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## The Disappearing Estate and Gift Tax Exemption

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It is difficult to miss the headlines, cocktail talk and political debates regarding taxes in an election year. By this time, most people who may be affected have heard that the estate and gift tax laws are scheduled to change for the worse in 2013. But what does that mean to the taxpayer? More importantly, how can you take advantage of current tax law before the "disappearing estate and gift tax exemption" – actually disappears? This article summarizes the estate and gift tax system and the available exemptions and suggests what you can do to take advantage of current transfer tax laws in 2012.

### How do the estate tax and gift tax systems work?

Gift and estate taxes are Federal excise taxes imposed on the transfer of property (sometimes called "transfer taxes"). Briefly, gift taxes are imposed on "taxable gifts" made during life, and estate taxes are imposed on items included in a decedent's "taxable estate" at death. The gift and estate tax are unified under current law, meaning that these taxes are imposed on the cumulative amount of taxable transfers made by one person during life and at death. Gift and estate tax exemptions allow an individual to make a certain amount of taxable transfers free of transfer taxes by applying a tax credit to avoid paying tax. Much succession planning revolves around the reduction of a taxpayer's transfer tax liability by using gift tax exemptions during life or estate tax exemptions at death.

### What is the disappearing estate and gift tax exemption?

The estate and gift tax rates and exemption amounts have been in flux since 2001, due in large part to a concerted effort to abolish the estate tax. In 2001, the estate and gift tax rates were 55 percent and the exemption amount was \$1 million. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Bush Tax Bill") gradually reduced the estate and gift tax rates from 55 percent to 45 percent and increased the estate exemption amount from 2002 through 2009 to \$3.5 million, ending with a repeal of the estate tax for decedents dying in 2010. Even during the one-year repeal of the estate tax, the Bush Tax Bill left a \$1 million gift exemption and a 35 percent gift tax rate on taxable gifts over the exemption. The Bush Tax Bill was to sunset in 2010, with the estate and gift tax rates scheduled to return to 55 percent and the estate exemption amount returning to \$1 million.

Instead, in December 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (the "2010 Act") established new estate and gift tax rates and exemptions for 2011 and 2012. Under the 2010 Act, the estate and gift taxes were unified at a 35 percent rate, with a \$5 million estate and gift tax exemption (indexed for inflation to \$5.12 million in 2012). The 2010 Act sunsets on December 31, 2012, however, and on January 1, 2013, the estate and gift tax rates are again scheduled to return to the maximum rate of 55 percent with \$1 million exemptions.

It is important to note a few things about the estate and gift tax system. It does not raise much money for the Federal government and it does not affect most Americans. Historically, estate and gift tax receipts amounted to about one to two percent of the annual Federal revenues. The Congressional Budget Office reports that since 1977, only one to two percent of adults dying each year have left estates large enough to be taxable. In 2010, only 15,000 estate tax returns were filed and, after giving effect to deductible marital and charitable gifts, less than half reported estate tax due; less than \$14 billion in estate tax was collected. By contrast, about 223,000 gift tax returns were filed in 2010, resulting in about \$2.5 billion in gift tax paid. Unlike income taxes, the estate and gift tax system really only affects the top one percent of taxpayers, as measured by their wealth. A disproportionate number of those taxpayers live on the East and West coasts.

### What are some possible outcomes for the estate and gift tax at the end of the year?

Congress and the Administration have not come to an agreement with respect to estate and gift taxes. President Obama has said that he supports a \$3.5 million death exemption, a \$1 million gift exemption and a 45 percent estate and gift tax. There does not seem to be any real movement on this issue at the moment.

There are several possible outcomes: (1) Congress could act before the November elections, which seems unlikely, or (2) Congress could act after the November elections and before end of the year, similar to what happened in December 2010; or (3) Congress could do nothing and the estate and gift taxes will revert to 2001 levels on January 1, 2013. Thereafter, Congress could act to revise the transfer tax system retroactively.

### What can you do to take advantage of the current estate and gift tax exemption?

Given the uncertainty of the exemption after 2012, many taxpayers are acting now to take advantage of the \$5.12 million gift exemption (\$10.24 million for married couples) while they still have time. The strategy taxpayers employ to use their exemption may depend on the assets they have and their willingness to part with such assets. Some of the options are as follows:

#### Cash Gift – The Simplest Approach

By gifting cash, the recipient will have full income tax basis in the gift, which may come in handy for future transactions. The down side is that the donor may not be able to use

valuation discounts to his/her advantage, and there is no leverage. Furthermore, many people may not have the liquidity for this strategy.

#### Advanced Planning – Grantor Trusts Increase Value to Beneficiaries

Referred to as a defective grantor trust or "DGT," this is an irrevocable trust treated as owned by the grantor for income tax purposes, but not for gift or estate tax purposes. A grantor can use his/her exemption to gift assets (using valuation discounts) or cash to a DGT and name a child (or anyone) as a beneficiary. The grantor is taxed on all items of income, deductions and credits of the DGT. By paying the income tax for the DGT, the DGT income can grow income tax-free. The income tax paid by the grantor on the DGT's behalf is effectively an additional tax-free gift. The grantor might also choose to sell assets to the DGT for a low interest promissory note, arbitrating the assets and earnings of the DGT without triggering additional income tax liabilities.

#### Spousal Access Trust

Some couples may feel uncomfortable giving away \$10.24 million this year, uncertain of their future needs. The Spousal Access Trust ("SAT") allows a spouse to create an irrevocable trust for the benefit of the other spouse by gifting the exemption amount to the trust (with cash or discounted assets). The beneficiary spouse receives the benefit of the funds and can even be the trustee. The SAT assets remaining at the spouse's death may then pass to children free of transfer tax. The SAT can be a great strategy for the couple that is not ready to part with their wealth or make their children (or another beneficiary) rich quite yet. The SAT will be treated as a grantor trust so long as both spouses are alive.

#### Irrevocable Trusts as Powerful Tools

Irrevocable trusts are powerful tools to implement gifting strategies and can be extremely flexible. For example, provisions in an irrevocable trust can allow the trustee to change jurisdictions to take advantage of favorable state tax havens (like Delaware or Nevada) or changes in tax law. Holding the gifted assets in trust can provide creditor protection and investment oversight, as well as prevent mismanagement or over-spending by a beneficiary.

#### Act sooner rather than later

Taxpayers should not wait until the end of the year to evaluate their estate plan and gifting opportunities, as they may be too late. Given the unusual circumstances of this election year, estate planning attorneys will be very busy. Additionally, many of the techniques used require an appraisal, and qualified appraisers may be forced to turn taxpayers away if they are too busy. Contact your estate planning attorney soon to discuss your options to take advantage of the estate and gift tax exemption – before it disappears.

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