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2011 Year-End Estate and Gift Tax Planning

We have set out below the techniques for making year-end gifts to your children and grandchildren without incurring any gift tax. Many of these techniques will also reduce your overall income tax burden.

Use of Gift Tax Exemptions to Reduce Estate and Gift Tax

Congress reinstated the federal estate tax for 2010 and thereafter, setting the unified federal estate and lifetime gift tax exemption amount at $5 million for 2010 through 2012, with a possible inflation adjustment for 2012. This increased amount is well above the $3.5 million amount effective for 2009.

Although the exemption amount and tax rates after 2012 are uncertain, there is no doubt that the estate tax is here to stay and must be planned for in larger estates. Therefore, a person should consider making sufficient lifetime gifts so that his or her estate will not exceed the exemption amount in effect at death.

Please understand that lifetime gifts are subject to a gift tax imposed at the same rate as the estate tax. This "unified" system is intended to eliminate any tax advantage to making gifts. But certain types of lifetime transfers are not subject to gift tax, and year's end could be a good time to make these tax-free 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 each year during 2010, 2011 and 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.

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, a donor could make $13,000 gifts to each of his son, his 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. The threat of higher income tax rates in future years makes this an important consideration.

Annual Gift Tax Exclusion (continued)

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 $52,000 to any individual by making a gift of $26,000 in December 2011 and another $26,000 gift in January 2012.

Note that Congress substantially increased the estate and lifetime gift tax exclusion amount, mentioned above, from $1.0 million in 2010 to $5.0 million in 2011 and 2012**; thus, providing a two-year window** for maximizing such giving. Congress also provided that, if a spouse dies in 2011 or 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.

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 tax-exempt school** at any level, 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.

Congress recently extended the income tax deduction for tuition payments through 2011. To obtain the deduction, the tuition payment must be made to an institution of higher education on behalf of a dependent, and the payor's adjusted gross income must be below certain limits. Thus, a tuition payment may have some income tax advantages.

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 $13,000 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 a 529 plan 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.

Section 529 College Savings Plans (continued)
A special rule allows a contributor to utilize up to five annual gift tax exclusions simultaneously when funding a 529 plan. He or she may fund the plan with up to $65,000 (5 x $13,000) this year, then file an election with the IRS to spread this gift over five years (2011 through 2015) for gift tax purposes. By using five annual exclusions, the entire gift becomes gift-tax-free, although the contributor must wait until 2015 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. These medical expenses must be of the type that would qualify for an income tax deduction. 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. Further, the payor may claim an income tax deduction for a payment made for his or her spouse or dependent.

Gifts in Trust

Despite the tax savings, a person may be uneasy about making outright gifts to children or grandchildren, due to the loss of control over how they use the gift. We can address these concerns by making the gifts in trust, which allows the trust creator to determine when the beneficiaries receive the money and how it is used.

Special requirements exist that ensure that a gift in trust qualifies for the $13,000 annual 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 the giver's 2011 income tax liability and whether all or a portion of the gift should be deferred to 2012. 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 2011 and 2012. If you wish to take advantage of any of the planning techniques that we have described, please feel free to call.

Pursuant to Circular 230 promulgated by the Internal Revenue Service, if this letter, or any attachment hereto, contains advice concerning any federal tax issue or submission, please be advised that it is not intended or written to be used, and that is cannot be used, for the purpose of avoiding federal tax penalties unless otherwise expressly indicated.