

# MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

## NEWSLETTER

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*\*Special Edition\**  
August 10, 2011

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DeEtte L. Loeffler



#### **Don't Wait - You May Only Have Until November to Make Transfers**

DeEtte L. Loeffler

At the 11<sup>th</sup> hour, Congress passed legislation raising the debt ceiling. Unfortunately, this bill, called the Budget Control Act of 2011 ("BCA"), did not resolve the uncertainty currently facing taxpayers. In addition to raising the debt ceiling another \$2.1 Trillion, the bill establishes a bipartisan committee ("Committee") charged with making recommendations for reducing the deficit by \$1.5 Trillion. The Committee's recommendations are due no later than November 23, 2011. In the event the Committee fails to reach agreement, or Congress fails to enact legislation for tax debt reduction by December 23, 2011, the BCA incorporates penalties that will go into effect January 1, 2013 (which is the same time the Bush Era Tax cuts are expected to expire). This double whammy is likely to have a significant adverse effect on both middle class and wealthy individuals who wish to pass on their assets and businesses to the next generation. Taxpayers should act to minimize their tax exposure before the new laws take effect.

#### How Much Time Do You Have to Plan?

While nothing is certain, you may only have until November, 23, 2011 (when the Committee's recommendations are due). Congressional leaders are already arguing over what the Committee is permitted to do, and some experts are predicting the Committee will be unable to produce any recommendations. Given the current situation in Congress, it is possible you

may have until December 31, 2012 to act (when the Bush Era tax cuts expire and the BCA penalties are imposed), but the risk is great that changes to the tax code will be enacted before then.

#### What Planning Options Will You Lose?

It is impossible to predict with certainty which planning options will be targeted, but certain options have been under repeated attack in the last few years. These planning options include Grantor Retained Annuity Trusts (GRATs) and valuation discounts. In addition, exemptions for the estate, gift and generation-skipping taxes are likely to be significantly reduced, and the tax rates for these types of transfers are likely to significantly increase.

#### Reduced Gifting Limit and Increased Tax Rate

Individuals can currently gift, outright and free of trust, up to \$5 Million of assets during lifetime without incurring a gift tax (additional gifts are subject to a 35% tax rate). This gifting exemption will expire on December 31, 2012 unless Congress acts to extend the exemption. However, the bipartisan Committee may recommend reducing the Gift Tax Exemption as early as January of 2012 (retroactive legislation appears unlikely). If you have considered making lifetime gifts, the time to do so is now.

Generation-skipping gifts to children (in trust) and to grandchildren and further issue (with or without trusts) are also in jeopardy. The Generation-Skipping Transfer Tax ("GST tax") is imposed on top of the Gift Tax and applies to transfers to persons who are more than one (1) generation below that of the giver (a "skip

person"). Under current law, individuals may gift up to \$5 Million to skip persons. Combined with the Gift Tax Exemption, cumulative gifts of up to \$5 Million can currently be made free of both taxes.

If both tax exemptions are allowed to decrease to \$1 Million in 2013, and the tax rates increase to 55%, this will significantly reduce the value of gifts to skip persons. *For example*, if a taxpayer gifts \$5 Million to a generation skipping trust for a child (or directly to grandchildren) in 2011, gift taxes and GST taxes would both be \$0, allowing the grandchildren to receive the entire \$5 Million. This same gift given in 2013 would result in nearly \$4 Million in federal taxes being owed (\$2,750,000 gift tax plus \$1,237,500 GST tax) so that the grandchildren would receive only \$1,012,500 of the original \$5 Million gift. The punitive taxation of such transfers in 2013 effectively precludes such a gift from being made at that time.

## Loss of Valuation Discounts for Family Transfers

For the last few years, Congress has discussed eliminating discounts for assets transferred between family members. The IRS has long argued that such discounts unfairly decrease the taxable value of gifts and other transfers between family members because the restrictions on re-transfer of the assets can be removed at the convenience of the family.

Currently, when an individual transfers a non-controlling interest in real property, or an entity, and restricts the ability of the recipient to sell that property, the value of the interest transferred is considered to be less valuable than the actual percentage given. Discounts can also be combined, by placing assets into an entity and then transferring interests in that entity. *For example*, if a parent transfers two rental properties into a family limited partnership and then gifts a 10% interest in the partnership to a child, the fair market value of the gift to the child would be less than 10% of the value of the real properties, because the child would not be able to control the entity or sell the property to obtain the cash value. The IRS wishes to restrict transaction discounts to those between unrelated persons, thereby eliminating the value of using discounts in planning.

