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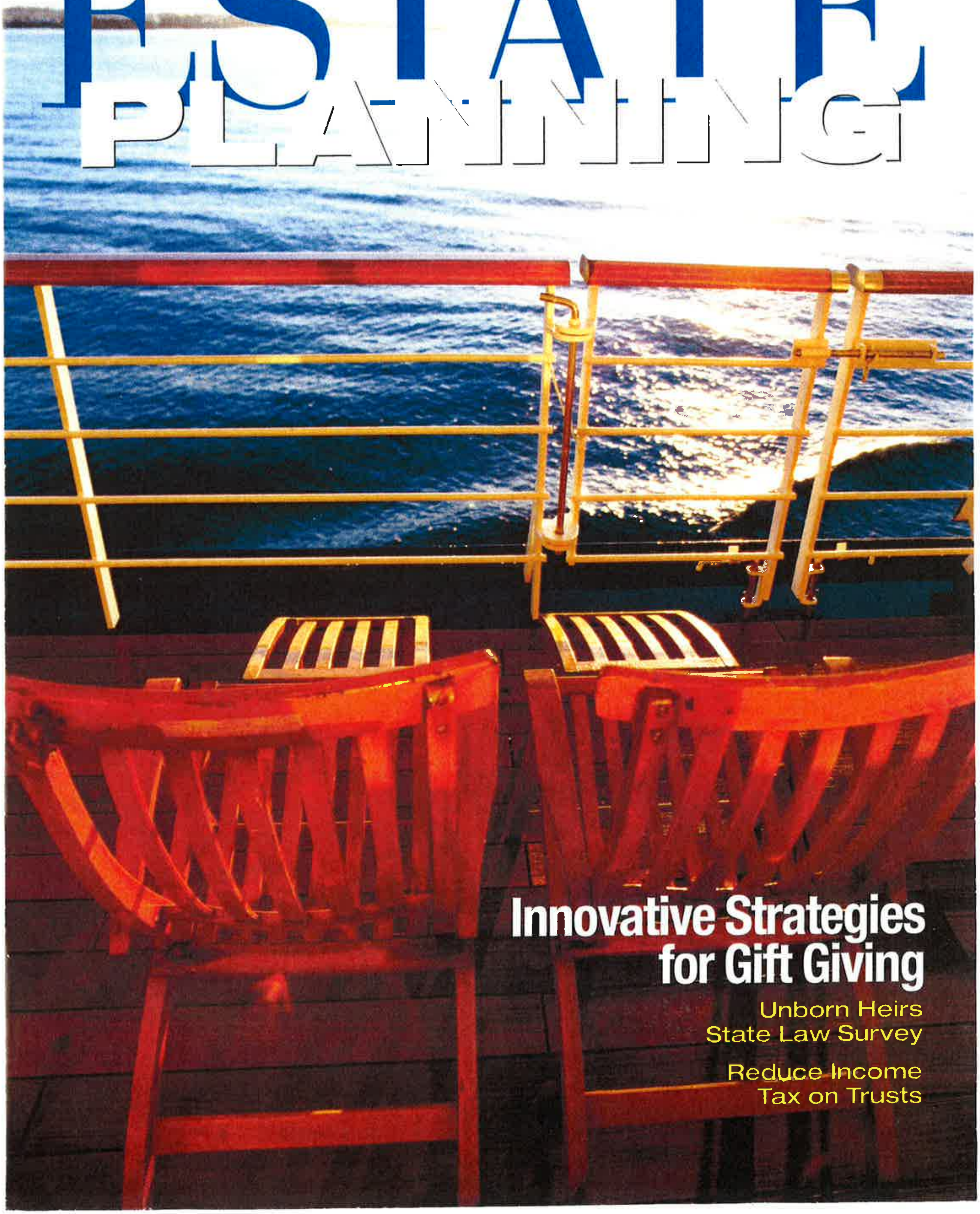

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ESTATE PLANNING

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Painless Giving Techniques That Achieve Transfer Tax Savings

Gifting techniques that were popular at the end of 2012 can still be used by estate planners to help clients achieve transfer tax savings while addressing common fears.

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Faced with the impending drop in the unified credit from $5.12 million to $1 million, clients and practitioners found themselves in a race against the clock at the end of 2012 to enable clients to make gifts using the larger unified credit amount before year end.

Congress surprised us all by passing the American Taxpayer Relief Act (ATRA) on 1/1/2013. ATRA locked in the $5 million inflation-adjusted unified credit amount. With the immediate inflation adjustment on January 1, the unified credit increased to $5.25 million.

Many in the estate planning community felt that all of the hard work done in 2012 was effectively for naught. Nothing could be further from the truth. The experiences of 2012 forced estate planners to develop important tools which enabled clients to overcome their gifting fears and to do what estate planners had been urging their clients to do for years—use their unified credits during life.

