
URGENT! AN ESTATE TAX BREAK MADE FOR YOU

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Many have heard about the \$5 million federal gift tax exemption but few believe it affects them. Even if you do not have a federally taxable estate, large gifts in 2012 will remove the appreciation on the transferred assets from your estate and may lead to substantial state estate tax savings, particularly for D.C. and Maryland residents.

BACKGROUND

The federal gift tax, a transfer tax¹ that has been a part of our Internal Revenue Code since 1934, now kicks in at an unprecedentedly high figure. Even when the estate tax exemption was \$3,500,000 in 2009, the gift tax exemption was only \$1,000,000.² However, in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of December 2010, Congress raised the amount at which gift tax would become due. For gifts made in two years, 2011 and 2012, there is no gift tax payable until aggregated lifetime taxable³ gifts exceed \$5,000,000, indexed. In 2012, the indexed figure is \$5,120,000.

To evaluate this opportunity, consider that 2011 was the first year since 1934 that a wealthy person could make gifts of up to \$5 million without paying gift taxes. From 1934 to 2010, the largest amount that prior law allowed to be given without triggering a gift tax liability was \$1 million (allowed from 2002 to 2010). We do not know whether this historically high exemption level will continue after 2012. Existing law provides that on January 1, 2013 we will return to a gift tax exemption of \$1 million and a gift tax rate of 55%, instead of 35%.⁴ Therefore, the time to consider making major gifts is now, before the end of 2012.

WHY? THREE REASONS

There are three reasons to make major gifts before the end of 2012. First, as with any completed gift, all appreciation on the transferred assets accrues to the donee. That is, the appreciation is not part of the donor's taxable estate to be subject to estate taxes upon the donor's death.

Second: this might be a one-time opportunity. Next year, as mentioned above, the federal gift tax exemption is scheduled to return to \$1 million. The President has indicated that he would

¹ There are three "transfer taxes" – gift tax, estate tax and generation-skipping transfer tax.

² Here we use the term "exemption" to mean the amount of aggregate taxable transfers at which a transfer tax is actually imposed.

³ The term "taxable" excludes annual exemption gifts, and certain other gifts.

⁴ The estate tax exemption will also return to \$1 million and the estate tax rate will be 55%, with an extra 5% rate imposed on large estates to consume any benefit of the lower rates and exemption amount.

like the gift tax exemption to be permanently set at \$1 million and the estate tax exemption to be \$3.5 million, with a 45% rate applicable to transfers over these amounts.

The idea is to use the \$5.12 million gift tax exemption amount now, while it is clearly available. Congress may change the law and keep it available next year, but we can not be sure of that.

We should note one uncertainty: there is a possibility of what is being called a “claw back”. If after making gifts to use the \$5.12 million gift tax exemption, the donor were to die when the exemption is again at the \$1 million level, some attorneys have expressed concern that the excess of the gift tax exemption that the donor used during his or her life, over the reduced \$1 million exemption at death, would essentially become subject to estate tax. While this would reduce the benefit of making the large gift, any appreciation on the gift would be free of estate tax, and the gift would still achieve the D.C. or Maryland estate tax savings discussed below. Therefore, even under the “claw back” analysis, the gift is likely to be beneficial in saving taxes.

The arguments against “claw back” are strong. We believe it was not intended, it is beyond the purpose of the applicable statute and that the statute currently does not mandate such result. Further, the Democrats have proposed a bill against “claw back” that the Republicans are unlikely to oppose. Our best guess is that Congress will clarify the applicable statute to eliminate this concern.

SOME NUMBERS: STATE ESTATE TAX SAVINGS

The third reason to consider making 2012 major gifts is state estate tax savings.

In 2001, the Economic Growth and Tax Relief Reconciliation Act created a sea change in the operation of the federal estate tax regime, and it affected all states. While it is not necessary to review the turmoil created in the states by the enormous change in federal estate tax law, suffice it to say that D.C., Maryland and Virginia now have three different approaches to state transfer taxes.

None of the three jurisdictions has a gift tax. D.C. and Maryland have an estate tax. Virginia does not have an estate tax now, but if old law is permitted to return, it may have an estate tax for estates of decedents dying after 2012.⁵ Maryland alone of the three jurisdictions has an inheritance tax—a tax on receipt, as opposed to transfer—but it is credited against Maryland’s estate tax.

HOW MUCH TAX ARE WE TALKING ABOUT?

At the federal level, the estates of decedents dying in 2012 are not required to file a federal estate tax return unless the sum of the gross estate plus lifetime taxable gifts exceeds \$5,120,000.

