Estate Planning Insights

A Quarterly Publication of

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Vol. 9, No. 2 **April 30, 2012**

THE UNIFIED ESTATE AND GIFT TAX SYSTEM

The gift tax and estate tax are related parts of a "unified transfer tax system." Thus, the term "transfer tax" can be used to refer to both the gift tax and the estate tax. In general, a transfer tax is an excise tax imposed on the person making the transfer (or his estate) and not on the recipient of the gift or inheritance. The lifetime gift tax exemption can be used to make transfers now without paying a gift tax; however, there is a lot of confusion regarding how the gift tax exemption works in relation to the estate tax. We will devote this issue to an explanation of the relationship of the gift tax to the estate tax and will also discuss income tax basis matters.

The Lifetime Gift Tax Exemption Amount. For 2012, the lifetime gift tax exemption amount is $5,120,000. This means that an individual who has not previously used any part of his lifetime gift tax exemption amount can transfer up to $5,120,000 worth of assets of any type (cash, real estate, stocks, bonds, mutual funds, etc.) to anyone (i.e., to any one or more persons, in the aggregate) without having to pay a federal gift tax. In other words, if the total value of all gifts made to all persons does not exceed $5,120,000 in the aggregate, then the person making the gifts will not have to pay any gift taxes at the time when the gifts are made. Note, however, that all gifts to individuals that exceed the annual gift tax exclusion amount (currently, $13,000 per person) and/or that do not qualify for the medical and tuition exclusions, *must be reported to the Internal Revenue Service* (IRS) on a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. Gifts that exceed $13,000 per person and/or that do not qualify for the medical and tuition exclusions are technically called "taxable gifts" even though no gift tax may be owed on those gifts. The term "taxable gifts" does not necessarily mean that gift tax must be paid. Taxable gifts means "reportable" gifts. All gifts (other than the direct payment of tuition and medical bills on someone else's behalf) that exceed the $13,000 per person annual gift tax exclusion amount (or that do not qualify for the gift tax annual exclusion) are taxable gifts. And all taxable gifts must be reported to the IRS on a Form 709 (gift tax return).

Why must taxable gifts be reported to the IRS? Taxable gifts must be reported to the IRS because they use up some of the lifetime gift tax exemption of the *donor* (i.e., the person making the gift) and, therefore, the donor will have less estate tax exemption available to his estate when he dies to apply to transfers being made at death. We have a unified transfer tax system and, theoretically, it should not matter whether a person transfers everything he owns the day before he dies or the day after he dies (through his Will or Living Trust or any other means). Both transfers should basically be treated the same way under the unified estate and gift tax laws.

Not reporting taxable gifts to the IRS is gift tax fraud. Plus, there is no statute of limitations on unreported taxable gifts. Thus, the Executor of a decedent's estate and the successor Trustee of a decedent's Living Trust have an affirmative duty to report to the IRS all previously unreported taxable gifts made by the decedent. The Executor and Trustee have personal liability for all taxes owed by the decedent, so they should not ignore unreported taxable gifts made by the decedent during life. All taxable gifts made during life are included in the deceased donor's tax base at death, as part of the calculation of the estate taxes payable by the donor's estate.

It may help to think of the gift tax exemption amount and the estate tax exemption amount as a book of coupons. The IRS allows individuals to use the coupons in their coupon book when they make taxable gifts during their life, to eliminate the need to pay a gift tax at the time when the gifts are made (up to the lifetime gift tax exemption amount, in the aggregate). If a person does not use any of the coupons in his coupon book during his life, then his estate can use all of those unused coupons when he dies, to eliminate or reduce estate taxes payable by his estate upon his death.

Unification of Estate and Gift Tax Exemptions. Every person has only one coupon book, which can be used during life or upon death, or used partially during life, with the balance available for use by the estate at death. No one gets two coupon books, one for use during life and another for use at death. Thus, people ought to think seriously about the best way to use the coupons in their one and only coupon book. Another consideration is the upcoming reduction in the exemption amounts.

First Example. Last year, the lifetime gift tax exemption amount was $5,000,000 (it was adjusted for inflation this year and that is why it is a higher amount now). In addition, the estate tax exemption amount for persons who died last year was $5,000,000. Suppose Henry Widower had a $10,000,000 estate in 2011. In February 2011, Henry gave $5,000,000 out of his $10,000,000 estate to his two children, Ann and Ben. No gift taxes would have been payable by Henry Widower when he gave $2,500,000 to each of his children in February 2011 (because the total gifts did not exceed $5,000,000), but Henry would be required to file a gift tax return to report the gifts because all gifts greater than $13,000 per person are "taxable gifts." In Henry's gift tax return, he would be using up his entire $5,000,000 lifetime gift tax exemption amount (technically, Henry could have given $2,513,000 to each child in 2011 and not paid a gift tax because the first $13,000 given to each child would qualify for the annual gift tax exclusion–we are going to ignore the gift tax exclusion in our simple example, however).

