ESTATE PLANNING IN 2011 AND 2012:
OPENING THE WINDOW OF OPPORTUNITY

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Milford B. Hatcher, Jr. and Edward F. Koren

The new year has arrived, and all of the favorable estate, gift, and generation-skipping tax provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act of 2010") are now in effect, or lapsed at the end of 2010. The focus of this article is on the planning opportunities presented by the Tax Relief Act of 2010 during the two year remaining window, 2011 and 2012, and when and how to take advantage of them. An in-depth review and analysis of the technical intricacies and the inevitable uncertainties of new legislation will be reserved for a later date or for others to cover.

SUMMARY OF PERTINENT ESTATE, GIFT AND GENERATION-SKIPPING TAX PROVISIONS OF THE TAX RELIEF ACT OF 2010

The starting point for appreciating the estate planning opportunities afforded by the new legislation is an overview of the economic changes in the estate, gift, and generation-skipping tax laws effected by the new legislation.

Gift Tax Changes.

The 35% highest marginal federal gift tax rate that was believed to be a "once in a lifetime" low rate limited to 2010 has been extended through 2012 and is now a "three years in a lifetime" low rate. Furthermore, the federal gift tax-free amounts have been reunified with the higher federal estate tax-free amounts. Through 2012, an individual can make up to $5,000,000 of cumulative taxable gifts during his or her lifetime without incurring any federal gift tax liability (the "$5,000,000 individual lifetime federal gift tax exemption"). If the individual and his or her spouse agree to treat gifts during the year by either of them as having been made one-half by each, up to $10,000,000 of lifetime cumulative taxable gifts can be made through 2012 without any federal gift taxes being imposed (the "$10,000,000 joint lifetime federal gift tax exemption"). The $5,000,000 and $10,000,000 exemption amounts may even be somewhat higher in 2012, because the new law provides for a cost-of-living increase that year.

Unless Congress again acts before the end of 2012, as of January 1, 2013, the highest marginal federal estate tax rate will revert to 55% and the federal gift tax-free amount will plummet to $1,000,000 (or $2,000,000 if a husband and wife agree to split gifts). Because the transfer tax provisions of the Tax Relief Act of 2010 were among the most contentious provisions in this legislation, and because the gift tax provisions represent some of the most pro-taxpayer transfer tax changes, there can be no assurances that either or both of the 35% highest marginal federal gift tax rate and the $5,000,000 individual lifetime federal gift tax exemption (or $10,000,000 joint lifetime federal gift tax exemption) will be available after 2012.

<u>Estate Tax Changes</u>.

For a death in 2011 or 2012, up to $5,000,000 (plus a possible cost-of-living increase for a 2012 death) will be tax free for federal estate tax purposes. In addition, the highest marginal federal estate tax rate will be only 35%.

Admittedly, these provisions do not compare favorably with the one-year elective "repeal" of federal estate taxes for a 2010 decedent. They are much more favorable, however, than the $1,000,000 estate tax-free amount and the 55% highest marginal federal estate tax rate (actually up to 60% for a "bubble" amount until the rate on the entire taxable estate equals 55%) which would have applied as of January 1, 2011 if the Tax Relief Act of 2010 had not been passed and which will again apply as of January 1, 2013 if new legislation is not passed in the interim.

The federal estate tax-free amount generally is reduced by taxable gifts made by the decedent during his or her life. Therefore, if an individual who passes away in 2011 has already fully utilized his or her $5,000,000 individual lifetime federal gift tax exemption, there would be no remaining federal estate tax-free amount. All assets in such decedent's gross estate for federal estate tax purposes (as distinguished from lifetime taxable gifts that are part of the estate tax base but are not includible in the gross estate) would, as a general rule, be subject to a 35% federal estate tax except to the extent the marital deduction, charitable deduction, or some other federal estate tax deduction applies.

If the individual fully utilizes his or her $5,000,000 individual lifetime federal gift tax exemption during 2011 and 2012 and passes away in 2013 when only $1,000,000 can be left federal estate tax free, the $4,000,000 excess of the $5,000,000 of taxable gifts over the $1,000,000 federal estate tax-free amount may be subject to federal estate taxes, even though the $5,000,000 of taxable gifts were transferred without incurring any federal gift tax liability at the time they were made in 2011 and 2012. This potential "clawback" estate tax liability, for a decedent passing away in 2013 or later, on 2011 and 2012 tax-free gifts in excess of $1,000,000 (or any other federal estate tax-free amount less than $5,000,000 that is in effect as of the date of death) is by no means certain even under existing statutory provisions and is likely to be addressed by future legislation. Until such future legislation is passed, however, a potential "clawback" estate tax liability could exist.

