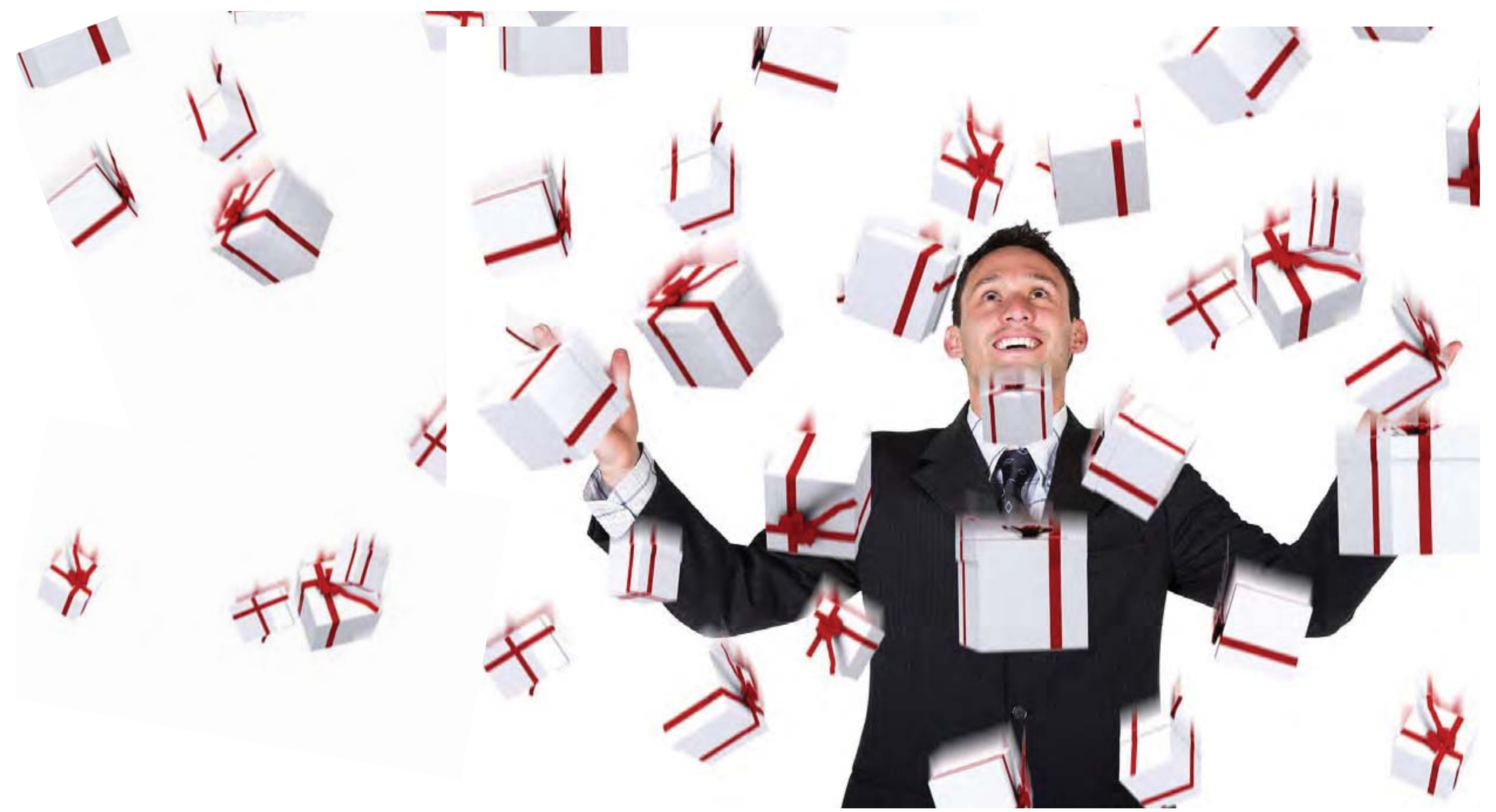

Gifts that Keep on Giving
THE 411 GIFT TAXATION

By Robert A. Hull, Michael Hackman and Kevin E. Rex

WITH THE 2010 TAX LAW set to expire at the end of this year absent further legislation, significant opportunities for those who wish to gift tax-free and/or reduce their potentially taxable estates may be coming to an end.

