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Tax Law

ALERT

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Taxable Gifts in 2010 – Opportunity Knocks, But The Door Is Closing

The failure of successive Congresses and Presidents to address the federal estate and gift tax system since 2001 has created unprecedented uncertainty, but also an historic opportunity: Make a taxable gift in 2010 to save taxes and benefit your intended beneficiaries.

If, after reviewing this Tax Law Alert, you want to make such gifts, you should contact us as soon as possible. Waiting until December may not allow sufficient time to implement such planning.

Background. The federal estate and gift tax system consists of three different taxes: the estate tax, the gift tax, and the generation-skipping transfer ("GST") tax. In 2010, these taxes changed in unprecedented ways. Beginning in January 2011, these taxes will change yet again.[1] The changes that have occurred in 2010, but which will expire on December 31, 2010, offer you a very short-term opportunity, as discussed below.

The Estate Tax Situation. To understand the gifting strategy discussed below, it is important to understand why removing assets from your estate in 2010 represents a way of reducing your overall estate tax.

- In 2009, there was a $3,500,000 exemption from the estate tax, and a 45% tax rate on transfers at death above $3,500,000.
- In 2010, there is no federal estate tax (in effect, an unlimited exemption and a 0% estate tax rate).
- Beginning on January 1, 2011, it appears there will be an estate tax with a $1,000,000 exemption from the estate tax, a graduated estate tax rate (from 18% to 53%) on the first $2,999,999, and a 55% tax rate on transfers at death above $3,000,000.[2]

The table below shows these changes:

Year of Death	Estate Tax Exemption	Maximum Estate Tax Rate
2009	$3,500,000	45%
2010	No Estate Tax	No Estate Tax
2011	$1,000,000	55%

The Opportunity – Making Taxable Gifts in 2010. Buried in this tax mess is a unique opportunity.

- *The Gift Tax.* As noted above, there is no estate tax in 2010. However, an individual who wants to transfer assets during her lifetime in 2010 must pay a gift tax on gifts in excess of the lifetime gift tax exemption. In other words, transfers at death are taxed at 0% in 2010, but lifetime transfers, even if made in 2010, are subject to gift tax.

[1] The tax savings discussed in this Tax Alert are based upon the law that we understand will go into effect in 2011, but subsequent changes in the law may have an impact on the extent of any actual tax savings derived from the making of gifts in 2010.

[2] Prior to 2002, a 5% surtax was levied on taxable estate values from $10 million through $17.184 million to reclaim the benefits from the graduated marginal rates below 55%. The surtax was repealed in 2002. Under current law, the surtax would be reinstated in 2011.

- *The Gift Tax Exemption and Rate.* In 2010, the exemption from the gift tax is $1,000,000. This means that an individual can transfer by gift up to $1,000,000 during her lifetime (in addition to annual exclusion gifts of up to $13,000 per beneficiary and unlimited gifts for tuition and medical expenses paid directly to the provider) without paying gift tax. In 2009, the maximum gift tax rate was 45%. This rate dropped to 35% in 2010, but jumps to 55% in 2011. The table below shows these changes:

Year of Gift	Gift Tax Exemption	Maximum Gift Tax Rate
2009	$1,000,000	45%
2010	$1,000,000	35%
2011	$1,000,000	55%

Lowest Gift Tax Rate. The 35% rate is the lowest in generations. The maximum rate is set to increase to 55% next year.

The Opportunity. The opportunity presented is simple: ***Gift tax rates are very low now, and are about to increase by 20% (representing a more than 50% rate increase) in just a few months. Making a gift now and paying a lower rate may be preferable to paying a higher rate later, whether as a gift tax or estate tax, in 2011 and beyond.***

Reasons to Make Gifts. Separate from the low rates, there are other reasons to make gifts in 2010.

- The values of many assets are currently depressed. Real estate, stocks, and interests in businesses are at low market values as the economy continues to dig out from the worst recession in over 50 years. Gifts made at lower values mean less gift tax on such gifts.

- Making gifts of these assets now means that any income from, and all future appreciation in, the transferred assets will not be subject to estate tax in the donor's estate. Making a gift now removes the asset from the donor's estate, leaving all the potential upside to the beneficiaries without having to pay tax at the donor's death on the post-gift income and gains.

- Valuation discounts for assets other than cash and publicly traded securities may be available to further lower the value of a gift. Valuation discounts may not be available if the asset remains in the taxable estate.

Example. A simple example demonstrates the benefits of making gifts at a 35% rate in 2010. Assume an individual has $10,000,000 in net worth and has used his lifetime $1,000,000 gift tax exemption. The individual considers two options:

- Option 1: Make a $3,000,000 taxable gift in 2010 (at a 35% tax rate), leaving the balance of his assets subject to estate tax at 55%.[3]

- Option 2: Do nothing, leaving the balance subject to estate tax at 55% in 2011 or later.

	Option 1 Make Taxable Gift	Option 2 Do Nothing
Initial Assets	$10,000,000	$10,000,000
Gift in 2010	$3,000,000	$0
Gift Tax (.35 of Gift)	$1,050,000	$0
Assets Subject to Estate Tax (Initial Assets less Gift and Gift Tax)	$5,950,000	$10,000,000
Estate Tax (.55 x Assets Subject to Estate Tax)	$3,272,500	$5,500,000
Total Tax (Estate plus Gift)	$4,322,500	$5,500,000
Assets Left to beneficiaries (Initial Assets less Total Tax)	$5,677,500	$4,500,000
Additional Assets to Beneficiaries	***$1,177,500***	

– Considering the benefits of making gifts with depressed assets that could appreciate in value, using available valuation discounts, and potentially removing appreciation from your estate, a taxable gift in 2010 represents a powerful way to take advantage of the current tax law.