Generation-Skipping Tax Provisions.

For 2011 and 2012, the generation-skipping tax rate will be 35%, and the GST exemption will be $5,000,000 (with a cost-of-living adjustment for 2012). It would be a mistake, however, to say that the generation-skipping tax provisions have been unified with the estate and gift tax provisions. Instead, the remaining GST exemption may vary materially from the unused balance of the lifetime federal gift tax exemption or federal estate tax exemption, even though all of these exemptions are set at $5,000,000 for 2011 and $5,000,000 plus a cost-of-living increase for 2012. For example, outright lifetime taxable gifts to children during 2011 or outright bequests to children upon a death in 2011 would count against the $5,000,000 individual lifetime federal gift exemption or the $5,000,000 federal estate tax exemption but would not exhaust any of the $5,000,000 GST exemption. Conversely, gifts that are excludable for federal gift tax purposes and are thus not "taxable gifts" for federal gift or estate tax purposes, such as the annual exclusion gifts to many generation-skipping trusts, may count against the GST exemption.

As of January 1, 2013, the generation-skipping tax rate is scheduled to revert to 55%, the pre-2001 rate, and the GST exemption is scheduled to drop to approximately $1,400,000. Again, intervening legislation may alter this post-2012 rate, GST exemption, or both, but it is impossible at this time to predict the terms of any such legislation even if Congress does act.

Portability.

The lower rates and higher federal estate tax-free amounts for a 2011 or 2012 decedent are not the only potentially favorable federal estate tax provisions. So-called "portability" provisions are included for the first time in the Tax Relief Act of 2010. Under these portability provisions, if and to the extent the taxable estate for federal estate tax purposes of the first spouse to die is less than the federal estate tax-free amount, that first deceased spouse's unused portion of the federal estate tax-free amount will potentially carry over and be available for use by the surviving spouse's estate on top of the surviving spouse's own federal estate tax-free amount, subject to limits imposed by the new legislation. Both spouses must die during the 2011 and 2012 time period, however, for the federal estate tax portability provisions to apply under the terms of the Tax Relief Act of 2010. Although the portability provisions seem to have bipartisan support and may very well be extended beyond 2012, planning on the basis of the portability provisions continuing to apply is fraught with considerable risk and probably should be avoided until Congress makes these provisions permanent. Even if the first spouse dies during 2011 or 2012, what is the likelihood of the second spouse also passing away before the end of 2012?

Although the portability provisions provide only extremely limited planning opportunities in the context of planning for an ultimate demise, they may present unique opportunities from a federal gift tax perspective if the first spouse dies in 2011 or 2012 and does not fully utilize his or her federal estate tax-free amount. The unused portion of the deceased spouse's federal tax-free amount will carry over to the surviving spouse and in effect will be added on top of the surviving spouse's $5,000,000 individual lifetime federal gift tax exemption.

For example, if the spouse dies in 2011, has no assets and has made no taxable gifts during his or her lifetime, none of that spouse's $5,000,000 federal estate tax exemption would have been used, and the entire $5,000,000 would be added to the surviving spouse's $5,000,000 individual lifetime federal gift tax exemption otherwise available through 2012. As a result, the surviving spouse could make taxable gifts of up to $10,000,000 by the end of 2012 without incurring any federal gift tax liability.

The federal gift tax considerations would be the same in the above example if the first spouse held at least $5,000,000 of assets at the time of death but left all of those assets outright to the surviving spouse. Because of the marital deduction, none of the first spouse's $5,000,000 federal estate tax exemption would have been used and would thus carry over to the surviving spouse.

Similarly, in a de-coupled state with a state death tax above a comparatively low exempt amount, such as $1,000,000, the first spouse may leave the state exempt amount in trust and give the balance outright to the surviving spouse. This would constitute only a partial use of the larger federal estate tax exemption. The difference between the larger federal estate tax exemption and the smaller state death tax exemption would carry over to the surviving spouse. Unless portability is extended, however, or the survivor dies before 2013, the only way to take advantage of portability would be for the survivor to make a gift using the two federal exemptions.

