WHAT TO DO BEFORE THE $5 MILLION GIFT TAX EXEMPTION AMOUNT IS REDUCED

by Douglas L. Youmans

On August 2, 2011, the Budget Control Act of 2011 (the "Act") created the Joint Select Committee on Deficit Reduction (the "Super Committee"), a 12 member bipartisan select Congressional committee tasked with reducing the federal deficit by at least $1.5 trillion on or before 2021. The Super Committee is supposed to be making its recommendations to achieve this goal to Congress on or before November 23, 2011. Congress is supposed to vote on the recommendations by December 23, 2011, by an "up-or-down" majority vote in each chamber. If Congress can't agree on the proposed bill, the Act will trigger automatic spending cuts.

Given that the President's Plan for Economic Growth includes a rollback of the estate, gift and generation-skipping transfer ("GST") tax exemption levels back to 2009 levels ($3.5 million for estate and GST tax and $1 million for gift tax), it is possible that the Super Committee's plan will include a reduction of the current $5 million exemption levels. While the content of the Super Committee's meetings has not been made public, few practitioners believe that the current $5 million exemption amount will survive its currently scheduled December 31, 2012 sunset. In fact, there has been a great deal of speculation that the Super Committee will decrease the gift tax exclusion amount from $5 million to $1 million at the end of next month (December 31, 2011), or, possibly, as early as November 23, 2011, when they present their plan to Congress.

What Should Be Done?

Although few believe that Congress will (can?) change the transfer tax system before year end, fewer still believed at this time last year that Congress would reinstate the estate tax retroactively, permit the estates of 2010 decedents to opt out of paying estate tax altogether and reduce the GST tax rate to zero. However, while we can continue to debate/speculate whether the $5 million exclusion will survive until the end of either this year or next, to avoid the risk of losing a substantial part of that exclusion (somewhere between $1.5 million and $4 million depending on whether it is rolled back to 2009 or 2002 values) those who have decided to use their full exemption amount should do so quickly—transfers should be completed no later than December 31, 2011, if not, November 22, 2011. Quickly, however, does not mean without proper legal and accounting advice.

For those intent on pursuing a $5 million "holy grail", the choices to be made at this time (meaning NOW) include identifying the property to be transferred, the persons to be benefitted, and the manner in which the recipients should receive their gifts.

Assets to be Gifted

With respect to the identification of which assets should be gifted, one rule of thumb has been to transfer those assets that are likely to appreciate in value, as the transfer of appreciating assets helps "leverage" the gift. Current market conditions make "temporarily" depressed investments and remainder interests in residences attractive gifts. Marketable securities, interests in hedge funds or other investment partnerships, real estate and interests in other closely held ("family") entities are also good candidates. High-basis assets typically are a good choice, while assets which are correctly valued at less than their basis are probably not the best choice. Further, under appropriate circumstances, forgiveness of loans previously made can be an ideal gift, particularly with respect to friends and family members with financial needs (like adult children who are having trouble meeting their living expenses).

If non-marketable assets are given, they should be appraised to ensure the gift(s) is (are) properly reported (note that a *qualified appraisal*[1] can be completed after the gift is made as long as it is completed before the gift tax return is filed). To the extent a formal appraisal accounts for any valuation discounts (e.g., lack of marketability and/or control), those discounts will further leverage the gift.

Recipients

Logical recipients of gifts include those family members intended to receive the estate. However, because tax-free gifts can be made to spouses, such gifts do not need to be "accelerated" simply to take advantage of the current $5 million exemption amount. In other words, other family members (children, siblings, parents, etc.) would appear to be more logical recipients.

Making Gifts

Once decisions have been made with respect to what is to be gifted to whom, the next/"final" decision relates to whether the gift(s) should be outright or in trust. While outright gifts are a simple way to use the gift and GST tax exemptions, gifts in trust can offer some advantages. For example, transferring assets to a trust can protect those assets from the claims of the donee's creditors (or, in the event a child is having (or might, in the future, be having) marital difficulty, from the claims of that spouse). In addition, the trustees of a trust can control the timing and manner of distributions, which might be particularly helpful to the extent a potential donee is a spendthrift or otherwise has any "special needs." To the extent there is any intent to benefit multiple generations, if portions of the remaining $5 million GST tax exemption are allocated to the trust, future distributions to grandchildren and more remote issue can be made free of the GST tax. Finally, if the "donee" trust is a "grantor trust" for income tax purposes, the donor, not the trust, will pay the income tax on the trust's income (another manner in which the gift(s) can be leveraged--when the donor pays the income tax on such a trust's income, the donor's estate is (further) reduced even if no additional taxable gifts are made).

[1] See IRC §170(f)(11)(E) and Regs. §1.170A-13(c)(3)(ii).

Other Considerations/Other Potential Changes

- Legislation that would substantially reduce the effectiveness of certain planning techniques (such as grantor retained annuity trusts ("GRATs") and family limited partnerships ("FLPs")) has been pending for some time and could be enacted as part of the deficit reduction package.

- With IRS interest rates at historic lows, integrating planning techniques that leverage low rates to maximize transfer tax savings may be particularly compelling (the low interest rates translate into larger gifts at a lower transfer tax cost).

- Sales to intentionally defective grantor trusts also give incredible leverage based on the historically low interest rate environment we are currently operating in.

- The possibility of a "Clawback" with respect to gifts made in excess of $1 million should be taken into consideration and discussed with any client contemplating any such gift.

While we have no way of knowing what, if anything, might actually happen with respect to the $5 million gift tax exclusion before December 31, 2012, it would be advisable for those who were planning gifts using the increased exemption amount (but were waiting until 2012 to do so) to consider making those gifts prior to the end of this year, provided those gifts are properly planned and structured using the right techniques.