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Trusts and Estates Law

ALERT

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$5,120,000 Lifetime Gift Tax Exemption Expiring Soon

The Clock is Ticking: The tax law is set to change in a radical way and opportunities may cease to exist at midnight on December 31, 2012.

1. **History.** To understand the impending deadline, a little history is in order. Former President George W. Bush signed a number of tax cuts into law in 2001 and 2003. The "Bush Tax Cuts" would have expired on January 1, 2011, but Congress and President Barack Obama, after a contentious debate at the end of 2010, extended the Bush Tax Cuts until January 1, 2013. The extensions included a new element, an unexpected increase in the estate tax, gift tax, and generation-skipping transfer tax exemptions to $5 million in 2011 and $5,120,000 in 2012.

2. **Effect of Increase.** Because of this increase, an estate having a net value of $5,120,000 or less is completely exempt from the estate tax (this tax-free result applies to the estate of a decedent who dies in 2012 and who did not make significant lifetime gifts). In addition, the increase in exemption allows individuals (regardless of the size of their estate) to make gifts during their lifetime of up to $5,120,000 before December 31, 2012, without incurring a gift tax. This tax exemption for lifetime gifts is in addition to, and does not include, smaller annual gifts of up to $13,000 or certain direct payments to schools or healthcare providers, excluded under a separate exclusion. Finally, the increased generation-skipping transfer tax exemption permits these gifts to benefit grandchildren and more remote descendants.

The increased exemptions apply only until December 31, 2012. Unless Congress and the President take action, the extensions expire and, as of Jan.1, 2013, the new exemptions and rates are as follows:

- The estate and gift tax gift tax exemptions fall to $1 million;
- The generation-skipping transfer tax exemption falls to $1 million, plus an inflation adjustment from 2001 to approximately $1,340,000;
- The tax rate on transfers above the exemptions increases from 35 percent to 55 percent;
- In the simplest terms, an individual can make a large gift in 2012 without owing any gift tax, **while the same gift in 2013 would result in a large gift tax liability**;
- There are two consequences and benefits to the current situation:
  - **First, a gift in 2012 represents what could be a one-time opportunity to transfer wealth to children or other beneficiaries without paying a gift tax and to accomplish multi-generational planning without paying generation-skipping transfer tax.**
  - **Second, these gifts can save estate taxes by removing the post-gift appreciation on and income from the gifted asset from an estate.**

3. **No One Knows What Will Happen.** Governmental gridlock in 2010 permitted an unexpected one year repeal of the estate tax, and the government lost billions of dollars in revenue.

No one predicted what happened in 2010, and no one can predict what will happen this year. If no legislative changes occur relating to estate, gift, and generation-skipping transfer taxes, the scheduled changes will take effect on January 1, 2013, and the opportunity to make large tax-free gifts may not occur again.

4. **Some Cautions.** Appreciated property transferred by gift does not receive an income tax basis increase to fair market value, as does property that is included in a decedent's estate at death. Part of the estate tax savings will eventually be "paid back" through higher income taxes when the donee sells the property that was the subject of the gift or through forgone depreciation deductions. The capital gains tax rate, however, has almost always been lower than the estate tax rate, so a significant savings is still likely. Also, gifts of cash do not present this basis issue.

A second concern is the possibility of "clawback" (i.e., an added estate tax that takes back some of the tax-free benefits of 2012 gifts). The gift tax and estate tax work on a unified basis. On a decedent's estate tax return, the taxable gifts he made during his lifetime are added at their date-of-gift value to the other assets of his estate. The estate tax is computed on this combined amount. The estate is then allowed a credit against the estate tax for gift tax that the decedent paid and the credit equivalent amount of his lifetime exemption.

If a person makes a gift in 2012 to use his $5,120,000 lifetime exemption, but in the later year of his death the exemption is only $1 million, some uncertainty exists about what credit equivalent amount will be subtracted to determine his estate's tax liability. In order for the current $5,120,000 exemption to work properly, the estate would have to be allowed a credit in the amount of the tax payable on $5,120,000 in the year of the decedent's death. Some concern exists, however, that the credit may be limited to the estate tax payable on $1 million or other lifetime exemption amount in effect in the year of the decedent's death. As a result, a significant part of the 2012 gift ultimately would be subjected to estate tax. This issue has never arisen before because, until now, the amount of the lifetime exemption has never been reduced from its previous amount.

Nobody knows today how this computation will work and the current law clearly was passed without any consideration of a possible clawback of the tax benefit of gifts using the current gift tax exemption. Congress is aware of this issue. H.R. 3467, the Sensible Estate Tax Act of 2011, introduced last November, contains language to prevent a clawback. Even if a clawback were to occur, however, any income earned on and any appreciation in the value of the gifted property between the date of the gift and date of the donor's death would still escape estate taxes.

5. **Conclusion.** Without a crystal ball, all we can know is that those who can afford to do so should consider 2012 gifts. As with all estate planning transactions, you should discuss these matters with your professional advisors, and determine that these gifts are appropriate in your financial and family circumstances. Because planning and implementing large gifts take time, however, you should start now to avoid hasty, last-minute decisions that may prove to be counterproductive.

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