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Dear Client:

With the end of 2012 approaching quickly, we think it is important to inform you of the current status of the estate and gift tax laws and how they could possibly apply to your situation. Below, we have outlined the current law, how the law is set to change and some different gifting techniques that you can use to lessen the possible burden of estate tax to your heirs. If you feel that you would like to take advantage of the current favorable estate and gift tax laws, we encourage you to contact us as soon as possible.

Use of Gift Tax Exemptions to Reduce Estate and Gift Tax

For 2012, the unified federal estate and lifetime gift tax exclusion amount is inflation-adjusted to $5,120,000, which is the amount a taxpayer may transfer without incurring estate, gift or generation-skipping taxes. Should a taxpayer's transfers exceed that amount, his or her maximum estate and gift tax rate is 35%, which applies once a taxable estate exceeds the exclusion amount by $50,000. Further, through a so-called “portability” provision, if a spouse dies in 2012 without exhausting his or her estate and lifetime gift tax exclusion amount, the surviving spouse may be able to gift against that amount. This latter provision does not apply to gifts given to grandchildren, i.e., generation-skipping transfers.

Absent Congressional action, after 2012, the applicable exclusion amounts automatically revert to $1 million with no inflation adjustments for gift and estate tax purposes, and $1 million as adjusted for inflation for generation-skipping tax purposes. Also, the maximum tax rate escalates to 55%, with a 5% surtax on taxable transfers exceeding $10 million. Further, the portability provision does not extend past 2012. Thus, unless Congress acts, a surviving spouse may not utilize a deceased spouse's unused exclusion amounts to make gifts in 2013.

Because of these unique circumstances, a taxpayer could, in 2012, through a well-crafted plan of giving, take advantage of what is possibly a one-time opportunity to transfer over $5 million in wealth without incurring either gift or generation-skipping transfer taxes. Further, these gifts could save estate taxes because they removed post-gift appreciation on and possibly income from the gifted assets from the transferor's estate. Obviously, a person whose estate exceeds $1 million must give serious consideration to enacting such a plan. *Since the plan must be executed by December 31, 2012, please call us as soon as possible if you wish to discuss not only the benefits but also the potential pitfalls of such a plan of giving.*

Please remember that there are certain types of lifetime transfers are not subject to gift tax, and year's end could be a good time to make such gifts.

Annual Gift Tax Exclusion

The most commonly used method for tax-free giving is the annual gift tax exclusion, which allows a person to give each donee up to $13,000, for 2012, without reducing the giver's estate and lifetime gift tax exclusion amount. A person is not limited as to the number of donees to whom he or she may make such gifts. Thus, if an individual makes $13,000 gifts to 10 donees, he or she may exclude $130,000 from tax. In addition, because spouses may combine their exemptions in a single gift from either spouse, married donors may double the amount of the exclusion to $26,000 per donee. For 2013, an individual may gift $14,000, while married donors may give $28,000, to each donee.

Because the annual exclusion is applied on a per-donee basis, a donor can leverage the exclusion by making gifts to multiple members of the same family. Thus, in 2012, a donor could give $13,000 each to his son, his son's wife and their daughter, for a total of $39,000 in tax-free gifts. He could double this tax-free amount to $78,000 if his spouse joins in the gifts.

The annual gift tax exclusion applies to gifts of any kind of property, although certain types of property may require an appraisal. Gifts of appreciated property also could result in income tax savings, because the recipient would pay the capital gains tax on any sale. Further, the threat of higher income tax rates and the possible future increase of the preferred capital gains tax rates makes the gifting of such property all the more enticing.

Because a donor may not carry over his or her annual gift tax exclusion amount to the next calendar year, year-end gifting is critical so as to maximize the exclusion's benefits for each year. If a donor wishes to make a gift exceeding the exclusion amount, he or she can effectively double the exclusion by making one gift in December and the second in January. For example, a married donor could make a tax-free gift of $54,000 to any individual by making a gift of $26,000 in December 2012 and a $28,000 gift in January 2013.