Prior to the passage of the 2010 tax law, an individual could gift tax-free only $1,000,000 over the course of his or her lifetime. Any amounts gifted above that amount were subject to a substantial gift tax (sometimes greater than 50 percent). However, during 2012, the tax code provides that individuals may currently gift up to $5,120,000 in total lifetime gifts tax-free, less any prior gifts made under the lifetime gift exclusion. However, the 2010 tax law provides that the gift and estate taxes are "unified," which means that use of the $5,120,000 gift tax exclusion also reduces the amount which can be excluded from estate taxes upon one's death by a like amount.

This gift tax exclusion amount may be extended to future years; however, there is no guarantee of such an extension, especially given the current federal deficit. Thus, if your clients wish to maximize the value of passing interests in the family business, provide seed money for children to start a business venture, gift interests in real estate or simply pass valuable gifts of cash or personal property to loved ones, they should act sooner rather than later.

Gifts Which Never Bear Gift Tax

First, there are certain gifts which one can make without incurring any gift tax and, therefore, without reducing the current $5,120,000 exclusion for gift or estate tax purposes (this amount was $5,000,000 in 2011, but was indexed for inflation). These gifts are: (1) medical or educational expenses paid directly to a medical or educational institution for anyone, (2) gifts to one's spouse, or (3) gifts to charities. No gift tax returns need be filed for such gifts.

In addition, an individual may give separate tax-free gifts of present interests in cash or property worth up to $13,000 to individuals annually without incurring any gift tax and without reducing the $5,120,000 exclusion (e.g., husband and wife together can gift $26,000 per year to each of their children, or one spouse can give a $26,000 gift of his or her separate property if the other spouse consents to join the gift). A gift tax return does not need to be filed for such gifts. However, a gift tax return will need to be filed to report any gift by a single grantor to a single beneficiary in excess of $13,000, even though no tax may be due because the gift amount falls under either the annual or lifetime exclusions.

Why Gift Now?

The gift tax exclusion reduces the amount one can pass tax-free on your death. However, by gifting, one's beneficiaries will receive an asset's appreciation, assuming the asset ultimately rises in value, rather than have that appreciation become part of one's potentially taxable estate. In current conditions, when asset values are low due to a sluggish economy and the gift tax exclusion is high, an

individual can gift, tax free, assets of significantly greater value than he or she can gift in more typical economic conditions. In addition, using favorable valuation techniques for gifts can result in an even more significant bang for your buck.

Take, for example, a present gift of ten shares of stock with an aggregate value of $1,000 for gift tax purposes (i.e., the value of the shares on the date of transfer). If the value of this stock on the date of the transferor's death increased to $10,000, then by gifting now, the transferor effectively froze the asset value at $1,000 for purposes of the gift tax and transferred $9,000 of wealth, gift and estate tax free, out of the person's estate to the person's beneficiary.

The beneficiary would have to pay capital gains tax when the stock is sold. Since the present federal 15 percent capital gains tax rate is significantly less than the current federal 35 percent gift and estate tax rate, this seems obvious. However, one should do a careful analysis as tax laws vary from state to state—certain states have no estate tax, while others do, and certain states like California have state income taxes.

It must be noted that making a gift which gets the appreciation out of the state means the beneficiary will not receive a step-up in basis on the appreciation, which the beneficiary would receive if the gift was passed on the death of the grantor (thus, upon subsequent sale of the gifted asset, the beneficiary will have to pay capital gains tax on such appreciation). Again, the above scheme presumes a rising market, which is more likely in the long term given the present state of our economy.

Small business and real property owners can also benefit from the higher gift tax exclusions, especially in combination with minority discounts, by being able to give more valuable interests tax-free and potentially reduce their estate taxes at the same time. The business interest may already exist, or the taxpayer may create a family limited partnership or family limited liability company to accomplish their goals.

The value of a minority interest in a business entity (including one which owns real property) is generally worth less than the corresponding percentage of the total value of the entity because such an interest lacks voting control and/or marketability. Thus, a 20 percent interest in an entity owning a family business may be effectively valued at, say, 12 percent of the total value of the entity by applying a 40 percent discount because of the lack of control and/or marketability (as long as such discount is supported by a valid appraisal). For example, one can gift an asset valued at $100,000 to the person making the gift for a gift tax value of $60,000, after taking into account the relevant discounts, thereby sheltering $40,000 from gift or estate taxes.

