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Winning (and Losing) Gifting Strategies

Can you have your cake and eat it too?

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Cue the ball to drop on Times Square, prepare to bid adieu to 2012 and its ironically short-lived "lifetime" gift tax exclusion of $5.12 million, and let's have a chorus of "Auld Lang Syne," lest our old acquaintance, the $1 million gift tax exclusion, be forgot.

Oh, how we would like to forget the $1 million exclusion from 2001 that was evicted from our Tax Code ages ago, yet, like an unwanted houseguest who has been blindfolded, driven 1,000 miles away, spun around three times but somehow finds his way back, the $1 million exclusion now comes a'knockin' on the door for 2013.

Cake!

Is it possible to exploit the $5.12 million gift tax exclusion in the waning days of 2012 and not lose control of one's wealth? Which techniques work and which may backfire? And what techniques apply if you miss the deadline?

Presented With Our Compliments

Gifting Under Pressure

If you've been living under a rock and recently emerged with only a few days left in 2012, then the news that the opportunity will soon expire to transfer $5.12 million without gift tax consequences may pressure you to make a prompt decision.

Of course, if you have less than $1 million in total assets and haven't already utilized your lifetime gift tax exclusion, then you can still make gifts next year, if you are so inclined, because even the potentially reduced gift tax exclusion for 2013 will still cover the entire estate.

If your net worth is very high and you've been on the verge of making an outright gift of $5.12 million to someone in early 2013 based on personal non-tax-related reasons, then, no pressure. You can accelerate your timing, make that gift in 2012, and make good use of the available exclusion.

But for those people with some wealth and no definitive gifting plan in place, the decision is decidedly more complex and has a number of relevant variables.

1. **Type of Assets:** As an example, an individual or couple with a net worth of $15 million probably owns several real estate properties, stocks, retirement plans, insurance, and perhaps a share of a business. Some of the assets may be in current use, others may have already appreciated in value, and others may be generating income. There are consequences for every asset that is involved in a gift.

2. **Liquidity:** Even if the analysis of a particular estate demonstrates a potential tax savings by making current gifts, it is rare that someone has $5.12 million in liquid assets that is ready to be transferred conveniently. It may not be strategically wise to disrupt investments or transfer certain types of assets.

3. **Capital Gains:** Is a donor better off holding onto an appreciated asset so that it can go through his or her estate at death and then be transferred with a stepped up basis that will avoid capital gains? Or does an asset have a likelihood of appreciating in the future, in which case a current gift can leverage the asset by having the future appreciation accrue while it is owned by the donee instead of the donor?

4. **Existing Plans and Estate Size:** Additional variables affect the gifting context. Is the donor married? What is the life expectancy of the donor? How would a current gift affect the donor's overall estate plan?

For example, an unmarried donor in his 80s with a net worth of $20 million has far more assets than necessary to provide for his future needs based on his life expectancy. By comparison, a married couple in their 50s, with a combined net worth of $10 million, should not automatically make gifts of $5 million. Such a couple has a collective life expectancy that could see a reduction in estate size. The couple may have many future opportunities for use of the annual gift tax exclusion and a greater likelihood of higher estate and gift tax exclusions in the future.

5. **Know Your Donee:** The transferred assets may be out of the frying pan and into the fire if they are transferred to a donee who has creditors, gets divorced, fails to invest assets, wastes assets, or who will end up with a highly taxed estate.

Bad Gifting Approaches

Perhaps astute readers are already aware of the dangers of making the types of gifts that will backfire in dramatic fashion. However, haste and large gifts are a troubling combination. No one wants a bad gifting approach to become notorious and "go viral on the Internet." So, at the risk of stating the obvious, here are several problems that donors may step into in their rush to make gifts.

1. **Borrowing money to make gifts:** This is a bad idea. Take the advice of Governor Chris Christie during Hurricane Sandy: "Anything that looks stupid, is stupid. If you think you're being overly clever, but you know it looks really stupid, don't do it!" When we are talking about large sums of money, the potential savings in taxes won't justify paying large interest rates. Even if the funds are borrowed from a family member without interest, that interest-free loan may be treated as another gift, may exhaust that benefactor's lifetime gift tax exclusion and may affect his or her plans.

2. **Promising gifts:** You don't have the money to make a gift before the deadline, so you promise the money now with the intention of getting it and giving it later. This is another variation of a bad idea—don't do it. You can probably make an enforceable promise in some state jurisdictions if you are careful, but having that work for Federal gift tax purposes is sketchy at best. And if you can't come up with the money and the donee forgives the promise, the IRS will probably want gift taxes on the donee's forgiven debt. If the donee doesn't forgive the promise, you'll wonder why you didn't listen to Governor Christie.

