Estate Planning Insights

A Quarterly Publication of

Karen S. Gerstner & Associates, P.C.

Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448
(713) 520-5205

Vol. 9, No. 3 **July 31, 2012**

SOMETHING OLD, SOMETHING NEW, SOMETHING BORROWED, SOMETHING BLUE

Because it's "wedding season," we thought it might be fun to design a newsletter using the wedding rhyme above for the categories of topics to discuss. The challenge was the "something blue" part of the saying!

Something Old. As noted in our last newsletter, the lifetime gift tax exemption amount for 2012 is $5,120,000. This is also the estate tax exemption amount for persons who die in 2012. This year's $5,120,000 exemption amount is not our "something old" for purposes of this newsletter. It is the $5,000,000 exemption amount from 2011, adjusted for inflation. These higher exemption amounts came in with the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" (the "2010 Tax Act"), which was signed into law on December 17, 2010. Thus, they are not that old. The "something old" that we want to mention in this newsletter is the same thing we discussed, in detail, in our last newsletter: how making *taxable* gifts during life affects estate taxes payable at death.

Last month we explained how the estate and gift tax are part of a unified transfer tax system. There really should be no difference in treatment between giving away all of your assets the day before you die and having all of your assets pass to others the day you die. Both are transfers of assets you own to someone else and, therefore, both come within the transfer tax system. You only have one estate and gift tax exemption amount to apply to all transfers you make, whenever made (i.e., during life or at death). Thus, if you make *taxable* gifts during life, you are using up some of your lifetime gift tax exemption amount and, at the same time, using the same amount of your estate tax exemption amount. This is not "bad," it's just the way the unified transfer tax system works.

As a reminder, the transfer tax applies to the person who makes a gift or other transfer, not the recipient. Second, a *taxable* gift basically means a "reportable" gift. The maker of the gift–the donor–is the one who reports the taxable gifts he makes. Often, no gift taxes have to be paid when the donor makes a *taxable* gift because the donor has sufficient lifetime gift tax exemption to apply to the *taxable* gifts he makes. In general, *taxable* gifts are gifts made to a person of cash or other assets having a total value greater than the annual exclusion from the federal gift tax for that year. The 2012 annual gift tax exclusion amount is $13,000 per donor per donee (recipient). As long as the total amount of cash and other assets given to a person in a particular year does not exceed the annual gift tax exclusion amount for that year, it's a *tax-free* gift (assuming the gift qualifies as a "present interest" gift, a subject that is beyond the scope of this newsletter). In contrast, *taxable* gifts use up some of the donor's lifetime gift tax exemption and, at the same time, some of his estate tax exemption, too.

There is nothing new about making *taxable* gifts in 2012, although there is a lot of "hype" about making *taxable* gifts this year. Persons with <u>significant</u> "taxable estates" have always considered making *taxable* gifts during life in order to transfer more wealth to children and other beneficiaries at a reduced transfer tax cost. What is causing the hype (and, in some cases, panic) this year is the fact that the exemption amount for 2013 is scheduled to be only $1,000,000. Ignoring the GST exemption, here is a little summary to consider:

2012 estate and gift tax exemption amount:	$5,120,000
2013 scheduled estate/gift tax exempt.amt.:	$1,000,000
2013 Obama proposed est. tax exmpt. amt.:	$3,500,000
2013 Romney proposed exemption amt.:	$5,120,000+

The Obama administration has proposed increasing the $1,000,000 estate tax exemption amount that is on the books for 2013 to $3,500,000, but keeping the gift tax exemption amount at $1,000,000. Mitt Romney has proposed keeping the estate and gift tax exemption amount at the $5,000,000 level, indexed for inflation. Either amount would be a significant improvement over next year's $1,000,000 estate tax exemption amount. Thus, it seems *very likely* that an estate tax exemption amount higher than $1,000,000 will apply next year. In fact, it seems likely that we will have <u>at least</u> a $3,500,000 estate tax exemption amount, going forward.

