or multi-generational planning, the power of an IDGT as a wealth transfer tool becomes truly significant.

Conclusion

Time is running out on the opportunity to take advantage of our increased gifting limits. Because there is some level of complexity associated with taking advantage of the current law, we strongly encourage you to call your CPA and Estate Planning Attorney TODAY! Even if, after thorough analysis and consultation you determine that a substantial gift is not a good fit for you, you will sleep better knowing that your planning is where it needs to be. ■

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