

'Tis the Season to Give Gifts

The new tax law signed late last year—the 2010 Tax Relief Act—creates an added incentive for wealthy individuals to give generous lifetime gifts to family members. Because the estate- and gift-tax provisions in the new law are scheduled to “sunset” after 2012, gift-giving decisions should be made relatively soon.

Background: Estate planning was turned topsy-turvy by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Among other important changes, the federal estate-tax exemption was gradually increased to a high-water mark of \$3.5 million in 2009 while the top tax rate decreased to 45%. The estate- and gift-tax systems were effectively “de-unified” under EGTRRA, so the lifetime gift-tax exemption remains locked at \$1 million. Finally, the estate tax was repealed, but only for 2010.

EGTRRA also created new modified carryover basis rules for inherited assets for 2010. Previously, heirs could benefit from a full step-up in basis to the value on the date of death.

Other provisions were coordinated with the estate- and gift-tax rules, including changes for the generation-skipping tax (GST) affecting most transfers to grandchildren.

Now the estate tax has been reinstated under the new law. For 2011 and 2012, the exemption is \$5 million (indexed for inflation in 2012) while the top tax rate is 35%. The estate- and gift-tax systems have been reunified by the new law. Once again, heirs may benefit from a full step-up in basis, beginning in 2011. Other changes have been coordinated with the GST.

One thing that did not change significantly during the last decade was the annual gift-tax exclusion. Under this long-standing exclusion, an individual can give gifts up to a stated amount for the year (indexed for inflation) without paying any gift tax. The exclusion for 2011 is \$13,000 per recipient (\$26,000 for joint gifts made by a married couple).

The gift-tax exclusion can shelter gifts in addition to the amount covered by the lifetime gift-tax exemption. (However, the amount used for the lifetime gift-tax exemption reduces the available estate-tax shelter.) Thus, these two tax provisions can be combined for a powerful one-two punch.

Take the example of a married couple with \$7 million in assets. Suppose the couple gives the maximum tax-free amount of gifts in 2011 and 2012 to ten other family members. This will remove a total of \$520,000 from their taxable estates ($10 \times \$26,000 \times 2$ years). If the couple chooses, they might give away, say, another \$3 million under the lifetime gift exemption. In this example, the couple has effectively cut their estate in half without paying any gift tax.

Be mindful that this is just a hypothetical example, and every situation is different. There are numerous other factors to consider. Nevertheless, individuals may want to take advantage of the generous provisions before 2013. Coordinate these activities within a comprehensive estate plan.