ALASKA TRUST COMPANY

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Efficient Use of the New $5 Million Gift and GST Tax Exemptions

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Introduction

It seems like an extraordinary event. The gift tax exemption has grown from $30,000 in 1976 to $1 million through the end of 2010 and to $5 million for 2011 and 2012. The GST and estate tax exemptions also grew to $5 million for 2010, 2011 and 2012. Under the law as written, all three exemptions will return to their $1 million levels after 2012 (although the GST exemption, which is been adjusted for inflation, like would be about $1.4 million after 2012). The $5 million

exemption for 2012 will be adjusted for inflation.

It is, at this time, uncertain whether the $1 million exemptions scheduled to take effect after 2012 will be increased by legislation and, if so, at what levels and when. In any event, a strong case can be made that the $5 million gift tax and $5 million GST exemption should be used as reasonably soon as possible. As a general matter, it is more efficient to use an exemption, exclusion or deduction as early as possible. The hesitation, of course, in using those significant a significant gift tax exemption is that usually the taxpayer who uses it loses all interest in the assets transferred. Except for the very wealthy, that may not be regarded as prudent. However, as this article details, there are ways to use the exemptions and yet keep an interest in the property used to make the transfers.

The Case For Using Exemptions Now

It usually is best to use an exemption as early as it becomes available. Once the transfer is made, provided the property will not be included in the transferor's gross estate for Federal estate tax purposes, not only will the property transferred under the protection of the exemption but all income and growth as well will escape later estate, gift or generation-skipping transfer (GST) taxes (collectively, referred to as "wealth transfer taxes"). In addition, where later legislation may curb the opportunity to use an exemption most effectively, it normally is best to use the exemption promptly. For example, although the 2010 Tax Act did not adopt measures that would have eliminated or reduced valuation discounts commonly available for wealth transfer planning purposes, they might be adopted in the future and, possibly, be adopted retroactively.

For example, if a taxpayer transferred $5 million in 2011 and died in 2041 (30 years later) and if the property grew at a rate of six percent a year (historically, a low return for a well balanced portfolio), nearly $29 million would be excluded from the property owner's gross estate. If the property grew at three percent a year, over $12 million would be excluded. If it grew at ten percent a year (approximately, the average growth over the past 80 years for equities), over $87 million would be excluded.

Those numbers are significant. In fact, they are so significant that many individuals will hesitate making such transfers for fear of being locked out of enjoying such bounty especially if their retained wealth suffers a "reversal of fortunes."

Another Key to Avoiding the Most Tax: The Grantor Trust

Regardless of the rate of return at which one assumes property will grow, some consideration must be given to the erosion of such growth by income tax. Rates of tax vary by the type of income earned (such as long term capital gain, dividends, interest, royalties, etc.), when it is

earned (e.g., income tax recognition of capital gain often can postponed which effectively reduces the taxation of the gain) and changes in taxation that are effectuated by the certain to be changed legislation. Whatever rates apply, trust gains and income will be eroded by tax. However, by making the transfers to a grantor trust (a trust the income of which is attributed to the grantor under section 671 of the Internal Revenue Code), the trust will still receive the gains or other income but the tax on them will be taxed by the grantor. Therefore, the trust will grow income tax free, one of the most significant factors in financial planning of which estate planning is a subpart.

In fact, one study comparing the effects of using grantor retained annuity trusts (GRATs), installment sales to grantor trusts and direct gifts indicates that the most significant factor in excluding wealth from estate and GST taxation was transferring the property to a grantor trust. See Blattmachr & Zeydel, "Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth,"*Tax Management Memorandum*, January 23, 2006, Vol. 47, No. 2; BNA Tax Management, March 16, 2006; updated and republished as "Comparing GRATs and Installment Sales," 41 Heckerling Inst. Est. Plan. Ch. 2 (2007). There are many ways to structure a trust to be a grantor trust and to terminate grantor trust status even prior to the grantor's death without causing the property to be included in the grantor's gross estate. See Akers, Blattmachr & Boyle, "Creating Intentional Grantor Trusts," 44 RPPRL 208 (2009). Although making the trust a grantor trust may greatly increase the amount of property excluded from the gross estate, the IRS has conceded that the grantor makes no gift by paying income tax on the trust income which the trust retains but that is attributed to the grantor for income tax purposes under the grantor trust rules. Rev. Rul. 2004-64, 2006-2 CB 7.

One potential downside of transferring appreciating property prior to death in a manner that it will not be included in the grantor's gross estate is loss of the "step up" in basis permitted for most inherited property under section 1014 of the Internal Revenue Code. However, a case has been made that the step up in basis occurs if grantor trust status ends by reason of the grantor's death even if the property is not included in the grantor's gross estate. Blattmachr, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death", 97 *Journal of Taxation* 149 (Sept. 2002). And it appears, under current law, that the practical effect of a step up in basis can be achieved by having the grantor purchase the appreciated assets back just prior to death with using and without any gain or income recognition. Id. ; Rev. Rul. 85-13, 1985-1 CB 184; Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust[sm]", 21*Probate & Property* 52 (July/August 2007).