Suppose Henry then died in November 2011. At the time of his death, Henry would have a "gross estate" worth $5,000,000 (his original $10,000,000 estate minus the $5,000,000 he gave away in February). Added to Henry's gross estate would be the taxable gifts made by Henry before he died, which means that the $5,000,000 that Henry gave to his children in February 2011 would be added to his gross estate to produce the total estate upon which the estate tax is calculated (i.e., $10,000,000). Once the tentative estate tax is calculated, the unified credit is subtracted. The unified credit shelters from estate tax the $5,000,000 exemption amount.

Ignoring other possible deductions that could reduce Henry's taxable estate at death (like the charitable deduction for charitable gifts made at death and the deductions for estate administration expenses, debts and funeral expenses), the estate tax due by Henry's estate in this example would be $1,730,800 (the marginal estate tax rate for persons who died in 2011 was 35%). The point of this example is to make it clear that taxable gifts made during life are brought back into the tax base at death and that every person only gets one coupon book to apply to all of the taxable transfers he makes. In this example, Henry already used his $5,000,000 lifetime gift tax exemption amount (i.e., his entire coupon book) with respect to the gifts he made to his children in February 2011, so he had no remaining exemption amount to apply to his $5,000,000 estate remaining at death. In other words, all of Henry's remaining estate (i.e., $5,000,000) was subject to estate tax upon his death under these facts.

NOTE: The estate tax result would have been the same in this case if Henry had not made any gifts to his children in February, but had given everything to his children in November when he died. Also, Henry's children may be worse off in terms of the income tax basis of the assets by receiving the gifts in February, versus inheriting everything in November. *See* the income tax basis discussion, below. What are the advantages of making taxable gifts during life then, versus just waiting and giving assets away at death?

Earlier Enjoyment. First, of course, the recipients of gifts generally like to receive them sooner, rather than later. Sometimes this is a good thing and sometimes it's not. Sometimes children really need the money sooner, rather than later. They might be trying to pay for private school or college for their children and/or they or one of their children might have significant medical expenses. Or, the children might have short term economic problems (perhaps due to loss of a job or a divorce). Also, some parents delight in being able to see their children enjoying the gifts the parents have made to them.

On the other hand, giving too much to children too soon (or even at death) can lead to the affliction referred to as "affluenza." Nothing ruins a person's drive to be productive and self-sufficient more than receiving too much money, too soon. Further, based on our experience working with lottery winners, having a lot of money does not seem to be related to achieving real happiness in life. Nevertheless, earlier enjoyment is an advantage of making lifetime gifts.

Gifts Made To Remove Post-Gift Appreciation and Earnings From The Estate: Estate "Freezes." If a person owns an asset that is likely to appreciate in value after it is given away, it might be smart, from a transfer tax standpoint, for that person to give away all or part of that asset during her lifetime, instead of holding on to that asset until her death and then giving it away. Also, if that same asset is likely to produce a significant amount of income after it is given away, that is another factor that weighs in favor of giving that asset away during life, rather than holding it until death. The reason for this is that all appreciation in value of the asset, plus all income earned by the asset, *after* the asset is given away escapes estate tax in the donor's estate. In other words, the post-gift appreciation and income inures to the benefit of the beneficiary of the gift and avoids transfer tax. One countervailing consideration, however, is income tax basis, discussed below. Another consideration is the donor's continuing need for the asset. Many objectively wealthy people are currently feeling a "cash flow pinch."

Second Example. Suppose Mary Widow has a tract of land that might be developed for a shopping center and/or that might be leased for oil and gas development in the future. Suppose Mary Widow gives this property to her child, Claire, right now, while it is worth $5,120,000. Suppose also that Mary has never used any of her lifetime gift tax exemption amount before. Thus, the entire gift to

Claire is covered by Mary's $5,120,000 lifetime gift tax exemption amount. This means that Mary will not pay any gift taxes when she makes this gift to Claire, although she will need to file a federal gift tax return with the IRS to report the gift. (Again, we will ignore the annual gift tax exclusion amount in our example.)

Suppose that, by the time Mary dies, the property is worth $10,120,000. In other words, *after* Mary gives the property to Claire, it increases in value by $5,000,000. Claire ends up owning property having a value of $10,120,000 at the time of her mother's death, but $5,000,000 of that value was growth that occurred *after* Mary gave the property to Claire. Thus, no gift tax or estate tax was paid on that $5,000,000 growth in the value of the property occurring after Mary gave it to Claire.

In addition, any income earned by the property *after* Mary gives it to Claire is income that is enjoyed by Claire. If Mary had kept the land until her death, then the date of death value of the property, $10,120,000, plus all of the income earned by the property during Mary's life that Mary did not spend (or give away via tax-free gifts) would have been included in Mary's estate, leading to more estate taxes upon Mary's death. This is a simple example of what estate planners call a "freeze" transaction. By making the gift of the property to Claire *before* it greatly appreciates in value and/or produces a lot of income, Mary is "freezing" the value of this asset at $5,120,000 for estate and gift tax purposes. This is a smart gift from a transfer tax standpoint. Another consideration, however, is income tax basis–see below.