A main point we tried to make in our last newsletter was this: *making* <u>*taxable*</u> *gifts does not remove the gifted assets from your estate* for federal transfer tax purposes. The total amount of all *taxable* gifts made during life is brought back into your estate tax base at death. In other words, the amount of *taxable* gifts made during life is added to the value of your remaining assets being transferred at death. The estate tax is then calculated on this combined tax base. Thus, again, the gifted amount is not "removed" from your estate for transfer tax purposes. Many people do not understand this and that is why we are trying to explain how the transfer tax system works.

Although the value of the gifted assets is still part of the donor's tax base for estate tax purposes, there are reasons why *taxable* gifts can make sense from a transfer tax standpoint. When people make *taxable* gifts, they are hoping to achieve ultimate transfer tax savings by (i) removing from their estate all appreciation (i.e. growth) in the value of the gifted asset after the asset is given away, (ii) removing from their estate all income earned by the gifted asset after the asset is given away, and (iii) utilizing a gifting technique that "leverages" their exemption amount (i.e., provides "more bang for the buck" than the dollar amount of exemption used).

Based on the assumption that the post-2012 estate tax exemption amount will be at least $3,500,000, couples with combined estates less than $7,000,000 (noting the reminder in the "Something New" section below), and individuals with estates less than $3,500,000, probably don't need to make any *taxable* gifts this year. In fact, people in this situation <u>may do more harm than good</u> if they make *taxable* gifts this year using low basis assets that have appreciated in value. When a gift is made during life, the recipient of the gift has a "carryover basis" in the gifted asset for income tax purposes (i.e., the recipient keeps the same tax basis in the asset that the donor had). This means that if the recipient sells the asset, the recipient will have a capital gain based on the sales price minus his carryover basis (i.e., the donor's tax basis). If, instead, the recipient inherits that asset when the donor dies, the recipient will receive that same asset at its "stepped-up" basis (i.e., the tax basis will be the fair market value of the asset on the decedent's date of death). If the recipient sells the inherited asset the next day, he will not have any capital gain. Thus, considering both estate taxes <u>and</u> income taxes, *if no estate taxes will have to be paid when the owner of the asset dies*, it is better for the recipient to inherit the asset than to receive it now, as a *taxable* gift. The key in this scenario is whether estate taxes will have to be paid on the death of the owner of the asset. And, while we don't know for sure what the future estate tax exemption amount will be, it seems likely that it will be at least $3,500,000. Thus, before *taxable* gifts are made, consideration should be given to **both** the donor's estate tax situation and the income tax basis issue.

For persons with *significant* estates, making *taxable* gifts in 2012 is probably the right thing to do. Defining the term "significant" is not easy. Obviously, just because a married couple can make *taxable* gifts totaling $10,240,000 in value in 2012 without paying gift taxes doesn't mean that a couple with a $20,000,000 estate is going to make gifts of $10,240,000 this year. On the other hand, for individuals or couples with a net worth exceeding $70,000,000 or $100,000,000, utilizing the 2012 gift tax exemption amount seems like a "no brainer."

For those individuals and couples who may or may not have taxable estates, but who have some concerns about future estate taxes, making *tax-free* gifts is the way to go. The term "tax-free gift" includes the $13,000 per donor per donee annual exclusion gift, as well as the direct payment of tuition and medical expenses on behalf of another person. Tax-free gifts do not use up any of the donor's lifetime gift tax exemption amount. Thus, they really are "tax-free transfers" and more people should be utilizing them on a regular basis.