As discussed in greater detail below, lifetime use of a client's unified credit permits the client to pass more "net to heirs" than if the client uses the unified credit at death. Although lawyers have consistently given this advice through the years, many clients declined to follow the recommendation and voiced two primary concerns:

1. Resistance to parting with assets due to a fear of "running out of money" before death (referred to herein as the "Run Out of Money Fear").
2. An unwillingness to provide significant funds to young children in the fear that they will not be motivated to become productive members of society (referred to herein as the "Too Rich Too Soon Fear").

Faced with the lost tax benefit that would result from the expected drop in unified credit at the end of 2012, clients challenged their estate planners to provide them with a way to use their credits that addressed the Run Out of Money Fear and the Too Rich Too Soon Fear. Creative planners were able to develop techniques that addressed these fears and enabled clients to make significant gifts using unified credits before the end of 2012—approaches referred to in this article as "painless giving techniques."

Although 2012 is over, those painless giving techniques remain and are now useful tools for use in 2013 and thereafter. With these newly developed techniques, many more clients are likely to take advantage of using their unified credits during lifetime than in years preceding 2012, and significant transfer tax savings will result. This

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EXHIBIT 1
Computations for Scenario 2

Growth Rate	Value at Donor's Death	Estate Tax Saved	Increased Savings Compared to Scenario 1
3%	$6,974,702	$2,789,881	$ 789,881
5%	8,670,045	3,468,018	1,468,018
7%	10,741,647	4,296,659	2,296,659

article describes those painless gifting techniques.

Advantages of using unified credit during lifetime

In order to understand the benefit of painless gifting techniques that encourage lifetime use of the unified credit, one must first understand the advantages of using the unified credit before death. The concept is simple; lifetime gifts of the unified credit amount allow not only the value of the gifts, *but also the value of any earnings or appreciation that are realized after the gifts are completed* to escape the application of the estate tax. Clients who make lifetime gifts are thereby able to "leverage" their unified credits to gain more than a dollar-for-dollar benefit. At-death transfers that use the unified credit shelter only the amount of the unified credit from estate tax.

To illustrate the benefits of lifetime use of the unified credit[1] as compared to using the unified credit at death, consider the following examples (all of which assume a $5 million transfer to a trust for children):

Scenario 1. The gift is made at the donor's death. Assume the estate tax rate is a flat 40%. If the value of the estate at the donor's death is $5 million, the estate tax saved is $2 million.

Scenario 2. The facts are the same as in Scenario 1, except the gift is made 15 years prior to the donor's death. Assume the trust is a non-grantor trust, and the trust's assets increase in value at a rate of 3%, 5%, or 7% per year. Half of the growth in each year is assumed to be ordinary income and the other half is assumed to be capital appreciation. No distributions are made from the trust, no assets are sold (so no capital gain is recognized), and no expenses are incurred other than a 39.6% income tax each year on the ordinary income portion of the growth.[2]

Based on these assumptions, a gift of $5 million today would grow for 15 years to the values set forth in the "value at donor's death" column of Exhibit 1. The "estate tax saved" column is the tax saved on that amount based on a 40% rate.

Not surprisingly, because the value at the donor's death is greater than $5 million, the estate tax saved is more than the $2 million that would be saved if the use of the unified credit were postponed until the donor's death.

If the gift of unified credit is made to a *grantor* trust for children, the benefits of lifetime use of the unified credit can be further enhanced. A gift to a grantor trust allows the grantor to pay the income tax on income or capital gains associated with the gifted asset. If the donor is treated like the owner (or "grantor") of a trust pursuant to Sections 671 through 679, all items of income, deduction, and credit are reported on the grantor's return. The grantor is obligated to pay the income tax on trust income. The grantor (who pays the income tax) sees his or her estate *drop* in value, while the value of the trust is effectively *increased* by the tax on trust income that the trust does not have to pay. Although this looks like a gift from the grantor to the trust, because the grantor trust rules make the grantor responsible for paying that tax, the income tax payment is not deemed to be a gift at all.[3] Gifts of unified credit amounts to grantor trusts enhance the use of the unified credit during lifetime.

Grantor trust status terminates when the grantor dies. This enhancement is not available, then, if the trust is funded with the unified credit upon the grantor's death. As a result, the benefits of this enhancement are available only if the unified credit is used as part of a lifetime gift.

1 The "unified credit" is referred to as a $5 million amount in this article. The unified credit is adjusted for inflation, so practitioners should stay abreast of annual changes in the unified credit amount. For 2013, the unified credit is $5.25 million per person, or $10.5 million per couple.

2 Currently, 39.6% is the top federal income tax bracket. Trusts reach the top federal income tax bracket at $11,950 in 2013. The illustration assumes that all of the trust's income will be taxed at the top federal bracket. State income taxes are ignored.

3 See Rev. Rul. 2004-64, 2004-2 CB 7.

4 To be a qualified terminable interest property (QTIP) trust, the trust must provide that the spouse receives all the trust income currently and that a QTIP election be made for the trust. As described below, the SLAT will often not require any distributions to the beneficiary spouse from the trust—so it would never qualify as a QTIP. Even if the trust is drafted so that the beneficiary spouse does receive all the income, by not making the QTIP election the trust will not qualify for the marital deduction—forcing the use of the unified credit as the donor spouse intends. See Section 2523(f)(4) requiring an election to be made on a gift tax return in order for the gift to qualify as a QTIP. See also Ltr. Rul. 199903040.

