OVERVIEW OF LIFETIME GIFT AND GST TAX PLANNING

This memorandum provides a broad overview of lifetime estate planning under current law. By making lifetime gifts, an individual can reduce the overall tax cost of transferring property to family members.

This memorandum is divided into five parts. Section I discusses the annual exclusion and other tax-free gifts. Section II discusses the benefits of making early use of an individual's Federal Gift Tax Exemption and Generation-skipping Transfer ("GST") Tax Exemption. Section III discusses various ways to enhance the use of lifetime gifts. Section IV discusses techniques designed to shift the appreciation on assets to lower generations. Finally, Section V discusses the potential benefits of making taxable gifts in excess of the Federal Gift Tax Exemption.

I. Annual Exclusion Gifts and Other Tax-Free Gifts.

Annual exclusion gifts and the payment of education and medical expenses are the most basic, yet effective, ways to transfer assets and the total return on those assets to children and other beneficiaries without a gift tax and without use of the donor's Federal Gift Tax Exemption.

A. Annual exclusion gifts. Each individual may make annual exclusion gifts of up to $14,000 (or $28,000 for a married couple who elects to split gifts)[1] per donee annually to children, grandchildren or other individuals without gift or GST tax consequences. We recommend that annual exclusion gifts be made early in each calendar year.

Annual exclusion gifts may be made directly to the individual donee (or, in the case of a minor, to a custodian under the Uniform Transfers to Minors Act) or to a specially designed annual exclusion trust.

B. Payment of education and medical expenses. In addition to annual exclusion gifts, payments of medical expenses, health insurance premiums and tuition to qualified educational institutions may be made transfer-tax-free. In order to qualify for this exemption, payments must be made directly to the qualifying educational institution, medical provider or insurance company.

[1] The annual exclusion amount is indexed for inflation.

C. 529 Plans. Annual exclusion gifts may also be made to a 529 Plan, which is an income-tax-advantaged college savings account. Depending on applicable state law, contributions to a 529 Plan may be at least partially deductible by the donor for state income tax purposes. Both the income in the 529 Plan and distributions from the 529 Plan for tuition, fees, books and supplies and room and board are free of Federal and state income taxes. Moreover, a donor may pre-pay up to five years of annual exclusion gifts to a 529 Plan if an election is made on the donor's gift tax return.[2]

A gift to a 529 Plan may not be the most efficient use of a donor's annual exclusion, however, since such a gift uses the donor's available annual exclusion with respect to the beneficiary of the 529 Plan, even though a separate exclusion will be available if the donor pays college tuition directly. In addition, accumulated earnings that are distributed and are not used for educational purposes are subject to income taxes and a ten percent (10%) Federal withdrawal penalty.

II. Use of Gift Tax and GST Tax Exemptions.

A. Gift Tax Exemption. Each individual may make "taxable" gifts (that is, gifts that do not qualify for an exclusion or deduction from the Federal gift tax) during his or her life up to the Federal Gift Tax Exemption without generating a gift tax. The Federal Gift Tax Exemption as of January 1, 2016 is $5,450,000[3] (or $10,900,000 for a married couple that elects to split gifts) and is indexed yearly for inflation. The gift tax rate for taxable gifts in excess of the Federal Gift Tax Exemption is 40%.

There are a number of benefits to making lifetime taxable gifts up to the Federal Gift Tax Exemption. First, early use of the Federal Gift Tax Exemption results in the removal of the investment return on the transferred property from the donor's estate tax base. In addition, a number of states , including New York[4] and New Jersey, do

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[2] However, if a donor pre-pays five years of annual exclusion gifts to a 529 Plan but dies before the close of the five year pre-payment period, the portion of the pre-paid contributions allocable to the periods after the date of the donor's death will be included in the donor's estate.

[3] In certain circumstances, under the "portability" rules, an individual may be able to use not only his or her own Federal Gift Tax Exemption but also part or all of the unused Federal Estate Tax Exemption of a predeceased spouse.