Keeping an Interest in Transferred Property

As mentioned above, the amount that may be removed from a taxpayer's estate by gifts early in life may retard the desire to make such transfers because the taxpayer may lose all interest in

those assets. However, there is a way in which the taxpayer can retain a discretionary interest in the property. That may occur by transferring the assets to what is called a "self-settled" (or created for oneself) trust created in a jurisdiction so that the self-settled nature of the trust will not cause the trust to be included in the grantor's gross estate. That turns on creditor rights.

Until 1997, virtually all American jurisdictions provided that all creditors of a grantor could attach property the grantor placed in trust for himself or herself even if the grantor was not trying to defraud any creditor and even if the grantor could receive trust distributions only in the discretion of an independent trustee. See, e.g., New York EPTL 7-3.1. Many states made exceptions for trusts that were individual retirement account (IRA) and other retirement type trusts, but not estate planning trusts. However, on April 1, 1997, Alaska adopted legislation that permitted individuals to created self-settled Alaska trusts that would not be subject to the claims of the grantor's creditors provided certain conditions were made.

The tax law has long provided that a transfer to a self-settled discretionary trust that remains subject to the claims of the creditors of the grantor is not a completed gift (and, therefore, not subject to gift tax) and is included in the grantor's gross estate. See, e.g., Outwin v. Commissioner, 76 TC 153 (1981), acq. 1981-2 CB 1; Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 77-378, 1977-2 CB 347; Rev. Rul. 2004-64, supra. On the other hand, the law also has consistently provided that if the grantor's creditors cannot attach the assets in a self-settled discretionary trust, the transfer to the trust is a completed gift the trust is not included in the grantor's gross estate, unless the grantor retains some interest or power other than being eligible to receive trust distributions in the discretion of another as trustee. See, e.g., Estate of Uhl v. Commissioner, 241 F. 2d. 867 (7th Cir. 1957); Estate of German v. United States, 7 Ct. Cl. 641 (1985); Rev. Rul. 2004-64, supra.

In fact, the IRS has ruled that a self-settled trust created under Alaska law will not be included in the grantor's gross estate unless there is an implied understanding or other factor that would cause estate tax inclusion. PLR 200944002 (not precedent). In fact, the key part of the private letter ruling is:

"In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036. ***We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036."

As explained in detail in a recent article, it seems that such a self-settled trust probably can be governed only by the laws of the state of Alaska (and, perhaps, Nevada) and be excluded from the grantor's gross estate. See Rothschild, Blattmachr, Gans & Blattmachr, "IRS Rules Self-Settled

Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning 3 (Jan. 2010). As that article explains, although there are now several self-settled asset protection states, each, except Alaska and Nevada, permits at least some creditors to access the trust property. These creditors often include claims by a spouse or child for support and the state for obligations owed to it. Rev. Rul. 2004-64 strongly indicates that, if any creditor of the grantor can attach the trust assets, the entire trust is included in the grantor's gross estate. In any case, the IRS has only issued a favorable ruling with respect to Alaska self-settled trusts

Hence, by creating a self-settled trust in Alaska, a taxpayer may be able to use his or her gift and GST tax exemptions, remain eligible to receive distributions and yet have the trust excluded from his or her gross estate for Federal estate tax purposes. By the way, the grantor can even retain the right to remove and replace trustees (as long as the substituted trustee cannot be someone related or subordinate to the grantor within the meaning of section 672(c)). See Rev. Rul. 95-58, 1995-2 CB 1.

Still Worried About Estate Tax Inclusion?

Although PLR 200944002 is quite explicit in its holding that an Alaska self-settled trust will not be included in the gross estate of the grantor (barring a finding that there was an implied understanding that the grantor would receive benefits from the trust), private letter rulings cannot be cited or used as precedent. Section 6110(k)(3). In any case, there are ways to structure the trust so that the risk of estate tax inclusion, if the private letter ruling is not followed by the IRS and the courts, can be reduced if not totally eliminated.

Section 2036 is the section that typically has been used by the courts and the IRS to find that a self-settled trust is included in the grantor's gross estate. See, e.g., Paxton v. Commissioner, 86 TC 785 (1986). Section 2036(a)(1) causes estate tax inclusion if the grantor retained the right to the trust income. The section applies even if there is no explicit or legally enforceable retention. As indicated above, it applies even if there is an implied understanding trust income will be paid to the grantor. The "theory" in applying section 2036 to cause estate tax inclusion of a self-settled trust where the grantor's creditors can attach the trust assets is that the grantor retained the power to "relegate" his or her creditors to the trust assets.

However, the section only applies if the grantor has such an interest at death, not before death. Therefore, if someone (such as a trust protector or someone else) can expunge the grantor's interest as a beneficiary of trust prior to the grantor's death, section 2036 cannot apply. Of course, section 2035 causes estate tax inclusion if the grantor had a section 2036 interest which he or she transferred within three years of death. However, if someone (such as a trust protector) expunges the grantor's interest, it does not seem the grantor has made a transfer of his or her interest in the trust. Note, however, that TAM 199935003 indicates that section 2035 may apply if the grantor set up the arrangement so his or her interest could be eliminated. It

seems questionable whether that private letter ruling is correct. But, obviously, it will be best to expunge the grantor's interest more than three years prior to death if the law develops that the IRS and the courts will not follow the conclusions in PLR 200944002, Estate of Uhl and Estate of German, supra.