– Note that this example assumes the donor survives for three years after the date of the gift. If the donor does not survive for three years, the gift tax paid is pulled back into the donor's taxable estate. While this reduces the magnitude of the planning opportunity, the net result should still be positive.

[3] For illustration purposes, this example uses the highest marginal estate tax rate for its calculations. The graduated rate structure for estate taxes (climbing in a graduated fashion to 55%) will reduce the estate tax shown in this example.

A Second Opportunity – Taxable Generation-Skipping Gifts in 2010. In addition to the estate tax and gift tax, there is a separate generation-skipping transfer ("GST") tax on any transfer of assets to a grandchild or more remote descendant (or to unrelated individuals more than 37 ½ years younger than the donor). This tax has a separate exemption and is imposed in addition to the gift tax or estate tax. There is no GST tax for generation-skipping transfers occurring in 2010.

The GST Tax Exemption and Rate. The exemption from the GST tax and the GST tax rate have changed. The table below shows these changes:

Year of Transfer	GST Tax Exemption	GST Tax Rate
2009	$3,500,000	45%
2010	No GST Tax	No GST Tax
2011	$1,000,000[1]	55%

No GST Tax. The repeal of the GST tax in 2010 means there is no separate tax on making transfers to grandchildren if the gift is made in 2010. The GST tax is reinstated in 2011, at a rate of 55% with an exemption of $1,000,000.

The Opportunity. Without a GST tax, there exists a short term opportunity to transfer wealth to grandchildren without incurring a separate GST tax. Clearly, making a generation-skipping gift now at no GST tax cost is preferable to paying a GST tax on the same gift in just a few months.

Example. An example illustrates the benefits of making generation-skipping gifts in 2010. Assume an individual wants to make a $1,000,000 gift to his grandchild. He has used his gift tax and GST tax exemptions. The individual considers two options:

- Option 1: Make the $1,000,000 taxable gift in 2010 (at a 35% gift tax rate but no GST tax).
- Option 2: Make the $1,000,000 taxable gift in 2011 (at a 55% gift tax rate and GST tax rate).

	Option 1 Generation-Skipping Gift in 2010	Option 2 Generation-Skipping Gift in 2011
Value of Gift	$1,000,000	$1,000,000
GST Tax	$0	$550,000
Gift Tax	$350,000	$852,500
Total Taxes on Gift	$350,000	$1,402,500
Sum of Gift and Taxes	$1,350,000	$2,402,500
Net Tax Savings by Making 2010 Gift	***$1,052,500***	

– ***The total tax rate on a $1,000,000 generation-skipping gift in 2010 is 35% ($350,000 on a gift of $1,000,000) The total tax rate on the same $1,000,000 generation-skipping gift in 2011 is over 140% ($1,402,500 on a gift of $1,000,000).*** In effect, the temporary repeal of the GST tax allows individuals to transfer significant wealth directly to their grandchildren without triggering a separate GST tax, and this has not been the case for 25 years.

– Making gifts to grandchildren offers the ability to "skip" generations. Transferring assets to children, with the ultimate goal of the children leaving those assets to the donor's grandchildren, can result in a transfer tax at both the donor's generation and the child's generation. Making a direct gift to grandchildren avoids any transfer tax upon the death of the middle generation.

– ***One special note of warning.*** The GST tax is scheduled to return in 2011. If a gift in 2010 is made to a grandchild in trust, it is not clear that the trust (and distributions from it to the grandchild) will be exempt from GST tax in 2011. Because gifts in trust can raise complex tax issues, we recommend gifts to grandchildren be made, free of trust. If you are concerned about giving a grandchild too much control over assets, but want to take advantage of the temporary repeal of the GST tax, there are possible strategies that may work to restrict a grandchild's ability to control assets.

[1] This number is subject to adjustment for inflation.

Time is of the Essence. The opportunities described above have a short fuse.

- The increase in gift tax rates and the return of the GST tax are only a few months away.
- Making a large gift requires careful planning. You will need to determine what assets to transfer and those assets may need to be appraised. We will need to discuss the costs and benefits of the gift, the legal structure of the gift, and we will need time to prepare the necessary documents.
- All of this must be completed before January 1, 2011.
- To meet this deadline and to enable the careful planning required when making a large gift, you should contact us as soon as possible if you are interested in these planning opportunities. There is still time, but not much.

Final Thoughts. The conventional wisdom was that the government would act to restore the estate tax and GST tax and to increase the gift tax rate before 2010. That wisdom was wrong, and the government's inaction presents exceptional opportunities. If the past is any guide, the government may fail to act again, and the estate tax, GST tax, and gift tax could be imposed at 55% in 2011 and beyond. Moreover, even if the government restores the estate tax, GST tax, and gift tax in the same manner as the tax law in effect in 2009, the benefits of 2010 gifts can be substantial. Depending on your circumstances, 2010 (or what is left of it) may be the time to make a large gift. We welcome your call.

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