ALASKA GIFT TRUSTS

February 27, 2020

Estate and Gift Tax Landscape

The federal estate and gift tax system taxes gifts and inheritances. This transfer tax system is completely separate from income tax. In short, there is a tax on all gratuitous transfers from one individual to another, with exceptions. Gifts that do not fit within any exceptions are referred to as "taxable gifts."

Each individual has a lifetime gift tax exemption – an aggregate amount that the person can give away without paying gift tax. Once a person exhausts the exemption, that person pays gift tax on any additional taxable gifts. When the person dies, the person has an estate tax exemption that is tied to the remaining gift tax exemption. Any amount of the person's estate that exceeds the exemption is subject to estate tax, with exceptions.

The gift and estate tax exemptions are unified. Currently, the exemption is $11,580,000 per individual, and the tax rate on gifts or inheritances that exceed $11,580,000 is 40%. Put another way, under the current exemption amount, a person can give away up to $11,580,000 either during life or at death without paying gift or estate tax; any gifts above that amount are taxed at a rate of 40%. The exemption amount is subject to inflation.

The exemption amount is at a temporary high. The exemption has fluctuated significantly throughout the years, from less than $1,000,000 to its current $11,580,000. Under our current tax law, on January 1, 2026, the exemption will be reduced to $5,000,000, indexed for inflation. Federal legislation has been introduced to reduce the exemption further to $3,500,000 or less.

Many families who expect to be affected by the estate tax would like to use their exemptions now, while they are at the temporary high, to save their children and grandchildren estate taxes in the future. For these families (we will call them "estate tax sensitive families"), saving estate tax can help preserve family owned businesses and ensure that one generation's wealth can continue to be used for the benefit of future generations. This is especially true in Alaska, where our trust law is designed to preserve family wealth in perpetuity. In addition, estate tax liabilities can result in fire sales of family owned businesses after the death of the business owner, and use of the exemption to minimize estate tax can help prevent that result.

Some estate tax sensitive families are well positioned to make conventional gifts now, while the exemption is high. For example, a retired individual whose wealth is mostly in the form of real estate and brokerage accounts would be able to easily make substantial gift to a trust now and use his or her gifting credit during this temporary window (which will close in 2026 or possibly earlier under a proposal already made in Washington). However, some estate tax sensitive families are not as well positioned to make conventional gifts now. These are families with sufficient assets to be concerned about estate tax at death, but for whom there are limited choices of assets with which to make a conventional gift.

To illustrate, consider a successful physician, a significant portion of whose wealth is comprised of her medical practice. Because her malpractice carrier does not allow non-physicians to own her practice, she is not able make a gift of any part of her practice to a trust for the benefit of her descendants. Thus, even though the physician's financial situation makes her estate tax sensitive and she would benefit from gifting while the exemption is high, she is not able to make a gift of her most valuable asset.

Also consider the owner of a trucking company, who owns a significant portion of a successful business along with other partners. Based on the partnership agreement, the owner needs approval from the other partners in order to make a gift of his partnership interest to a trust for his children and one of the partners has refused to consent to the gift. Like the physician above, this trucking company owner is estate tax sensitive, but is not able to make a gift of the estate tax exemption amount while it is temporarily high.

Finally, also consider a contractor who owns a successful construction company. He is interested in making gifts of the construction business to an Alaska trust for the benefit of his descendants, but his bonding company is concerned about the gift of ownership and has told the contractor that his favorable bonding rates would be increased if he gifted the his interest in the company to a trust. Like the physician and trucking company owner above, the contractor is estate tax sensitive, but is prevented from making a gift while the exemption is high.

The Alaska Gift Trust is a new solution for people like the physician, trucking company owner, and contractor.

Alaska Gift Trust – The Concept

The concept of the Alaska Gift Trust is simple. A person makes a written promise to gift money to an Alaska Gift Trust, without getting anything in return. Typically, this type of promise would not be enforceable because it lacks consideration (i.e., there is nothing given in return). With this new statute, the promise would be enforceable and irrevocable, although there are plenty of safeguards in the statute to make sure a person does not inadvertently make such an enforceable promise. The promise must be irrevocable to be enforceable. The promise, because it now is enforceable with nothing in return, is a taxable gift. The taxable gift uses the promisor's gift tax exemption. The promise must be satisfied within 9 months of the promisor's death, so it cannot last forever. But until then, the promisor can use lifetime gift tax exemption without gifting assets that are difficult to transfer.

Alaska Gift Trust – The Mechanics

To use the statute, there are a number of specific steps that need to be followed.

First, a person needs to create an Alaska Gift Trust, which must be a written document saying that the trust is a gift trust created under the statute, the trust must hold at least $10,000 in an Alaska bank account, and at least one trustee must be an Alaskan resident or a bank or trust company with its primary place of business in Alaska. This trust is a written instrument that is registered with the Alaska court system, and the trustee submits to jurisdiction in the State of Alaska.

Second, the person signs the written promise. The writing must include an express reference to the statute and a statement that the person intends to be legally bound by the promise, both of which are safeguards against inadvertent usage of the statute. The promise is for a certain amount of money, and the terms of the promise must require that the money be delivered to the trust within nine months of the person's death or sooner.

