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A report for clients and friends of the firm.

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With over a century of combined experience, the lawyers of Proskauer's Personal Planning Department regularly provide their diverse clientele – from business entrepreneurs and corporate executives to sports figures and performing artists – with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer's clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning, as well as cutting-edge corporate, real estate and tax concepts.

Use It or Lose It - Increased Gift and GST Exemption Amounts Expire on 12/31/12

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Act") was signed into law, making significant modifications to the estate, gift and generation-skipping transfer ("GST") taxes. The 2010 Act:

- reduced the estate, gift and GST tax rates to 35%.
- increased the estate tax exemption from $3.5 million to $5 million.
- increased the GST tax exemption from $1 million to $5 million.
- reunified the estate and gift tax exemptions so that an individual can gift up to $5 million during life.

Unfortunately, these favorable provisions of the 2010 Act will remain in effect only through December 31, 2012, when the act is scheduled to sunset. Unless the law changes, in 2013, the law reverts to the 2001 law, and the top gift and estate tax rate will be 55% and the estate and gift tax exemptions will be $1 million. In addition, the GST tax rate will revert to 55% and the GST tax exemption will be $1 million (indexed for inflation). Moreover, certain favorable provisions in the GST tax laws that were enacted in 2001 would no longer apply. Thus, you may wish to consider one or more of the following planning techniques before the current law expires at the end of 2012.

Use Your Exemption to Make Non-Taxable Gifts

With the increase in the gift tax exemption from $1 million to $5,120,000 per person ($5,000,000 adjusted for inflation), you now have the ability to reduce your estate by simply making direct gifts to your descendants or anyone else you wish to benefit (or to trusts for your descendants or anyone else, as discussed below). In fact, a married couple can gift $10,240,000 to their descendants without paying gift tax. Even if you used your entire gift tax exemption in prior years when it was limited to $1,000,000, the additional $4,120,000 increase in the gift tax exemption is available to you ($8,240,000 for a married couple).

Additionally, in the event that you made loans to your children or grandchildren, you may wish to use your gift tax exemption to forgive those loans.

Making gifts during life not only reduces your estate by the amount gifted, but also by all the appreciation on that gift over time. For example, if you make a $5 million gift this year and die twenty-five years from now, the value of that gift, including appreciation, will be over $21 million, assuming 6% growth (or over $10 million, assuming only 3% growth).

Gifts in Trust

Although it is simple to make a direct gift of cash or marketable securities to various individuals, there are many advantages to using the current exemption amounts to make gifts of property in trust instead of outright gifts to individuals. Gifts to trusts for the benefit of your descendants allow you to allocate your GST tax exemption to that trust. Allocating your GST tax exemption to the trust enables the funds in the trust, plus all future growth, to pass to your descendants without the imposition of any estate or GST tax at each beneficiary's death.

Gifts in trust also provide an additional opportunity for the trust's income to be taxed to you instead of to the trust or the trust beneficiaries. This lets you, in essence, make additional tax-free gifts to the trust of the amount of the tax that the trust otherwise would pay. This type of trust is known as a grantor trust.

Furthermore, gifts in trust are protected from claims by the beneficiary's creditors, including spouses, and ensure that the assets do not pass outside the family bloodline. These benefits apply at every generation for the longest period allowed under law.

Leveraging Your Gifts

Leveraging your gift tax exemption provides you the opportunity to get more bang for your buck from your gift. For instance, an alternative to making a gift of cash would be to form a partnership or limited liability company ("LLC") and give away part of that partnership or LLC to a trust for the benefit of your descendants. The advantage of gifting interests in a partnership or LLC is that such interests may be able to be valued in such a way that discounts would be available on account of the gift being a minority interest in the partnership or LLC and/or due to restrictions on transfer in the partnership or LLC agreement. Assuming a 30% discount, a gift of a partnership or LLC interest with an underlying value of $14 million would still be under the $10,240,000 combined gift tax exemption of you and your spouse. Additionally, as mentioned above, GST tax exemption could be allocated to the trust, enabling both the interest transferred to the trust, and all future growth to pass to your descendants without the imposition of any estate, gift or GST tax.