EXHIBIT 2
Computations for Scenario 3

Growth Rate	Value at Donor's Death	Estate Tax Saved	Increased Savings Compared to Scenario 2	Increased Savings Compared to Scenario 1
3%	$7,562,949	$3,025,180	$235,299	$1,025,180
5%	9,899,658	3,959,863	491,845	1,959,863
7%	12,892,671	5,157,068	860,409	3,157,068

Scenario 3. Same facts as Scenario 2, except the gifts are made to a grantor trust. The tax savings available using this approach are illustrated in Exhibit 2.

In addition, if the assets are sold by the trust and capital gains tax incurred and paid by the grantor prior to his or her death, additional transfer tax savings can be achieved.

If the assets in Scenario 3 are sold immediately prior to the donor's death, the donor will pay the capital gains tax at a 20% rate. Payment of that tax allows the trust beneficiaries an additional benefit of $231,755, if the trust grows at 3%; $412,974, if the trust grows at 5%; and $618,694, if the trust grows at 7%—without transfer tax. Of course, the donor could choose to buy the assets back from the trust immediately prior to his or her death, for cash, without any gain being recognized by the trust (because it is a grantor trust). As a result, the trust has "full basis" dollars when the donor dies, and the re-purchased assets are part of the donor's taxable estate at death. The re-purchased assets get a basis step-up, eliminating the capital gain in full.

The above Scenarios illustrate the considerable benefit to clients of using their unified credits during life instead of waiting until they die. The Run Out of Money Fear and the Too Rich Too Soon Fear, however, discourage clients from doing so. The painless giving techniques described below allow the client to overcome those fears and make their gifts of unified credits during life, taking advantage of the benefits described in Scenario 2 or Scenario 3, above.

SLATs

Spousal lifetime access trusts (SLATs) are trusts where one spouse (the "donor spouse") makes a gift to an irrevocable trust for the other (the "beneficiary spouse"), and when the beneficiary spouse dies, the assets pass on for children and grandchildren. Although a gift to a trust for a spouse is generally viewed as one that does not use the unified credit because the spouse's trust is structured as a marital deduction trust ("QTIP trust"), the SLAT is created so that it specifically does not qualify for the marital deduction and causes the use of the unified credit.[4] For clients in search of painless giving techniques, SLATs were—and are—a wonderful option.

Upon establishment, the beneficiary spouse should assume that he or she will not receive distributions from the SLAT during lifetime. However, *if the beneficiary spouse needed the funds to live on, he or she could access them.* The Run Out of Money Fear is eliminated, removing one roadblock to a reluctant client's use of the unified credit during lifetime.

The SLAT also addresses the Too Rich Too Soon Fear. Clients typically believe that they must transfer assets to trusts for children or grandchildren in order to remove those assets from their taxable estates, and if the children knew $5 million (or if both spouses made the gifts, $10 million) was available in trust for their use, they might lose ambition. However, the SLAT transfers assets out of the donor spouse's taxable estate to a trust for the beneficiary spouse, not the children. The children do not benefit from the SLAT until the beneficiary spouse dies. Therefore, their ambition will be unaffected because the funds will be inaccessible for many years.

By definition, SLATs are grantor trusts.[5] As a result, the grantor trust enhancement described in Scenario 3, above, is also a benefit of establishing a SLAT.

SLAT terms and trustees. In order to accomplish the tax benefits of a SLAT, certain specific provisions regarding distributions and trustees are required. These provisions are described below:

1. So long as the donor spouse is alive, the provisions of the SLAT must not call for required distributions to the beneficiary spouse for "support, health, and maintenance" or "support in his or her accustomed manner of living." Otherwise, the entire trust would be included and taxed as part of the donor spouse's estate upon his or her death, because the trust would have been created to satisfy the legal obligation of the donor spouse to support the beneficiary spouse.[6] Instead, the distribution standard for the beneficiary spouse during the donor spouse's lifetime should be for the beneficiary spouse's "best interests" or "comfort and welfare." In order to fully ensure that support distributions could not be made under these broader standards, the trust could also include a savings clause specifically restricting the trustee from making support distributions to the beneficiary spouse during the donor spouse's lifetime.
2. Without an ascertainable standard, neither the donor spouse nor the beneficiary spouse could act as trustee of the SLAT during the donor spouse's lifetime.[7] Instead, a trusted friend who is financially responsible and will make appropriate distributions upon request of the donor or beneficiary spouse (or, if no such individual is available, a bank or trust company) would be an appropriate choice.[8]
3. Clients often wish to appoint a child or children to act as trustee of the SLAT. Although this can avoid causing the SLAT to be subject to estate tax on the death of the donor or beneficiary spouses, it will likely cause a gift tax problem for the child who acts as trustee. Where the child is a remainder beneficiary of the SLAT, any distributions made to the beneficiary spouse reduce the child's ultimate inheritance. If distributions to the beneficiary spouse are not limited by an ascertainable standard, any distributions the child-trustee makes to the beneficiary spouse will be treated as a gift from the child to the beneficiary spouse. In other words, the child will "shift beneficial interests" from himself or herself to the beneficiary spouse.[9] The child may still be the trustee, but to avoid the gift tax problem for the child, two additional terms must be included in the SLAT document. The first is a restriction against the child-trustee from making any distributions that would be deemed a gift from the child. The other is a trustee power to appoint a co-trustee solely for the purpose of exercising those powers that the trustee is disqualified from exercising. With these provisions, the child can act as trustee and manage the trust assets, but if the beneficiary spouse wanted a distribution (which, at least at the outset, is not anticipated to actually occur), the child could appoint a co-trustee to direct the distribution. The client should also be carefully counseled about the need for a co-trustee if distributions are to be made; in fact, if there is an expectation that distributions may in fact be made in the future, a special trustee with the power to direct such distributions can be named in the SLAT document from the outset.
4. If the goal is to provide regular cash flow to the beneficiary spouse, the SLAT can be drafted accordingly. For example,