In contrast, there is no generation-skipping tax portability. To the extent that the first spouse to die during the 2011 through 2012 time period does not fully utilize his or her $5,000,000 GST exemption, the unused portion will be lost.

TESTAMENTARY AND OTHER DEATH TRANSFERS

Given the increase to $5,000,000 exempt amounts for both federal estate tax and generation-skipping tax purposes, standard formula clauses used in wills and revocable trusts may need to be revisited to see if the individual really wants the assets to be left in a manner consistent with such formula clauses. Not only have the tax law changes effected by the Tax Relief Act of 2010 dramatically altered the potential allocations under formula clauses, but the economic losses during the recent Great Recession may exacerbate the impact of the shifting allocations.

For example, assume that an individual's will and revocable trust provide that an amount equal to the remaining GST exemption is left to a generation-skipping trust for descendants. The balance of the estate is left outright to the individual's two children. This will and revocable trust were executed in 2000, shortly after the death of the individual's spouse, when the individual had a net worth of $7,500,000. At that time, the GST exemption was not expected to be in excess of $1,000,000 plus a cost-of-living increase. Because substantial amounts were expected to go outright to children, even after a very substantial estate tax liability, grandchildren were accorded a higher priority than children under the GST exempt trust. By 2011, the Great Recession has taken a toll on the individual's net worth and the financial position of the children. The individual now only has a net worth of $5,000,000. Potential estate taxes are the least of the children's concern. The individual is likely to be very surprised to know that if he or she does not revise his or her will and revocable trust and dies in 2011, each of his or her children would receive nothing and the entire $5,000,000 would go to the GST exempt trust primarily for the grandchildren's benefit. At a minimum, the individual would probably want to give the children a much higher priority under the GST exempt trust. Because the children may not have substantial estates in their own rights, there may be considerably less reason to leave the full $5,000,000 remaining balance of the GST exemption to the GST exempt trust. In fact, the individual may decide to scrap use of the GST exempt trust altogether if the children are not likely to have large enough estates to be concerned about estate taxes. It is appropriate, however, to remind the individual that the favorable transfer tax provisions in the Tax Relief Act of 2010 sunset after 2012, potentially leaving only a $1,000,000 federal estate tax exemption for each of his or her children, and that a trust can afford important asset protection benefits. This reminder may make the individual pause before totally abandoning the GST exempt trust, although the GST exempt trust may need to be reworked to add a higher distribution preference for the children.

The above "example" mirrors the actual facts of an individual who passed away in 2010 when the GST exemption was retroactively increased to $5,000,000. Not unexpectedly, the children are less than enthralled at what they perceive as the loss of their inheritance.

In another example, a married individual executed a will in 2007 when his or her net worth was $10,000,000. That will left an amount equal to the federal estate tax exemption to a bypass credit shelter trust for his or her descendants. The balance of the assets were left to a marital trust. When the will was executed, the individual expected not more than $3,500,000 to be left to the bypass credit shelter trust and at least $6,500,000 to be left to the marital trust. After financial reverses during the Great Recession, the individual's net worth has declined to $6,000,000 by early 2011. The individual is likely to be taken aback when he or she is informed that, if he or she dies now, $5,000,000 would go to the bypass credit shelter trust for descendants and only $1,000,000 would go to the marital trust. If the client dies before the will is revised, the surviving spouse is likely to be even more surprised, shocked, and appalled.

Admittedly, the above examples represent extreme cases. Such cases are by no means isolated, however, and even less extreme cases may distort what the individual would want if he or she is apprised of the shifting allocations of assets under formula clauses that he or she never fully understood anyway.

