Is the $5 Million Gift Tax Exempt Amount About to End?

November 10, 2011

The Tax Relief Act of 2010 made significant changes to the gift, estate and generation-skipping transfer tax regimes by increasing the amount each individual can give without incurring tax from $1 million to $5 million. The increase was not permanent however, and rumor has it that it may be in jeopardy. To avoid any risk, those who have decided to use their full exemptions should do so no later than December 31, 2011, and, if feasible, November 22.

The Rumors

The Tax Relief Act of 2010 made significant beneficial changes to the gift, estate and generation-skipping transfer tax regimes. Most important, it increased the amount each individual can give without incurring gift tax and generation-skipping transfer tax to $5 million from $1 million. For married individuals, the combined exemptions can be as high as $10 million. The 2010 increase was not a permanent one. Congress scheduled the exemption to return to $1 million after the end of 2012.

Rumors circulating recently within the financial and estate-planning communities have suggested the $5 million exemptions may be in immediate jeopardy. Democratic staff on the U.S. House Committee on Ways and Means recently proposed decreasing the $5 million gift, generation-skipping transfer tax and estate tax exemptions to $3.5 million, effective January 1, 2012. There also are rumors the Joint Select Committee on Deficit Reduction (the Super Committee) may recommend a drop down in the gift tax exemption to $1 million, effective at year end, or possibly as early as November 23, 2011, when its recommendations are scheduled to be released, though there is no confirmation this rumor is true.

What Should You Do?

Although it seems unlikely that Congress will focus on changes to the transfer tax system before year end, congressional action in the transfer tax area has been notoriously difficult to predict. Congress' decision in December 2010 to reinstate the estate tax retroactively, to permit the estates of 2010 decedents to opt out of paying estate tax and to reduce the generation-skipping transfer tax rate to zero, was a noteworthy example of congressional action that took the entire estate-planning community by surprise. A congressional decision to reverse the 2010 transfer tax reductions would be more surprising because it would immediately strip from taxpayers a benefit that was clearly agreed to last December. However, Congress is unpredictable.

In view of the uncertain availability of the $5 million exemption, those who have decided to use their full exemptions may want to do so quickly, rather than run the risk of losing them. To avoid any risk, your deadline should be no later than December 31, 2011, and, if feasible, November 22. The choices to be made include identifying the property to be transferred, selecting the individual recipients and determining the manner in which the recipients should receive their gifts.

Selection of Assets to Give

Assets to be transferred to the trust should be those that are likely to appreciate over time. The transfer of appreciating assets will help leverage the initial gift. Investments that are temporarily depressed as a result of recent market conditions, for example, could prove to be successful gifts. Remainder interests in residences in today's depressed housing markets may also be attractive gifts. Marketable securities, interests in hedge funds or other investment partnerships and real estate are all good possibilities. High-basis assets typically are a good choice, but assets that are valued today at less than their basis are not usually the best choice.

If non-marketable assets are given, an appraisal of those assets is needed to properly value and report the gift, but the appraisal can be completed after the gift is made. In most instances, a formal appraisal of non-marketable assets will take into account certain valuation discounts (for example, lack of marketability and minority interest discounts). The effect of these valuation discounts will be to further leverage the gift tax credit.

Selecting Recipients

The logical recipients of gifts will be those family members who will receive the estate. Because tax-free gifts can be made to a spouse and charity, gifts to them do not need to be accelerated to take advantage of the gift tax exemption. In some cases, clients may plan to use their increased exemptions to forgive debts previously made to friends and family members with financial needs, or to meet the living expenses of adult children.

Making Gifts in Trust

Outright gifts are a simple way to use the gift and generation-skipping transfer tax exemptions, but gifts in trust offer many more advantages. For example, transferring assets to a trust for the benefit of children can protect those assets from the claims of their creditors or spouses. In addition, with a trust the trustees of the trust can control the timing and manner of distributions to children.

Furthermore, if portions of the remaining $5 million generation-skipping transfer tax exemption are allocated to the trust, future distributions to grandchildren and more remote issue can be made free of the generation-skipping

transfer tax. Finally, if the trust that is established is a so-called “grantor trust” for income tax purposes, you, and not the trust, will pay the income tax on the income generated inside the trust. When the gift-giver pays the income tax on the income of the trust, the size of the estate is reduced without having to make additional taxable gifts to the trust.

An Existing Trust or a New Trust?

Once the decision is made to make a gift in trust, the next question is whether to make the gift to an existing trust or to a new one. Whether an existing trust or a new trust is selected is a function of a number of considerations, such as whether the trusts that are already created have the appropriate beneficiaries, whether a spouse also plans to make a gift in trust and whether certain provisions should be in the trust to address uncertainties at this time.

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