5 See Section 677.

6 Reg. 20.2036-1(b)(2). Discretionary distributions for a spouse's support determined by a trustee other than the settlor should, however, avoid estate tax inclusion. See, e.g., Estate of Sullivan, TCM 1993-531.

7 The donor spouse could not act as trustee if the "best interests" or other broad standard is used. In that event, the donor spouse would be deemed to have made a transfer but retained the right to decide who could possess or enjoy the property or the income there from—causing estate tax inclusion under Section 2036(a)(2). Similar issues would arise under Section 2038. Without an ascertainable standard, the beneficiary spouse also could not act as trustee; he or she would be deemed to hold a general power of appointment which would cause the SLAT assets to be taxed as part of the beneficiary spouse's estate before passing to the children. See Section 2041(b).

8 The donor spouse and trustee cannot have a "pre-arranged plan" pursuant to which the trustee will simply execute the donor spouse's direction, or estate tax inclusion on the death of the donor spouse could occur. See Reg. 20.2036-1(c). With that in mind, the trustee should still be a person who would take the donor spouse's goals into consideration.

9 See, e.g., Reg. 26.2601-1(b)(4)(i)(E), Example 7 and Ltr. Rul. 8624014. See also Reg. 25.2511-1(g)(2).

the SLAT can provide that (a) the beneficiary spouse receive all income, (b) a certain dollar amount be distributed to the beneficiary spouse each month, or (c) a unitrust payment be made. Note that if the goal is to pass more to heirs, this type of provision can reduce the accomplishment of that goal; however, if the donor spouse can be convinced to make the gift to the SLAT only if his or her spouse has a guaranteed cash flow from the SLAT that the couple can use to satisfy their expenses of living, then including this type of provision can overcome that roadblock.

5. The donor spouse's obligation to support the beneficiary spouse ends at the donor spouse's death. Therefore, upon the donor spouse's death, the SLAT provisions can be drafted to allow for required distributions to the beneficiary spouse (a) for his or her support, health, and maintenance, or (b) for support in his or her accustomed manner of living or other ascertainable standard. Once the ascertainable standard applies, the beneficiary spouse can act as trustee of the SLAT (with the ascertainable standard the beneficiary spouse would no longer hold a general power of appointment that would cause inclusion in his or her taxable estate upon his or her death).
6. Regardless of the choice of trustee, the donor spouse should retain the power to remove and replace the trustee during his or her lifetime. With that power, a trustee who is not willing to make distributions to the beneficiary spouse upon request can be removed and replaced with someone who can (although provisions allowing for that appointment of a replacement trustee should prohibit the appointment of someone who is a "related or subordinate party" to the donor spouse as defined in Section 691(c) in order to avoid inclusion in the donor spouse's estate).

Reciprocal trust doctrine

Both husband and wife should use their unified credits during lifetime. As a result, one might assume that in each case a husband would establish a SLAT for wife and wife would establish a SLAT for husband.

However, if the two SLATs are established with identical terms and trustees, with similar assets and at the same time, the IRS is likely to attack the plan using the reciprocal trust doctrine, which would "uncross" the trusts and treat husband as establishing a SLAT for himself and wife as establishing a SLAT for herself. If successful, each SLAT would be subject to estate tax when the donor spouse dies[10]—defeating the tax plan.

As part of 2012 planning, most practitioners advised that only one spouse create a SLAT for the other. Due to the year-end deadline for completion, there simply was no opportunity to put enough time between the creations of the first and (potential) second SLAT so that practitioners could be confident that the application of the reciprocal trust doctrine would be avoided.

Now that there is no deadline, each spouse can create a SLAT for the other and sidestep the reciprocal trust doctrine. A practitioner should, therefore, have a solid understanding of the reciprocal trust doctrine and take steps necessary to avoid its application so that "two SLAT planning" can accomplish the tax goals sought.