Something New. Before we discuss "something new," we want to remind married couples that the traditional way of making sure that a married couple gets two exemptions from the federal estate tax, and not just one per couple, is to include some type of "Bypass Trust" in the couple's Wills or Living Trust Agreement. This is actually a reminder of another "something old." Under applicable law from 1981 through 2010, while no estate taxes were due on the death of the first spouse if all of his assets passed directly to his surviving spouse (assuming she was a US citizen), when the surviving spouse later died, her estate included 100% of the couple's assets and, since she was just one person, her estate was only entitled to one exemption from the federal estate tax, not two. In other words, the unlimited marital deduction deferred all estate taxes until the death of the surviving spouse, but it caused the estate tax exemption of the first spouse to die to be "wasted" in this case, often leading to the payment of "unnecessary" estate taxes on the surviving spouse's death. Over the years, millions of dollars in estate taxes were paid on the second spouse's death that could have been avoided if the couple had created and funded a Bypass Trust on the first spouse's death. Thus, in these cases, the unlimited marital deduction resulted in a "marriage penalty" for estate tax purposes.

The 2010 Tax Act added *something new* to fix this problem, applicable to estates of decedents who die in 2011 and 2012: the portability election. The main problem with this new portability election is that it is set to expire at midnight on December 31, 2012.

As already noted, if the first spouse dies and leaves everything he owns directly to the surviving spouse (i.e., outside of a Bypass Trust), the first spouse's exemption from the estate tax will be "wasted" because of the effect of the marital deduction. There is no immediate estate tax when the first spouse dies (because of the marital deduction), but 100% of the combined estate of both spouses is subject to estate tax when the surviving spouse dies, and the surviving spouse only gets 1 estate tax exemption, not 2. If the new portability option is elected, the surviving spouse will have 2 exemptions (and not just 1) when she dies to shelter all of the assets from estate taxes. Specifically, she will have her own exemption plus her deceased spouse's unused exemption amount.

To elect portability, the Executor of the estate of the first spouse to die *must* file a Form 706, United States Estate Tax Return, within 9 months of the first spouse's death (or within 15 months of the first spouse's death if an extension of time to file the Form 706 is obtained). This can be viewed as a "disadvantage" of portability because of the cost of preparing a Form 706. However, obtaining two exemptions from the federal estate tax has the potential to save hundreds of thousands (and even millions) of dollars in estate taxes when the second spouse dies, so it can be viewed as money well spent.

Another problem with portability, however, is that it can be lost through remarriage. Even if a Form 706 is filed for the first spouse's estate to elect portability, the deceased spouse's unused exemption amount that is transported to the surviving spouse can be "lost" if (i) the surviving spouse remarries, (ii) the new spouse has little or no unused exemption, and (iii) the new spouse predeceases the first spouse's surviving spouse. Only the unused estate tax exemption amount of the most recently deceased spouse can be used at death by the surviving spouse. Thus, a surviving spouse in this situation should <u>use</u> the deceased spouse's unused exemption to make *taxable* gifts before remarrying, so it won't be "wasted" if her new spouse dies first, with little or no unused estate tax exemption amount.

The good news is that, even though the portability election expires at the end of this year, both parties like it and, therefore, it is likely to be continued as part of any new tax law passed next year.

Something Borrowed. Many people are not comfortable irrevocably giving away $5,120,000 in assets this year just because the lifetime gift tax exemption amount for 2012 is $5,120,000. Before making any gifts of any size, the first question should always be, how much can a person or couple give away and still have enough for his/her/their own support until death? Many financial advisors and CPAs can calculate this amount with a high degree of probability. Thus, persons who have any doubts about their lifetime gifting capacity ought to ask their financial advisor or CPA to "run the numbers" for them, to find out what their "excess" estate amount is. This is the amount that can be given away during life–either to family members or to charity or to both.