Tax Rates for Taxable Gifts (those above the $5 million exemption amount)

In 2012, the gift tax rate is 35%. In 2013, that rate is scheduled to revert to 2001 rates (ranging from 41% to 55% for gifts over $3 million). Thus, to the extent that you wish to make taxable gifts (those in excess of $5,120,000, the current individual lifetime gift exemption), you may wish to consider making such gifts this year. In addition to paying tax at a lower rate, the gift tax paid is removed from your estate (assuming you live for three years or more from the date the gift is made) and all the appreciation on the gifted asset is removed from your estate.

By way of example, a gift of $5 million made in 2012 by an unmarried individual who had used his $5 million gift tax exemption in 2011 would result in a gift tax payable of $1,750,000. In 2013, the same $5 million dollar gift would result in a gift tax payable of $2,750,000. Moreover, assume that the individual dies in 2020 and that there is 5% growth, the gift tax of $1,750,000 and the appreciation of $2,387,277 (compounded annually over eight years) would be removed from the estate tax-free.

Non-Reciprocal Trusts Created by Married Couples – Having Your Cake And Eating It Too

Let’s suppose you really do not want to make a gift at this time, but you also do not want to waste the savings available by the increased exemption amount available in 2012. You can have your cake and eat it too by creating a trust for the benefit of your spouse. By doing so, the assets transferred to the trust (and any growth on those assets over time) would be removed from your taxable estate. However, if you need to use some of the funds in the trust, your spouse can simply receive a trust distribution. If you add your descendants as potential beneficiaries of the trust, the Trustee also could make a distribution to one or more of them, which will also occur free of gift tax. This flexibility would allow (but not necessarily require) distributions to be made to your spouse or descendants. Since trust distributions are not required, the funds also could accumulate in the trust and not be subject to any further estate, gift or GST tax. It is possible for each spouse to create trusts for each other, if desired.

Each spouse (the "grantor-spouse") would establish a trust for the other spouse (the "beneficiary-spouse"). The trusts would be mutual but would contain some differences to avoid the trusts being deemed "reciprocal," which could cause adverse estate tax consequences. For example, one trust would be for the benefit of the spouse and descendants, while the other trust would be only for the benefit of the spouse. Or the trusts can have different Trustees, with one beneficiary-spouse acting as sole Trustee of one trust and the other beneficiary-spouse acting with another individual as co-Trustees of the other trust. In addition, in one, but not both of the trusts, the spouse can be given a limited power to appoint trust property upon his or her death to any one or more of your descendants and charity.

The beneficiary-spouse can be Trustee of the trust for all purposes except to make distributions to himself or herself during the grantor-spouse's lifetime. During the grantor-spouse's lifetime, any such distributions to the beneficiary-spouse must be made by the non-spouse Trustee, and distributions for the beneficiary-spouse's "support" must be prohibited. However, the grantor-spouse may retain the power to remove and replace the non-spouse Trustee. After the grantor-spouse's death, the beneficiary-spouse, as Trustee, may make distributions to himself or herself for his or her support. If your descendants are also beneficiaries of the trust, either the beneficiary-spouse or the non-spouse Trustee may make distributions to your children, grandchildren and further descendants.

In addition, each trust would be structured as a "grantor trust" for income tax purposes. When a trust qualifies as a "grantor trust" for income tax purposes, all of the trust's income is taxed to the grantor, as opposed to the trust. In addition, even though the grantor pays income tax on the trust's income, any gifts to the trust by the grantor are complete for estate and gift tax purposes and, thus, the trust should not be included in your estates upon your deaths for estate tax purposes. The main benefit in structuring a trust as a "grantor trust" for income tax purposes is that the payment of income tax by the grantor on behalf of the trust should not be considered a gift for gift tax purposes. Therefore, if you pay income tax on income received by the trust, you would be removing additional assets from your estates. Because you would be in the 35% estate tax bracket, for every dollar of income tax you pay on behalf of the trust, an additional $.35 of tax is saved.

Upon the death of the survivor of both spouses, the remaining trust property would be divided into equal shares for your children (or your grandchildren) and held in continuing trusts for them. The terms of those trusts would mimic the terms of the trusts for your children (or grandchildren) in your revocable trusts or Wills. In addition, if you allocate your GST exemptions to the trusts, the property would be held in trust for the lifetime of your children, then grandchildren and future generations. Those trusts are sometimes referred to as "dynasty trusts" or "perpetual trust" because they continue in perpetuity. For as long as the assets are held in trust, there is no estate or GST tax imposed and the assets are protected from creditors. Accordingly, wealth can be transferred from generation to generation tax-free.

