



**October 2012**

**Hoffman, Sabban & Watenmaker strives to keep its clients and friends informed of important developments affecting their estate, gift and tax planning. This letter summarizes some of those developments.**

The future of the gift tax, estate tax and generation-skipping transfer tax (collectively, “transfer taxes”) continues to be uncertain as we approach the end of 2012. There may be a window of opportunity closing at the end of this year, relating to the ability to make significant tax-free gifts. This update will focus on this important opportunity to transfer assets this year.

This year, the amount that an individual can give without incurring gift tax is \$5,120,000, the highest gift tax exemption ever (reduced, however, by any exemption used in prior years). Unless Congress passes and the President signs a new law, that exemption will drop to \$1,000,000 effective January 1, 2013. Also scheduled to change is the exemption from the generation-skipping transfer tax, which is \$5,120,000 this year and scheduled to decrease to \$1,430,000 next year. Finally, the maximum transfer tax rate will increase from 35% this year to 55% next year (and with an extra 5% surcharge for a portion of larger estates).

Congress is likely to take some action - perhaps not until well into 2013 - to soften the unfavorable impact of the scheduled changes in the transfer tax laws. It is entirely possible that the current exemptions and tax rates will be reinstated next year. However, we have no way of knowing with any certainty what changes any new law may bring. We therefore suggest that our clients with sufficient assets consider taking advantage of the current opportunity to make large gifts to children, grandchildren or other beneficiaries, free of gift tax.

As an example of the tax saving opportunity available this year, assume a single individual opts not to make a \$5,120,000 gift this year, when the gift could be free of gift tax. That wealth will be taxed in his estate in a later year when he dies. If the estate tax exemption is only \$1,000,000 in the year of his death and his estate exceeds \$16 million, his estate could pay as much as \$2,472,000 in additional estate taxes (assuming the maximum 60% rate applies to the extra \$4.12 million that could have been gifted this year).

It is possible, although unlikely, that the IRS will argue for a “clawback,” which would impose a tax, at death, on lifetime gifts made which turn out to be in excess of the estate tax exemption

amount in effect at the time of death. For example, if an individual makes a lifetime gift in 2012 in the amount of \$5,120,000, and then dies in a later year when the estate tax exemption is \$1,000,000, the difference between these two amounts, \$4,120,000, would be included on the estate tax return and taxed at the time of death under the “clawback” theory. However, neither political party advocates the imposition of a “clawback” law at this time.

Even if a clawback rule is enforced, making a large lifetime gift this year would allow any post-gift appreciation in the value of, and income generated by, the gifted assets to remain outside the taxable estate of the donor.

There are a number of methods for making large gifts; from simple, outright gifts of cash or other assets directly to individuals, to irrevocable trusts of various types. You might also want to consider making fractional interest gifts (such as a percentage interest in partnerships), to obtain a discount of the value of the asset given.

- For clients who are not comfortable taking full advantage of the \$5,120,000 gift tax exemption (because there may not be enough wealth left over to keep them financially secure), certain irrevocable trusts (such as a qualified personal residence trust) allow the donor to retain some benefits from the gifted property.
- For clients who do not want to give large amounts to children or others who are not financially responsible enough to manage the wealth, trusts can be drafted to hold the assets under a wide variety of optional terms for paying out benefits over time.
- The client's exemption from the generation-skipping transfer tax (also currently an unprecedented high of \$5,120,000) can be allocated to a gift trust so that it can benefit grandchildren and further generations without imposition of that tax. Children could also be beneficiaries of this type of trust if the client feels that diversion of this much wealth to grandchildren would not leave enough for the children.
- Some irrevocable trusts are designed to hold certain types of assets, and some are written so that the donor pays the income taxes for the trust (which serves to enhance the value of the trust assets without additional gift taxes).
- Assets transferred to an irrevocable trust may qualify to be valued at a discount for partial interest, lack of marketability, cost of partition, or built-in capital gains.

We are happy to discuss with you the best options for taking advantage of this opportunity to save gift, estate and generation-skipping transfer taxes, based on the makeup of your assets and your circumstances. **If you are interested in discussing a gift plan with us, we urge you to contact us as soon as possible.** As we get closer to the end of the year, it may be less likely that we will be able to assist you, as we are already very busy with gift planning for our clients.