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Is It Wise to Make Big Gifts Before 2013?

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Is It Wise to Make Big Gifts Before 2013?

-by Neil E. Harl*

The controversy has been raging for months – is it wise for an individual with a $5 million estate (or larger) to make a major gift before the end of 2012?[1] As with many tax issues, it comes down to the governing objectives of the taxpayer. There is no one right answer to the question of whether gifts should be made before the $5,120,000 applicable credit amount/applicable exclusion amount for 2012 (shared by federal gift tax, federal estate tax and generation-skipping transfer tax) is scheduled to "sunset" back to 2001 at a level of $1,000,000 after December 31, 2012.[2]

The future of the applicable credit amount/applicable exclusion amount

The major issue, of course, is what the applicable credit amount/applicable exclusion amount will be after 2012.[3] Some believe that the sunset provision, taking the amount back to $1,000,000, could well become the permanent level beginning in 2013. Others, this author included, believe that is unlikely and the most likely outcome will be to continue the 2012 "exemption" level, rate and income tax basis rules. However, at this point no one knows.

Income tax consequences

An important factor for a rational decision is to examine the potential income tax consequences of a gift of significant size. A gift of cash (or any asset with no gain involved) does not pose a particular problem. But a gift of heavily appreciated commercial property, farm or ranch land or securities is quite a different matter.

EXAMPLE 1: A gift is made in 2012 of 400 acres of unimproved farmland valued at $8,000 per acre or $3,200.000. The land was acquired in 1940 for $100 per acre or $40,000 as its income tax basis. If a gift is made of the tract of land, the valuation for federal gift tax purposes would be $3,200,000 (which could be reduced by the $13,000 per donee federal gift tax annual exclusion available in 2012) but otherwise the gift would reduce the $5,120,000 available applicable exclusion amount by $3,200,000 to $1,920,000. More importantly, the old basis of $40,000 would carry over to the donees *and would be their basis on later sale or taxable exchange*.

EXAMPLE 2: The same facts, except that the owner, after careful review of the alternative outcomes, decides to retain the 400 acres until her death. The potential gain of $3,160,000 would be wiped off the books, the income tax basis would become the fair market value at death ($3,200,000) and the heirs would have no income tax to pay on later sale or exchange.

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Retained economic interest in the gift property

For many who are considering a major gift in 2012, out of concern that the "sunset" after December 31, 2012, could diminish the list of acceptable planning alternatives, they are at least partially dependent upon the gift property for income. Whether the gift transaction specifically provides for a retained right to income, or the commitment to pay income to the donor for the rest of the donor's life, a retention of economic benefits would pull the property back into the donor's estate for federal estate tax purposes.[4] That would nullify much or all of the major gift advantages of a large gift.

Economic vulnerability

With federal health programs under attack politically, prudence would suggest retaining sufficient assets to assure financial independence under a worst-case scenario. There are worse outcomes than paying taxes. . . like running out of assets. In many instances, the question is whether beneficiaries receive the property by gift in 2012 or by inheritance in some future year. With a few exceptions, it would not mean a great deal of difference to the recipients; it could mean a great difference for the donor.

The possible "claw-back"

A gift that meets the requirements for an effective transfer of property to another for no consideration (or inadequate consideration) should not be subject to second guessing by the Department of the Treasury if the "sunset" back to 2001 becomes reality.[5] However, there is one possible problem relating to the way gifts are treated at death.[6] That problem is in the way the federal estate tax is calculated at death.

Basically, if large gifts are made during life, say in 2012, and the gifts use up part or all of the applicable credit amount for that year, $5,120,000 for 2012 gifts, the gift may be subject to inclusion in the federal estate tax calculations on all or a portion of the gifts at death later if the applicable credit amount is lower at the time of death.[7] That could be the result if the "sunset" provision rolls the applicable credit amount back to $1,000,000 effective after 2012. This would diminish the advantage of making large gifts.[8] It has been in the Internal Revenue Code for years but this would be the first time for a reduced credit amount *after* a gift is made.

The Code section[9] states as follows –

"The tax imposed by this section shall be the amount equal to the excess (if any) of –

(1) tentative tax computed under subsection (c) on the sum of –

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the modifications described in subsection (g) had been applicable at the time of making the gifts."

Subsection (g) of the Code section states that the rate of tax in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used to compute the gift tax and the credit allowed against the tax.[10]

In light of the fact that few (if anyone) anticipated the consequences of the provision, if the "sunset" occurs, it is possible that the Congress would amend the statute to eliminate the "claw-back" problem. However, there is no certainty that would happen. The uncertainty of an amendment adds to the balance of reasons not to make large gifts before 2013,

ENDNOTES

[1] See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010). See also Harl, "Tempted to Make Big Gifts in 2010?" 21 *Agric. L. Dig*. 2010.

[2] The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a)(2), 115 Stat. 41 (2001). See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (2010).

[3] See I.R.C. § 2010(c).

[4] I.R.C. §§ 2036 (retained interest for life), 2037 (transfers taking effect at death), 2038 (revocable transfers).

[5] See note 2 *supra*.

[6] I.R.C. § 2001(b).

[7] See I.R.C. § 2001(b).

[8] *Id*.

[9] I.R.C. § 2001(b).

[10] I.R.C. § 2001(g).