Wealth Planning Services

Tax Update # 16: 2013 Year-End Estate and Gift Tax Planning

Year-end 2013 brings many new planning opportunities, along with the traditional year-end tax planning strategies. It also brings challenges, for both individuals and businesses. There is much for taxpayers and their tax advisors to consider in taking action before 2013 ends, including the important changes made by the American Taxpayer Relief Act of 2012 (ATRA) (signed into law on January 2, 2013), the provisions in the Patient Protection and Affordable Care Act of 2010 (PPACA) (scheduled to take effect in 2013 and 2014), the Supreme Court's decision on same-sex marriage, and the release of significant new IRS rules on many pressing issues. There is also the prospect of comprehensive tax reform in 2014, which will require some "crystal ball" forecasting as to what Congress may or may not do in the coming year. On top of everything, the IRS shutdown in October could delay the start of the 2014 filing season, although the long-term effects have yet to be determined.

This summary explores some of the **2013 year-end estate and gift tax planning opportunities** available to individual taxpayers. Of course, every taxpayer's situation is unique and a year-end planning strategy, whether for an individual, family, or business, should be customized in consultation with a qualified professional. Harbour Capital Advisors (HCA) stands ready to assist clients with year-end planning issues and opportunities.

For a summary of 2013 individual income tax-savings opportunities, please request a copy of our separate **Tax Update # 14: 2013 Year-End Individual Income Tax Planning**. For a summary of 2013 business income tax-savings opportunities, please request a copy of our separate **Tax Update # 15: 2013 Year-End Business Income Tax Planning**. Please note that all tax information contained herein is general in nature, is provided for informational and educational purposes only, and should not be construed as legal or tax advice.

Overview

Estate planning is never easy. You must address your own mortality while determining the best strategies to ensure that your assets will be distributed according to your wishes and that your loved ones will be provided for after you're gone. You also may need to consider how loved ones will react to your estate planning decisions, which may be difficult if, for example, a family business is involved or you wish to provide more to certain family members.

Transfer Tax Landscape for 2013 and 2014

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act) lowered estate, gift, and generation-skipping transfer (GST) tax rates and substantially increased the relevant exemption amounts for 2011 and 2012. In addition, the 2010 Tax Act "reunified" the gift and estate tax exemptions. [The "exemption amount" is the amount an individual can transfer without paying a transfer tax.] ATRA made many of the changes introduced with the 2010 Tax Act permanent. So the current transfer tax exemptions are at all-time highs, and the top estate tax rate only increased from 35% in 2012 to 40% in 2013. The Federal tax rates and exemptions available under current law are as follows:

	2013	2014
Estate Tax Exemption Amount	$5.25MM	$5.34MM
Gift Tax Exemption Amount	$5.25MM	$5.34MM
GST Exemption Amount	$5.25MM	$5.34MM
Highest Estate Tax Rate	40%	40%
Highest Gift Tax Rate	40%	40%
GST Tax Rate	40%	40%

Any prior use of gift and GST tax exemption during an individual's lifetime reduces the amount of gift and GST exemption remaining during the individual's lifetime and the exemptions available at the individual's death. For example, if an individual has already made $1MM in lifetime taxable gifts prior to 2013, the individual's remaining gift and estate tax exemption amount in 2013 would be $4.25MM.

Also introduced as part of the 2010 Tax Act was exemption "portability" between spouses. If part (or all) of one spouse's estate tax exemption is unused at death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. Making this election is simple, although it does require that the estate of the first spouse to die file an estate tax return on which the portability election is made. Such an election provides flexibility if proper planning hasn't been implemented before the first spouse's death. Note however that exemption portability doesn't provide all of the benefits that applying the exemption to a bypass (or credit shelter) trust does. So married couples should still consider making asset transfers and setting up bypass trusts to ensure they take full advantage of both spouses' exemptions. Transfers to your spouse, whether during life or at death, are tax-free under the marital deduction (assuming he or she is a U.S. citizen).

