Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS JULY 10, 2012

UPDATE
For 2011 and 2012: An Unprecedented Opportunity to Make Lifetime Gifts

With slightly less than six months remaining before the reappearance of the lower $1 million exemption from US gift tax, we are resending our June 2011 Client Alert regarding the advantages of using part or all of the $5 million (now $5.12 million) gift tax exemption before it expires at year-end.

Please contact your Chapman and Cutler LLP Trust and Estate attorney to discuss how and whether you may benefit from this unprecedented gifting opportunity.

Under the new federal transfer tax laws passed at the end of 2010, Congress increased the lifetime gift tax exemption to $5 million for gifts made in 2011 and 2012. This figure represents the total amount that you may give away during your lifetime without paying any gift tax. Prior to 2011, the lifetime gift tax exemption was $1 million, and if Congress does nothing, the gift tax exemption will revert to $1 million in 2013.

This Client Alert discusses certain strategies to take advantage of this limited opportunity, as well as basic gifting strategies that can be utilized in any tax environment.

Benefits of Lifetime Gifts

Lifetime gifts offer significant advantages:

- All future appreciation on the gifted property belongs to your gift recipients. Therefore, this future appreciation will not be subject to estate tax in your estate following your death.
- All future income on the gifted property will pass to your gift recipients and not to you.
- Your gift recipients may enjoy a better lifestyle earlier because of the gift rather than having to wait until your subsequent death.
- If the gift tax exemption reverts to $1 million in 2013, you will pay less transfer tax if you make significant gifts in excess of $1 million in 2011 and 2012.
- Given the difference in how the gift tax and estate tax are imposed, you will pay less tax by making a gift during your lifetime in excess of the lifetime gift tax exemption as opposed to making no gift and waiting to make your bequest at death.
- Unlike the estate tax, most states, including Illinois and Florida, do not impose a separate gift tax on gifts made by their residents.

Example: Mike, a widower, has a $10 million estate and intends to leave his entire estate to his four children. Mike has made prior gifts to his children that have used up $1 million of his lifetime gift tax exemption. In 2011, Mike gives a total of $4 million to his four children. Since Mike made the gift in 2011, the entire amount of the gift is covered by the balance of his $5 million lifetime gift tax exemption. No gift tax is due, and Mike has $6 million left in his estate. If Mike subsequently dies in 2013 when the top marginal estate tax rate has reverted to 55 percent, Mike’s estate owes $3.3 million in estate tax. Including the

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prior gifted property, Mike's family receives $7.7 million in total from Mike.

Example: Same example as above, except Mike does not make the $4 million gift in 2011. Mike subsequently dies in 2013 when the estate and gift tax exemptions have reverted to $1 million and the top marginal estate tax rate has reverted to 55 percent. Mike's estate owes $5,140,800 in estate tax. Including the prior gifted property, Mike's family receives $5,859,200 in total from Mike. Since Mike did not make the $4 million gift in 2011, his family receives $1,840,800 less than the first example.

What to Give

Any type of property may be gifted, including cash, securities, tangible personal property, real estate, and ownership interests in a partnership or LLC. The choice of property for gifting will necessarily depend on (i) your personal situation and objectives, (ii) your beneficiary's needs, and (iii) tax considerations, including the basis of the donated property. Transfers of assets with the potential for significant future appreciation will generally result in the greatest transfer tax benefit. An important consideration is that gifted property retains your income tax cost basis for capital gain tax reporting purposes. Thus, if your gift assets have significant built-in appreciation, your donee will recognize substantial gain on the subsequent sale of the property. On the other hand, the beneficiary of a transfer you make at death receives an income tax basis equal to the fair market value of most types of transferred property on the owner's death; therefore, your donee should have less gain on the subsequent sale of the inherited property.

Forms of Gifting

There are a variety of different ways to make gifts, and some methods have more tax consequences or are more complicated than others. Two simple forms of gifting that have no adverse gift tax consequence and are easy to implement include annual exclusion gifts and direct payments of tuition or medical expenses.

Annual Exclusion Gifts

The transfer tax laws currently provide an exclusion from gift tax for the first $13,000 given to any person in any year. This annual exclusion amount is indexed for inflation in $1,000 increments and has been fixed at $13,000 since 2009. Thus, currently you can make annual gifts of up to $13,000 to any number of people, without any gift tax on the transfers or any use of your lifetime gift tax exemption. If you are married, together you and your spouse can make annual gifts of up to $26,000 to any number of people without incurring gift tax.

Example: Mary Ellen has four children and eleven grandchildren. Each year, Mary Ellen is permitted to give up to $13,000 to each of her children and grandchildren without any gift tax consequence. If Mary Ellen makes maximum use of her annual exclusion gifting, Mary Ellen can give away up to $195,000 to her children and grandchildren each year. Over the course of five years, Mary Ellen can give away as much as $975,000 to her children and grandchildren without any tax implication. If Mary Ellen's estate will otherwise owe estate tax following her death, this five year program of annual exclusion gifts will save her estate $350,000.

Direct Payment of Tuition or Medical Expenses

Tuition payments made directly to an educational institution and payments for medical care and insurance made directly to the provider also are excluded gifts and do not count towards your lifetime gift tax exemption or your permitted level of annual exclusion gifting. The educational expense exclusion is limited to tuition payments. It does not cover books, supplies, room and board, or similar expenses. The medical expense exclusion applies to a variety of medical care expenses, including doctor and hospital bills, prescriptions, and medical insurance premiums.