One fairly easy gift for individuals and couples to make this year is to forgive outstanding loan balances. Many people lend money to their children--they want to help their children, but they also want them to be responsible and to repay the loan over time. Sometimes, with intra-family loans, lenders forgive note payments in one or more years, which is a gift each time. In those cases, the annually required payment on the loan is usually designed, up front, to come within the gift tax annual exclusion amount, so that forgiving annual payments on a loan will be a tax-free gift. Thus, many lenders of intra-family loans are not really depending on note payments for their support. People in this situation might find it easier, this year, to forgive the full amount owed on a loan than to make large gifts of other assets they own. If the entire amount owed to the lender on a loan, meaning both the outstanding principal balance and all accrued interest, is forgiven this year, the amount forgiven is likely to exceed the gift tax annual exclusion amount. That is not a problem, however, for those persons who still have sufficient lifetime gift tax exemption amount to cover such a *taxable* gift. As noted many times before, *taxable* gifts are gifts that must be reported on a Form 709, US Gift Tax Return; however, most *taxable* gifts made these days do not result in gift taxes having to be paid by the donor because the current lifetime gift tax exemption amount is $5,120,000. Thus, most donors have sufficient gift tax exemption to cover the *taxable* gifts they make this year. Taxable gifts, then, use up some of the donor's lifetime gift tax exemption amount and, at the same time, use up the same amount of the donor's estate tax exemption amount, but do not result in gift taxes having to be paid by the donor unless his exemption is exhausted.

The only "downside" of forgiving the entire balance on a loan as a gifting strategy is that this type of *taxable* gift is not a "leveraged" gift. In other words, the size of the *taxable* gift is the remaining principal balance on the note, plus accrued interest, minus this year's annual exclusion amount ($13,000). It is virtually identical to making a cash gift, which also is not a *leveraged* gift. Because tax exemptions are finite in amount, when people make *leveraged* gifts, they are able to transfer more value than the reported taxable gift amount due to that leverage. We have discussed *leveraged* gifts before and will discuss *leveraged* gifts again in future newsletters.

Something Blue. For something "blue," we decided to mention "clawback." We won't go into too much detail regarding clawback because it is very likely that the clawback problem will be fixed. Based on the first section of this newsletter, and our last newsletter, a *glitch*

KAREN S. GERSTNER & ASSOCIATES, P. C.
A Professional Corporation
Attorneys at Law
5615 Kirby Drive, Suite 306
Houston, Texas 77005-2448

Telephone: (713) 520-5205
Fax: (713) 520-5235

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should appear: if "Sam," a person who never made *taxable* gifts before, gives away $5,120,000 this year (the 2012 gift tax exemption amount), but then dies next year, when the estate tax exemption amount is only $1,000,000 (assume it isn't changed), and Sam's remaining estate at death is $1,000,000, Sam's estate will owe estate taxes on the $5,120,000 he gave away in 2012. This is because *taxable* gifts made by Sam during life are added to Sam's remaining estate at death to produce the tax base on which estate taxes are calculated: $6,120,000. After utilizing the 2013 estate tax exemption amount ($1,000,000), estate taxes will be owed on $5,120,000 ($6,120,000 - $1,000,000). Thus, even though Sam did not have to pay any gift taxes when he made the *taxable* gifts in 2012 (because the total amount he gave away was covered by his lifetime gift tax exemption), estate taxes will be owed by Sam's estate at death, based on the way the unified transfer tax system works. This is an example of "clawback."

While the result above is the way the law has worked for the 31+ years we have been practicing, it seems unfair in this situation. The estate and gift tax exemption amounts have never declined before. They have always increased and that is why this clawback situation has never happened before. Clawback is technically correct, but clearly unfair. Thus, we have selected clawback as "something blue." Again, it is very likely that, if the estate and gift tax exemption amounts actually do decline in the future, the clawback problem will be fixed by Congress.

Something Old And Something New. If the estate and gift tax exemptions decline in the future and if the clawback problem is fixed, then there will be one additional benefit of making a *taxable* gift of the full $5,120,000 exemption amount this year: the exemption reduction savings. In addition to the transfer tax savings of making *taxable* gifts previously discussed, there would be additional transfer tax savings based on the difference between $5,120,000 and the actual future exemption amount times the applicable tax rate. Consult your crystal ball and you will know exactly what to do!

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:

Karen S. Gerstner* karen@gerstnerlaw.com

Sharon Riccucci sharon@gerstnerlaw.com
Biljana Salamunovic biljana@gerstnerlaw.com
Laura Gerstner laura@gerstnerlaw.com

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