[4] Under New York law, however, a gift made by a New York resident who dies before January 1, 2019 will be subject to the New York estate tax if the gift was made on or after April 1, 2014 and within the three (3) year period prior to the donor's death. This rule does not apply if the property given away was real or tangible personal property located outside of New York or if the gift was made at a time when the decedent was not a resident of New York.

not impose a gift tax but do impose an estate tax.[5] Thus, taxable lifetime gifts may avoid entirely a state transfer tax on the transferred property.

B. *GST Tax Exemption.* With certain exceptions, gifts to grandchildren and more remote issue are subject not only to a Federal gift tax but also to a GST tax. Further, if a donor creates a trust for the benefit of a child and the child's issue, a GST tax will generally be imposed during the life of the child when distributions are made to grandchildren or more remote issue, as well as upon the child's death if the trust continues for the benefit of grandchildren or more remote issue or if distributions are made at that time to grandchildren or more remote issue. The tax is imposed at the top estate tax rate, which is currently 40%. The imposition of the GST tax can be avoided, however, by allocating the donor's GST Exemption to the direct gift to the grandchild or more remote issue or to the trust (a "GST-exempt trust"). The GST Exemption as of January 1, 2016 is $5,450,000 (or $10,900,000 million for a married couple who elects to split gifts) and is indexed yearly for inflation.

The property transferred to a GST-exempt trust and the total return on the transferred property are removed from the estate tax base of the donor, as well as the estate tax base of the donor's children and more remote issue, and may pass to multiple generations without an estate, gift or GST tax. An individual who is interested in making early use of his or her Federal Gift Tax Exemption should therefore consider establishing a trust for multiple generations and allocating GST Exemption to that trust.[6] Further, if a GST-exempt trust is set up in Delaware, New Jersey or another jurisdiction that has abolished the rule against perpetuities, under current law, the trust may continue indefinitely without the imposition of an estate or GST tax.

III. Strategies to Enhance Lifetime Gifts.

A. *High-basis assets.* To the extent possible, lifetime gifts should be made with cash or other assets in which the donor has a high income tax basis. While an asset passing at death generally benefits from a "step-up" in the asset's income tax basis to its fair market value at the time of death, an asset transferred by lifetime gift retains the donor's basis (a so-called "carry-over basis").[7] Thus, a lifetime gift of low-

[5] Unlike New York and New Jersey, Connecticut has a gift tax. In Connecticut, each individual may make taxable gifts up to the Connecticut gift tax exemption, which is currently $2 million, without generating a Connecticut gift tax.

[6] A donor may also allocate GST Exemption to currently existing trusts that are not already exempt from the GST tax. By way of example, a trust that was funded on the termination of a GRAT or QPRT, discussed in Sections IV.C and IV.D. below, would not typically be GST-exempt, unless an allocation of GST Exemption was made at the end of the GRAT or QPRT term. A "late" allocation of GST exemption may be made to such a non-exempt trust at any time after the donor's interest in the trust terminates.

[7] If, however, the donor's basis is greater than the fair market value of the asset at the time of the gift (so that, if the asset were sold, it would generate a loss), for purposes of determining a loss in the hands of the donee, the

basis assets may result in capital gains taxes being payable by the donee on the subsequent sale of the transferred asset, thereby potentially reducing the value of the gift. However, if a gift of low-basis assets is made to a so-called "grantor trust", as discussed below, the donor will pay the capital gains tax on the sale of the assets, including the capital gains tax associated with pre-gift appreciation, so long as the sale occurs during the donor's lifetime.

B. ***Grantor trusts.*** A gift to a trust of the donor's Federal Gift Tax Exemption or annual exclusion can be enhanced by structuring the trust as a grantor trust. A grantor trust is ignored for income tax purposes, and all trust income and capital gains are reported on the donor's income tax return. Because the donor pays the income taxes on trust income, trust assets grow free of income taxes during the donor's lifetime, and the donor is able to provide a gift-tax-free benefit to the trust beneficiaries.

In addition, because a grantor trust is ignored for income tax purposes, transactions between the donor and the trust, such as sales and loans, as discussed in Sections IV.A and IV.B below, are disregarded for income tax purposes, providing additional estate planning opportunities.