A Potential Pitfall: The Clawback

Some practitioners have raised the concern that if a donor uses the increased exemption of $5,120,000 during 2012, and, in 2013, that exemption is reduced back to $1 million, then, upon the death of the donor, there could be a potential clawback of the gifts made in excess of that reduced exemption when determining the estate tax owed by the donor's estate. However, there is nothing in the current law to suggest that the government would take this approach.

We feel that individuals should take full advantage of the current exemption amounts and rates while the opportunity is still there. Gifts always have the advantage of transferring future growth out of one's estate, in addition to removing the assets that have been transferred. We recommend that you contact your personal planning attorney to discuss the best way to utilize your increased exemption amounts.

Income Tax Deductions for Charitable Donations May Be Denied Without a Qualified Appraisal *Mohamed v. Commissioner,* T.C. Memo 2012-152

Obtaining a qualified appraisal is an essential requirement for claiming an income tax deduction for charitable donations of property worth more than $5,000. In a recent Tax Court Memorandum, Judge Holmes denied millions of dollars in charitable deductions because the taxpayers failed to obtain a qualified appraisal of several parcels of real estate. The court ruled against the taxpayers despite the fact that the value of the property (and the tax deduction to which they were entitled) was likely greater than reported.

In 2003 and 2004, Joseph and Shirley Mohamed donated millions of dollars in real estate to a charitable remainder unitrust ("CRUT"), a type a charitable trust that pays the donor income for life (or for a term up to 20 years) with the remainder to pass to charity. Had they complied with the relevant regulations, the Mohameds would have been able to claim an immediate income tax deduction for the present value of the charitable remainder. When reporting the gifts, however, they submitted statements prepared by Mr. Mohamed, which valued the properties at approximately $18.5 million. In response to an IRS audit, the Mohameds hired outside appraisers who valued the properties at over $20 million. In addition, by the end of 2004 one of the properties (valued by Mr. Mohamed at almost $14.9 million and by an appraiser at almost $16.4 million) was sold in 2 pieces for nearly $23 million. Despite the fact that Mr. Mohamed most likely undervalued several of the properties, the IRS claimed that all charitable deductions should be denied because he failed to submit a qualified appraisal.

Although the Court was sympathetic to the Mohameds' claim that they found the relevant tax forms confusing, the Court ruled that no tax deduction could be allowed because the taxpayer failed to comply with the regulations for reporting the value of donated property. The regulations require that the appraisal be made by a qualified appraiser (someone other than the taxpayer, the donor or the recipient of the property) no more than 60 days before the gift and no later than the due date of the return, include specific information about the property and the appraisal fee charged most not be based on the appraised value of the property. Mr. Mohamed (who was both the donor and, as trustee of the CRUT, recipient of the property) was clearly not a qualified appraiser, and the statements attached to his returns did not contain all of the required information. The Court also rejected the Mohameds' claims that the relevant regulations were invalid.

In addition to the importance of obtaining a qualified appraisal, the *Mohamed* case highlights the need to consult qualified professionals when preparing Federal tax filings. Although the Court was sympathetic to the taxpayers' claim that the relevant forms were unclear, the decision emphasized that Federal tax law is governed statutes, regulations and judicial decisions, not by language contained in tax forms.

Crummey Withdrawal Notices – Recommended Practices

Under current tax law, an individual is entitled to make gifts of up to $13,000 per donee per year without being subject to gift tax. This $13,000 is commonly referred to as the "annual exclusion amount" because it refers to the amount a donor can give annually to a person that is excluded from the donor's taxable gifts. Gifts in trust are not eligible to be annual exclusion gifts – the gift must be outright.

However, to take advantage of this annual exclusion amount, irrevocable trust agreements frequently contain provisions that allow one or more trust beneficiaries to exercise withdrawal rights over a portion of the donor's contributions to the trust (generally the right to withdraw up to $13,000 per beneficiary). These withdrawal rights allow the trust donor to utilize his or her annual exclusion amount with respect to each beneficiary holding a withdrawal right in the trust since the right to withdraw the funds is the same as the right to get the funds outright, thereby minimizing the taxable gifts transferred to the trust. These withdrawal rights, which are frequently contained in insurance trusts, are commonly called Crummey withdrawal rights.