Individuals with prospective estates under $5,000,000, or possibly even higher amounts, might seriously consider leaving all assets to a single marital trust for a spouse with the expectation that, if and to the extent appropriate, a partial QTIP election would be made following the individual's death. Another alternative would be to leave the entire estate to a Clayton marital trust. Under a Clayton marital trust, the property left to the trust would remain in the marital trust for the benefit of the surviving spouse to the extent that a QTIP election is made by the personal representative of the individual's estate. Any remaining property would be left in the manner provided in the Clayton trust to the extent that the QTIP election is not made. The property not covered by the QTIP election could go, for example, to a trust for the surviving spouse and descendants. It could also go to a trust for children and descendants, thus bypassing the surviving spouse, but when the scheduled federal tax exempt amounts range from $5,000,000 to $1,000,000, use of a formula clause that could cause a surviving spouse to be cut off from any interest in up to $5,000,000 of the estate has all of the earmarks of a disaster in the making if $5,000,000 represents the largest part, if not all, of the estate. Such expanded use of potentially all-inclusive marital deduction provisions, which generally should be limited to stable and harmonious marital and family situations, contemplates that Congress is likely to act before 2013, making portability permanent, providing a federal estate tax exemption materially in excess of $1,000,000, or both. At the same time, the partial QTIP election or Clayton marital trust provisions should provide a material hedge against Congress again becoming stalemated and doing nothing before 2013.

If a married individual with an estate in the $5,000,000 range still prefers a more traditional two trust approach, he or she may want to consider capping the bypass trust gift at an amount or percentage of the estate that is substantially below $5,000,000. Even if a decision is made to leave the full $5,000,000 federal estate tax-exempt amount to the bypass trust, the individual may want to strengthen the safeguards that a surviving spouse has first priority under the trust.

A bequest of the remaining balance of the GST exemption to a generation-skipping exempt trust may also need to be reevaluated. That reevaluation should take into account not only the new $5,000,000 GST exemption, but also the likely estate tax situation of the individual's children. The individual may choose, in the aftermath of the reevaluation, not to leave the full remaining GST exemption to the GST exempt trust, may alter the beneficial interests of the beneficiaries under that trust (especially by according a higher priority to children), or both.

There is understandably a temptation to do nothing when the law is in a state of flux, but this is not the time to be paralyzed by the transfer tax uncertainty after 2012. As much as individuals are prone to procrastinate until there is certainty, which is unlikely for at least another two years, the drastic swings in potential allocations (or, in many instances, unintended misallocations) under formula clauses almost compel that individuals review wills and revocable trusts including formula clauses. This is especially important for individuals with net worths of under $10,000,000.

GIFTING AND LIFETIME TRANSFERS:TO USE OR NOT TO USE THE NEW OPPORTUNITIES,THAT IS THE QUESTION

The threshold question in regard to possible lifetime transfers is whether an individual wants to take advantage of the gifting opportunities afforded by the Tax Relief Act of 2010. That will depend upon many factors, including, without limitation, the individual's net worth, his or her predisposition to make gifts irrespective of the tax laws, the extent to which he or she has "discretionary" assets or funds with which to make gifts, and the basis, volatility, and other characteristics of assets which may be gifted or retained. It will be assumed, for the purposes of this article, that the individual does want to make substantial gifts. In days past, the tax laws, especially the pre-2011 $1,000,000 lifetime federal gift tax exemption (or $2,000,000 if a husband and wife agreed to split gifts), imposed material constraints on how much an individual was willing to gift. With the $5,000,000 gift and GST exemptions for 2011 or 2012, the focus is less on transfer tax constraints and more on how much the individual really wants to give. The starting point is the extent of the individual's "discretionary assets." Even if there are $5,000,000 or $10,000,000 of "discretionary assets," however, an individual may balk at giving such large amounts.

"Discretionary Assets".

What are "discretionary assets"? There is clearly no "one size fits all" definition. One individual may be able to live quite comfortably with $10,000,000 of investable assets generating pre-tax cash flow of $400,000. Another individual with the same levels of investable assets and pre-tax cash flow might not be able to come close "to making ends meet." Needless to say, any evaluation of "discretionary assets" must take into account not just present living expenses but also reasonably anticipated living expenses in the future, factoring in inflation. At best, any estimate of "discretionary assets" is an educated guess that is best made by the individual contemplating possible gifts.

Several available techniques may, however, expand the individual's calculation of which assets are viewed as being "discretionary." Among these techniques are the following:

Trust for Donor's Spouse. Gifts may be made to a trust under which the individual's spouse is one of several permissible beneficiaries, or even the sole permissible beneficiary for the balance of such spouse's life. The possibility of distributions to a spouse may make the individual more comfortable with the idea of making a large gift to such a trust, subject to three potential drawbacks. The first potential drawback is that the spouse might die. The second is that the individual or his or her spouse may divorce. The third is a tax consideration. If the spouse is a beneficiary of a trust to which a substantial gift is made, gift-splitting by the spouses is not permitted. Therefore, only the $5,000,000 individual lifetime federal gift tax exemption, and not the $10,000,000 joint lifetime federal gift tax exemption, would be available for such a gift.

