# Estate Planning Insights

**Special Edition**

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## 2012 GIFTING CONSIDERATIONS

**The $5,120,000 Lifetime Gift Tax Exemption Amount is Set to Expire at the End of This Year.** As you know (and who would not know by now), the current $5,120,000 lifetime gift tax exemption amount is set to expire at midnight on December 31, 2012, unless changed by Congress. As you also know, the lifetime gift tax exemption amount that is on the books for next year is only $1,000,000. Most people believe that Congress will increase the $1,000,000 post-2012 lifetime gift tax exemption amount to a higher amount, but no one knows that for sure and no one knows the actual future exemption amount.

Prior to his re-election, President Obama proposed that *the 2009 exemption amounts be re-instated* for 2013 and beyond. As you recall, in 2009, the estate tax exemption amount was $3,500,000, while the lifetime gift tax exemption amount was (only) $1,000,000. So, political advisors are not sure whether President Obama was proposing this same split in the exemptions for 2013 and beyond, or proposing to use $3,500,000 for *both* the estate tax exemption amount and the lifetime gift tax exemption amount for years after 2012.

Some of our clients have used, and are using, their $5,120,000 lifetime gift tax exemption amount this year. Many of these clients are making gifts of interests in family limited partnerships (FLPs) and/or in limited liability companies (LLCs) to "intentionally defective, dynastic [GST-exempt] grantor trusts" (IDGTs). Some are making gifts of real estate to IDGTs. Some are creating and funding Irrevocable Life Insurance Trusts with single premium payments (subject to the MEC rules). Some clients are forgiving loans made to children in prior years--that's an easy way to use some of your lifetime gift tax exemption amount.

We have been really swamped helping our clients with their 2012 gift planning matters and we do not have very much capacity left–certainly not enough capacity to create *new* entities before year-end. Thus, the purpose of this newsletter is not to "drum up business" but to make sure that you have considered whether it would be appropriate for you to make any *taxable gifts* this year. The firm's prior newsletters sent earlier this year discussed the benefits of making taxable gifts. You may already have entities in place (IDGTs or other irrevocable trusts and/or FLPs and/or LLCs) that you can use to make "taxable gifts" before year-end, if you wish. Even if you don't have entities in place (like FLPs or LLCs) that you can use to make taxable gifts, if you have irrevocable grantor trusts in place that include a "swap power," gifts of cash can be made to those trusts before year-end and that cash can then be swapped out of the trust in exchange for other assets of equal value next year.

Before making *sizeable* taxable gifts, however, you should consider a variety of issues and factors. In other words, you should not "let the tax tail wag the dog." Here are *some* taxable gift considerations (some of which were discussed in our newsletters sent earlier this year):

1. Carryover Basis. 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. This is called "carryover basis." In other words, if a parent (the donor) gives his child (the donee) property currently worth $100,000, which has an income tax basis of $20,000, the donor must use $100,000 of his lifetime gift tax exemption amount (which will, at the same time, use the same amount of his estate tax exemption amount) 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 capital gains taxes on that gain. *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. Thus, if the child instead were to receive the 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. The other factor to consider, however, is whether giving away the property now will save estate taxes later. That will be the case if the property greatly increases in value and/or produces a lot of income *after* the gift is made.

2. What Effect will the Gift Have on your Children? Giving too much to children (or others) too soon can lead to the affliction referred to as "affluenza." Nothing ruins a young 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 one advantage of making lifetime gifts to children, grandchildren and other family members. Most wealthier clients, however, make significant taxable gifts to *trusts* for children and grandchildren, rather than to them directly (i.e., outright). And, most wealthier clients use "lifetime, divorce and creditor-protected trusts" for children and grandchildren that are "grantor trusts" for federal income tax purposes (i.e., IDGTs). We have discussed these planning ideas in prior newsletters.

3. Using Your Lifetime Gift Tax Exemption Also Uses Your Estate Tax Exemption. When a donor makes a taxable gift that uses up some of his lifetime gift tax exemption amount, he is also using the same amount of his (future) estate tax exemption amount. So, it's not true that, if you give away $5,120,000 this year, you "remove" that amount from your estate. Taxable gifts are brought back into the estate tax base at death, upon which estate taxes are calculated. Thus, when you make taxable gifts during life, you are "freezing" the value of the gifted assets for estate and gift tax purposes. What you are *removing* from your estate for estate tax purposes is the post-gift appreciation (growth) in value and the post-gift income produced by the assets given away. In some cases, this post-gift growth and income is substantial, so we are not saying it is not worth it to make taxable gifts during life, but we are saying that some people who have been "promoting" making taxable gifts this year are misleading people into thinking that there is no future tax consequence at all–that it's a "total freebie" under the tax laws (not true). Further, if the future estate and gift tax exemption amounts turn out to be lower than the $5,120,000 in effect for this year, Congress is going to have to fix the "clawback" problem that will arise due to that drop in the exemption. Clawback happens because taxable gifts are brought back into the donor's tax base at death and if the estate tax exemption amount is lower at that time than the gift tax exemption was in the year when the taxable gifts were made, estate taxes will be owed on the "excess" taxable gift amount, even though no gift taxes were payable when the taxable gifts were made. Most political pundits believe that the clawback problem will be fixed but, as of this moment, we don't know that for sure.

4. Retaining Sufficient Assets for your Own Support. At a recent conference, two lawyers, plus an IRS agent, were on a panel discussing ways for clients to use their $5,120,000 lifetime gift tax exemption amount this year. The IRS agent made this comment: "Lawyers have an obligation to prevent clients from putting themselves in a position they will later regret. Before entering into somewhat convoluted transactions in 2012, to take advantage of a large gift exemption that *may* disappear, lawyers should carefully consider the client's other assets, the client's age and life expectancy, other, future ways to utilize exemptions, etc."

**The Future is Uncertain.** We do not know what the future will bring. Nearly everyone believes that Congress will have to address *all* of the tax issues sometime soon and most believe that the post-2012 estate and gift tax exemption amounts will be increased above the $1,000,000 amount that is on the books. Even if only the estate tax exemption amount is increased from $1,000,000 to $3,500,000, married couples with a Bypass Trust in their Wills or Living Trust will be protected up to $7,000,000 (and single people will be protected up to $3,500,000). They will also be protected if "portability" is continued (which seems likely). In the meantime, hopefully, you have already considered the current situation and have come to your own conclusion about what, if anything, is best to do this year.

**Questions?** If you have any questions about the material in this publication, 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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