The seminal case regarding reciprocal trusts[11] established a two-prong test:

1. Do the trusts leave the parties in the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries?
2. Are the trusts interrelated?

To avoid the first prong of the test, the SLATs should have different terms. Some suggested differences would be to:

- Have the donors contribute different assets.
- Give the beneficiaries different powers of appointment (e.g., one power of appointment expands to charities while the other does not) or include powers in one trust but not the other.
- Provide a different succession after the spouse's death (e.g., one trust provides 10% in trust for grandchildren at the spouse's death while the other trust provides for all assets to pass to the children).
- Appoint different trustees and different successor trustees.

Clients who make lifetime gifts are able to "leverage" their unified credits to gain more than a dollar-to-dollar benefit.

To avoid the second prong, "interrelated" part of the test, planners may want to wait an appropriate period between the date the first SLAT is established by one spouse and the date that the second SLAT is established by the other. Although waiting does not guarantee that the IRS will be unable to apply the reciprocal trust doctrine, it certainly makes it harder to do so.

No rule or applicable law indicates how long a period is "safe," although two or three years would certainly seem to be long enough. Care should be taken, however, to avoid creating a paper trail (e.g., notes and emails) indicating at the time the first SLAT was created that the clients planned to return in a few years to create the second SLAT.

A complete discussion of the reciprocal trust (and related) doctrines is outside the scope of this article. However, practitioners can consult some excellent published resources for this purpose.[12]

Separate property and gift splitting. Assets contributed to a SLAT must be the donor spouse's property. If instead the beneficiary spouse makes a contribution to the trust (either of his or her own assets or from community property assets in a community property state), that portion of the SLAT created with the beneficiary spouse's assets will be included as part of the beneficiary spouse's taxable estate under Section 2036.

It would be of great benefit if one spouse could create a SLAT with $10 million for the other using the donor spouse's property and then electing gift splitting[13] on the gift tax return filed to report the gift. Only one SLAT would need to be created to use both unified credits, and the reciprocal trust doctrine could never be applied. However, in the case of a SLAT, because the donor's spouse is the beneficiary of the SLAT, gift splitting is not permitted to the extent the gift to the SLAT is for the beneficiary spouse.[14] Determining by actuarial analysis which part, if any, of the SLAT is not for the benefit of the beneficiary spouse is an uncertain process. As a result, most practitioners apply only the donor spouse's unified credit to the gift to the SLAT—meaning that one SLAT cannot be used for a gift of $10 million in order to avoid the application of the reciprocal trust doctrine using that approach.

10 See Section 2036(a)(1).

11 Grace, 395 U.S. 316, 23 AFTR2d 69-1954 (1969).

12 See, e.g., LISI Estate Planning Newsletter # 1270 (4/3/2008), LISI Estate Planning Newsletter # 1273 (4/11/2008), LISI Estate Planning Newsletter # 1282 (4/24/2008), LISI Estate Planning Newsletter # 1332 (8/13/2008), and LISI Estate Planning Newsletter # 1339 (9/5/2008) at http://www.leimbergservices.com. See also BNA Tax Portfolio 826-2nd § I(C.)(7).

13 Under Section 2513, spouses who are U.S. citizens or residents may elect to treat gifts made by one of them as instead made half by each of them. In the typical case, the donor spouse is still treated as funding the trust all with his or her assets, even though the unified credit of both spouses is applied to the gift.

14 Section 2513(a).

Divorce. If one spouse creates a SLAT for the other funded with his or her entire unified credit, should the couple divorce, the donor spouse will have given up $5 million of assets which might otherwise have been split with the beneficiary spouse in the divorce action. The only potential benefit the donor spouse could get from creating the SLAT in the context of divorce is an argument that the beneficiary spouse needs less alimony because she is the beneficiary of the SLAT. Note that it is unclear how much benefit this could provide, as the SLAT will typically not require distributions to the beneficiary spouse and will condition such distributions on the discretion of the trustee pursuant to a non-ascertainable standard.

Clients should be informed of these risks before the SLAT is created. Of course, if the clients stay married until the second SLAT is created as part of a two SLAT (not prearranged!) plan, the risk is eliminated; in that case, each spouse has a $5 million trust for his or her benefit, so neither spouse is disadvantaged if divorce occurs.

If divorce is at all a concern but the client is still interested in establishing a SLAT, the client should consider including language which provides that upon divorce the SLAT terminates and the assets pass immediately to the children. That way, at least the donor spouse can be comfortable that the assets will benefit his or her children and not his or her spouse if a divorce occurs.

Spouse's death before the settlor. The SLAT is attractive to a hesitant donor because it avoids the donor's Run Out of Money Fear by allowing him or her to receive indirectly the benefit of the SLAT assets through distributions to the beneficiary spouse who then uses the assets for items of mutual benefit.[15] Also, if the beneficiary spouse outlives the donor spouse, the SLAT assets continue to be available to the beneficiary spouse until he or she dies. If the spouses die in the predicted order (i.e., donor spouse first and beneficiary spouse second), the SLAT truly works to leave the gifted assets available to the couple throughout their lifetimes.