Tuition Payment Exclusion

In addition to the annual gift tax exclusion, a person may make tuition payments for any individual without incurring gift tax. Though the amount that may be excluded is not limited, all payments must be made directly to a qualifying educational institution for the purpose of education or training. The exclusion applies only to tuition. Thus, payments for room and board, books, required equipment, or related expenses are not excludible. Because there is no limit on the gift amount, its timing is less important than with the annual exclusion. Nevertheless, if a person has the choice of making either a tuition payment or an annual exclusion gift for a particular beneficiary, it usually is preferable to make the tuition payment, because he or she still could make an annual exclusion gift later in the year.

Section 529 College Savings Plans

Contributions to a college savings plan established according to section 529 of the Internal Revenue Code (529 plan) do not qualify for the exclusion for tuition payments, but are covered by the annual gift tax exclusion. A contribution to the plan also may entitle the contributor to a state income tax deduction. Thus, a contributor can reduce his or her own income taxes by funding 529 plans for children, grandchildren, etc., with savings that would have been used for college anyway.

Qualified distributions from a 529 plan may be used for a wide range of educational expenses, including tuition, fees, books, supplies, required equipment, and room and board, but not transportation costs. An added advantage of a gift to a 529 plan is that, generally, the income earned by plan contributions is tax-free, so long as it eventually is used for educational purposes. Also, because the contributor may be the plan's custodian, he or she can ensure that the beneficiary uses the account for educational purposes.

A special rule allows a contributor to utilize up to five annual gift tax exclusions simultaneously when funding a 529 plan. Thus, for 2013, he or she may fund the plan with up to $70,000 (5 x $14,000), then file an election with the IRS to spread this gift over five years (2013 through 2017) for gift tax purposes. By using five annual exclusions, the entire gift becomes gift-tax-free. However, the contributor must wait until 2018 to make another tax-free contribution.

Medical Payment Exclusion

Subject to limitations, a person may exclude from gift taxes all payments he or she makes directly to medical providers on behalf of another individual. The exclusion for medical payments also includes the payment of medical insurance premiums. Thus, paying a child or grandchild's insurance premiums is an efficient means of making a tax-free gift that does not consume either the annual gift tax or the estate and lifetime gift tax exclusions.

Gifts in Trust

Despite the tax savings, a person may not wish to make outright gifts to children or grandchildren, due to the loss of control over how they use the gift. Gifts in trust allow the trust creator to determine when the beneficiaries receive the money and how it is used.

By observing special requirements, a trust creator can ensure that a gift in trust qualifies for the annual gift tax exclusion. Generally, the trust is drafted to provide the beneficiary with temporary withdrawal rights over the gift (usually for 30 days), such that the gift is considered a present interest rather than one that vests in the future. Although this arrangement presents a risk that the beneficiary could withdraw the gift from the trust, the likelihood of the trust creator terminating any further gifts to the trust is usually sufficient to prevent such withdrawals. If you are interested in making a gift in trust, we can explore this option more thoroughly.

Charitable Gifts

Year end is a good time to review charitable giving to ensure it is accomplished in the most tax-efficient manner. Charitable giving is a form of estate planning because a gift to charity never will be subject to estate or gift tax, and provides the giver with an immediate income tax deduction. If a person wishes to make a large gift before January 1, his or her circumstances must be reviewed to determine the gift's impact on this tax year's income tax liability and whether all or a portion of the gift should be deferred to a later tax year. If the gift is property and requires an appraisal (usually for gifts of property with a value in excess of $5,000, other than publicly traded stock), the process must be started as soon as possible so that the appraisal is available before year end.

In conclusion, we hope that the information in this letter is useful in your gift planning for 2012 and 2013. If you wish to take advantage of any of the planning techniques that we have described, please feel free to call.

Sincerely yours,

Freeman + Williams, LLP

Freeman & Williams, LLP