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EstatePLANNING

To gift or not to gift? A very good question

The changes to the federal tax laws in December 2010 have created opportunities and risks. The purpose of this article is to show that the techniques are still with us, the opportunities are greatly enhanced and the risks are minimal.

Federal Law Changes

Prior to the 2001 "Bush Tax Cuts," the federal estate and gift taxes were "unified." For example, when the federal estate tax exemption was \$675,000 per person, the federal gift tax exemption was also \$675,000. Under this regime, a taxpayer could choose to use her exemption either during her lifetime or at her death, or partially in both.

The 2001 legislation, however, "decoupled" the estate and gift taxes. In doing so, the estate exemption rose from \$1,000,000 per person in 2001 to \$3,500,000 per person in 2009, while the gift tax exemption remained at \$1,000,000. Consequently, a taxpayer who made a lifetime gift of \$1,100,000 would have to pay a federal gift tax regardless of whether she died in 2001 or 2009. If the taxpayer had not made the gift, her \$1,100,000 estate would have been taxable if she had died in 2001, but not if she had died in 2009.

The 2010 law once again "coupled" the federal estate and gift taxes, but it did so in a strange way. Specifically, the law raised the federal estate tax exemption to \$5,000,000 for 2010, 2011 and 2012. However, it left the gift tax exemption at \$1,000,000 per person for 2010, and raised it to \$5,000,000 per person in 2011 and 2012.

Aside from that quirk in the law with regard to gifts made in 2010, this increase in the federal gift tax exemption has created excellent planning opportunities because individuals can use the increased gift tax exemption to remove the growth on up to \$5,000,000 of assets from their taxable estates.

For example, if we assume that a donor lives for 20 years after making a \$5,000,000 gift and we assume that the gifted asset has an annual rate of growth of 3.5%, then the \$5,000,000 will have increased to \$10,000,000 with no estate tax being paid on the appreciation. If the growth rate is 7% per year, the gift would grow to \$20,000,000 at the end of the 20-year period.

Does it make sense to make gifts? Yes. The accepted techniques are still valid, even though the Treasury Department wants to limit or eliminate some. The Treasury Department has

had a "wish list" for years which has never borne fruit, thus leaving individuals free to pursue the following options:

- If you have a second home, consider transferring it to a Qualified Personal Residence Trust (QPRT), especially if the property has fallen in value over the past few years.
- Create a Grantor Retained Annuity Trust (GRAT) while interest rates are still low and fund it with assets that you believe will appreciate within the next few years. Closely held (small business) assets are excellent candidates and your only downside is the cost of creating the GRAT.
 - Sell high-yielding assets to a "grantor" trust that you create. The trust will purchase assets from you using the dividends, interest or rent that it receives and you will not have to pay capital gains taxes on the sale. Subchapter S Corporation stock and partnership interests in rental real estate properties work well.
 - Consider a Charitable Lead Annuity Trust (CLAT). As long as the income and assets of the trust grow at a greater rate than the interest paid on the annuity, your beneficiaries will receive assets at little or no tax cost, while you receive an income tax charitable deduction and also benefit your favorite charity.



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- Make outright gifts of minority interests in closely held businesses and obtain valuation discounts.
- Just make a plain vanilla gift of assets to your children and/or grandchildren. Although you will not get the leverage of the above techniques, none of the appreciation in value on the gifted assets will be subject to federal estate tax at your death.
- If you want to be conservative, make a gift to a trust for your spouse and your children from which an independent trustee can distribute the income to your spouse and/or to your children. At your spouse's death, the assets will pass to your children free of estate tax.

Keep in mind that, except for the sale to the grantor trust, the family members who receive these gifts will eventually realize a capital gain on the difference between your cost basis for the asset and the value at which the asset is sold. Nevertheless, the old saw that says "a tax deferred is a tax saved" is a good one.

The risk in making a very substantial gift is that this law expires at the end of 2012. If the gift/estate tax exemption

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remains at \$5,000,000, then everything is fine. However, if the exemption is reduced, say to the 2009 level of \$3,500,000, it is unknown whether the donor of a gift made in 2011 or 2012 will have to pay either a gift tax on the \$1,500,000 difference in the year in which the law changes or, more likely, an estate tax on that difference when the donor dies.

The term for this potentially retroactive tax treatment is "clawback." At this point, as a practical matter, it seems the "clawback" is not an issue unless a gift tax must be paid when the law changes. Furthermore, in my opinion, a retroactive gift

tax would be unconstitutional. If a tax does not have to be paid until the donor's death, the post-gift growth is still excluded from the donor's taxable estate and the tax on the now "taxable amount" has been deferred until the donor's death.

The lesson: if you have the resources to make a substantial gift (any amount greater than \$1,000,000 and less than \$5,000,001) and if making that gift does not adversely affect your current or projected lifestyle, go for it!

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