Example: Joe has two grandchildren, Julie and Jeff. Julie attends college where the total cost for a year of college is $45,000 and the tuition expense is $32,000. Jeff attends a private high school where the annual cost of tuition is $16,000. Joe can pay Julie's annual tuition of $32,000 directly to her college and Jeff's annual tuition of $16,000 directly to his high school, and these payments will not count towards Joe's lifetime gift tax exemption or towards the permitted amount of annual exclusion gifting that Joe can make to Julie and Jeff. If Joe also pays the balance of Julie's college expenses for the year ($13,000), the payment will not qualify for the exclusion for direct payments of tuition. However, this additional amount will be covered by Joe's permitted annual exclusion gifting to Julie discussed above. If Joe makes no other gifts to Julie for the year, Joe can pay Julie's entire cost of college education without gift tax consequence.

Annual exclusion gifts and direct payments of tuition and medical expenses are excluded gifts (or “free” gifts) and

make sense in any tax environment. Therefore, an individual first should take advantage of these exclusions to the fullest extent possible. However, if your estate is significantly more than $5 million or the number of potential recipients of annual exclusion gifts and direct payments of tuition and medical expenses is relatively small, additional forms of gifting should be considered.

With the new higher $5 million gift tax exemption in 2011 and 2012, if you have the resources to do so, the next year and a half represents an unprecedented opportunity to make more significant lifetime gifts to or in trust for family members with little or no gift tax cost.

We note that there is a possibility that if the exemption reverts to $1 million in 2013, gifts that you make in 2011 and 2012 that were covered by the higher gift tax exemption and not subject to the payment of gift tax may be “clawed” back into your estate when you subsequently die and they may be taxed as part of your estate for federal estate tax purposes. It is unlikely that Congress intended this result and most practitioners do not expect such an interpretation to prevail.

A major gift of cash or property can take many forms:

Outright Gift

The advantage of an outright gift is its simplicity. Cash or investment property simply can be moved from your account to your recipient’s account. However, you can leverage (or increase) the tax benefits of your gift by making the gift to a lifetime trust that is exempt for generation skipping transfer tax (“GST”) purposes. The next section discusses the power of such a gift.

In addition, if you wish to make a gift to a minor or to someone who needs assistance in managing their gift, an outright gift would not be appropriate. Finally, any assets gifted outright can be used to satisfy the recipient’s creditors’ claims and will be included among assets in assessing alimony and child support payments. If those are potential concerns, then you should consider making your gift to a trust, under which you can protect the assets you pass on to your family.

Lifetime GST Trust

As an alternative to making an outright gift, you may consider making the gift to a lifetime trust that is exempt for GST purposes. The current GST exemption is $5 million and, similar to the gift and estate tax exemption, is due to revert to $1 million in 2013.

A GST trust ultimately will benefit your grandchildren or more remote descendants. The GST trust can provide for your child and your child’s descendants during your child’s lifetime. After your child’s death, the trust can continue for the benefit of your grandchildren and your child’s more remote descendants, if any. Your child (or some other family member or trust company) can be the initial trustee.

The primary advantage of a GST trust is that once the gift is made in trust and your GST exemption is allocated to the trust, the gifted property and all future appreciation will be free from transfer tax at each succeeding generation. If the property remains in trust for your child’s lifetime and then eventually distributes to your grandchildren, no estate tax will be due at your child’s subsequent death. If you create a “dynasty” trust that is designed to continue for multiple generations, no estate tax will be due at your child’s or grandchildren’s subsequent deaths. Since the current maximum estate tax rate is 35 percent (and is scheduled to climb to 55 percent in 2013), the tax savings can be significant, and the savings will accelerate with the passing of each succeeding generation.

Example: Bob has a $10 million estate and has three children and eight grandchildren. Bob determines that he has more than enough money for himself and transfers $5 million to a GST trust that he creates in 2011 for the benefit of his children and grandchildren. Bob allocates his lifetime GST exemption to the trust so that the trust is entirely exempt for GST purposes. The trust terminates at the death of the last to die of Bob’s children. If we assume that Bob lives for five more years and the trust property appreciates five percent per year after income tax, the trust will be worth $6.4 million at the time of Bob’s death. By making the gift in 2011, Bob successfully transfers an additional $1.4 million from his estate without any gift or estate tax consequence, and that additional amount also is not subject to GST tax. If the last to die of Bob’s children lives for 25 more years, the trust will be worth more than $21 million and will not be subject to subsequent estate or GST tax when Bob’s children die. After 30 years, the total amount available to Bob’s family from Bob’s entire estate is more than $26 million.

Example: Same example as above except Bob does not make the lifetime gift to a GST trust. Instead, Bob dies five years later and his entire estate is subject to estate tax when the estate tax exemption has reverted back to $1 million. Twenty five years later, subsequent estate taxes are paid when Bob’s children die. After 30 years, the total amount available to Bob’s family is approximately $10 million. By not making the lifetime gift to a GST trust in 2011, due to the payment of additional estate taxes at

Bob's death and again at the subsequent deaths of Bob's children, Bob's grandchildren will receive over $16 million less.

More complex gifting strategies may be appropriate for your situation. These strategies include valuation discounts for closely held business interests, intra-family loans, grantor retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs), sales to irrevocable grantor trusts, charitable split interest trusts, etc. Given the current persistent low interest rate environment, intrafamily loans, GRATs, and charitable lead annuity trusts (CLATs) are particularly attractive. Distressed real estate values offer additional gifting opportunities.

The next six months represents an unprecedented opportunity to make lifetime gifts to family members with little or no gift tax cost. You and your family may benefit from a variety of different gifting strategies. Please contact your Chapman and Cutler LLP Trusts and Estates attorney to discuss how and whether you may benefit from this limited gifting opportunity.

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