Anything that looks stupid, is stupid.

3. **Self-settled trusts:** These are trusts in which you essentially give yourself money in trust. Normally, giving yourself money doesn't constitute a taxable gift. However, a carefully designed trust could effectuate a completed gift to the trust remaindermen. In fact, many trusts are funded with *Crummey*-style annual increments that utilize the annual gift tax exclusion.

In this rushed context, a large gift is made to a trust and, in concept, is a gift to the ultimate beneficiary; however, in practice, the donor may be including himself or herself as a

beneficiary because the gift is only being accelerated because of the expiring lifetime gift tax exclusion.

However, self-settled trusts are only recognized in states that have a domestic asset protection trust (DAPT) statute. These currently are Delaware, South Dakota, Wyoming, Tennessee, Utah, Oklahoma, Colorado, Missouri, Rhode Island, and New Hampshire, and each of these states have rules that must be followed. Not following these rules and/or utilizing the trust as the grantor's personal piggy bank is going to invite scrutiny, and the IRS may apply substance over form analysis. If no gift is completed, the assets will remain in the donor's estate and will not have taken advantage of the $5.12 million gift tax exclusion.

"Wolde you bothe eate your cake, and have your cake?"

4. Transfers that avoid known creditors: These are called fraudulent transfers. They don't work. So giving away more money than you should and then declaring bankruptcy to beat your creditors is a terrible plan. The transfer may qualify for the gift tax exclusion, but the donor then faces civil and criminal liability and the transferees end up disgorging the transferred funds.

5. Transfers prior to Medicaid: A large gift is made, and the elderly benefactor subsequently exhausts funds, checks into a nursing home, and tries to sign up for Medicaid. The 60-month look-back rule is in effect. Medicaid coverage is denied.

6. Gifting an overvalued asset: Why are you doing this again? Oh yes, to qualify for the exclusion and exploit the exclusion fully. But if you don't have sufficient assets to give, it accomplishes nothing to exaggerate the value of the transferred assets. The donee's basis for future capital gains purposes is not the fair market value at the time of the transfer but the donee's basis, plus a portion of any gift tax paid, which in this context is probably zero. Falsely increasing the asset's value serves no purpose and just begs for trouble.

7. Gifting the wrong assets: Selecting the right gift for the right person is never easy. Generally speaking, socks are never appreciated. Pottery provides a long-term guilt trip that causes the recipient to store it in the attic for 40 years. Cashews make a nice gift—who doesn't like cashews? But assets with genuine value all have their own sets of tax rules, investment rules and other strategic considerations.

An item of great value that is ultimately going to be kept in the family forever might be suitable for a carefully designed long-term trust. Land that will never be developed that is near the family property might best be left to charity or be part of a conservation easement. Assets mentioned in the categories above—insurance, retirement, capital gains—all have consequences when gifted.

Caveat: The rules on conservation easements may potentially shift automatically in 2013 as well. Realistically, these automatic shifts could eventually be corrected. The President's proposed budget for 2013 includes a one-year extension of the enhanced conservation easement incentive.

Controlling Gifts

"Wolde you bothe eate your cake, and have your cake?" This phrase was first recorded in 1546 by John Heywood in "A dialogue Conteinyng the Nomber in Effect of All the Prouerbes in the Englishe Tongue."

Having and eating one's cake is a somewhat global concept, judging from the Wikipedia collection of similar proverbs from other cultures. The French idiom is "to want the butter and the smile of the female buttermaker." This is close but a bit enigmatic—and leave it to the French to leverage the butter into something implicitly about l'amour. The Swiss have a saying, "You can't have the five cent coin and a Swiss bread roll," but, realistically, nobody cares about a Swiss bread roll. And the German sentiment goes, "Please wash me, but don't get me wet," which is a bit strange—and not about cake.

For our purposes, cake is something you want to possess and eat…yet is gone once it is consumed. The decision to take advantage of what may be a once-in-a-lifetime opportunity to make a lifetime gift of up to $5.12 million without any gift tax may be very tempting, but the task of matching the right gift with the right beneficiary, while still maintaining some control over assets, is often central to the gifting decision.

The short answer: Gifts in trust.

The worrisome issues here are that large numbers of do-it-yourself donors who are rushing to make large gifts by a deadline may be moving assets into their existing revocable living trusts (not realizing that they are not making completed gifts), moving assets into bank accounts with "in trust for" designations that are essentially pay-on-death accounts but NOT irrevocable gift arrangements, or making transfers into pre-existing trusts that the donor has been using indiscriminately for so long that the transfers may ultimately be disqualified.

