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Skyfall 2012

Maximizing Year-End Gift Planning

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Alert! The sky may be falling (again)!

This is the time of year when the Earth passes through the tail of Halley's Comet and the annual Orionid meteor shower provides a spectacular show of falling stars. This year's show has some people mixed in with the meteors, i.e., James Bond is falling in *Skyfall,* and Felix Baumgartner accomplished a freefall from 24 miles high.

Felix Baumgartner jumping from space.

"The sky is falling!" is also what people say whenever the "Bush tax cuts" are about to expire. It has become combination of *Cinderella* and *Ground Hog Day.* Our federal tax code may turn into a pumpkin at year's end by reverting to 2001 levels and Congress has us re-living this crazy scenario over and over.

Let's look at year-end planning for this unique time.

Presented With Our Compliments

3, 2, 1, Jump!

The view from 24 miles high is spectacular, and the prospect of breaking many records on the world's stage is alluring; however, placed in those circumstances, some of us might have told the world, "I've changed my mind about this jumping thing."

To jump from that height is literally a leap of faith. But consider the planning that leads to such a bold step. It is not a spontaneous decision based on a newly discovered opportunity; rather, it involves careful planning over a long period of time—with test jumps and attention to every detail—so that the results can be nearly certain.

Felix Baumgartner's jump represented extensive preparation. A 55-story helium balloon was needed to bring his capsule to the stratosphere, and a special space suit was required to withstand falling at 833 miles per hour.

Baumgartner broke the sound barrier. He broke the free fall height record. He broke the record for the highest manned balloon flight. He broke all kinds of jumping-from-space-type records.

The space jump was also a singular cultural moment. A record number of more than 8 million people watched concurrent live streams of the event on YouTube. The Twitterverse went into some kind of Tweeting frenzy, and Baumgartner's post-jump photo on Facebook got 216,000 "likes" within 40 minutes—demonstrating that the modern world is both amazing and annoying.

Note, however, that with a classy, old-fashioned nod, Baumgartner purposely popped his parachute at the 4-minute, 20-second mark so that he would NOT break the record for the longest free fall. The existing record of 4 minutes 36 seconds was set by Joe Kittenger in 1960 when he jumped from about 20 miles high. Kittenger, now age 84, had been assisting Baumgartner as the capsule communicator in the Red Bull Stratos project.

In all, Baumgartner spent more than five years of planning before his jump took place.

3, 2, 1, Gift!

As 2012 draws to a close, and our recurring "sky is falling" scenario of the automatic reversion to 2001 estate and gift tax rules is almost upon us, many people are contemplating whether they should take advantage of the current $5.12 million gift tax exemption before it expires. The gift tax exemption is scheduled to return to $1 million in 2013.

Estate planners are experiencing what it is like to suggest that clients consider giving away significant portions of their estate before the $5.12 million gift tax exemption expires. Some possible responses from clients:

"Say again?"

"Give away HOW much?!"

"You're fired."

A fleeting opportunity to minimize estate tax savings may be more appealing to estate planning professionals than to clients who are offered the chance to give away their assets.

For many people, those assets are difficult to part with because they were hard to come by over the course of a lifetime. Sacrifices were made to keep them. Watching them diminish in bad markets in recent years has been an ordeal. So it is not easy to embrace the concept of giving assets away on short notice. This is especially true when the motivating factor is not based on a firm and reliable tax code system with known rules but, rather, on the expiration of one favorable set of rules and the uncertainty of what may follow.

Give assets away and jump into a void? Some people would rather jump from the Red Bull Stratos capsule and plummet 128,000 feet. Which has the more certain outcome at this point?

Making a significant year-end gift in 2012 may be a lot easier for someone who is extremely wealthy. It is easier to justify giving away 10% of your assets than 50%. Making a significant gift is also easier if the donor is retaining sufficient assets to maintain the same lifestyle, income, and control over business interests.

However, logic may not enter into every situation. For example, Donor M, age 85, was finally convinced to set up an irrevocable trust for his grandchildren so that some of his assets could be moved out of his estate for transfer tax purposes, as well as for pre-Medicaid qualification purposes. The trust was set up. Some assets were moved into the trust.

But, at the last minute, Donor M refused to transfer $500,000 of assets. The reason? He wanted to be able to directly control how the assets were invested. It did not matter that the trustees would do exactly as Donor M told them. It did not matter that the assets in question were in long-term municipal bonds that Donor M never reinvested anyway. Having an irrelevant level of control was more important to Donor M than reducing future transfer tax liabilities.

