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2011 & 2012: The Golden Gifting Years

By Richard M. Morgan & Loraine M. DiSalvo

Disclaimer: This material has been prepared as a tool to assist in a general discussion of the matters discussed herein. These materials should not be relied upon without an attorney being consulted with regard to your particular situation. The interpretation of any laws and rulings should be independently verified by local counsel.

As you should now know, The Tax Relief, Unemployment Insurance, and Job Creation Act of 2010 (the "2010 Tax Act") became law December 17, 2010, and made a number of changes to the federal wealth transfer tax laws. The federal wealth transfer taxes are the estate tax, the gift tax, and the generation-skipping transfer ("GST") tax. One of the biggest changes made by the 2010 Tax Act was an increase in the lifetime gift tax exemption to an historically high $5,000,000, and a reduction in the gift tax rate to an historically low flat 35% rate. At $5,000,000, the gift tax exemption will now be equal to the estate and GST tax exemptions for 2011 and 2012.[1]

These changes to the gift tax laws present an unprecedented opportunity for people to transfer wealth to their intended beneficiaries. In 2001, Congress passed a tax act which was designed to increase the estate and GST tax exemptions from $1,000,000 to $3,500,000. However, under the 2001 tax act, the gift tax exemption remained at $1,000,000 even as the estate tax and GST tax exemptions increased. The relatively low gift tax exemption made it more difficult to undertake lifetime transfers as part of an overall estate plan. The dramatic increase in the gift tax exemption made by the 2010 Tax Act will now make many lifetime planning techniques more attractive and potentially more beneficial. The opportunity is currently limited, since the changes made by the 2010 Tax Act are scheduled to expire at the end of 2012.

For this reason, we at Morgan & DiSalvo have begun fondly referring to 2011 and 2012 as the "Golden Gifting Years." These two years offer many people the ability to use a wide array of gifting transactions to help reach their estate planning goals, with very low or no negative wealth transfer tax consequences.

The benefits of making lifetime gifts as part of your estate plan include:

1. You can prevent the gifted asset from being included in your estate for estate tax purposes at the time of your death. This means that you can also prevent all of the post-gift appreciation in the value of that asset, and all of the post-gift income that asset may generate, from being included in your estate for estate tax purposes at your death.

2. You can help ensure that the gifted asset will be valued for all wealth transfer tax purposes based on its value at the time of the gift, including any valuation discounts.

3. If you file a properly prepared gift tax return to report the gift, and meet the IRS's rules for adequate disclosure, you can rely on a three-year statute of limitations. This statute of limitations prevents the

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IRS from coming back many years after the gift and challenging the value and other adequately disclosed aspects of the gift. This can give you a fairly high level of certainty as to the wealth transfer tax effects of the gift.

4. Those who are able and willing to make taxable gifts <u>beyond</u> the $5,000,000 exemption may be able to lock in at least some of the benefits of the historically low 35% tax rate, even if the gift and estate tax rates are higher than 35% in later years. This is because, if you make taxable gifts above the amount covered by your gift tax exemption and actually pay a gift tax, and then you survive for at least three years after the gift is made, the gift taxes you paid will not be counted as part of your estate for estate tax purposes. [2] If you survive for at least three years after making a taxable gift and paying gift taxes at a 35% rate, then having the gift taxes you paid removed from your estate for estate tax purposes creates the same effect as if you paid the taxes at a 26% estate tax rate.

5. Using a "grantor" trust as the recipient of gifts can allow you to provide additional benefits to your intended beneficiaries in subsequent years even if you don't make additional gifts. This is because a "grantor" trust is treated for income tax purposes, but not for federal wealth transfer tax purposes, as if it were the trust's creator (the grantor of the trust). Income generated by assets held in a grantor trust is taxed as if it were paid directly to the trust's creator. Since the income taxes generated by the trust's income are legally the responsibility of the trust's creator, the trust's creator can pay the income taxes, using his own assets, and will not be considered to have made additional gifts to the trust by doing so. This effectively allows the trust's creator to let the trust receive tax-free income while the creator's eventual estate for estate tax purposes is reduced by the income taxes the creator pays on the trust's income - almost as if the trust's creator gets to make additional, tax-free gifts to the trust.

