

# ESTATE PLANNING MATTERS!

## Gifts in 2011 and 2012

Our previous issue of *Estate Planning Matters!* described the continuing uncertainty about U.S. estate tax laws. Although a new tax law was passed, uncertainty remains. The tax law increased the federal estate, gift, and generation-skipping transfer (GST) tax exemption amounts for transfers made in 2011 and 2012, creating attractive gifting opportunities, especially for people who have made significant gifts in the past. After 2012, exemption amounts will decrease unless Congress again acts to change the law. So, talk to your Gray Plant Mooty estate planning attorney soon about gifting options that may be right for you.

The new tax law provides for federal gift tax, estate tax, and GST tax exemptions of \$5 million per person, with a top tax rate of 35% for each tax. You can pass \$5 million to children or grandchildren during life or at death in 2011 or 2012 without paying any federal estate, gift, or GST tax on the transfers. If you have already used some gift tax exemption on gifts you made before 2011, your combined estate and gift tax exemption is \$5 million reduced by the amount of gift tax exemption you have already used.

Some gift strategies may be advantageous in 2011 and 2012 because of the significant increase in the federal exemption amounts. Other opportunities make good sense at any time. However, because making large gifts poses some risks, it is important to read our “word of caution” at the end of this article.

### 1. Gifts to Grandchildren

The GST tax is levied on gifts to “skip persons.” Broadly speaking, skip persons are persons who are assigned to a generation that is more than one generation below the donor, with a few exceptions. A skip person is typically a grandchild or a trust for the benefit of a grandchild.

For individuals and couples with even moderate wealth, making gifts to grandchildren can take many forms. Certain gifts do not use any gift or GST exemption. You can give \$13,000 each year (\$26,000 per couple) outright (or in a qualifying trust) to each grandchild without using any gift or GST exemption. If you follow certain rules, you can also pay a grandchild’s education and health care costs without using gift or GST exemptions. Gifting in this manner is beneficial because you remove assets from your estate that would be taxed if you owned the assets at your death.

If you have greater wealth, you may want to create trusts that benefit your children and, later, your grandchildren. Frequently, a trust runs for the life of a child and then passes to grandchildren at the child’s death. In 2010, when the gift tax exemption was \$1 million, if a single person made a gift of \$1.5 million to such a trust, that individual would have used her entire exemption and paid gift tax of \$175,000. In 2011, that gift would use \$1.5 million of her gift exemption, but no gift tax would be due.

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If you have a very large estate, the increased gift and GST exemptions and lower tax rates make 2011 and 2012 gifts to grandchildren particularly attractive. For example, if grandparents with 10 grandchildren have not used their full gift and GST exemptions, they could fund a separate trust for each grandchild with \$1 million. In 2010, a gift tax of \$2.8 million would have been due on a gift of this size. If they make these gifts in 2011 or 2012, they will pay no gift or GST taxes on the gifts. This type of plan works best when the donor's children already have enough wealth and prefer to have property pass directly to their children. The benefit is that the assets are not taxed in the donor's estate or in the child's estate.

## 2. Loan Forgiveness

Using gift tax exemption to forgive loans to children is wise regardless of the size of your estate. If you took advantage of recent low interest rates and loaned money to children, the increased gift tax exemption provides a wonderful opportunity to forgive all or large portions of these loans without incurring gift tax. Remember too that you can forgive up to \$13,000 of principal and interest per year per child without using any gift tax exemption. However, because interest that you forgive is taxable to you under imputed interest rules, seek legal advice before engaging in this strategy.

## 3. Gifts of Closely Held Business Interests

If you own an interest in a closely held business that you want to pass to children, now may be a good time to take action. Gifts of interests in closely held businesses can be valued at a discount if there is a small or nonexistent market for the shares or units, or if the donor owns 50% or less of the company. Discounts recognize that a share that has no market or that provides the owner no control over the entity is worth less than a share that can be readily sold or that is a controlling share. Congress has recently considered prohibiting valuation discounts for closely held businesses in the gift, estate, and GST tax context, but the 2010 tax law did not include prohibitions on discounts. Thus, valuation discounts are still available in the right circumstances. The ability to use discounts, combined with the new \$5 million gift tax exemption, provides an opportunity to pass the closely held business to the next generation at a reduced tax cost.

## 4. Gifts to Irrevocable Life Insurance Trusts

If you have a life insurance trust and want to purchase additional insurance, or if you are considering purchasing a large policy now, you may want to talk to your Gray Plant Mooty attorney about whether creating a trust or funding an existing trust with additional insurance fits with your estate plan. Irrevocable life insurance trusts are beneficial because, with certain exceptions, if an irrevocable trust owns the policy, the proceeds escape taxation in the insured's estate. Payments of premiums are gifts to the trust. Often, insurance trusts are structured so that premium payments fall within the \$13,000 annual exclusion amount. Now, when the gift tax exemption has increased from \$1 million to \$5 million, using your gift

tax exemption, and possibly your GST exemption, to cover large premium payments may make a great deal of sense. Because life insurance trusts have varying terms, your attorney should analyze the gift and GST tax consequences before you purchase additional insurance. However, if the circumstances are right, you will be able to provide greater liquidity to your estate, or transfer a larger benefit to your family, at a much lower tax cost.

