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Changing estate and gift tax laws and international family succession planning

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- **Scheduled changes to high exemption and low rates for estate and gift taxes**
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The Tax Relief, Unemployment Insurance Reauthorisation and Job Creation Act of 2010 created advantageous tax and wealth-planning opportunities that are scheduled to expire on December 31 2012. Advisers to international families should be aware of these opportunities as it may be advantageous for US family members to take advantage of them while they still exist.

Scheduled changes to high exemption and low rates for estate and gift taxes

The act increased the federal exemption for a US individual's total wealth transfers, whether during life or at death. For tax year 2012, that exemption shelters $5,120,000 per US individual from transfer taxes – that is, gifts during life plus transfers at death are exempt from estate and gift tax up to a total of $5,120,000. Aggregate transfers in excess of this amount are taxed at progressive rates, the highest of which is currently 35% (for further details please see "Tax Relief Act, reporting requirements and planning for use of foreign trust property"). Without further legislation, the exemption

will fall to $1 million in total, and the top bracket will increase to 55%, from January 1 2013. Although it is unknown what action Congress will take going forward, it is clear that there is an opportunity to make tax advantageous gifts in 2012.

Changes to the generation-skipping transfer tax

The act also provided an increased exemption from the generation-skipping transfer (GST) tax, which in 2012 shelters $5,120,000 of a US individual's aggregate generation-skipping transfers from the tax, whether during life or at death. The GST tax is levied in addition to the federal gift and estate taxes. A transfer is generation skipping if there is a transfer from a grandparent to or for a grandchild, either directly or indirectly through a trust (for further details please see the "Overview"). Moreover, the GST tax has a maximum rate of 35% for the remainder of 2012 for a US individual's aggregate generation-skipping transfers exceeding that amount. Like the exemption and rates on estate and gift transfers, without further legislation the GST tax exemption will fall back to $1 million (approximately), and the top bracket will return to 55%, on January 1 2013.

Additional tax advantageous planning techniques threatened

The president's budget for the next fiscal year proposes to eliminate valuation discounts attributable to minority, non-controlling interests in family business or investment entities. Such discounts are usually highly advantageous for taxpayers; discounts of 20% to 40% of net asset value are not uncommon, hence the desire to eliminate them to increase government revenue. At least under existing law, during the remainder of 2012 valuation discounts will be useable where appropriate. Other advantageous estate planning techniques are also at risk under the budget, such as short-term grantor retained annuity trusts.

Application to succession planning for international families

Succession planning for international families generally utilises foreign grantor trusts while the non-US matriarch and patriarch are living (for further details on grantor versus non-grantor trusts please see "Taxation of offshore trusts and impact of new lower tax rates"). Planning for the next generation balances the interests of US children and grandchildren with those of non-US descendants, and sometimes results in domesticating trusts or portions of trusts to the United States. The estates of family

members who are not citizens of or residents in the United States will not be subject to US estate tax, with the exception of any US situs property owned by the non-US family member at death (for further details please see the "Overview"). As the estate tax exemption amount for the estate of a non-citizen, non-resident decedent shelters only $60,000 from tax, careful planning is needed to ensure that the estate does not include US situs property.

Since the generation immediately below that of the matriarch and patriarch may also have significant assets, advisers to international families that include wealthy US children should consider discussing with the family the advantages of those US children using the larger gift and estate tax exemption in 2012. For example, a US child can establish a US domestic trust for that child's descendants by giving $5,120,000 (or $10,240,000 if the US child elects to split the gift with a qualified spouse) to an irrevocable trust. Gifts in trust are less likely to be subject to the claims of a beneficiary's creditors, including ex-spouses, and can help to ensure that family wealth does not pass outside the family bloodline.

Even if a child has previously made taxable gifts, the act's increase of the exemption amount makes available for further tax planning the difference between the amount previously used and the new maximum amount of $5,120,000. If the child owns a family business or investment entity, then valuation discounts attributable to minority, non-controlling interests in the business or entity may be available to leverage any gift. The child would need to file a US gift tax return to report the gift, but the gift would be designed to generate no actual gift tax liability. Making gifts during life not only reduces the child's estate by the amount gifted, but also by the appreciation on that gift over time; this is an often over-looked, yet quite powerful, planning advantage.

A US domestic trust will be subject to US income tax going forward but could be sheltered from future estate tax by applying the US child's current $5,120,000 GST tax exemption. With additional planning, the income tax liability could remain with the US child so that the sheltered trust essentially grows income tax free during the child's lifetime. The child will further reduce his or her estate by paying the income tax but can continue to support his or her lifestyle by receiving gifts from the non-US parents.

Although gifts directly from non-US persons over a certain amount must be reported to the US Internal Revenue Service, they are not subject to US income tax (for further details please see the "Overview").

There may also be situations where a foreign non-grantor trust that benefits both US and non-US children should consider making a substantial distribution to a US child in 2012. A distribution from a foreign non-grantor trust that has been maintaining US tax accounting records and managing its distributable net income will result in a US income tax liability to the child, but not an adverse interest charge (for further details see "Taxation of offshore trusts and impact of new lower tax rates"). The US child can then use some of the net distribution to settle a US domestic trust for his or her US descendants. Rather than providing for US beneficiaries by distributing property from the foreign trust to a US non-grantor trust, allowing the child to settle a US domestic grantor trust provides an added tax benefit where the child retains the income tax liability during his or her lifetime.

Comment

Given the potential tax savings, US individuals should consider making large gifts in 2012 even though Congress could take action at some point in 2013, retroactive to January 1 2013, that would alleviate some or all of the scheduled tax increases. Of course, it would be preferable if Congress addressed these issues in a timely manner this year, particularly given the necessity of increasing the federal debt ceiling again. However, given the tardiness with which Congress addressed the scheduled repeal of certain tax laws in 2010, there is little confidence in its ability to act in a timely manner this year.

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