For additional details on the 2010 Tax Act and longer-term planning issues and opportunities arising as a result thereof, please request a copy of our separate **Tax Update # 1: The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010**.

Gift Tax

As noted above, the amount of the Federal estate tax exemption in 2013 is $5.25MM. Since the estate tax is likely here to stay and must be planned for in larger estates, wealthy individuals should consider making sufficient gifts during lifetime so that the estate will not exceed the exemption amount in effect at death. The gift tax follows the estate tax exemptions and top rates for 2013 and 2014, as noted in the chart above. Any gift tax exemption used during lifetime reduces the estate tax exemption available at death.

GST Tax

The GST tax generally applies to transfers (both during life and at death) made to people two generations or more below you, such as your grandchildren. The GST tax also follows the estate tax exemption and top rate for 2013 and 2014, as noted in the chart above. Note that exemption portability between spouses doesn't apply to the GST tax exemption.

State Taxes

Many states, prompted by changes to the Federal estate tax (such as increases in the Federal exemption amount and elimination of the credit for state death tax), now impose estate and/or inheritance taxes at a lower threshold than the Federal government does. To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law as well.

Year-end Gift Planning

Any gift-giving programs must take into consideration that your lifetime gifts are subject to a gift tax that is imposed at the same rate as the estate tax. But certain types of lifetime transfers are not subject to gift tax, and the end of the year could be a good time to make these tax-free gifts. Giving away assets now will help you reduce the size of your taxable estate and may be especially beneficial this year.

In terms of which assets to consider for purposes of gifts, consider the following rules of thumb:

- To minimize estate tax, gift property with the greatest future appreciation potential.
- To minimize your beneficiary's income tax, gift property that hasn't already appreciated significantly since you've owned it.
- To minimize your own income tax, don't gift property the fair market value of which is less than tax cost basis. Instead, sell the property so you can take the tax loss and then gift the sale proceeds.

Annual Gift Tax Exclusion

The most commonly-used method for tax-free giving is the annual gift tax exclusion, which allows you to make a gift of up to $14,000 in 2013 to each donee without using any portion of your lifetime $5.25MM gift tax exemption. [The annual gift tax exclusion will hold steady at $14,000 for 2014.] There is no limit on the number of donees to whom you can make such gifts; if you make $14,000 gifts to 10 donees, you can exclude $140,000 from tax. In addition, if you are married, you can double the amount of the exclusion to $28,000 per donee, because you and your spouse can combine your exclusions in a single gift from either of you. Further, because the annual exclusion is applied on a per-donee basis, you can leverage the exclusion by making gifts to multiple members of the same family. The exclusion applies to gifts of any kind of property, although certain types of property may require an appraisal. Qualifying tuition payments and medical payments (as discussed below) do not expend annual gift tax exclusions.

Annual gift tax exclusions expire at the end of each year (with no carry over to the next year), so year-end is the appropriate time to use them. If you want to make a gift that exceeds the amount of the exclusion, you can effectively double the exclusion by making one gift in December and the second in January. For example, if you are married, you can make a tax-free gift of $56,000 to any individual by making a gift of $28,000 in December 2013 and another $28,000 gift in January 2014.

Tuition Payment Exclusion

In addition to the annual gift tax exclusion, you are allowed to make gift-tax-free tuition payments for any individual. There is no limit on the amount that can be excluded, except that the payment must be to a tax-exempt school at any level and for the purpose of education or training. The exclusion applies only to tuition; payments for room and board, books, computers, or related expenses are not eligible. Because there is no limit on the amount of the gift, its timing is less important than it is with the annual exclusion.

You need not rely on this exclusion for payments made on behalf of individuals for whom you may be required to provide legal support (such as your minor children), as those payments are not otherwise treated as gifts (since they are, by definition, obligations).