Pondering Gifting Outcomes

What level of tax savings are at stake with a year-end gift in 2012? Must the gift be $5.12 million to obtain the full advantage? Or should a wealthy married couple transfer $10.24 million collectively?

Example #1: If all the stars were aligned for a grantor in 2012 and $5.12 million was given before year's end with 1) no prior gifts having been given; 2) a reversion in 2013 to the $1 million exemption for gifts and estates; 3) no "claw back"

recapture of taxes saved by the 2012 gift; 4) no subsequent increase in the estate tax exemption before the grantor's death; 5) no use of annual gift tax exclusions or other estate planning techniques; and 6) an applicable tax rate of 55% based on the grantor's taxable estate, then the net outcome would be the exposure of $4.12 million of funds (assuming no appreciation or depreciation from those funds) to a tax rate of 55%.

So a maximum gift in 2012, with all conditions being exactly right, could have a maximum savings of $2,266,000.

Example #2: Now let's change the assumptions so that the ultimate exemption turns out to be $3.5 million with a top estate tax rate of 35%, i.e., one of the more plausible scenarios. If the grantor maximized his 2012 gift, an extra $1.62 million would be transferred and would avoid a 35% estate tax, saving $567,000.

A number of other benefits apply:

- Transferred assets continue to generate income that is taxed to a beneficiary who is in a lower income tax bracket.
- There is an additional appreciation of value on the gifted assets that is also excluded from the donor's estate.
- This gift can also be given to grandchildren and can qualify for the generation skipping transfer tax exemption for 2012.
- The gift can be part of an FLP and Family Trust that provides asset protection benefits.

Example #3: Here is another example with more realistic conditions. The grantor has a more modest estate and makes a 2012 gift of $3 million. The estate and gift tax exemption reverts briefly to $1 million, but Congress ultimately sets the exemption at $2 million and keeps the estate tax capped at 35%. In this scenario, the grantor would be able to gift $3 million instead of the ultimate limit of $2 million. His extra $1 million gift would avoid estate tax of 35% or $350,000.

Example #4: The grantor hears what he wants to hear about the gift tax exemption expiring at the end of 2012 and gifts $2 million before year's end. The gift tax reverts to $1 million. For argument's sake, let's assume that Congress breaks up the gift and estate tax credit again and has a $3.5 million estate tax exemption, even though the lifetime gift tax exemption remains at $1 million.

In this scenario, the grantor would have hedged his bets a bit. He would have given away more during his lifetime than the ultimate limit but would not have been prejudiced entirely by holding his assets due to the ultimate estate tax exemption.

Donor's Remorse

What could go wrong with an accelerated gift? Opportunities may be lost for the donor who could have invested funds that were transferred. Once funds are distributed among various beneficiaries, they may not be conserved and invested effectively and may simply be spent.

Transferred assets may be wasted by the beneficiaries, exposed to creditors, split up during divorces, and eroded away.

Appreciated assets that are transferred may subsequently trigger capital gains instead of being transferred with a stepped-up basis at death.

A donor at 72 may greatly underestimate his life expectancy; upon living to 92, he may wish he had some of that money he gave away in 2012.

A Contrarian's Summation

Is Congress so deadlocked and the nation is so debt ridden that the $5.12 million estate and gift tax exemption will revert to $1 million or stay there permanently? That argument simply doesn't convince every estate planner or client.

Congress intervened the last time we were threatened with the reversion to 2001 and not only prevented the reversion but actually increased the exemption significantly from the pre-estate tax repeal plateau of $3.5 million up to $5 million in 2011 and $5.12 million in 2012. And Congress didn't stop there. It provided a major innovation in the portability of spousal exemptions, making it possible for married couples to take full advantage of both spouses' exemptions by conserving the exemption of the first spouse to die.

A-B Trust Planning: Let's linger on that point for just a moment. A couple had previously been able to exploit the exemptions of both spouses by incorporating two trust plans into an estate that would apply the marital deduction to a portion of the estate that was transferred to a marital or qualified terminable interest property (QTIP) trust, aka "A" trust, and then apply the deceased spouse's lifetime exemption to a second trust, a bypass trust or credit shelter trust, aka "B" trust.

With the advent of the portability clause, Congress made it possible to just leave the entire estate to the surviving spouse and have that spouse utilize the cumulative exemptions at death. This assumes, of course, that the married couple has identical beneficiaries. If there are children from previous marriages, trust planning remains important. Trusts also remain relevant for asset protection.

