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UPDATE
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Gifting in 2010 – A Window of Opportunity Will Soon Close

INTRODUCTION

Although the current economic climate and tax situation appear uncertain, calendar year 2010 has provided many taxpayers with the incentive to make significant gifts this year, even when such gifts generate a gift tax liability for the donor-taxpayer. Several factors have prompted such gifting and have created a willingness to pay federal gift taxes, but at least a major one of these factors, the reduced federal gift tax rate, likely will disappear by year end.

WHY PAY TAXES NOW?

Most taxpayers prefer to defer as long as possible the payment of taxes. There may be advantages, however, to transferring assets in 2010 and paying any resulting federal gift taxes now, rather than retaining those assets and paying federal estate taxes on them at death.

Federal Gift and Estate Tax Rates

Since 2001, the maximum federal gift tax rate has dropped from 55 percent to its current rate of 35 percent, the lowest top rate in over 25 years. Unless Congress amends the current federal gift tax laws, however, that rate will return to 55 percent for gifts made after December 31, 2010. And even if Congress amends the gift tax rules, there is widespread belief that the maximum federal gift tax rate will not be lower (and likely will be higher) than the current 35 percent rate.

Further, although the federal estate tax is repealed for 2010, absent Congressional action, this tax returns in 2011, with a rate of 55 percent on taxable estates in excess of $1 million (plus a 5 percent surcharge on certain large estates). Therefore, unless Congress amends the current federal estate and gift tax laws, a significant tax rate differential will exist between the gift tax imposed on lifetime transfers made in 2010 and the estate tax imposed on assets owned by a decedent dying after 2010. (Basis adjustments allowed for assets included in a taxpayer's estate, however, may lessen to some extent the impact of this potential tax differential.)

Depressed Asset Values

Due to current market conditions, the values of many assets are still depressed. A gift of assets that have declined in value, combined with the low federal gift tax rate, results in a reduced transfer tax cost to the donor-taxpayer. Also, a current gift of a low value asset removes any post-gift appreciation on that asset from the donor-taxpayer's taxable estate, thus avoiding federal estate taxes attributable to that appreciation.

Low Federal Applicable Interest Rates

Each month the federal government sets interest rates that must be used in connection with certain transactions, such as intrafamily loans, grantor retained annuity trusts, charitable lead trusts, and installment sales to intentionally defective grantor trusts. Current interest rates are at record lows, making these estate planning techniques attractive options for transferring wealth to family members at little or no gift tax cost.

Income Shifting

Gifts of income-producing assets remove the taxable income generated by such assets from the donor-taxpayer's taxable income. When such assets are gifted to family members who are in lower income tax brackets, the family attains a net income tax savings.

Reduction in Taxpayer's Taxable Estate

A lifetime gift not only removes any post-gift appreciation from the donor-taxpayer's taxable estate but also any gift tax paid in connection with the gift, provided the gift was made more than three years prior to the donor-taxpayer's date of death. If the asset is not gifted and is subject to tax in the taxpayer's estate, a federal estate tax is imposed on both the value of the asset at the taxpayer's death *and* the cash in the taxpayer's estate used to pay estate taxes attributable to that asset.

GIFTS TO GRANDCHILDREN AND MORE REMOTE DESCENDANTS

2010 offers even greater incentives for making gifts to grandchildren and more remote descendants. These gifts generally are subject to both gift taxes and generation-skipping transfer ("GST") taxes, the latter of which are imposed on gifts to persons more than one generation below the donor-taxpayer. Like the federal estate tax, the GST tax is repealed for 2010 *only*. And like the federal estate tax, the GST tax is scheduled to be reinstated in 2011, with a maximum rate of 55 percent imposed on gifts in excess of the donor's GST exemption amount ($1.12 million for 2011). Thus, many taxpayers are making gifts to grandchildren and more remote descendants in 2010, including outright transfers, gifts to custodian accounts, and gifts of interests in family partnerships and/or limited liability companies.

Taxpayers considering 2010 gifts to trusts for the benefit of grandchildren and more remote descendants should consult their tax advisors prior to making such gifts because of concerns that such trusts could be subject to the GST tax in the future.

SUMMARY

The calendar year 2010 provides several incentives for taxpayers to make significant taxable gifts before year end: (1) a record low federal gift tax rate, combined with the potential future increase of federal gift and estate tax rates; (2) the depressed value of assets due to market conditions; (3) the low federal interest rates; (4) the removal from a donor's taxable estate of funds used to pay gift taxes; (5) the shifting of taxable income to family members in lower income tax brackets; and (6) the temporary repeal of the GST tax. In determining whether to make significant gifts before the close of 2010, taxpayers should consider their personal and financial situation and consult their tax advisors. ■

Individual Clients Group

Judith M. Keppelman, Linda J. McDowell, Robert H. Smith, Jr.,
William C. Ely, Kelley Galica Peck, Jeanmarie B. Shea, Kenneth M. Gammill,
J. C. David Hadden, Edward J. Heath, Christopher J. Hug

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