Section 529 College Savings Plans

Contributions to a Section 529 college savings plan do not qualify for the exclusion for tuition payments but can qualify for the $14,000 annual gift tax exclusion. A contribution to the plan may also entitle you to a state income tax deduction.

Distributions from a 529 plan can be used for a wide range of educational expenses, including tuition, fees, books, supplies, computers, and room and board. An added advantage of a gift to a 529 plan is that the income earned on the plan contributions is tax-free, as long as it is eventually used for educational purposes. Thus, you can reduce your own income taxes by funding a 529 plan with savings that would have been used for college anyway. And because you can name yourself as the owner of the account, you ensure that your beneficiary uses the account for educational purposes.

A special rule allows you to use up to five years' worth of annual gift tax exclusions when funding a 529 college savings plan. You can fund a savings plan with up to $70,000 (5 x $14,000) this year and then file an election with the IRS on a Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) to spread this gift over five years (2013 - 2017) for gift tax purposes. [The election on Form 709 need only be made related to the initial $70,000 transfer; no additional Form 709 need be filed in later years provided there is no independent cause for filing the Form, such as would arise if additional reportable gifts were made.] By using five years' worth of annual exclusions, the entire gift becomes gift-tax-free (provided you survive the 5-year period).

Medical Payment Exclusion

The payment of a beneficiary's medical expenses is also excluded from the gift tax, with no limitation on the amount excluded. To qualify for this exclusion, the payment must be made directly to the provider, and it must be for medical expenses of the type that would qualify for an income tax deduction. You may also be able to claim an income tax deduction for the payment if it is made for your spouse or dependent.

The exclusion for medical payments includes the payment of medical insurance premiums. If you have a child or grandchild who is paying for his or her own insurance, payment of their insurance premiums is an efficient means of making a tax-free gift that does not consume annual exclusions or your lifetime gift tax exemption.

You need not rely on this exclusion for payments made on behalf of individuals for whom you may be required to provide legal support (such as your minor children), as those payments are not otherwise treated as gifts (since they are, by definition, obligations).

Gifts in Trust

Despite the tax savings, you may be uneasy about making outright gifts to your children or grandchildren, due to your loss of control over how they use the gift. This concern can be addressed by making the gifts in trust, which will allow you to determine when they receive the money and how it is to be used.

There are special requirements for ensuring that a gift in trust qualifies for the $14,000 annual exclusion. Usually, the trust is drafted to provide the beneficiary with temporary withdrawal rights over the gift (*e.g.,* for 30 days), such that it is considered a present interest rather than one that vests in the future. Although this presents a risk of the beneficiary withdrawing the gift from the trust, the probability of your terminating any further gifts to the trust is usually sufficient to prevent this. If you are interested in making a gift in trust, HCA stands ready to assist and to guide you in working with your attorney.

Gifts to Grandchildren

Annual exclusion gifts are often exempt from GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts that don't qualify for the exclusion to be completely tax-free, you usually must apply both your GST tax exemption and your gift tax exemption if the gift will benefit an individual two generations or more below you, such as your grandchildren. [Certain types of transfers qualify for ***gift*** tax annual exclusion treatment but not ***GST*** tax annual exclusion treatment.]

So, for example, if you make an annual exclusion gift to your grandson and you want to give him an additional $30,000 in the same year to help him make a down payment on his first home, you may need to use $30,000 of your GST tax exemption plus $30,000 of your gift tax exemption to avoid any tax on the transfer for purposes of the home down payment. If preserving exemptions is important to you, you may want to consider restructuring such a transfer so that it is a loan instead of a gift. If you are interested in structuring a loan to a member of a lower generation of the family, HCA stands ready to assist.

Specific Types of Assets

If you own a business, you may be able to leverage your gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation discounts. So, for example, if the discounts total 30%, in 2013 you may be able to gift an ownership interest equal to as much as $20,000 tax-free because the discounted value doesn't exceed the $14,000 annual exclusion. Note that the IRS may challenge the value; a professional appraisal is strongly recommended. If you are interested in pursuing such a valuation, HCA can provide you with a short list of valuation specialists qualified to handle such work.