Third, the person delivers the written promise to the Trustee of the trust. After 180 days, the Trustee can treat the promise as a note, and then the promise becomes a negotiable instrument with all of the safeguards and remedies of any other promissory note under Alaska law. The treatment as a note provides safety and security to the beneficiaries of the trust, because the trust would have recourse against the person who made the promise if the promise was not satisfied. More information regarding the rights of beneficiaries is discussed below.

To see these mechanics in action, let us examine a few examples based on two of the scenarios discussed above:

1. The physician mentioned above creates an Alaska Gift Trust for her children, and makes a promise to transfer $10,000,000 to the gift trust in 20 years, when she is sure she will have retired. The promise conforms to the requirements in the statute. Years later, when she retires, she sells her medical practice to her partners. She now takes $10,000,000 of those proceeds and pays the trust, which satisfies her promise.

2. The trucking company owner mentioned above also creates an Alaska Gift Trust for his wife and children. He promises to transfer $10,000,000 to the gift trust within 9 months of his death. He keeps the business until his death, so he is not able to satisfy the transfer before then. Upon his death, however, he and his partners already had a buy-sell agreement in place, and now his partners buy out the interest from the estate. Meanwhile, the trustee of the gift trust files a claim in the estate, and the claim is satisfied with the proceeds from the sale.

Impact on Promisor's Estate After Death

The promise must be satisfied within 9 months of the death of the promisor. If the promise has not been satisfied by the person's death, then the trust becomes a creditor of the person's estate. Once a personal representative is appointed for the estate, the personal representative will publish a Notice to Creditors in the newspaper. The trustee of the trust then will have four months from the date of the first publication to bring forward a claim against the estate to enforce the promise. There is a hierarchy to creditors, which comes into play if a person's estate has insufficient assets to satisfy all creditors. If the estate does not have sufficient assets to pay all claims, then remaining assets are apportioned according to a statutory hierarchy.[1] Before any claims are paid, the surviving spouse is entitled to certain exemptions and allowances (see below). Then, costs of administration, funeral arrangements, child support, and taxes generally would be paid, and then the remaining assets are divided up pro rata among the general creditors. The trustee of the trust would be a general creditor. As a creditor, the trust would receive its money before beneficiaries under the decedent's will.

Alaska law provides several safeguards for surviving spouses of decedents. The surviving spouse is entitled to a homestead allowance of $27,000, an exempt property allowance for up to $10,000 of tangible property, and a family allowance to support the surviving spouse (and minor children) during the estate administration.[2] All of these protections would come before, and be unaffected, by the promise to make a transfer of money. The surviving spouse also is entitled to an "elective share" of the estate, which essentially is a statutorily defined fraction of the decedent's estate, reduced by enforceable claims and expenses.[3] The promise to pay under the new statute would be a claim that reduces the elective share available; *however, the result should be no different than if the decedent had made a conventional gift before death.* In addition, if the promise was made during the marriage and during the two-year period immediately preceding the decedent's death, then the spouse would be entitled to a portion of the promised money if he or she claimed the elective share.[4]

Potential Risks and Resolutions

No estate planning technique is free of risk. As with every other estate planning tool, the promise to pay money under the new statute has some risks. The safeguards in the statute make every effort to mitigate the risks.

Suppose a person tries to use this new statute to settle a debt. If the promisor makes the promise to settle a debt, then there is consideration (i.e., something in return). The promise, in that case, is a promissory note and is covered by existing Alaska law. This statute is created for promises without consideration.

After a person's death, suppose the person's child comes forward and tries to claim that the decedent promised to give them money. The requirements in the statute that the promisor use an Alaska gift trust, that the promise be in writing, reference the statute, and state that the promisor intends to be legally bound, all serve to prevent both inadvertent use of the statute and false claims of a promise after the person's death.

There is a risk that the promisor will not have enough money to satisfy the promise either during life or at death. The risk of inability to pay is present whenever debt is involved. But as described

[1] AS 13.16.470.
[2] AS 13.12.402-404.
[3] AS 13.12.202.
[4] AS 13.12.205(a)(3)(C).

above, the Alaska gift trust is intended for estate tax sensitive families and so the risk of inability to pay is relatively low.

But let us consider what would happen if the contractor mentioned above $10,000,000 written promise under the new statute and then suffered a reversal of financial fortune such that he in unable to fully pay off the debt during his life or at death. If the contractor dies and his estate is not able to pay the debt, then the trust would be general creditor of his estate as described above. In this event, the contractor would have "wasted" his exemption amount that he used when made the $10,000,000 written promise, but such "waste" does not impact his family negatively. If his estate has contracted in value such that it cannot pay its obligations, his estate will not owe any estate tax, anyway. Accordingly, his family is not in any worse off position as if he had not made the promise in the first place.

As detailed above, the proposed Alaska gift trust legislation provides an innovative way for estate tax sensitive families to take advantage of the temporarily high exemption amounts even in cases where the nature of the family's assets makes conventional gifting unworkable.