The 2012 Federal Estate And Gift Tax: Problem and Opportunity

Lynwood P. VandenBosch & Anna K. Gibson
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AUTHORS/ CONTRIBUTORS
Anna K. Gibson
Lynwood P. VandenBosch

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When a person dies, his or her assets are subject to the *federal estate tax*. This tax is imposed on virtually all assets in which a decedent has any interest, including life insurance proceeds, after the assets exceed an exemption amount. For decedents dying in 2012, the exclusion amount is $5.12 million. This means that the first $5.12 million of a person's assets are free from federal estate tax. Assets over and above this amount are taxed at the rate of 35% (in 2012).

Because gifts reduce a person's assets that are taxable for estate tax purposes, the government subjects gifts to the *federal gift tax*, which can be summarized as follows:

a. Annual exclusion amounts. Gifts from any person to any other person of less than a certain amount each year (currently this amount is $13,000) are not counted for gift tax purposes. A husband and wife can effectively double up on these gifts to make a $26,000 gift to each child each year.
b. Exclusion amount. Gifts in excess of the annual exclusion amount are allocated against the estate tax exclusion amount (currently $5.12 million). Gifts applied against this exclusion amount reduce the available exclusion amount for federal estate tax purposes.
c. Tax rate. Gifts that exceed the annual exclusion amount and the estate tax exclusion amount are subject to gift tax at the rate of 35%.

THE CURRENT PROBLEM

Currently, the amount excluded from federal estate tax, and federal gift tax is $5.12 million and the excess is taxed at a rate of 35%. This will probably continue through December 31, 2012. However, if Congress does not act prior to December 31, 2012, the exclusion amount will be reduced to approximately $1 million effective January 1, 2013 and the gift and estate rates will increase to as high as 55%. Many commentators believe that Congress may act to change the exemption

amount and tax rates before 2013, but we don't know what these numbers will be.

This uncertainty especially affects estates of more than $2 million. In a $5 million estate, for example, the estate tax consequences of resetting the exemption amount to $1 million could be more than $1,250,000, and for a $10 million estate, the estate tax consequences of such a resetting could be more than $3,500,000.

THE CURRENT OPPORTUNITY

The good news is that, currently, and probably at least through December 31, 2012, several favorable conditions exist to reduce a person's exposure to the federal estate tax. These include:

a. The $5.12 million exclusion for gift taxes and generation skipping transfer taxes;

b. Asset values are relatively low;

c. Interest rates are historically low;

d. Discounting (e.g., a minority interest in a family company) is currently permitted, and can be used to keep values down. As a general rule, discounts should only be taken where they can be supported by a qualified appraisal.

There are many options to take advantage of the current favorable environment. The following lists, very generally, a few of those options:

1. Consider using the annual exclusion amount for gifts ($13,000 per spouse, per beneficiary) before the end of 2012.
2. Consider making gifts that use up much, most, or all of your current $5.12 million exclusion amount, since in the next few months, we don't know what the exclusion amount will be next year or in future years. Examples of such gifts include:
    a. You can make the gift in trust for your spouse, with your spouse as the trustee and the beneficiary with the right to receive all income, to receive principal to the extent required for his or her health, support or maintenance, and to withdraw from principal an additional amount (not to exceed 5% each year).

    b. Alternatively, the exclusion can be used to make gifts to or in trust for children.

The best candidates for gifts include assets that can be discounted and/or those with high potential for future appreciation.

For example, if you currently have a $6 million estate, you could set aside $5 million in an irrevocable trust right now. No gift tax would be due because you would utilize your full exclusion amount. You could draw income/principal from the trust as needed, but the $5 million would be out of your estate at death, and only the remaining $1 million in your estate would be subject to estate tax. If the exclusion amount is only $1 million at your death and the estate tax rate is 55% (the law in 2013 and beyond unless Congress acts to change it), this approach would save you approximately $2.7 million in federal estate tax.

1. Consider advanced estate planning techniques (e.g., irrevocable life insurance trust, sale to intentionally defective grantor trust, grantor retained annuity trust, generation-skipping transfer tax trusts, dynasty trusts, etc.).

There are many things to consider when reviewing your possible exposure to the federal estate tax and ways to minimize the tax. Like many other things in life, there are always trade-offs of pros and cons which must be balanced, and not all of the options listed above may be appropriate for your circumstances.

This article was only intended to provide a big picture view of the current federal estate and gift tax problem and opportunity. Please talk with your estate planning attorney to determine what the most appropriate plan is for you.