Another way to benefit from valuation discounts is to (i) set up and fund a family limited liability company (FLLC) and (ii) gift non-managing interests. Note that the IRS is closely scrutinizing FLLC interest transfers, so be sure to set up and operate yours properly. HCA stands ready to assist clients interested in pursuing this and similar techniques.

Other Opportunities

Potential additional opportunities include:

Non-Taxable Gifts. With the increase in gift and GST tax exemptions, additional non-taxable lifetime gifts can be made this year to heirs (outright or in trust). A couple could potentially give as much as $10.5MM to heirs without triggering Federal transfer tax. If the gift were made to a trust, the trust could then leverage the gift by purchasing additional assets from the couple's estate. The sale would have the effect of "freezing" the value of the purchased assets in the couple's estate for estate tax purposes, while shifting the assets' future growth to the trust, transfer-tax-free. Such a trust could also shelter the trust assets from estate tax for many generations. Taxpayers with substantial estates who would like to transfer wealth to lower generations should consider doing so with high-basis assets with significant growth and/or income potential. [Since lifetime gifts generally carry with them the cost basis of the donor (whereas assets inherited from a decedent generally receive a basis stepped-up or down to date of death value), high basis assets are ideal.]

Insurance. Taxpayers wanting to fund life insurance trusts in the past were often constrained by gift tax limitations and costs. This sometimes resulted in the purchase of smaller policies than desired or complicated funding structures (such as so-called "split dollar" arrangements or sales of existing policies to irrevocable grantor trusts) in order to minimize potential gift tax exposure. The $5.25MM gift tax exemption makes 2013 an ideal year for establishing life insurance trusts that are funded adequately so as to allow for the purchase of large life insurance policies, unwinding existing split dollar arrangements, and/or transferring existing individually-owned life insurance policies to life insurance trusts to protect death benefits from potential estate tax exposure.

Dynasty Trusts. As noted above, the GST tax exemption was increased to $5.25MM for 2013. Taxpayers wishing to make substantial gifts that could benefit multiple generations should consider making such gifts to a GST-exempt "dynasty" trust in 2013. The dynasty trust allows assets to skip several generations of transfer taxation. You can fund the trust either during your lifetime by making gifts or at death in the form of bequests. The trust remains in existence from generation to generation. Because the beneficiaries have restrictions on their access to the trust funds, the trust is excluded from their estates. If any of the beneficiaries have a real need for funds, the trust can make distributions to them. In order to maximize the potential duration of such a trust, consideration should be given to establishing it in a jurisdiction that permits perpetual trusts, such as Delaware or Alaska. A dynasty trust can help you take full advantage of the GST tax exemption.

Taxable Gifts. The tax rate for gifts above the exemption amount is 40%. Thus, there could be instances in which an individual would want to take advantage of this low rate to transfer additional assets out of his or her estate.

Charitable Gifts

The year end is a good time to review your charitable giving to ensure that it is being done in the most tax-efficient manner. Charitable giving is, among other things, a form of income tax and estate planning, because a gift to charity will never be subject to estate or gift tax and provides you with an immediate income tax deduction. If you are planning to make a large gift before January 1, we should review its impact on your 2013 income tax liability and whether it may make sense to defer all or a portion of the gift to 2014 (if, for example, your marginal ordinary income tax rate in 2014 is projected to be higher). If the gift is of property and will require an appraisal (usually required for gifts of property with a value in excess of $5,000, other than publicly-traded stock), we should start the process as soon as possible so that the appraisal is available before year end.

While we are getting very close to the end of the year, there is still time to implement strategies that may help you minimize estate and gift tax liabilities. If you have questions about topics reviewed above or other tax planning matters, please contact Hunter Payne at 703.992.6485.

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