An individual and his or her spouse might be tempted to set up two trusts. In addition to the trust that the individual establishes for the benefit of his or her spouse, the spouse may form a trust for the benefit of the individual (the "spouse's trust"). This two trust structure could enable each of the individual and his or her spouse to exhaust his or her own $5,000,000 individual lifetime federal gift tax exemption without having to resort to gift-splitting. Very careful planning would be required, however, to avoid two potential tax traps. The first of these concerns is the so-called "reciprocal trust doctrine," under which the individual would be deemed to have established a trust for his or her own benefit, thus causing the assets in the trust to be includible in his or her gross estate for ultimate federal estate tax purposes. This risk could be mitigated by materially varying the terms of the trusts and by setting them up on different dates ideally as far apart as reasonably possible (such as early 2011 and late 2012, respectively). Another possible risk is the step transaction doctrine if the individual furnishes the assets used by the spouse to fund the spouse's trust formed for the individual's benefit. Optimally, the spouse should use his or her separate assets to fund the spouse's trust. If that is not possible, it would be prudent to let as much time as reasonably possible lapse between the date of the gift to the spouse and the later gift to the spouse's trust so that the gift would have the best possible chance of being treated as "old and cold" at the time that at least part of the gifted assets are transferred by the spouse to the spouse's trust. It would also be advisable for the terms of the spouse's trust not to have been determined at the time of the gift from the individual to his or her spouse. These precautions should not be viewed as panaceas, however. They only reduce the tax risks inherent in the two trust structure, hopefully to acceptable but not guaranteed levels.

<u>Trust with Donor as Permissible Discretionary Beneficiary</u>. With two major caveats, an individual can even set up a trust with an independent trustee and give that independent trustee the power to make discretionary distributions from the trust to the individual. There can be no prearrangement, however, for the independent trustee to make distributions to the individual, and regular and recurring distributions to the individual may be regarded as evidence of prearrangement. As a result, the individual grantor should, at most, view the trust as a possible, but not assured, emergency fund. Also, the trust would need to be formed in a state with favorable self-settled trust laws that would not expose the trust assets to the claims of the individual's creditors because the individual is a permissible trust beneficiary.

<u>Preferred Partnership</u>. A preferred partnership may, in effect, shift annual cash flow from assets contributed by an individual in exchange for common interests to assets contributed by that same individual for preferred interests. This in turn, may facilitate the individual's

determination that part or all of the common interests are "discretionary assets" available for gifting. For example, assume that an individual with a $20,000,000 net worth does not currently need all of the cash flow that potentially could be generated by distributing to a spending account 4% of the value of the investable assets as of the first of the year, but he or she does not want to gift $5,000,000 if that reduces his or her potential annual cash flow generation by $200,000 (4% of $5,000,000). If $10,000,000 is contributed to a new preferred partnership, with $5,000,000 being contributed for a preferred interest with a cumulative 8% annual net cash flow preference (that is, $400,000 per year) and with another $5,000,000 being contributed for a common interest entitled to distributions only after the preferred interest's cumulative $400,000 annual cash flow preference has been satisfied, the individual would not be giving up any potential current cash flow by gifting part or all of the common interests. Also, as discussed in greater detail subsequently, the gift of the highly illiquid, ideally non-controlling common interests may, in effect, leverage the individual's use of his or her $5,000,000 individual lifetime federal gift tax exemption, because only the discounted value of the gifted common interests would count against that exemption.

Effectively Utilizing and Leveraging the Gift and GST Exemptions.

Don't Forget the Basics. The much higher gift and GST exemptions present opportunities, but there continues to be no reason to use a portion of these exemptions when the use of gift tax or generation-skipping tax exclusions would suffice. Importantly, the Tax Relief Act of 2010 does not limit the use of previously available gift and generation-skipping tax exclusions.