Do-it-yourselfers may also think that the gift tax exclusion applies automatically to gifts, and they may fail to file a gift tax return or inform their accountants that they have made gifts for which they want their lifetime gift tax exclusion attributed. These large gifting opportunities are no time to try to save on the costs of professional advice.

For those with business assets and sufficient time, there are excellent tools to be utilized. A business or income-producing real estate can be transferred into a family limited partnership, an LLC, or a Subchapter S corporation with voting and nonvoting shares. The donor can retain the voting shares and thus continue to control the assets, while the gifted assets reach

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the intended donees. This also allows future income and appreciation to reach beneficiaries without accumulating in the donor's estate.

Oh, No! Too Late?

It is never too late to take some constructive action. If you are reading this in 2013 and the unthinkable has already transpired, you are not alone. News does not reach everyone, uncertainty is not conducive to major transfers, and not everyone has had time to implement worthwhile plans. So if the $5.12 million gift tax exclusion has expired and a lower exclusion of $1 million or some other amount is in effect, take heart and have a look at the available options.

Time may cure temporary tax afflictions. Congress will revisit these issues again and again. If you are 70 years old, remember that 70 is the new 60. Your life expectancy is 13.7 years if you are male and 16 years if you are female. Even if Congress doesn't restore transfer tax exclusions, you may have time for future gifting opportunities, as well as estate tax planning.

For spouses with a $3.5 million estate tax exclusion and "portability," that would work out to $7 million passing without transfer tax, even if the gift tax exclusion remains at $1 million. The $3.5 million level for the estate tax is proposed in the President's budget and has very little opposition.

The annual gift tax exclusion remains a potent tool as well. Each donor can currently transfer $13,000 per year to an unlimited number of donees. For spouses, that amounts to $26,000 per donee. With two married children and six grandchildren, the annual tax free gift can add up to $260,000. **Note:** Donors engaging in this program tend to become rather popular family figures.

The GRAT Option

Some might argue that the Grantor Retained Annuity Trust (GRAT) has been tarnished by the proposals to require a minimum 10-year term. If a donor fails to outlive the term of a GRAT, it fails as a gift. The very fact that the GRAT has been targeted by the Treasury is cause for concern.

However, the efforts to curb GRATs are not yet implemented and they are a tribute to the GRAT's effectiveness. So while speedier vehicles for gifting may have left you behind, the reliable GRAT may still be exceedingly useful in getting you to the same destination.

Let's take a look at how a GRAT works and what it still has to offer. The GRAT is simply a trust that will pay the grantor an annuity for a period of time. Whatever is left in the trust at the end of the term belongs to the trust beneficiary. If the donor fails to outlive the term of the trust, the assets are included in the grantor's estate. To offset this weakness, term life insurance can be obtained on the donor's life for the amount of the additional tax that would be incurred. Keeping the term shorter also reduces the risks.

Once assets are placed in a GRAT, the respective interests of the grantor and the future beneficiary can be carefully measured using Treasury tables and taxed accordingly. The more valuable the grantor's retained interest, the lower the value of the transferred interest. At times when interest rates are low, such as the present, GRATs are more advantageous because the actual growth is likely to exceed the presumed growth, so the beneficiaries end up getting more than the size of the gift that is calculated for tax purposes under the rules.

The grantor of a GRAT receives annuity payments for a fixed term. Thus, if the assets placed in a GRAT grow faster than the rate assumed under Section 7520 (the Treasury's valuation tables), the extra growth ends up belonging to the remaindermen.

GRATs evolved into highly effective tools over the past decade and overcame an erroneous Treasury Regulation in *Walton v. Commissioner,* 115 T.C. 589 (2000). As a result, there are some great GRATs, such as the SuperGRAT that "zeroes out" all estate tax, or the SOGRAT, a patented technique that is ideal for working with nonqualified stock options.

Let's look at a GRAT in action. A grantor transfers an income-producing building worth $2.5 million into a limited liability company (LLC) with 1% in Class A voting shares that the grantor retains and 99% in Class B non-voting shares for the remaindermen. The Class B shares are transferred to a GRAT that will pay the grantor an annuity each year.

The net result is that the grantor continues to manage the property and also continues to collect the income for the term of the GRAT. The value of the gift to the remaindermen is discounted by the lack of control and marketability of that interest. The size of the gift is also reduced by the value of the stream of income that the grantor retains. If the term is 10 years and the building is worth $5 million at the end of the term, the remaindermen receive a $5 million asset, but the grantor has only made a relatively small gift for gift tax purposes.

Gone Again

"Did you really leave me again? After all the seasons I spent waiting, watching out the window, listening at the door, waiting for the news of your return? * I can't believe you're not coming back. I can't believe I'm supposed to stop waiting. I can't believe you left me again...**

—Letter read by Zooey Deschanel "Eulogy," (2004).