Should You Give It Away?

For wealthy individuals and couples, gifting has always been an important part of estate planning. And now that the gift tax exemption stands at $5 million (5.12 million adjusted for inflation in 2012) and the top gift tax rate is 35%, the tax environment is especially favorable for making large gifts. Gifts of up to $5.12 million ($10.24 million for couples) in 2012 incur no gift tax. BUT – these levels are scheduled to expire after 2012, with the exemption automatically shrinking to $1 million and the top tax rate jumping to 55% on January 1. So – should you take advantage now? If you do, are there any pitfalls? .

1. <u>If you think Congress will act before next January 1 to make the $5 million exemption and 35% tax rate permanent, there's no pressure to act</u> (and I've got a bridge I'd like to sell you).
2. <u>On the other hand, if you expect Congress to allow the estate tax to revert to 2001 levels</u> – a $1M exemption and 55% top tax rate – you should seriously consider a gifting strategy – but you should be aware of a potential pitfalls.

First, the advantages. If you can afford to give up some or all of the benefit of the gifted property, it will remove from your estate all of the appreciation on and income from the property and avoid state estate taxes in states, such as Maryland, where there is no state gift tax.

Second, the pitfalls. Your donees will loss the benefit of the "step up" capital gains basis (although this will not be a problem if the asset already has a high basis), and gifts will still be included in your federal taxable estate and subject to the unlikely, but possible "clawback" tax, a scenario in which you might lose the benefit of the $5.12 million exemption.

To understand the "clawback" issue you should know how the estate tax actually is calculated (optional reading for the mascohistic):

Example 1. Assume a man is unmarried and owns assets worth $6 million, and makes a gift of $5 million in 2012, fully shielded by his $5 million exemption. He then dies, also in 2012, owning the remaining $1 million. When the trust or estate attorney prepares his federal estate tax return, the 2012 taxable gift of $5 million must be added back into the taxable estate at the date-of-gift value for purposes of calculating the estate tax amount. (Yes, it doesn't make sense. Write your Congressperson.) Thus the full $6 million would be included in the man's taxable federal estate, but would be offset by full use of his $5 million estate tax exemption[1]. This is done so that the remaining $1 million is "bumped" into a higher estate bracket, if there are higher brackets at the time of death. As long as the estate tax exemption available at death ($5 million in this example) is at least the same as the gift tax exemption used during life (also $5 million in this example), however, only the $1 million would be taxed.

In this example, the only advantage to making the gift is that any future appreciation in the gifted asset's value is shielded from gift and estate taxes, although there may be a capital gains income tax disadvantage because of loss of the "stepped up" basis to the donee of the gift.

Example 2. Now assume the gift and estate tax exemptions are $5 million in 2012, as in Example 1. Also assume future legislation establishes the exemption at $3.5 million after 2012, keeping the estate tax rate at 35% (a legitimate possibility if Congress finally gets its act together next year). Assume you own $6 million and in 2012 you gift $5 million to your adult children, fully shielded by your 2012 exemption. You die in 2013, owning the remaining $1 million.

Following the methodology described above in Example 1, to calculate your estate tax, you must include the gifted $5 million in your estate tax calculation, and then make full use of your estate tax exemption, which we have assumed to have decreased to $3.5 million. The result is to expose to the 35% estate tax not only your remaining $1 million, but also another $1.5 million (i.e., the decrease in exemption from $5 million to $3.5 million). The result could be an estate tax of $875,000 on an estate of $1 million. If the estate tax rate in 2013 is assumed to be 45%, the result could be an estate tax of $1,125,000 on an estate of $1 million – and Internal Revenue Service might try to collect $125,000 from the gift recipients!

This result is the "recapture problem" or "Clawback." Important – despite the Clawback, making the gift does NOT incur any additional tax. The estate ultimately receives just the benefit of the applicable exclusion amount at the individual's death if the Clawback applies. But liquidity certainly is an issue in this example – how will the estate tax will get paid, and which beneficiaries will bear the cost

Will Clawback happen?

Probably not, at least according to most tax experts, who contend that the Clawback interpretation is flawed. Many point to the obvious public policy concerns raised by such a tax – it obviously is unfair for taxpayers to make gifts in reliance on the current tax law and later be subject to tax because those laws change, and it is "likely not what Congress intended."[2]

But if Clawback happens . . .

If Clawback happens, the donor's estate still is likely to have benefited from the gifts made in 2012. The Clawback would be at the amount of the taxable gift, not the current value of the property given away. Therefore, the appreciation on the property given will not be taxed.[3] If the gift had not been made, the amount of the gift plus appreciation would be subject to tax. In a large estate, this can be significant.

In summary . . .

On balance, taking advantage of a $5 million exclusion that likely will disappear in 2013 is a great opportunity, and it is recommended for large estates with high basis assets that are likely to substantially appreciate. But – as always, a cost-benefit analysis should be made of the risk and timing of the gift, and the loss of control in the assets.

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[1]Technically it's not an exemption, but a credit equivalent. However, it is more understandable to refer to it as an exemption.
[2]Am. Bar Ass'n, Estate and Gift Tax Comm., *Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 27 (2011)*
[3]But this must be balanced against the loss of the "stepped up" basis of the assets that would be available if the assets passed at death.