For example, annual gifting to take advantage of the $13,000 per donee annual gift tax exclusions should be continued to the extent that such annual gifting accomplishes what the donor is attempting to achieve and the donor has no preferable alternative use for the annual exclusion gifts. In the case of an irrevocable life insurance trust (an "ILIT"), this may warrant continued annual or more frequent gifts to the ILIT that are sufficient to meet premium obligations and that include Crummey withdrawal powers enabling the gifts to qualify for the federal gift tax annual exclusions, although there would be no comparable generation-skipping tax exclusion if the ILIT is a generation-skipping trust. Unless the donor wants to make annual exclusion gifts to children, grandchildren, or both for another purpose, such as providing a more comfortable standard of living, it is probably not advisable for the donor to make a large taxable gift to the ILIT except to the extent that the annual premium payments exceed the available annual exclusion gifts or except to the extent that the policy is a second-to-die policy and the donor wants to relieve the funding pressure on the second insured if the donor dies first.

Similarly, why should a donor make a substantial taxable gift for federal gift tax purposes to a HEET trust if the primary purpose of the trust is to pay health and education costs of children and more remote descendants during the donor's lifetime? If the donor pays all of his or her descendants' health and education costs directly for the balance of his or her life, the direct payment of such health and education costs would be excludable for federal gift and generation-skipping tax purposes, and none of the donor's $5,000,000 individual lifetime federal gift tax exemption or $5,000,000 GST exemption would need to be used.

Another basic tenet of gifting is that basis matters. If a highly appreciated asset is the proposed subject of a gift, the donor's low basis at the time of the gift will generally carry over and constitute the donee's basis. If it is anticipated that the donee would sell the asset shortly after it is gifted, the after-tax proceeds from the sale may be materially less than the reportable taxable gift, thus resulting in a wasted use of part of the donor's $5,000,000 individual lifetime federal gift tax exemption and possibly his or her $5,000,000 GST exemption, unless the gift is made to a grantor trust.

<u>Holding Back in Lieu of Maximum Gifting</u>. There may be valid reasons to use less than all of the donor's $5,000,000 individual lifetime federal gift tax exemption, his or her $5,000,000 GST exemption, or both. Especially in a period of low interest rates, a "leaky freeze" technique may have non-tax advantages that override the tax advantages of the only true freeze technique, a gift.

For example, a possible donor may be uncertain as to whether he or she has sufficient "discretionary assets" to make a gift of $5,000,000, but that donor may be willing to make a $500,000 gift and sell the $4,500,000 balance of the assets with a $5,000,000 aggregate value for an installment note. The value of that $4,500,000 installment note would, in effect, serve as the financial security blanket needed to make that donor sufficiently comfortable to proceed with the transfers. If the installment sale occurs during January, 2011 and the term of the installment note is nine years, the interest rate could be as low as 1.95% per year, compounded annually if the interest is not paid at the end of the particular year. The 1.95% per annum interest charge is a relatively low cost to pay for the would-be donor's increased comfort level and resulting willingness to make the smaller $500,000 "seed" gift and sell the $4,500,000 balance of the assets. From a transfer tax perspective, the difference is not that great, at least in relative terms. If the donor gifts the full $5,000,000 and dies nine years later, $5,000,000 of taxable gifts would be includible in the deceased donor's taxable estate computation. In contrast, if the donor gifts $500,000 and enters into a $4,500,000 installment sale with a nine-year balloon note (under which all interest accrues and is payable on the ninth anniversary when the principal also comes due), the donor's taxable estate computation upon his or her assumed death nine years after the sale would include $500,000 of taxable gifts, the $4,500,000 principal balance of the note, and approximately $900,000 of accrued interest. The difference for transfer tax purposes would be the $900,000 or so of accrued interest, but approximately $4,100,000 of assets would be removed from the estate tax base if the total return from the transferred assets proves to be an annually compounded 8%, thus causing those assets with a $5,000,000 value initially to double in value to $10,000,000 over the nine-year period. This is a classic case of not letting the perfect get in the way of the good if the perfect might not otherwise be attainable.