C. ***State income tax planning.*** If a trust is not a grantor trust, many states, including New York and New Jersey, impose a state income tax on the trust's accumulated income and capital gains if the trust was created by a resident of that state.[8] However, it may be possible, depending on the residence of the donor at the time the trust is created, to avoid the payment of state income taxes on trust income.

For example, in both New York and New Jersey, a trust established by a resident of the state will be exempt from paying state income taxes (an "exempt resident trust") if the trust (i) does not hold any property located in the state, (ii) has no trustees who are residents of the state and (iii) has no New York or New Jersey source income. Assuming that the exempt resident trust is not subject to an income tax in another state[9], the trust will be subject only to Federal income taxes on the trust's capital gains and accumulated income.

donee's basis will be the fair market value at the time of the gift. This exception to the carry-over basis rules (which does not apply to transfers to a spouse) has the effect of preventing a donor from transferring a loss to another individual.

[8] Connecticut also imposes a state income tax on a trust created by a Connecticut resident, but if the trust is created by a trust agreement (rather than under a Will), the tax is based on the proportion of current beneficiaries who are Connecticut residents.

[9] Some states impose a state income tax on trusts that have one or more trustees that are resident in that state. Accordingly, if a resident exempt trust has a trustee that resides in such a state, the trust will pay a state income tax to that state, even though the donor is not a resident of the state.

For exempt resident trusts created by New York residents, however, New York will impose a state income tax on trust income that has been accumulated in the trust if that income is subsequently distributed to a New York resident beneficiary (with a potential offsetting credit for taxes paid in another jurisdiction).[10]

D. Discount entities. A gift of an interest in a closely held corporation, limited partnership or limited liability company (or similar type of entity) may allow a donor to transfer significant wealth with the benefit of a valuation discount for gift (and estate) tax purposes to reflect restrictions on transferability and liquidation. In order to take advantage of the discount, it is important to have a business purpose for the entity. It is also important to have a contemporaneous appraisal of the entity, documenting the basis for the valuation discount. It is anticipated, however, that regulations may be issued in the near future that could significantly curtail the availability of valuation discounts for entities controlled by family members. Thus, if a taxpayer is interested in making a gift of an interest in such an entity, he or she should consider doing so promptly.

Note that gifts of interests that are restricted as to transferability or liquidation may not qualify as annual exclusion gifts because of rules requiring annual exclusion gifts to provide the donee with an unrestricted right to the immediate use of the property or income from the property.

IV. Techniques Designed to Shift Appreciation to Lower Generations.

The following techniques are designed to pass the future investment return on assets to children or more remote issue with minimal or no transfer taxes and may be appropriate for many clients.

A. Intra-family loans. A low-interest loan may be made to family members or to a trust for family members. The Internal Revenue Service issues the "applicable federal

[10] There are several tax benefits associated with New York exempt resident trusts despite the imposition of an income tax on income distributed to a New York beneficiary. In particular, an exempt resident trust may result in (i) the avoidance of New York income taxes on capital gains (which, in general, are taxed to the trust even if distributed to a beneficiary), (ii) the deferral of New York income taxes on income accumulated in the trust and (iii) the avoidance of New York income taxes on accumulated income if the income is eventually distributed to a non-New York beneficiary.

rate" ("AFR") monthly, which is the lowest rate that may be used for loans of varying duration without gift tax consequences. The rates for February 2016 are as follows:

Short-term AFR *(3 years or less)*	**.81%**
Mid-term AFR *(more than 3 years but not more than 9 years)*	**1.82%**
Long-term AFR *(more than 9 years)*	**2.62%**

If a loan is made to a trust, the trust should have sufficient additional assets to provide equity coverage for the note in order for the transaction to be respected as a loan and not recharacterized as a gift. If the trust is structured as a grantor trust, the loan by the donor to the trust will have no income tax consequences during the donor's lifetime. Therefore, the donor will not report the interest as income and the trust will not deduct the interest. Furthermore, the donor will pay the income taxes on any income earned on the loan proceeds, thereby allowing the trust investments to grow income-tax-free.