More Protection for Married Persons

One option for a married person is not to create a self-settled trust but rather to create a perpetual GST exempt trust for his or her spouse. As long as the couple remains "happily" married, both the spouse and the grantor may enjoy the trust to the extent the trustee makes distributions to or for the benefit of the spouse or makes the use of trust property (such as a home or a work of art) available to the spouse. Because the trust will not be designed to qualify for the gift tax marital deduction under section 2523, the grantor's spouse can be defined as the person to whom the grantor is married to and living with at the time in question and without causing the trust to be included in the grantor's estate. See, e.g., Rev. Rul. 80-255, 1980-2 CB 272; Estate of Tully, Sr. v. United States, 528 F. 2d 1401 (Fed Cir. 1976). Therefore, if the couple separates, the grantor's spouse will no longer be a trust beneficiary and any "new" spouse would succeed in becoming a trust beneficiary.

The grantor's spouse could be given a sufficiently broad special power of appointment, exercisable at death (or even during lifetime) to appoint the trust property to a class that includes the grantor. It could be made exercisable only with the consent of a non-adverse party (perhaps, a sibling of the grantor) to ensure spouse will not exercise it in a manner that the grantor would find inappropriate. In addition, the non-adverse party could block any change in the spouse's exercise that the non-adverse party had previously consented to. Therefore, if the grantor's spouse exercised the power soon after the trust was created to continue the trust for the grantor if the spouse dies first, the non-adverse person could be given the power to prevent the spouse from changing the exercise.

Of course, if the spouse does exercise the power of appointment to continue the trust for the grantor, it might be, under applicable local law, that the grantor's creditors could attach the trust assets because, even though the grantor succeeded to his or her successor interest by reason of the exercise of a power of appointment by the spouse, the grantor did, in fact, create the trust. As a consequence, if it is anticipated that the spouse will exercise any power of appointment in favor of his or her spouse who is the grantor, it would be prudent to create it under the laws of the state of Alaska or, perhaps, Nevada.

Of course, if each spouse creates a trust for the other, the reciprocal trust doctrine may be triggered. That doctrine causes the beneficiary of the trust created by the other trust to be treated, for tax purposes, as the actual grantor of the trust. For example, if the wife creates a trust for her husband and he creates a trust for her, he may be treated as creating the trust for

his benefit and the she treated as creating the trust for her benefit. If the spouses have even an implied understanding that each would receive the income of the trust or have a power to control the beneficial enjoyment of the trust property, estate tax inclusion would occur. See, e.g., Estate of Grace, 395 US 316 (1969); Estate of Bischoff v. Commissioner, 69 TC 32 (1977).

In other words, application of the doctrine would mean that each spouse would be treated as having created his or her own self-settled trust. If the trusts are created in Alaska, that should not be problematic as far as estate tax inclusion is concerned by reason of PLR 200944002. However, it would be best if the doctrine was not applied. In any case, if the trusts are "substantially" different the doctrine should not apply. See, e.g., Levy v. Commission, 46 TCM (CCH) (1983), in which the IRS conceded that, if one spouse had a presently exercisable special power of appointment and the other did not, the doctrine could not apply. See, also, Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust[sm]", supra, for suggestions on how to avoid the reciprocal trust doctrine when spouses create trusts for each other.

Any Unique Downside?

As strange as it may seem, making a large gift can cause what is perhaps an unexpected result when the donor dies if the estate tax exemption then is smaller than the gift tax exemption used during lifetime. In effect, the benefit of the larger exemption may be "recapture" although grow and income earned on the gift should not be recaptured. That gift tax exemption recapture occurs because the calculation of estate tax under section 2001(b) is based, in part, on the amount of adjusted taxable gifts. This can cause, in some cases, estate tax not just to be higher than the what the tax would be if the estate tax rate were just applied to the taxable estate but actually can result, it seems, in estate tax greater than the gross estate. That, in turn, raises complications. It might be anticipated that Congress will "cure" this potential problem. But right now the result is uncertain and thought should be given to this possible effect. In any event, there seems to be no recapture of the use of the larger GST exemption.

Summary and Conclusions

The increase in gift tax and GST exemptions to $5 million for 2011 and 2012 only provides an extraordinary opportunity to effectuate significant lifetime estate planning. Some may readily take advantage of that by creating a long term "dynasty" trust for descendants. However, others may be hesitant to part with such a large amount of wealth. However, creating a self-settled trust in Alaska or, perhaps, Nevada seems to provide an opportunity to use those enhanced exemptions without terminating all interests in the trust property. For a married couple, the opportunities can be even more substantial by providing additional opportunities to retain an interest in the trust property.

If you have any questions contact our office at: (888) 544-6775
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Thank you,
Alaska Trust Company