There may also be non-tax reasons warranting a "leaky freeze," instead of the absolute freeze afforded by a gift if the potential subject of the gift is a volatile asset, such as an interest in a highly leveraged start-up business. The asset, which will be assumed to have a $5,000,000 value, could easily double or treble in value in a relatively short period, but it could also become worthless. The downside risk of gifting such an asset would be that the gift would result in $5,000,000 of taxable gifts being includible in the donor's ultimate estate tax base even if the asset becomes worthless after the gifting. In effect, the donor would have wasted all of his or her $5,000,000 federal estate tax exemption, as well as all of his or her $5,000,000 individual lifetime federal gift tax exemption. To hedge against this downside risk, the would-be donor should seriously consider a short-term or even an intermediate-term GRAT instead of an outright gift. The GRAT could be structured so that only a nominal taxable gift would occur at the time of the funding. If the asset subsequently drops in value or becomes worthless, no material portion of the donor's federal estate exemption or individual lifetime federal gift tax exemption would be wasted. If the property doubles or trebles in value, the dramatic increase in value shifted to the remainder beneficiaries of the GRAT would be reduced only by a 2.4% per annum interest factor if the GRAT is funded in January, 2011.

Letting It all Hang Out. If the donor believes that he or she has sufficient "discretionary assets" and is not unduly concerned by any non-tax considerations, he or she may want to give the full $5,000,000 or $10,000,000 and exhaust the full $5,000,000 individual lifetime federal gift tax exemption or $10,000,000 joint lifetime federal gift tax exemption. If the gift is made in trust or outright to grandchildren or more remote descendants, the donor may also want to utilize the entirety of his or her $5,000,000 GST exemption or the combined $10,000,000 GST exemptions of the donor and his or her spouse if they agree to split the gifts.

Some high net worth individuals may want to gift or otherwise transfer even more than $5,000,000 or $10,000,000 to his or her family members or in trust for their benefit. There are several techniques for doing so that do not involve additional taxable gifts.

First, if the gift is made to a grantor trust for income tax purposes, all trust income would be taxable to the grantor so long as the trust continues to qualify as a grantor trust. The grantor's payment of the income tax liabilities attributable to him or her being taxed on the trust income would not be considered an additional taxable gift to the trust for gift tax purposes, but the effect would be to enable the trust to build up income tax-free.

A second technique involves a gift of assets with a discounted value. The basis for the discount could include, among others, lack of marketability, lack of control, or undivided fractional interest. The Tax Relief Act of 2010 imposes no new limits on gifting assets with discounted values, and transferring assets with discounted values can, in effect, be used to leverage gift tax-free gifting. It should be noted that this reprieve for discounting may be short-lived if the IRS issues its long-awaited Section 2704(b)(4) regulations that are expected to materially reduce allowable discounts for interests in partnerships and corporations, but not undivided fractional interests in real estate.

One option involving a gift of assets with discounted values would start with a contribution of assets to a newly-formed family limited partnership or limited liability company. In exchange, the individual making the contribution would receive illiquid, non-controlling limited partnership or membership interests in the entity worth less than the value of the contributed assets because of allowable valuation discounts for lack of marketability and lack of control. There should be a legitimate and significant non-tax reason for forming and funding the limited partnership or limited liability company. The individual making the contribution would subsequently gift the limited partnership or membership interests with the discounted values. For example, if the donor contributes $19,800,000 to a limited partnership for a .99% general partner interest and a 98.01% limited partner interest, he or she could subsequently, after the lapse of sufficient time to avoid application of the step-transaction doctrine, gift a 71.428% limited partner interest with a value of just under $10,000,000 [($20,000,000 x .71428) x .7], assuming that the underlying partnership assets continue to have a $20,000,000 value at the time of the gift and that 30% combined discounts for lack of marketability and lack of control are appropriate.

Another option with even deeper allowable discounts would involve a preferred limited partnership or limited liability company. For example, assume that a total of $30,000,000 is contributed to a preferred limited partnership. The donor contributes 99% of this total, or $29,700,000, with $9,900,000 being contributed for a preferred limited partner interest representing 99% of all preferred limited partner interests, with $198,000 being contributed for a .99% general partner common interest representing 99% of all general partner common interests, and with $19,602,000 being contributed for a 98.1% limited partner common interest representing 99% of all limited partner common interests. Because the common interests are subordinate to the net cash flow and liquidation preferences of the preferred interests, the common interests are riskier, and the combined lack of marketability and lack of controlled discounts should be significantly greater. If 30% combined discounts were properly allowable for the limited partner interest in the non-preferred limited partnership in the above example, the combined discounts for the limited partner common interest in the preferred limited partnership should be in the 35% to 40% range. If the properly allowable combined discounts are 40%, the donor could gift an 83.33% limited partner common interest with a value of just less than $10,000,000 [($20,000,000 x .8333) x .6]. If 35% combined discounts are appropriate, a

76.923% limited partner common interest would have a value of slightly less than $10,000,000 [($20,000,000 x .76923) x .65].