As an enhancement to the example above, if, instead of giving the land directly to Claire, Mary had given the land to an irrevocable gift trust for Claire as to which Mary is treated as the grantor for federal income tax purposes, as long as the trust for Claire remains a grantor trust, Mary would be required to pay the income taxes on the income earned by the property held in Claire's trust. Why is this a good thing? From an estate and gift tax standpoint, Mary's paying the income taxes on the income earned by the trust (i) increases the value of what Claire is receiving from her mother without requiring Mary to use any more of her gift tax exemption amount or to pay a gift tax, and (ii) reduces the size of Mary's remaining estate for federal estate tax purposes, thereby potentially reducing future estate taxes when Mary dies. We discussed the use of "intentionally defective grantor trusts" in our newsletters dated April 30, 2010 and July 31, 2010, so we will not go into more detail regarding grantor trusts in this newsletter.

There are other gifting techniques that can be used to transfer future growth and income to children or other beneficiaries in a manner that is designed to "leverage" the federal gift tax exemption. The idea of these leveraged techniques is to "get more bang for the buck" in view of the finite amount of gift tax exemption available to each person. For example, transferring an undivided interest in a piece of property to another person, instead of transferring the entire property to that person, is a somewhat leveraged transaction because the value of the undivided interest is not a straight proportion of the value of the entire property as a whole. Undivided interests are discounted due to co-ownership issues. Of course, co-ownership truly makes the property less desirable. There are other gifting techniques that rely on discounts in value also. Thus, it almost never makes sense for a person to write a check in the amount of $5,120,000 to another person in order to utilize his lifetime gift tax exemption amount because there is no leverage in a gift like that.

Consider Income Tax Basis Issues. One of the *disadvantages* of making gifts of assets during life is that the donor's income tax basis in the asset given away will *carry over* to the donee (the recipient of the gift). This is called "carryover basis." In other words, if a parent (the donor) gives his child property currently worth $100,000, which has an income tax basis of $20,000, the donor must use $100,000 of coupons out of his coupon book to avoid paying a gift tax (because gifts are valued at fair market value for federal gift tax purposes), but his child will receive that property with the same tax basis that the donor had: $20,000. Thus, if the child then sells the property for $100,000 (its fair market value), the child will incur a capital gain of $80,000 ($100,000 sales proceeds minus $20,000 tax basis) and pay taxes on it.

In contrast, assets received by inheritance obtain a "step up" in tax basis to fair market value as of the decedent's date of death (note that it could also be a step down in basis–it depends on whether the asset was worth more or less than its tax basis at death). Thus, if the child instead were to receive this same property pursuant to the father's Will upon the father's death, assuming the property is worth $100,000 when the father dies, the child would have a tax basis of $100,000 in the property. The prior $20,000 income tax basis (and $80,000 of capital appreciation) would be "wiped out" on the father's death. In the case where the child inherits the property on the father's death, if the child then sells the property for $100,000 (its fair market value), he would have no capital gain and no capital gains taxes to pay ($100,000 sales proceeds minus $100,000 income tax basis). Obviously, this is a better result for the child.

Of course, the countervailing consideration in this example is *whether estate taxes have to be paid when the father dies*. If not (because the size of the father's estate at death, including taxable gifts made by him during life, is less than the applicable estate tax exemption amount), then it is better *not* to give away highly appreciated assets

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during life and, instead, to transfer those assets at death. This is because those assets will receive a "tax-free step up in basis" when the owner dies. If the donor's estate *will* be subject to estate taxes at death, however, then further evaluation is necessary. It may be that a gifting technique transferring future growth and income is still warranted, especially one that is "leveraged."

At a recent seminar, graphs were presented comparing these estate and income tax issues. The current estate and income tax rates (35%) and exemption amounts ($5,120,000) were used in the calculations. Various average annual appreciation rates were assumed also. In some cases, it took 8 to 16 years for the estate tax savings of making a gift with a "low basis, appreciated asset" to outweigh the disadvantage to the donee of receiving a carryover basis in the gifted asset (assuming a sale by the donee). Of course, next year, per the law on the books, the estate tax exemption amount will be (only) $1,000,000 and the estate tax rates will be 41% to 55% (unless changed by Congress). That is a huge difference compared to this year's exemptions and tax rates and certainly would affect these types of calculations. Thus, people who are considering making gifts this year need to consider both estate tax and income tax issues. For these (and other) reasons, we recommend that a CPA and/or a financial planner be involved in the gift planning discussions. Also, in cases involving gifts of hard to value assets, a valuation expert (appraiser) will be needed.

Annual Exclusion Gifts. Persons with a taxable estate should consider making annual exclusion gifts ($13,000 per person per year). It's an easy way to reduce your estate and no gift tax return has to be filed if you strictly observe the limits and rules. Direct payments of another's tuition and medical bills are also tax-free gifts.

Are You Due For An Estate Planning Check-Up? We recommend that all of our clients come back for a comprehensive estate planning "check up" at least once every 5 years. Both state laws and federal tax laws change frequently and rapidly these days. In addition, changes in your personal and financial situation affect your estate plan. Are ***you*** due for a check up?

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

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