If, however, the donor spouse outlives the beneficiary spouse, the donor spouse will lose the ability to access indirectly the SLAT funds; in that circumstance, the assets will have passed on to the next generation. Therefore, the donor spouse who is hesitant to gift the amount of his or her unified credit may inquire as to potential methods that could be employed to allow the donor spouse to avoid running out of money if the beneficiary spouse dies first.

One alternative would be for the donor spouse to seek to borrow funds from the successor beneficiaries of the SLAT (presumed to be his or her children) who take after the beneficiary spouse dies. If the donor spouse is on good terms with his or her children, and the children take upon the beneficiary spouse's death, the donor spouse can feel comfortable that he or she will be able to borrow funds from the children to provide for the donor spouse's needs if necessary. If the donor spouse is unsure that the children will loan funds back to him or her if needed, the terms of the SLAT can be drafted to provide that assets pass to a *trust for* the donor spouse's children, rather than outright to them, when the beneficiary spouse dies.

If the trustee of the children's trust is friendly to the donor spouse, and if the donor spouse retains the right to remove and replace that trustee during the donor spouse's lifetime, then the ability of the donor spouse to convince the trustee of the children's trust to loan funds back to the donor spouse if needed is almost assured. The SLAT could include a provision that holds the trustee harmless for making such loan. This would increase the certainty that a loan is likely to be provided on request. Further, the debt owed by the donor spouse would allow for an estate tax deduction at the donor spouse's death, so the loaning of funds back to the donor spouse should be transfer tax neutral.

A second alternative would be for the donor spouse to purchase term insurance on the life of the beneficiary spouse in the amount equal to the value of the assets given to the SLAT. This approach hedges the risk that the donor spouse will be short of funds if the beneficiary spouse dies first. If the beneficiary spouse is uninsurable, the donor spouse may consider purchasing the life insurance on another relative of similar age as the ben-

15 If the use of the assets can be postponed for a period following the creation of the SLAT, the appearance of a transfer with a "prearranged plan" for the donor spouse to retain the benefit of the assets drops significantly.

eficiary spouse instead. With such insurance, the donor spouse would collect the insurance proceeds and use those funds to replace the SLAT assets that passed to the children when the beneficiary spouse died.

As time passes, and before the term policy on the beneficiary spouse (or other relative) comes to the end of the typical 20-year low premium period, the donor spouse may decide that he or she will not need the SLAT assets and, in that circumstance, let the term policy lapse. If the policy is a "convertible term" policy, should the donor spouse decide that he or she really will need the policy proceeds to survive, the option always exists to convert the term policy to a more permanent policy. The insurance can be purchased by an irrevocable life insurance trust for the donor spouse's benefit—so that any proceeds not spent by him or her can pass to the children without the imposition of estate taxes.

Generation-skipping tax planning for SLATs. Although the discussion above focuses on the use of unified credit during a client's lifetime, gifts to SLATs can be wrapped in the donor spouse's generation-skipping tax exemption so that multiple generations can benefit from the SLAT assets without tax. The estate tax inclusion period rules will not deny the effective allocation of the donor spouse's generation-skipping tax exemption to the SLAT at the time it is created.[16]

Painless gifts and lease back transactions

In addition to SLATs, painless gifting can be accomplished in the right circumstance by making gifts of assets and then leasing those assets back. This technique is described below as it applies to specific asset types.

Residential real estate. This plan involves a gift by a client of his or her residence or vacation home to an irrevocable grantor trust for his or her children. Immediately after the gift, the client leases the property back from the trust.[17] The trustee of the trust uses the rent to pay the expenses the client regularly incurred with respect to the property (e.g., mortgage, property tax, insurance payments, etc.). So long as the rental value of the donor client's use is roughly equivalent to the regularly incurred expenses, the donor client remains in the same basic cash position as he or she was in before the gift/lease back—allowing the client to overcome the Becoming Poor Fear. (He or she also is able to continue to enjoy the use of his or her property.)

The SLAT transfers assets out of the donor spouse's taxable estate to a trust for the beneficiary spouse, not the children.

Further, if the cash paid in rent to the trust is used in its entirety to pay the property expenses, no cash will be available for distribution to the children, and if the client's lease is for life and the trust prohibits the sale of the property during the client's lifetime without his or her consent, the effect is that nothing in the trust can benefit the children until the client dies. As a result, the Too Rich Too Soon Fear can be eliminated. This prohibition also gives the donor comfort that the residence cannot be sold out from underneath him or her. If the client prefers, a provision requiring sale and replacement of the sold residence upon the instruction of the client can also be included.

The donor will be required to pay fair market rent for his or her use. If fair market rent is not paid, Section 2036 will cause the value of the residence to be included in the client's estate when the client dies, subjecting that asset to estate tax.[18] If the rent is more than fair market rent, the client will be treated as making a gift to the trust of the excess. Therefore, rent surveys should be taken to determine the rent—not only in the first year, but each year thereafter, and in the absence of a rent survey (they can be difficult to obtain and, in some cases, clients forget to do them) the lease can call for a cost-of-living adjustment in the amount of the rent.[19] A formal lease should be entered into and rent payments made monthly.