A trust agreement with a typical "withdrawal right" provides that, whenever property is contributed to the trust, one or more trust beneficiaries (or a guardian or other person on behalf of a minor or incapacitated beneficiary) has a right to withdraw a portion of such contribution for a certain period of time. The trust agreement usually provides that the trustee of the trust must give the beneficiary timely notice of each contribution and notify the beneficiary of the amount subject to his or her withdrawal right. The amount subject to withdrawal by each beneficiary is generally capped at the annual exclusion amount reduced by any previous gifts to that beneficiary by the donor within the same calendar year. If the beneficiary does not notify the trustee of his or her election to exercise the withdrawal right, the right to withdraw usually lapses after a period of time or at the end of the calendar year.

Trust beneficiaries rarely exercise their withdrawal rights. However, donors and beneficiaries must never have an express or implied agreement that the withdrawal rights will never be exercised. The IRS views any advance agreement between donors and beneficiaries *not* to exercise withdrawal rights as though the withdrawal rights were illusory, and will deny treatment of such gifts as gifts of present interests that qualify for the annual exclusion.

Tax law states that a donee has a “present interest” in gifted property if he or she has an unrestricted right to the immediate use, possession, or enjoyment of such property or the income from such property. If a trust beneficiary does not have a right to withdraw assets contributed to an irrevocable trust, the gift is generally treated as a gift of a “future interest.” The withdrawal right *converts* that “future interest” to a “present interest,” and makes the annual gift tax exclusion available to the donor.

The landmark case approving the above arrangement is a 1968 Ninth Circuit decision, *Crummey v. Commissioner*. This case is the reason that the beneficiaries holding withdrawal rights are often referred to as “Crummey beneficiaries” and the rights as “Crummey withdrawal rights.” To have a present interest under Crummey, a trust beneficiary must be legally and technically capable of immediately possessing the gifted property, and have a reasonable opportunity to do so. So long as a beneficiary can legally exercise his or her withdrawal rights, this requirement is easily met. It is therefore, necessary for trustees in the administration of these trusts to provide beneficiaries with a reasonable opportunity to exercise the withdrawal rights.

In order for a beneficiary to have a reasonable opportunity to exercise a right of withdrawal, the beneficiary must be (i) aware that the right exists and (ii) given enough time to exercise the right before it lapses. All of the circumstances surrounding the making of the gift, the timing of notice, and the length of the exercise period are taken into account in assessing whether a beneficiary has a reasonable opportunity to exercise his or her withdrawal right.

Requirement (ii) noted above can be easily met. As long as a beneficiary (or guardian) is given at least 30 days after receiving notice to exercise his or her withdrawal right prior to any lapse, the period is sufficient. Therefore, it is recommended that the withdrawal period specified in the trust agreement start on the date upon which the property was contributed to the trust and continue until at least 30 days after the date of notice before it lapses.

Requirement (i) noted above – ensuring that the beneficiary is “aware” of his or her withdrawal right – is of greater concern and the authority is clear: *so long as actual notice is provided to the beneficiary, requirement (i) is satisfied*.

Notice May Be Required in the Trust Agreement

A trust agreement itself frequently includes guidance regarding the steps that the trustee must take whenever a withdrawable contribution is made. The trust agreement will likely require the trustee to provide to each beneficiary a notice of withdrawal rights within a reasonable time after any gift subject to a withdrawal right is made to the trust. The precise manner, timing and contents of this notice (discussed in greater detail below) may not be specified in the trust agreement, but if the trustee provides notice to the beneficiaries in a manner that differs from what the agreement requires, the trustee will be in violation of the terms of the agreement, and potentially liable to the beneficiaries, *even if* the trustee has met the legal requirements regarding notice. Ideally the trust agreement will include a nonexclusive list of several manners by which notification may be provided, such as written, verbal, or electronic notification, in order support a trustee's assertion upon audit that notice was provided via a method sanctioned by the agreement.

Written Notice

From an evidentiary perspective in the event of an audit, the optimal way for a trustee to notify a beneficiary that he or she has a withdrawal right with respect to a trust contribution, is for the trustee to give the beneficiary written notice. A copy of the notice, signed by the trustee, along with a statement affirming that the notice was mailed to the beneficiary or guardian is strong evidence, in the event of an IRS audit, that the beneficiary was made aware of his or her withdrawal rights. Alternatively, notice can be emailed by a trustee to a beneficiary, and the email can be printed as written evidence that notice was sent to the beneficiary.

