SHOULD I UTILIZE MY $5 MILLION GIFT TAX EXCLUSION?

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Introduction

In December of 2010, a last minute deal in Congress concerning the estate and gift taxes increased the gift tax exemption to $5 million. This amount matches the $5 million estate tax exemption. However, this $5 million exemption ($10 million for a married couple) is only effective for the tax years 2011 and 2012. Congress also lowered the estate and gift tax rate to a top rate of 35% in 2012.

Unfortunately, the law is short-lived and will end on January 1, 2013. Unless Congress acts on the estate and gift tax, the gift tax exemption and the estate tax exemption will both be lowered to $1 million. In addition, the top estate tax rate will return to its 2001 level of 55%.

With a $5 million gift and estate exemption and the possibility of the exemption returning to $1 million, many people are scrambling to determine whether it is a good idea to utilize all or part of their $5 million exemption by making major gifts. Clients with assets in excess of $1 million often want to know what effect the change in the law will have on their estate and whether their current non-taxable estate will become taxable unless they make a gift.

A 2012 Gift May Not Change Your Ultimate Estate Tax Liability

Unless 2011 and 2012 gifts are eventually grandfathered in under a change in the law, a large gift may not change your tax liability. Assume that you have a $2.5 million estate. If you pass away in 2012, you would be well below the $5 million exemption and no estate tax would be paid. However, if you die in 2013 and the exemption was $1 million, you would end up with a $1.5 million taxable estate which would result in a tax liability of over $700,000.

If you utilized your gift tax exemption and gave away $1.5 million in 2012 it very well may not change the outcome above. When you die in 2013 with $1 million of assets and a $1 million estate tax exemption, you might think you are home free (other than being dead). However, the gift and estate tax rules operate together and the $1.5 million taxable gift is brought back into your estate increasing your estate to $2.5 million and resulting in the same $700,000 tax liability. Consequently, while many people are suggesting you make large gifts this year, the benefits may be overstated.

There are advantages and disadvantages of making the gifts. Some advantages include:

1. Congress may grandfather in large gifts this year even if the estate tax exemption is lowered.

2. You will remove from your estate the appreciation on the gifted assets between the time of the gift and the date of your death. If the $1.5 million in gifted assets increase

to $2.5 million by the time of your death, you effectively eliminated $1 million of assets from your estate and saved over $500,000 in taxes by making such gifts.

3. You can leverage your gifts by utilizing valuation discounts when you gift shares of a limited liability company or a corporation. Or you can leverage your gifts through uses of charitable remainder trusts, charitable lead trusts and other estate planning tools. There are many vehicles to maximize your gifts which you should discuss with your advisor.

Capital Gain Disadvantage

When you are dealing with appreciated assets, you may be better off not making the gifts and instead simply transfer the assets upon your death. The reason is that assets that are gifted take a carryover basis of the donor. Consequently, if you gift stocks worth $1 million that have a $100,000 tax basis to your children and your children sell those stocks, they will have a $900,000 capital gain. However, if you held those stocks until your death and they were still valued at $1 million, your estate will receive a step up in tax basis to $1 million on those stocks. Consequently, when your children sell those stocks (assuming they sell them for $1 million) there would be no capital gain. By rushing to get assets out of your estate to avoid estate tax, you may actually be causing capital gains taxes. This would be an especially unfortunate result if it turns out you would not have had to pay estate tax even without making the gifts.

In Conclusion

To make a large gift this year, you should be very comfortable in your remaining net worth and also with how your donees will utilize the gifts. There are a number of vehicles you can utilize to make gifts if you feel uncomfortable about leaving a large amount to your children all at once. For example, you can create trusts for those children so that they do not have immediate access.

You should meet with your estate planning advisor to discuss the possibility of gifts under your particular set of facts. There are no easy answers to the decision whether to make the gifts. Some people with a $4 million taxable estate should want to make gifts while other people with a $4 million taxable estate are in different circumstances and should not want to make a large taxable gift. Now is a good time to review the situation to make sure that any planning is due prior to December 31.

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