Although there would be no basis step-up for the residence held by the trust at the donor client's death, the client could repurchase the property from the trust for cash just before his or her death.[20] So long as the trust is a grantor trust, no gain will be recognized on this sale. The trust would then pass "full basis" cash to the children, and the residence would be taxed when the client dies—achieving a full basis step-up.

The client may seek to create discounts for his or her gift of the residence, increasing the transfer tax savings available using this tech-

16 See Section 2642(f)(3).

17 Rent paid to one's own grantor trust is not taxable. The mortgage interest and property tax deductions flow through the grantor trust back to the client grantor. Also, if the trust owns the client's principal residence and sells the property during the client's lifetime, the gain exclusion under Section 121 remains available to reduce any capital gains tax. Reg. 121-1(c)(3). See also Ltr. Rul. 199912026.

18 See Rev. Rul. 78-409, 1978-2 CB 234, and Rev. Rul. 70-155, 1970-1 CB 189.

19 To avoid the application of Section 2036, the rent must not only be fair market value at the time the lease is signed, but for the entire period of the lease.

20 The qualified personal residence trust rules prohibit a sale back to the grantor from his or her own grantor trust. Reg. 25.2702-5(c)(9). There is no such applicable restriction in this case.

nique. The typical lack of control and lack of marketability discounts can be accomplished by making gifts of undivided interests in the property to separate trusts for each of a number of children, although this approach will be a bit more difficult to administer as it results in two or more trusts as payees of the rent and as owner-landlord responsible for payment of expenses. To streamline administration, the trustees of the donee trusts may consider creating an LLC into which the trusts contribute their interests in the residence. Because the "tax owner" of the LLC will be multiple grantor trusts, the LLC should be a disregarded entity for income tax and reporting purposes.[21] In fact, if the client intends to use the LLC structure to administer the residence, he or she might create the LLC first and gift the LLC interest to the trusts for the children.[22]

Classic cars, yachts and planes. The gift/leaseback approach can also work for classic cars, yachts, or planes. For example, assume the client owns classic cars. He or she can gift the cars to a grantor trust for his or her children. On the weekends, when the client would have driven the cars for pleasure, he or she could lease the car back from the grantor trust. (Of course, fair market rent would need to be determined for that use by survey, a written rental agreement should be entered into, and the rent should be paid in a timely and commercially reasonable manner.) The lease payments would be received by the trusts income tax free, and used to maintain, store, and insure the cars. Again, if the fair market value of the donor's use is approximately equal to the costs of maintaining the cars, the client's cash position is not materially altered and the Becoming Poor Fear is circumvented.

The trust will not hold large sums of cash; the Too Rich Too Soon Fear is avoided. In addition, as with real estate, the trust may prohibit sales without the donor's consent, so the donor may be assured that the children will not compel a sale of the assets in exchange for property which produces more income or appreciation. To prevent leasing to third parties, the trust may also require the donor's approval before any such transaction.[23] The client may also choose to include a provision restricting the children's access to the trust assets until after the donor's death. Such provision will be especially desirable to a donor who does not want the children to use the classic car or other asset during the donor's lifetime.

The client may make annual exclusion gifts to the donee trusts if the rent does not fully cover the expenses (e.g., if the client's use is infrequent). The trusts should therefore include *Crummey* provisions to allow this alternative to be used.

Loans to children

A practitioner should ask clients whether any outstanding loans are owed to them by their children. A client's loan presumably was for the child to buy or invest in something that the parent thought worthwhile—so the parent does not have a Too Rich Too Soon Fear. If the parent also never expected to be paid back, forgiveness of these loans is an easy way to use the client's unified credit—and the Becoming Poor Fear will not apply.

Investments in new or start-up ventures

Some of the most successful estate planning results can arise when a parent who starts a new business venture arranges for his or her children to own a piece of the business from the outset through a trust that invests at the time of the start-up. The gift in most cases is very small and the transfer-tax-free benefits, if the business is successful, can be significant.[24] However, clients might balk at giving away a piece of the action at the outset; either because they want to keep all the upside for themselves (a version of the Run Out of Money Fear) or because of the Too Rich Too Soon Fear.

A SLAT is a perfect way to avoid these fears for the client. If the SLAT is given the opportunity to buy in to the start-up, the beneficiary spouse can spend the proceeds of a successful venture, and the children get nothing until the beneficiary spouse dies.

As discussed above, if the investment is made by a grantor trust,[25] the potential transfer tax savings are even greater because the donor spouse pays the income tax on the trust's income. However, the hesitant donor spouse may worry that he or she might not be able to pay

[21] Rev. Rul. 77-402, 1977-2 CB 222.

[22] Note that in California, the LLC should be created by the trusts after they have received the residence to allow the donor to avoid a property tax reassessment by using Proposition 58 where applicable. See Penner v. County of Santa Barbara, 37 Cal. App. 4th 1672 (Calif., 1995).