Qualified personal residence trusts ("QPRTS") are another option for making taxable gifts with discounted values. The value of the interest in the residence transferred to the QPRT, which may itself be a discounted undivided fractional interest, would be reduced by the value of the grantor's retained right to occupy the residence for a specified term and a mortality factor to account for the potential reversion of the interest in the residence to the grantor's estate if the grantor dies before the end of that term.

If the donor wants to make transfers in excess of these gift tax-free amounts, he or she could make additional gifts and pay the resulting 35% federal gift tax. Even the payment of gift taxes could result in an ultimate transfer tax advantage, not a disadvantage, although this admittedly sounds counter-intuitive. The payment of gift taxes could, of and by itself, effect substantial ultimate estate tax savings by removing the gift taxes paid from the donor's ultimate estate tax base. This assumes that the donor lives for more than three years after the date of the gift. In addition, the 35% gift tax rate in effect for 2011 and 2012 may be materially lower than the estate tax rate in effect at the time of the donor's death after 2012. A gift in 2011 or 2012 triggering a federal gift tax liability may, in effect, lock in the lower 35% federal transfer tax rates currently in place, although this could be changed by later legislation.

If the donor is averse to paying any gift taxes and wants to transfer more than the $5,000,000 or $10,000,000 gift tax-free amounts, the $5,000,000 or $10,000,000 gifts to a grantor trust could provide "seed" funding for a later installment sale of up to $45,000,000 or $90,000,000 of additional assets. Such transfers could be fully exempt not only for federal gift tax purposes but also for federal generation-skipping tax purposes.

The problem with higher levels of debt relative to the seed gifts, such as a nine to one debt to seed gift ratio referred to in the preceding paragraph, is that even a 10% market downturn could wipe out the seed gifts, thus wasting the donor's $5,000,000 individual lifetime federal gift tax exemption or the $10,000,000 joint lifetime federal gift tax exemption and the $5,000,000 or $10,000,000 GST exemptions. If the donor wants to reduce the risk by maximizing gift tax-free gifts but reducing the debt by selling assets with a lesser value to the grantor trust, the transfers could be structured to limit the exposure of the gifted assets to the installment sale debt. For example, assume that $10,000,000 is gifted to a grantor trust and another $30,000,000 is proposed to be sold on an installment basis. Instead of selling the $30,000,000 of assets to the grantor trust to which the $10,000,000 gift is made, it may make more sense for the grantor trust to transfer $3,333,334, or one-third of the gifted assets, to a new wholly-owned limited liability company formed by the grantor trust and have that limited liability company purchase the $30,000,000 of assets in exchange for that limited liability company's installment note. This structure would enable two-thirds of the $10,000,000 gift to be free and clear of any liability for the $30,000,000 installment note representing the fair market value purchase price of the assets sold to the grantor trust's wholly-owned limited liability company.

If generation-skipping tax exemption is less important to the donor than avoiding any exposure of the gifted assets to the liability resulting from additional transfers above and beyond the gift tax and generation-skipping tax exempt amounts, the donor may want to make additional transfers to a zeroed-out GRAT with children or trusts for their benefit as remainder beneficiaries. Not only would GRATs not require that prior taxable gifts be used as collateral for such transfers, but there would also not be any constraints on how much could be contributed to the GRATs. In effect, the sky would be the limit. In contrast, there are perceived safe harbor limits on the value of the assets which could be sold on an installment basis to a grantor trust following a "seed" gift. It is widely believed that the installment debt should not exceed nine (or possibly ten) times the value of the prior "seed" gift, and all of that "seed" gift would need to be used to collateralize the installment debt if the debt to "seed" gift ratio is bumping this nine (or ten) to one leverage cap.

The bottom line is that not only has the Tax Relief Act of 2010 dramatically expanded the value of assets that can be gifted to a generation-skipping exempt trust without incurring a federal gift tax liability, but it also has dramatically expanded the potential leveraging of such "seed" gifts to make additional transfers. The real question now for a would-be donor is less likely to be how much can I transfer but is instead whether I really want to transfer as much as I can.

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