## 5. Installment Sales to Grantor Trusts

If you own a closely held business or income-producing real estate that you expect will appreciate, and want to transfer that asset to children, using an installment sale strategy can reduce transfer taxes. In this strategy, a donor creates an irrevocable trust, called a "grantor trust," that is excluded from the donor's estate for estate tax purposes but considered the grantor's property for income tax purposes. The donor makes a cash gift to the trust, using some gift tax exemption. The donor also sells the closely held asset to the trust in exchange for a cash down payment and a promissory note. The interest rate charged on the note is based on the interest rate set by the IRS for the month of the sale. In June 2011, the rate for a midterm note (more than three years but less than nine years) is a relatively low 2.27%. So, the trust's annual

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installment payment on the note will be low. Although the installment note and annual payments will be in the donor's estate, the asset and any appreciation on that asset will be in the trust and out of the donor's estate. For example, a couple can establish a grantor trust with a cash gift of \$2.5 million. They can then sell a \$20 million asset to the trust in exchange for \$2 million and an installment note for \$18 million. The trustee makes annual note payments from cash available in the trust, presumably from income earned by the asset held in the trust. At the end of the installment term, the note is paid off, and the asset, including any appreciation, passes into trusts for the children.

#### A Word of Caution

If you want to use a significant portion of your gift tax exemption in 2011 or 2012, talk to your estate planning attorney about the risks of making a large gift. The benefits of gifting are substantial, but there are some drawbacks as well. For example, if property you gift has a very low income tax basis, your children or grandchildren may owe a large capital gains tax when they dispose of the property. You should also be aware that there is at least some risk that future transfer tax laws may subject the gifts you make in 2011 or 2012 to additional tax at your death. Given the continuing uncertainty of estate tax laws, it is more important than ever to consult with your estate planning attorney before you make large gifts.

## IRA Charitable Rollover Extended to 2011

The "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the Act) included an extension of the IRA Charitable Rollover through the end of 2011. With the current extension, a donor can make up to \$100,000 of IRA Charitable Rollover gifts<sup>1</sup> in 2011. To qualify for the favorable tax treatment afforded these gifts, a transfer of IRA assets to a charity must have the proper features:

- The donor must be age 70½ or older when he or she makes the gift.
- The gift must come directly from the donor's IRA. The IRA custodian can satisfy this requirement by drawing a check payable to the charitable organization and mailing it to the charity or to the donor, who can then transmit it to the charity.
- An individual with a qualified retirement plan account such as a 401(k) can, in many cases, make a tax-free rollover of part of the account to an IRA, then make an IRA Charitable Rollover gift from the IRA.
- The donee must be a public charity. It cannot be a private foundation. The donee cannot be classified as a "supporting organization," and the gift cannot create or add to a donor advised fund administered by the donee public charity.
- The gift can satisfy the donor's pre-existing pledge.
- The gift must be outright. Therefore, it cannot fund a charitable remainder trust, charitable gift annuity, or charitable lead trust.
- The donor must substantiate the gift with a "contemporaneous written acknowledgment" issued by the donee.

A transfer that meets these requirements qualifies for the special tax treatment accorded IRA Charitable Rollovers.

A qualifying IRA Charitable Rollover gift is excluded from the donor's federal gross income even though the gift is technically a withdrawal from an IRA. Because the gift is not included in the donor's gross income, it does not cause the phase-out of other federal tax benefits (e.g., personal exemptions and itemized deductions). No income tax charitable deduction is available for an IRA Charitable Rollover.

The IRA Charitable Rollover gift also counts towards the donor's minimum required distribution (MRD) from the IRA for the year made.

<sup>1</sup> The technical term for these gifts is "Qualified Charitable Distributions," and "IRA Rollover" is more commonly used. We use the term "IRA Charitable Rollover" to emphasize the transfer of IRA assets to charities.

This newsletter is a periodic publication of Gray Plant Mooty and should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and readers are urged to consult with an attorney concerning their own situations and any specific legal questions they may have.

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## Jim Lamm Launches Digital Passing Blog

Gray Plant Mooty principal Jim Lamm recently launched the Digital Passing blog—covering the intersection between estate planning (planning for a person’s incapacity and death) and the digital world (passwords, online accounts, intellectual property, and other digital property).

The purpose of this blog is to introduce family members, fiduciaries (a guardian, conservator, executor, personal representative, trustee, attorney-in-fact, etc.), and their advisors (a lawyer, accountant, financial advisor, etc.) to the types of digital property that they need to locate and access as they deal with a person’s incapacity or death. Planning in advance is critical for digital property, and it may provide the only way for family members and fiduciaries to access that digital property.

Visit [www.digitalpassing.com](http://www.digitalpassing.com) to read and subscribe to the blog.



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