At the state level, Virginia currently has no estate tax, so no return is necessary in Virginia. D.C. and Maryland, however, require the filing of a state estate tax return if a decedent’s gross estate

⁵ In addition to Virginia, Florida and twenty-five other states essentially have no state death tax for 2012. However, state death taxes remain a significant consideration in the other twenty-three states and the District of Columbia.

exceeds \$1,000,000. The valuation information is submitted on the federal form, even when the federal form need not be filed for federal tax purposes.⁶

The D.C. and Maryland estate tax returns in effect ignore gifts made before death.⁷ Thus, major gifts can produce potentially hundreds of thousands of dollars of state estate tax savings, as shown by the following examples.

Example 1. Joseph, a widower with children, an estate of \$16,120,000, and \$1,000,000 of deductions for debts and administration expenses, is deciding whether to make a gift to his children of \$5,120,000 in 2012. Assume the large gift would be in addition to the annual exemption gifts of \$13,000 to each child. Thus, the entire \$5.12 million is a “taxable” gift. For purposes of Joseph’s federal estate tax return, when he dies, this \$5.12 million would be added back in for calculation of his federal estate tax. That is, the federal tax will be the same whether he dies with \$16,120,000, or with \$11,000,000 having made a taxable gift of \$5,120,000.⁸

However, since neither D.C. nor Maryland has a gift tax, the gift is not added back in when figuring Joseph’s D.C. or Maryland estate tax.

If Joseph is a D.C. or a Maryland resident and makes this gift in 2012, his D.C. or Maryland estate tax will be \$1,067,600.

If Joseph simply holds onto the \$5,120,000, and we assume that any growth in his estate attributable to that amount is offset by expenditures so that his gross estate is still \$16,120,000 and the debts and administration expenses are still \$1,000,000, his D.C. or Maryland estate tax will be \$1,886,000.

That is, the state estate tax difference between making this gift and not making it is
\$818,400.

But perhaps you do not believe you will have an estate that will be taxable for federal estate tax purposes. Is there any tax savings in making a gift? Yes. If your potential gift would exceed \$1,000,000 (i.e., the highest gift tax exemption ever allowed before 2011), you can still have significant state estate tax savings from making a gift.

Example 2. Marianne, a widow with children, an estate of \$4,200,000, and \$200,000 of deductions for debts and administration expenses, is considering a gift of \$2,000,000 in 2012. If at Marianne’s death there is no requirement that her estate file a federal estate tax return, we are concerned only with the effect of this gift on her state estate tax.

⁶ If the decedent left a surviving spouse and had any unused federal estate tax exemption, we would also recommend filing a federal estate tax return to elect the so-called “portability” of the estate tax exemption amount - see prior client alert entitled [Portability, By-Pass Trust, and Special By-Pass Trusts](#). Since the valuation information is already needed for the DC and MD returns, this additional step is no great burden for residents of those jurisdictions.

⁷ If these gifts are made within 2 years of death, to persons who are not exempt from inheritance tax, there can be a Maryland inheritance tax on assets not included in the estate tax base.

⁸ Here we are assuming that Congress modifies the law such that the basic estate tax regime remains as it is today. We are also assuming there is no “claw back” of gift taxes that would have been due if in the year of Joseph’s death the gift tax exemption is lower than \$5,120,000.

As above, if Marianne removes the \$2,000,000 from her estate for D.C. and Maryland purposes, there is a significant tax savings in state estate taxes. If she makes the gift in 2012, her D.C. or Maryland estate tax would be \$99,600 on her remaining \$2,000,000 taxable estate (\$2.2 million minus debts and administration expenses of \$200,000). If she does not make the gift, and dies with the foregoing assets, her D.C. or Maryland estate tax would be \$280,400.

The state estate tax difference between making this gift and not making it is
\$180,800.

HOW TO MAKE THE GIFTS?

There are many ways to make gifts to qualify for the foregoing treatment, many of them using trusts. The key is that the gifts be treated as “complete” for tax purposes. Further, although the foregoing examples show the savings for two unmarried individuals, there are additional planning opportunities for married individuals.

When making large gifts, the income tax implications must be carefully considered. A gift could produce a worse income tax result than a transfer upon death. With good planning this concern can be mitigated. Trusts can be used to achieve even better estate and income tax savings, and provide protection against creditors (including divorcing spouses) of the donor's beneficiaries.

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We have many ideas on how to plan and implement large gifts. To attain the most favorable results requires careful planning. Trusts may need to be created and appraisals are frequently needed for hard to value assets such as real estate or closely held businesses. Time is running out as we are on the cusp of the final calendar quarter.

Call us if you would like to discuss making gifts before the end of 2012.

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