[23] Prevention of sale and leasing choices are types of investment decisions. Since retaining investment powers does not cause estate inclusion, such provision is permissible. See Estate of Peters, TCM 1964-167.

[24] Note that if the parent works in the business without a contract that requires him or her to be compensated, then the value of those services will be free of gift tax as they do not constitute a gift "of property" and the gift tax does not apply. See Hogle, 165 F.2d 352, 36 AFTR 539 (CA-10, 1947).

[25] Note that a SLAT is always a grantor trust until the settlor's death.

[26] With grantor trusts other than SLATs, the grantor can always release the power that makes the trust a grantor trust to cause the trust to begin to pay the tax on its income thereafter. Since a SLAT is a grantor trust simply because it is a trust the "grantor" establishes for a spouse, there is no power to convert the trust from a grantor to a nongrantor trust.

[27] See Rev. Rul. 2004-64, 2004-2 CB 7.

the income tax in the future if the new venture is very successful and generates significant income (on which the donor spouse will have to pay income taxes) or is sold (resulting in huge capital gains taxes being passed through to the donor spouse's return)—and this worry might stop the donor spouse from funding the SLAT.[26]

To allay this concern, practitioners should consider including a provision in grantor trusts permitting someone other than a person who is a related or subordinate party to the grantor (as defined in Section 672(c)) to reimburse the grantor (donor spouse) for income taxes he or she incurs on trust income. Under Rev. Rul. 2004-64,[27] such provision by itself would not be deemed a retained interest that would subject the trust to estate tax on the donor spouse's death under Section 2036 unless other issues were causing inclusion, such as a provision under the applicable state law that gives the donor spouse's creditors access to the trust's funds if the reimbursement provision is added to the trust.

Some states—including Arizona, Delaware, Florida, Iowa, New Hampshire, New York, North Carolina, Pennsylvania, South Dakota, and Texas—have passed statutes specifically providing that such provisions would not expose the assets to creditor's claims.[28] In certain other states, like California, the law is unclear. The reimbursement provision should, therefore, allow such payments only if the governing law applicable to the trust would not make the assets of the trust reachable by the donor spouse's creditors.

Because the donor spouse should not be reimbursed under California law and similar situated states until there is explicit authority protecting assets from his or her creditors, in such states the donor spouse will need other options to protect him or her from having to pay income tax on the income of the grantor trust at a time when he or she cannot afford to do so. For example, if the grantor trust is a SLAT, the beneficiary spouse may receive distributions and then use the funds to pay those income taxes reflected on the joint income tax return filed by the donor spouse and the beneficiary spouse for that year.

Another alternative may be for the trustee of the grantor trust to loan the money to the donor spouse to use to pay the taxes (and when the donor spouse dies, that debt will afford his or her estate an estate tax deduction). And, as mentioned above, for trusts other than SLATs, if the donor spouse wants to stop paying the income taxes altogether, he or she may release any of the powers causing grantor trust status and thereafter cause the trust to pay its own income taxes.

These options should be discussed, considered, and resolved prior to the transfer of the business venture to the grantor trust.

Gifts of life insurance

Life insurance is the classic example of a painless gift. The insured owner who purchased the policy to provide a death benefit (rather than like an investment that allows for funds invested in the policy to grow income tax free, which the insured might borrow out and spend during his or her lifetime) does not intend to use the policy during life, so making a gift of that policy should not raise the Run Out of Money Fear. The children do not benefit until the policy pays off at the insured donor's death, so the Too Rich Too Soon Fear is also not an issue. Gifts of life insurance policies to irrevocable life insurance trusts should therefore continue.

Conclusion

In 2012, estate planners rushed to beat a year-end deadline to avoid the reduction of the unified credit—seemingly to no avail when Congress took action to allow the unified credit to continue at the same (inflation-adjusted) level. The pressure from clients to make them comfortable with gifting the amount of their unified credits before the end of 2012 forced estate planners to develop painless giving techniques. Although the law did not change, clients who made lifetime gifts that fully absorbed their unified credits during life rather than waiting to use their unified credits at death will achieve significant tax savings for their families. Those painless giving techniques can continue to be used by clients to save significant transfer taxes in the future.

Painless giving techniques should continue to be used by estate planners to convince clients that they can feel comfortable using their unified credits during their lifetimes rather than at death. Significant transfer tax savings can be accomplished by clients if they follow this approach. The legacy of 2012 will be that lifetime use of unified credits becomes a regular feature of estate plans undertaken by high net worth individuals in 2013 and beyond. ■

28 Ariz. Rev. Stat. § 14-10505(2)(a); 12 Del. Code § 3536(c)(1); Fla. Stat. § 736.0505(c); Iowa Code § 633A.2304(3); NH Rev. Stat. § 564-B:5-505(a)(2)(B); N.Y. EPTL § 7-3.1(d); NC Gen. Stat. § 36C-5-505(a)(2a); 20 Pa. Consol. Stat. § 7745(2); and SD Cod. Laws § 55-1-36, Tex. Property Code § 112.035(d).