If discounting is lost for family transfers, the tax incurred when selling or gifting a family business to the next generation would significantly increase. *For example*, if in 2011 a parent transfers an interest in a family limited partnership holding real properties and related triple net leases to his children, the transfers would likely be entitled to a discount of between 25% to 35% (depending on a variety of factors), with one set of discounts applying to the real properties and leases in the partnership, and a second discount applying to the partnership interests. If discounts are prohibited for family transfers, it is possible that this same transfer would be denied all discounts, making it more expensive, tax wise, to sell the business to one's children than to a total stranger (where a discount would be allowed and even expected by the buyer). This may cause some businesses to be sold to third parties rather than attempt a transfer within the family. Making gifts and sales now, however, will secure the application of discounts to such inter family transfers.

## Elimination of GRATs as a Useful Tool

Grantor Retained Annuity Trusts, or GRATs, are also under attack and may be eliminated or greatly restricted in the near future. A GRAT allows an individual (the "donor") to make a gift in trust of an asset (usually stock) that is expected to appreciate more rapidly than the current interest rate while retaining an annuity interest in the trust for at least two years. When the term expires, the asset is distributed to the beneficiary. The donor usually reinvests the annuity payments in subsequent GRATs in hope of making a gift at the lowest value. The recent drop in the stock market makes a GRAT very attractive for gifting. *For example*, a parent transfers Cricket Wireless stock to a GRAT and retains an annuity payment for three (3) years. During this time, the stock value increases well beyond the required annuity payments, allowing the appreciation to pass to the children for a nominal gift value.

The IRS has urged Congress to require GRAT terms of no shorter than ten (10) years, and Congress seriously considered adopting this change in late 2010. This longer term would significantly increase the mortality risk for the donor, as well as increase the risk that the interest rate applicable to the GRAT will exceed

the total return earned by the asset during the trust term. If you have been considering establishing a GRAT, we strongly recommend you discuss this option with us before November of 2011 while interest rates remain at historic lows, stock values are depressed, and shorter GRAT terms are still permitted.

## Other Planning To Be Considered Now

Generation-Skipping. Now more than ever, inter vivos (lifetime) generation skipping transfers should be closely evaluated. With the increasing likelihood that the estate and GST tax exemptions will be reduced from \$5 Million to \$1 Million (or possibly even less), and the virtual certainty that Congress will increase tax rates across the board (including the estate gift and GST taxes), taking advantage of opportunities to defer taxes as long as possible is highly recommended. Transferring growth assets now to a generation skipping trust, as either a gift or a sale using a low interest rate promissory note, is an attractive means to avoid future estate taxes while retaining cash flow to older generations.

Generation skipping in a trust allows growth assets to avoid estate taxes while still providing a child with income and assets (as needed) during his or her lifetime. The child can be given various powers to change the form of distribution, if appropriate, to the grandchildren.

Marital Trusts. Larger estates (those currently over \$5 Million, but possibly as low as \$2 Million) may benefit from a marital trust in the current uncertainty, while smaller estates (\$ 1-5 Million) may benefit from using a disclaimer trust. Using a marital trust would allow deferral of the estate tax until the second death, while leaving assets available to the surviving spouse for needs. Unlike assets left directly to the surviving spouse, which are also protected by the marital deduction, assets in a marital trust are protected from the spouse's creditors. Deferral can translate into substantial savings if in the future the estate tax rate decreases or the estate tax exemption increases.

Estates that currently appear less likely to exceed the estate tax exemption amount should consider adding disclaimer provisions to their trusts to give the surviving spouse more flexibility in this uncertain tax environment. It allows the surviving spouse to decide, at the time of the first death, whether or not a marital trust is needed to minimize taxes. If you have questions regarding

which option may be best for you, please contact us to discuss it.

ILITS. Life insurance (and Irrevocable Life Insurance Trusts (ILITs)), also appear to be a good option at this uncertain time. Those concerned about asset replacement in a down market, or having sufficient liquid assets to pay anticipated estate taxes, should consider purchasing life insurance through an ILIT. With the gift tax and GST tax exemptions at \$5 Million, it is unlikely a taxpayer will owe transfer taxes on the insurance premiums he or she pays to obtain the insurance. Single pay policies are a good option where the taxpayer may exceed \$1 Million in lifetime transfers prior to 2013 (in order to prevent payment of premiums at a future date when the higher exemptions might no longer apply).

## Other Tax Issues

The President continues to urge Congress to increase taxes on higher income taxpayers (defined as couples earning \$250,000 a year). Those living in high cost locations such as San Diego are likely to fit into that category, especially if many of the current tax credits and deductions are eliminated. *For example*, this summer Congress again discussed eliminating the mortgage interest deduction for "high income" taxpayers.

In addition, capital gains tax rates are expected to rise in 2013 when the Bush Era tax cuts expire. If income tax rates also rise for higher income taxpayers, shifting income down a generation may have increased appeal. Making discounted gifts of high income assets in 2011 and 2012 will avoid the risk that the gift tax exemption will decrease back down to \$1 Million while these assets remain in the higher income taxpayer's estate.

If you are interested in implementing any of these planning options, or wish to have your plan reviewed, please contact us.

*If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or [newsletter@mmpph.com](mailto:newsletter@mmpph.com).*

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