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Gift Tax Holiday

Introduction

We celebrate the start of the year 2011 with dramatically expanded federal gift tax exemptions. The 2010 Tax Act provides a $5 million exemption until January 1, 2013, from the following federal transfer taxes:

- Gift tax on transfers during lifetime;
- Estate tax on transfers upon death; and
- Generation-skipping transfer tax on transfers to grandchildren and younger generations during lifetime or upon the death of the transferor.

These changes present new opportunities for lifetime transfers of wealth to children and grandchildren. A national commentator recently noted that "a surge in gifting" is expected in 2011 as a result.

Annual Exclusion Gifts

Gifts to children and grandchildren equal to the annual gift tax exclusion amount continue to be an effective method for transferring wealth to children and grandchildren. The annual exclusion amount for the year 2011 is $13,000 per recipient. A married couple may give each recipient $26,000 without the need to file gift tax returns.

Gifts for Tuition or Medical Expenses

In addition to the annual exclusion gifts, a parent or grandparent may pay tuition or medical expenses for a child or grandchild free from gift tax. To qualify for this exception from the gift tax, the tuition check must be payable directly to the educational institution and the medical expense check must be payable directly to the medical provider.

$5 Million Gift Tax Exemption

Beyond the existing annual exclusion gifts and gifts for tuition and medical expenses, each person now has a $5 million lifetime cumulative gift tax exemption ($10 million for couples), a dramatic increase from the prior $1 million exemption. The 2010 Tax Act unified the gift and estate taxes. Thus, each person may give up to a maximum of $5 million during his or her lifetime or upon death free from gift and estate taxes. Any portion of the $5 million not given away during lifetime will pass free from estate tax after death.

Generation-Skipping Transfer Tax Exemption

Each person also has a $5 million generation-skipping transfer ("GST") tax exemption ($10 million for couples). The GST exemption enables a grandparent, during his or her lifetime or upon death, to make significant gifts to grandchildren free from GST. This exemption is co-extensive with the gift tax exemption and not in addition to it.

Valuation Discounts

Discounts are often applied in determining the fair market value of closely-held stock, limited partnership units, or limited liability company membership units to reflect the lack of control and lack of marketability of such ownership interests. Bills have been introduced in Congress that would restrict or eliminate the use of valuation discounts in determining fair market value for gift tax purposes. The 2010 Tax Act does not include any restrictions on the use of valuation discounts. For now, valuation discounts remain an important tool to be used with the $5 million exemption to leverage gifts of closely-held business ownership interests.

Minnesota Gift and Estate Tax

Currently, Minnesota does not have a gift tax. Minnesota has an estate tax with a maximum estate tax rate of 16% for gross estates of $10 million or more. The filing requirement for the Minnesota estate tax is $1 million.

Opportunities and Advantages of Gifting

The dramatic increase in the gift tax exemption was unexpected and presents new opportunities to transfer wealth to children or future generations. Advantages of gifting include the following:

1. A gift removes future appreciation on the property from the estate and, thus, is more effective than a transfer at death.

2. A transfer is more tax-efficient if made during lifetime due to differences in the way the gift tax and the estate tax are computed.

3. Transfers can be made in trust as well as outright. Transfers in trust during lifetime allow a parent or grandparent the opportunity to guide the recipient on the wise use of the assets transferred.

Disadvantages of Gifting

Lifetime gifts have the following disadvantages:

1. To make a completed gift, the donor must relinquish all control over the property given.

2. The recipient of the gift must use the donor's basis ("carryover basis") in determining gain or loss on a subsequent sale of the property. If the recipient received the property as a result of the death of the donor, the recipient's basis in the property is "stepped-up" to fair market value as of the donor's death. Gifting leads to higher taxes than transfer upon death if the value of the property appreciates in the hands of the recipient.

3. The 2010 Tax Act expires on December 31, 2012. Thereafter, the gift and estate tax exemptions will be $1 million unless Congress takes further action. One action Congress could take is to lower the gift and estate tax exemptions to something between $1 million and $5 million. If the estate tax exemption is less than $5 million at the time of a donor's death, there is a risk of additional estate taxes being imposed on the donor's estate as a "clawback" of the tax benefits of utilizing the higher gift tax exemption.

The dramatic change in the gift tax exemption is available for only two years. Further, Minnesota could enact a gift tax in the coming years. Those who see opportunities in the current law should act soon.