Does this sound like the plan of a Congress that would now go back to a $1 million exemption that is not portable? Could Congress fail to act and have the Bush tax cuts expire automatically? Yes. A dysfunctional Congress could get into an immense brawl (figuratively or perhaps even literally) that distracts them, while the estate and gift tax exemption reverts to 2001 levels.

However, realistically, it is hard to imagine such a reversion remaining the law of the land for very long. Members

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of Congress, their families, their constituents, and their donors all have estates and know when their ox is being gored. The more likely adjustment to the transfer tax system would be to reset the exemption at $2 million or $3.5 million and retain the portability feature.

An Unconventional End Game

Conventional year-end financial planning may not fit every person's circumstances this year. The reason is that 2013 could bring higher federal, state, and local taxes. The composition of the Federal Congress is changing, but even knowing the outcome and proposals cannot help fully anticipate the potential deals or gridlocks that will affect tax rates or deductions.

Based on revenue constraints, the default setting of the Bush tax cuts expiring, and the new health care law surtaxes, one can anticipate higher tax rates in 2013 while deductions would be cut back. If this holds true, then several strategies would follow:

- Normally, those who can control the timing of when they receive income generally defer income so that it is taxed in the following year. With higher taxes coming next year (potentially), the reverse would be true and income should be accelerated to 2012. This may also make sense based on the security of the source of income. These days, one should seize his or her income before sources run out of funds.

- Bunching deductions to meet the 25%-of-income threshold continues to be a useful strategy. For higher income taxpayers, itemized deductions and personal exemptions could be phased out in 2013, making them more valuable in 2012. On the other hand, if income is accelerated to 2012 and next year's income and the 2% threshold is lower, that may be a better time to utilize deductions.

- Aside from the lifetime gift tax exemption, there is the annual gift tax exclusion, in which every donor can make annual gifts to an unlimited number of donees. For 2012, the exclusion is $13,000. With gift splitting, a husband and wife can give $26,000 to every donee. That works out to about $52,000 to each child and his or her spouse. So if a couple has two married children who each have two children, an annual gift program to all eight donees can transfer $208,000 every year, free of gift tax. Over 10 years, that amounts to more than $2 million. Set up properly in a trust with *Crummey* powers, life insurance purchasing designs, and other planning techniques, simple annual gifting can provide a powerhouse of planning without incurring transfer tax liabilities.

- Capital gains have been an endangered species for the last few years; when one has any actual gains, realizing them by selling that asset almost feels like shooting the last white rhino. But taking a gain also provides an opportunity to sell off a bad investment and neutralize the gain.

- Capital gains might be better taken in 2012, even if there aren't offsetting losses because of higher tax rates on capital gains that would apply starting in 2013. The anticipated rate would be a return from 15% to 20%. For those who want to retain certain investments, it is possible to sell the position in 2012 and wait 30 days prior to repurchasing the security to comply with "wash sale" rules.

- Businesses set up as C and S corporations that pay dividends, which are currently taxed at 15%, should consider accelerating dividend payments in 2012 to avoid having those same dividends taxed at the highest marginal tax rate of 39.6% and being potentially subject to the additional 3.8% Medicare surtax.

- Where businesses set up as LLCs generate more than $250,000 to owners, the potential of having additional income subject to Social Security taxes may be reason to consider changing to a Subchapter S business entity.

- Business asset expensing is also a critical category. There is a 50% bonus depreciation that is expiring, and the section 179 deduction that allows certain assets to be expensed instead of depreciated will be reduced from $139,000 in 2012 to $25,000 in 2013.

What's Next?

There are expiring provisions of the tax code that could lead to higher individual tax rates. Overall, the top rate may return to 39.6%. This is noteworthy for small business owners who operate pass-through entities, such as LLCs, where income is taxed at the owner's individual tax rate.

The coming year is scheduled to have some new taxes as well. Under the new health care law, a new 3.8% Medicare surtax will apply to net investment income for taxpayers with adjusted gross income exceeding $200,000 ($250,000 for married couples filing jointly). There will also be an increase in the employee Medicare tax of 0.9%.

2010 to 2012		
Income Tax Rate	**Short Term Capital Gains Tax Rate**	**Long Term Capital Gainst Tax Rate**
10%	10%	0%
15%	15%	0%
25%	25%	15%
28%	28%	15%
33%	33%	15%
35%	35%	15%
2013 (Projected)		
15%	15%	10%
28%	28%	20%
31%	31%	20%
36%	36%	20%
39.6%	39.6%	23.8%

Careful planning for business owners and individuals is needed before year's end, and the process should incorporate legal and accounting advice. A flexible plan with alternatives is the ideal approach where possible.