As there is no requirement that written notice itself be given, there is naturally no requirement that written acknowledgment of receipt of notice be given by the beneficiary or guardian. However, a copy of the written notice mailed along with a copy of a signed acknowledgment that the beneficiary received the written notice does provide solid evidence, in the event of audit, that notice was actually received by the beneficiary.

Verbal Notice

It is important to note that, while written notice is recommended, the Internal Revenue Code, the Treasury Regulations, Revenue Rulings and case law, are devoid of any requirement that a beneficiary receive written notice. The provision of written notice, as opposed to verbal notice, is recommended merely as an evidentiary matter so that the donor has proof, in the event of audit, that notice was in fact given to the beneficiary. However, as a legal matter, verbal notice meets the requirement that a beneficiary or guardian be made aware that the withdrawal right exists and the requirements for timely exercise.

Actual Notice

In cases where the trustee is himself or herself a beneficiary holding a withdrawal right, or the trustee is the parent and natural guardian of a minor beneficiary holding a withdrawal right, the IRS has noted that the trustee has "actual notice" of the withdrawal rights by virtue of his or her status as trustee. As a result, the trustee need not provide any formal notice to himself or herself with respect to either his or her own withdrawal rights, or the withdrawal rights of his or her minor children, because actual notice suffices.

Turner v. Commissioner

In August 2011, the Tax Court addressed the issue of the notice requirement in its decision in the case *Turner v. Commissioner*. In *Turner*, a donor had established a life insurance trust, and premium payments on the policy owned by the trust were made by the donor directly to the insurance company. The trust agreement provided that each "direct or indirect" transfer to the trust gave rise to a withdrawal right for each of the donor's children and grandchildren – however none of the beneficiaries ever received notice of the indirect contributions nor of his or her resulting withdrawal rights.

The Tax Court determined that the present interest requirement was met under these facts, and that the "indirect" gifts to the trust of the premium payments qualified for the annual exclusion solely because each beneficiary had the "legal right" to demand the property. While the decision in Turner suggests that none of the beneficiary notice procedures described above may be necessary to secure annual exclusion treatment for gifts to trusts which provide beneficiaries with a legal right to withdraw property, it remains to be seen whether the IRS will fully acquiesce to the Tax Court's decision, given the Service's reasoning in multiple rulings regarding "illusory" rights and what constitutes a "reasonable opportunity" to exercise them.

If the IRS ultimately does acquiesce to the reasoning in Turner, it will certainly make the administration of these kinds of trust far simpler. However, in the interim, if a donor is audited, he or she can always point to Turner in support of the claim that only a legal right, and not actual notice of the right, is required in order for a trust and its trustee to comply with the Crummey decision. We recently obtained a favorable result for a client who was audited by the IRS in connection with annual exclusion gifts to trusts by citing the rationale in the Turner case. The client never provided any written notice to the beneficiaries who held withdrawal rights. Nevertheless the IRS accepted the argument in Turner, and closed the audit.

Recommended Contents of Notice

When a trustee provides notice of withdrawal rights to a beneficiary, the notice should include the following items: (i) a statement that a gift that was made to the trust, (ii) the amount of the gift that is subject to the particular beneficiary's right of withdrawal, (iii) the amount of time the beneficiary has to exercise the withdrawal right before it lapses, and (iv) a request that the beneficiary notify the trustee if he or she wishes to exercise the withdrawal right. Including these four items will ensure that the beneficiary is fully aware of the nature of his or her withdrawal right and informed of the manner in which it must be exercised. The initial notice could also include a copy of the relevant portions of the trust instrument providing the withdrawal rights.

Conclusion

Adherence to the rules regarding notice of withdrawal rights is a dreaded annual burden to trustees of many irrevocable trusts. For trustees who have not given annual notices, the *Turner* case provides some cover in case of a gift tax audit.

The Personal Planning Department at Proskauer is one of the largest private wealth management teams in the country and works with high net-worth individuals and families to design customized estate and wealth transfer plans, and with individuals and institutions to assist in the administration of trusts and estates.

If you have any questions regarding the matters discussed in this newsletter, please contact any of the lawyers listed below:

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