The $5,000,000 gift tax exemption for 2011 and 2012 may also allow people to take much more significant steps towards achieving their estate planning goals. If you own a family business, you can now more easily transfer the family business to the next generation. Similarly, you can now more easily transfer investment assets, vacation homes, or other family assets to your intended, ultimate beneficiaries. There are many ways to make gifts to take advantage of the new exemption, from very simple gifts, made directly and outright, to more complex, and potentially very powerful, transactions, such as a sale to a defective grantor trust, a charitable lead annuity trust ("CLAT"), a grantor retained annuity trust ("GRAT"), a qualified personal residence trust ("QPRT"), or other selections from the alphabet soup of estate planning techniques.

Careful planning can also allow you to take advantage of the ability to make gifts in a manner which is consistent with your overall estate planning objectives but which minimizes the impact of those gifts on your personal and financial well being. The best and most appropriate planning techniques in your case will depend on your particular situation, but the potential benefits for those willing to plan during this two year period will likely be tremendous.

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Now that we've pointed out some of the potential benefits of making gifts during 2011 and 2012, here is a caveat: When deciding whether to make taxable gifts, you should consider the possibility that the gifted amount may effectively be recaptured by the estate tax if the gift and estate tax exemptions are reduced to less than $5,000,000 in the future. This effective recapture can occur if you use all or part of the $5,000,000 gift tax exemption and the gift and estate tax exemption is later reduced to less than the total value of taxable gifts you made. For example, let's assume that you used up the full $5,000,000 gift tax exemption during 2011 and 2012, the estate tax exemption returned to $1,000,000 on January 1, 2013 as currently scheduled, and the estate tax exemption is still $1,000,000 at the time of your death. Under the estate tax rules, the total value of taxable gifts you made during your life is added (as "previously taxed gifts") to the value of the assets you owned at your death. The value of the estate tax exemption is then effectively applied to the combined estate and previously taxed gift value to determine the value on which estate taxes will be actually payable. This means that $4,000,000 of your lifetime gifts ($5,000,000 of previously taxed lifetime gifts less $1,000,000 estate tax exemption for year of death) will effectively be subject to estate tax. The estate tax will be calculated based on the estate tax rates in effect at the date of your death. Careful planning, which should consider this possibility along with other factors, can help ensure that this result does not create a problem at your death. However, the penalty for failing to properly consider this factor when planning lifetime gifts could be harsh.

The main risks posed by a possible estate tax recapture include: (1) the risk that the estate tax will exceed the available liquid assets, and (2) the risk that the estate taxes generated by the inclusion of the "excess" lifetime gifts will end up harming a beneficiary who did not benefit from the gift. One way to deal with these risks would be to use life insurance as part of the overall estate plan. A way to help deal with the second risk is to ensure that your estate planning documents are clear about how the estate tax burden should be allocated among different beneficiaries. As we've already stated, careful planning will be critically important for those who want to try to maximize the extra benefits of lifetime giving during 2011 and 2012.

If you are interested in learning how lifetime gifts during 2011 and 2012 may fit into your estate plan, please contact us at (678) 720-0750 or sollila@morgandisalvo.com to schedule an appointment to talk to either Richard Morgan or Loraine DiSalvo. Remember, time is limited, and the sooner you begin planning, the better.

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[1]The gift, estate, and GST tax exemptions are also scheduled to be indexed for inflation, beginning in 2012, and the gift and estate tax exemptions have been made relatively "portable" between the members of a married couple. We have not previously devoted any attention to the potential that the exemptions will be indexed for inflation, since the 2010 Tax Act's changes, including the indexing, are scheduled to expire at the end of December 31, 2012, which means that, unless the 2010 Tax Act's changes are made permanent or extended in the fairly near future, indexing will be of limited, if any, benefit. For a discussion of exemption portability, please see our January 2011 newsletter.

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[2]Unfortunately, if you do actually pay a gift tax but then die within three years after the gift, the value of the actual gift taxes you paid during the three years prior to your death will be added to your estate for estate tax purposes.