To the extent that the total return on the investments made with the loan proceeds exceeds the interest payable on the note, wealth will have been shifted to the borrower without gift and estate tax, and, if relevant, without GST tax.

B. Sales to grantor trusts for a note. A variation of the loan to a grantor trust is the sale of an interest in a closely held corporation, limited partnership or limited liability company (or similar type of entity) in exchange for a note bearing interest at the AFR. The sale of an interest in such an entity can be particularly effective if the interest purchased is valued at a discount because of its lack of marketability and the purchaser's lack of control. Because the sale is made to a grantor trust, no gain or loss occurs as a result of the sale,[11] and there are no income tax consequences associated with the payment of interest. To the extent that the total return on the asset sold to the trust exceeds the interest rate on the note, a shifting of wealth will have been achieved without gift and estate tax, and, if the borrower is a GST-exempt trust, without GST tax. As with any loan to a trust, the trust should have sufficient assets to provide equity coverage for the note.

[11] However, it is possible that on the death of the donor, a realization event will occur, resulting in the imposition of a capital gains tax if the note is outstanding at that time.

C. *Grantor retained annuity trusts ("GRATs").* A GRAT may be used to transfer to children (or trusts for children), on a gift-tax-free basis, the total return on assets transferred to the GRAT in excess of a benchmark interest rate. A GRAT is a trust in which the donor retains the right to receive a fixed annuity for a term of years that is designed to return to the donor the entire amount of the initial gift, plus interest at the benchmark rate. The benchmark rate for a GRAT is approximately 120% of the mid-term AFR in the month the GRAT is established (2.2% for February 2016). At the end of the GRAT term, if the total return on the trust property exceeds the benchmark rate, any remaining property in the trust passes to children or to trusts for their benefit, without the imposition of a gift tax. Because a GRAT is a grantor trust, the donor pays the income taxes on trust income, with the result that the trust grows income-tax-free.

If the total return on the trust property is equal to or less than the benchmark rate, all of the trust property will be returned to the donor, but at no tax cost to the donor. If the donor dies before the end of the GRAT term, the trust property is includible in the donor's taxable estate, and there is generally no tax benefit (or tax cost) associated with the gift.

The present value of the children's remainder interest in the GRAT is a taxable gift. The value of the gift equals the value of the assets transferred to the trust less the present value of the donor's retained annuity. The annuity is set so that its present value absorbs almost the entire value of the property given to the GRAT. As a result, the present value of the children's remainder interest, and, thus, the taxable gift, is close to zero. Further, because the annuity is stated as a percentage of the value of the assets transferred to the trust, if the value of those assets is increased on an audit of the gift tax return, the donor's retained annuity will also increase, and the taxable gift to children will still be minimal. This self-adjustment mechanism is particularly valuable if the asset transferred to the GRAT is difficult to value.

D. *Qualified personal residence trusts ("QPRTs").* A QPRT may be used to transfer a primary or secondary personal residence to children (or trusts for children) at a discounted value for gift tax purposes. To create a QPRT, the donor transfers a whole or fractional interest in a residence to the QPRT while retaining the right to occupy the residence and the obligation to pay expenses on the residence for a term of years (the "QPRT term"). After the termination of the QPRT term, the residence is typically held in further trust for a spouse or children. If the donor wishes to continue to use the residence after the end of the QPRT term, he or she will be required to enter into a lease with the trust and pay fair market rent, as determined by regular appraisals.

The present value of the remainder interest in the QPRT, valued at the time of funding, is a taxable gift. The present value of the remainder interest is calculated by reducing the value of the residence (i) by the present value of the donor's retained interest and (ii) to account for the possibility that the donor will die during the term, in which case the residence will revert to the donor's estate. As a result, the longer the QPRT term, the smaller the taxable gift. On the other hand, a longer term increases the risk that the donor will die prior to the termination of the QPRT term, which would result in an inclusion of the residence in the donor's taxable estate.

