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TO: OUR CLIENTS AND FRIENDS
FROM: JACKSON M. PAYNE
DATE: SEPTEMBER 1, 2010
RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

GIFTING IN 2010: UNDERSTANDING THE ENVIRONMENT

It appears unlikely that Congress will pass any transfer tax reform in 2010. As a result, 2010 could be the best of times for gifting by affluent clients. This newsletter considers the multiple factors that surround gifts in 2010. Our next newsletter will cover select gift planning opportunities available this year, while our following newsletter will cover 2010 strategies and planning for terminally ill clients.

Consider the following factors that encourage gifts in 2010:

- ◆ Historically low applicable federal rates that encourage certain gifting strategies;
- ◆ Low asset values, particularly in real estate and family businesses;
- ◆ Intra-family transfer discounts could be curtailed by Congress or the IRS in the near future;
- ◆ A gift tax rate of 35% for 2010;
- ◆ Because the gift tax is a tax-exclusion tax, the effective tax rate for gifts in 2010 (when the donor survives the gift by three years) is only 25.93%;
- ◆ The increasing probability of restoration of the 2001 transfer tax rules in 2011, with the estate tax exemption going to \$1.0 million and the transfer tax rate at 41-60%; and
- ◆ The benefit of “income shifting,” given the likely significant increases in state and federal income tax rates in the coming years and the resulting spread in income tax rates at the upper and lower ends of taxation.

Tax Exclusion Planning

Payment of gift taxes can have a significant advantage over the payment of estate taxes. The principal reason is that gift tax is calculated on a tax-exclusive basis (on the value of the property transferred), while the

estate tax is calculated on a tax-inclusive basis (on the value of property transferred plus any amount used to pay the estate tax). If the donor pays the gift tax, the donor effectively transfers \$1.35 of value for each dollar gifted (when compared to the estate tax), but is only subject to transfer tax on one dollar.

Planning Example

Assume a client has \$4,000,000 available to make a transfer to heirs and pay the resulting transfer tax. Assume further that the full amount of the transfer is taxable and that a 55% estate tax rate (assuming death occurs after 2010) and 35% gift tax rate applies. The client can make a \$2,962,963 gift in 2010 and pay the resulting gift tax liability of \$1,037,037 ($\$2,962,963 \times 35\%$). If, on the other hand, the client bequeathed the entire \$4,000,000 after 2010, then the client could only transfer \$1,800,000 ($\$4,000,000$ less a 55% tax). The net result is that the gift transferred an additional \$1,162,963 ($\$2,962,963 - \$1,800,000$).

The Gross-Up Rule

However, the gift tax can become a tax-inclusive tax if the donor of the gift tax fails to survive the gift by three years. Note that the date of the gift, not the date of the payment of the gift tax, begins the three year statute.

Basis Issues

In general, Code Sec. 1015(a) provides that the donee of a gifted asset takes over the tax basis of the donor. However, if the donor's basis in the asset exceeds its fair market value, the rules get a little more complicated for the donee. If the donee subsequently sells the asset for a gain, the donee uses the donor's basis in the property. If the donee sells the asset for a loss, the fair market value of the donated assets is used as the basis. Thus, if the donee sells the asset for a price between the fair market value and the donor's basis, neither a loss nor a gain is incurred.

GST Taxes

Serious planning for generation skipping transfers is virtually impossible in 2010. The only thing we know is that outright generation-skipping transfers in 2010 are not taxable. With the uncertainty over the GST tax treatment of post-2010 distributions from GST trusts, clients should consider:

- ◆ Making such gifts directly (as opposed to using GST trusts) to grandchildren and other skip persons.
- ◆ Using family limited partnerships and limited liability companies or non-voting stock, if they want to reduce the control of the donee.

Holding Period

Code Sec. 1223(2) provides that the donee's holding period is tacked to the holding period of the donor. Therefore, the donee can more easily qualify for long term capital gain treatment.

Timing

Generally, clients should consider putting the plan in place and then waiting to complete the gift until the end of 2010, because:

◆ If the client dies before the end of 2010, not only would the gift have created an unnecessary transfer tax, but the partial step up in basis (of up to \$4.3 million) provided in Code Sec. 1022 would also be lost.

◆ Congress might still act before the end of 2010 to change the transfer tax rules. Retroactive changes could sabotage the plan. Other legislative changes might create new and unexpected planning opportunities or traps.

◆ Other family changes might occur that reduce the benefit of the proposed plan (e.g., divorce of a child).

Clients could complete the entire process and then place all the documents and appraisals in escrow with an independent party who is directed to deliver the relevant documents to the donees by December 31, 2010, if none of the above conditions have occurred. To assure that the gifts are deemed completed gifts, the escrow release date should leave sufficient time for actual delivery to the donees or their designated agents. The escrow agent may need to know where the recipients are vacationing at year-end to make sure delivery occurs.

Hoarding Cash

One of the reasons that planning should start now is the need for many clients to start accumulating cash (e.g., selling or mortgaging assets) to pay for the gift taxes which will be due by April 15, 2011. The amount of cash the client can accumulate by April 15, 2011 will directly determine how much can be gifted by December 31, 2010.

A Few Other Thoughts

In considering a taxable gift to a non-spouse, one of the considerations should be the impact of the donee dying within a few years of the transfer. While Code Sec. 2013 provides an estate tax credit for estate taxes paid by a previous decedent/owner, there is no comparable benefit for gift taxes paid. Potentially, the combination of the gift tax on the initial gift coupled with the estate tax liability upon the donee's death could eliminate the tax benefits of gifting in 2010. If there are no GST issues, it may make sense to gift to a trust in lieu of a direct gift (particularly for an heir with significant health issues) and give the intended initial donee a lifetime interest in the trust. The trust could provide potential estate tax savings to the remaindermen and asset protection to the donee.

And, be wary of gifting assets with secured debt. Assume a real estate lot is worth \$1,000,000 with a \$900,000 mortgage and a \$700,000 basis. The gift of the real estate could create \$200,000 in tax recognition to the donor.

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