It is likely that in the current economy, the total value of the entity owning a family business or an interest in real estate is less than what it was a few short years ago, and also less than what it is likely to be when the economy picks up. Thus, a client can take advantage of these low values by gifting interests in the entity and using less of his or her gift tax exclusion. Plus, as mentioned above, the client will likely reduce his or her future estate tax burden at the same time. However, the client needs to get several appraisals, both to value the business' underlying value and, as mentioned, a separate one to determine the value of the minority discount.

Make a Gift and Use it Too

One of the requirements of making a present gift is divesting oneself of control over the gifted asset. Many people find this difficult. However, it is possible to still receive the tax benefits of gifting without giving a gift outright. This can be accomplished by using one of several specialized trust instruments to effectively remove an asset from one's estate. Such an instrument will reserve to the grantor the right of limited use of or control over the gifted property (and/or a right to an income interest), while fixing the gift's value for tax purposes. The gift's value is calculated based on the present value of the beneficiaries' remainder interests determined using the IRS' tables.

Depending on what type of property interest a client wishes to retain, such an instrument is set up for a specified period of time (or your lifetime) and the instrument is funded with certain assets. The greater the term of such instruments, the greater the potential transfer of wealth tax-free (again, assuming a rising market). However, a longer instrument term comes with an additional risk. If the client does not survive the trust term, the assets may be pulled back into his or her taxable estate.

Some examples in this complex area of estate planning include:

- **Qualified Personal Residence Trusts (QPRTs)** are irrevocable trusts for a residence or vacation home (which can also hold cash for reasonable operating expenses) in which client can retain the right to use the property for a certain period of time, after which the beneficiary receives the balance of the trust.

- **Grantor Retained Annuity Trusts (GRATs)** are irrevocable trusts in which client can retain an annuity right (i.e., a fixed sum) for a certain time, after which the beneficiaries receive the balance of the trust.

- **Grantor Retained Unitrust (GRUTs)** are similar to a GRAT, but using a fixed percentage of the value of trust assets (rather than a fixed sum) which must be revalued every year.

- **Charitable Remainder Trust (CRT)** allows a present charitable income tax deduction. The CRT is an irrevocable trust, but the grantor can change the ultimate charitable beneficiary. The grantor can retain (or gift to other beneficiaries) a fixed annual amount (the annuity trust) or a percentage of the trust's value (the unitrust) for a specified period of time, usually the grantor's lifetime. The charitable income tax deduction is based on the present value of the remainder interest calculated under IRS tables. The CRT is not a taxable gift. Others may want to consider the Charitable Lead Trust, which provides benefits to the charity during the term of the trust, with the remainder interest reverting to the grantor or his beneficiaries.

- **Intentionally Defective Grantor Trust (IDGT)**, though not considered a gift for tax purposes (the IRS treats a transfer to an IDGT as a non-taxable sale because the Grantor Trust is involved), the Grantor can receive similar tax benefits as with GRATs and GRUTs. The "seller" receives from the trust a promissory note equal to the value of the assets (perhaps calculated at a discount, if properly appraised) sold to the trust. The trust gets the income from the property transferred. Because of the grantor trust element, the seller is not taxed on the interest from the note, but instead is taxed on the transferred property's underlying income. There is a gift element to consider, because the IRS requires that the trust be "seeded" by gifted assets in an amount to be determined on a case-by-case basis (usually, equal to 10-15% of the initial balance on the note).

An individual can always gift minority interests in a business without using any of the above instruments. Since the grantor retains the majority interest, he or she will effectively retain control over the affairs of the business while still passing valuable business interests to the beneficiary tax-free.

In order to take advantage of gifting under the most favorable conditions in recent memory, one should timely consult an experienced estate planning attorney and/or financial planner to help plan the most advantageous gifting regimen. This window of opportunity may close sooner rather than later.

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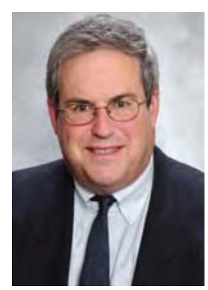

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