The value of the residence may also be discounted if a fractional interest in the residence is given to the QPRT. In addition, as with any lifetime gift, if the value of the residence appreciates over time, the appreciation is also removed from the donor's transfer tax base without gift taxes if the donor survives the QPRT term.

Because a QPRT is a grantor trust, if the residence is sold during the QPRT term, the donor will pay the capital gains taxes imposed as a result of the sale. On the sale of the residence during the QPRT term, the QPRT will typically either invest in a new residence or convert to an annuity trust for the donor.

QPRTs are generally more effective if the residence transferred to the trust has a high income tax basis at the time of the transfer (see discussion in Section III.A regarding gifts of high basis assets) and if it is anticipated that the residence will not be sold during the QPRT term.

E. Charitable lead annuity trusts ("CLATs"). A CLAT is also an effective means of removing assets from a donor's taxable estate. A CLAT operates in a similar manner to a GRAT, except that the annuity is paid to charity instead of to the donor. The annuity may take the place of part or all of the donor's regular charitable gifts.

As with a GRAT, the CLAT annuity is stated as a percentage of the initial value of the property transferred to the CLAT and is fixed as of the date that the CLAT is created. Like the annuity payable to the donor of a GRAT, the charitable annuity for a CLAT is set by a formula designed so that its present value absorbs almost the entire value of the property given to the CLAT. Charity will receive over the CLAT term the entire amount of the initial gift to the CLAT, plus interest at a benchmark rate of approximately 120% of the mid-term AFR in effect in the month of the gift to the CLAT or in either of the two months preceding the gift to the CLAT.

A CLAT can transfer significant assets to children without a gift tax cost. If the total return on trust investments during the charitable term exceeds the benchmark rate, the excess return passes to children at the end of the term, free of gift tax.

A CLAT may be structured as a grantor trust. In that event, the donor will receive an income tax deduction in the year the CLAT is created equal to the present value of the annuity payable to charity over the CLAT term (which, as noted above, will equal almost the entire value of the initial gift to the trust). During the term of the CLAT, however, the donor will pay income taxes on trust income with no offsetting charitable deduction. As with other grantor trusts, a CLAT structured as a grantor trust will grow income-tax-free because the donor pays the income taxes on the trust income.

A CLAT may also be structured as a non-grantor trust, in which case the donor does not benefit from an up-front charitable deduction from income tax. A non-grantor CLAT receives a charitable deduction each year for the charitable annuity, with the result that it may pay minimal income taxes over the CLAT term.

V. Taxable Gifts in Excess of the Federal Gift Tax Exemption.

Lifetime taxable gifts in excess of the Federal Gift Tax Exemption are subject to a Federal gift tax at a 40% rate. Because of a difference in how the estate tax and the gift tax are calculated, the payment of a gift tax (in lieu of an estate tax) can reduce overall transfer taxes. A gift tax is imposed on the amount of property received by the donee (a "tax exclusive" tax), while the estate tax is imposed on both the property received by the donee and the funds used to pay the estate tax (a "tax inclusive" tax). As a result, when a gift tax is paid, the funds used to pay the gift tax are removed from the donor's transfer tax base, thereby potentially resulting in a significant tax savings.

In considering whether to make lifetime taxable gifts in excess of the Federal Gift Tax Exemption, a number of factors should be considered:

- As discussed above, in a number of states, including New York and New Jersey, there is no state gift tax, so the property gifted will escape state transfer taxes.
- If the gift is to a grantor trust, the grantor pays the income taxes on the income generated by the property given away, thereby creating an additional opportunity for the donor to transfer wealth to the trust beneficiaries without incurring additional gift tax.
- As with any gift, it is preferable for the donor to give property with a high income tax basis in order to avoid losing the benefit of the step-up in basis that otherwise would have been available at the donor's death if the donor had retained the property.
- If the donor dies within three (3) years of making the gift, the funds used to pay the gift tax will be brought back into the donor's estate, thereby eliminating the benefit of having paid the gift tax.

Please contact any of the attorneys in our Private Clients Practice Group if you have any questions regarding this memorandum or would like to discuss any aspect of your estate plan.

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