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Making Sense of Making Gifts in 2011 & 2012

The Unemployment Insurance Reauthorization and Job Creation Act of 2010

The Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the “2010 Act”), which went into effect December of 2010, brought with it significant reforms to our existing tax laws. Specifically, the 2010 Act addresses the estate, gift, and generation skipping Transfer (GST) taxes by dramatically increasing the tax exemptions available and the manner in which those transfer taxes are applied. Interestingly, the sweeping reforms created by the 2010 Act are set to expire on December 31, 2012, returning us to 2001 tax laws.

Under the 2010 Act, each individual has a \$5,000,000 exemption from the estate and gift taxes and will pay a maximum gift and estate tax rate of 35%. This exemption amount can be used in any combination during life or at death, as long as the total amount covered by the exemption does not exceed \$5,000,000. In addition to the \$5,000,000 of exemption from gift and/or estate taxes, each individual has a \$5,000,000 exemption from the GST tax.

The increase in the available tax exemption amounts and reduction in the maximum tax rates for the gift, estate and GST taxes appears to have provided a narrow window during which individuals can employ some powerful tax planning techniques. There has been some confusion, however, about whether gifts made in 2011 and 2012 will be subject to tax at a later date if new rates and/or exemptions come into effect in 2013. To address this confusion, we are providing a series of examples to demonstrate the treatment of gifts made during life, when the donor dies under current estate tax laws (i.e. 2010 Act) and prior law (i.e. law existing in 2009 and before).

CHANGES TO THE CALCULATION OF THE GIFT AND ESTATE TAXES

To calculate the estate tax, the tax laws require that a decedent's estate include (1) all lifetime gifts made by the decedent after 1976 and (2) all gift taxes paid on gifts made within three years of the decedent's death.

After these amounts are added to the estate, a “tentative estate tax” is computed using the estate tax rates in effect as of the date of death.

This tentative estate tax is then reduced by the amount of “deemed” gift taxes that would have been paid had all post-1976 gifts been made on the actual date of death. This “deemed” gift tax reduces the tentative estate tax, but it is not reflective of actual gift taxes paid during the decedent's life.

Subtracting the “deemed” gift taxes paid from the tentative estate tax results in the net estate tax due on the decedent's overall estate.

The method for calculating the aforementioned “deemed” gift tax for all post-1976 gifts relies on the tax laws in effect at the decedent’s death. Let’s compare the old method with the new method created under the 2010 Act:

Old Law: Under the law in existence in 2009 and before, the calculation for determining the “deemed” gift taxes is made using the gift tax rate in effect as of the *date of death*, and the gift tax exemption amount in effect as of the *date of the gift*. This method of calculation is illustrated in **Examples 1, 2, 5 and 7**.

New Law: Under the law created by the 2010 Act, the “deemed” gift tax is calculated using both the gift tax rate and the gift tax exemption amount in effect as of the *date of death*. The method of calculation created by the 2010 Act is illustrated in **Examples 3, 4 and 6**.

To illustrate how the “Old Law” calculated the “deemed” gift tax on lifetime gifts, please consider the following examples:

Example 1: Death in 2009, Estate of \$4,500,000, Gift of \$1,500,000 in 2008

Assume an individual had a \$4,500,000 estate, made a gift of \$1,500,000 in 2008 and then died in 2009 with a \$4,500,000 taxable estate. The calculation her executors would have done to determine the estate tax due would look something like this:

Tentative Taxable Estate	\$4,500,000
Adjusted Taxable Gifts Made After 1976	\$1,500,000
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate ¹	\$2,580,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$210,000
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,370,800
Maximum Unified Credit against Estate Tax ²	\$1,455,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$915,000

Example 2: Death in 2009, Estate of \$6,000,000, No Gift

If that same individual had died in 2009 with a total estate of \$6,000,000, not having made any gifts, her estate tax calculation would be as follows:

Tentative Taxable Estate	\$6,000,000
Adjusted Taxable Gifts Made After 1976	\$0
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate	\$2,580,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$0
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,580,800
Maximum Unified Credit against Estate Tax	\$1,455,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$1,125,000

Comparing Example 1 with Example 2, you will see that the estate with a taxable gift (Example 1) results in lower overall estate tax liability, allowing the decedent to pass more assets on to her heirs. This is because the estate tax is reduced by the “deemed” gift taxes that would have been due on the overall value of decedent’s lifetime gifts had such gifts been made in the year of death.

WHAT IF THE SAME DECEDENT WERE TO DIE IN 2011 OR 2012?

As opposed to prior law, under the 2010 Act, the calculation for “deemed” gift taxes due relies on both the gift tax rates and the gift tax credit amount in effect as of the *date of death*. How does this change affect the estate tax liability for our fictional decedent who dies with a \$4,500,000 estate in 2011 having made a lifetime taxable gift of \$1,500,000 in 2008? Consider the following examples:

Example 3: Death in 2011, Estate of \$4,500,000, Gift of \$1,500,000 in 2008

Tentative Taxable Estate	\$4,500,000
Adjusted Taxable Gifts Made After 1976	\$1,500,000
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate ³	\$2,080,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$0
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,080,800
Maximum Unified Credit against Estate Tax ⁴	\$1,730,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$350,000

Under the 2010 Act, even though the decedent actually paid a gift tax in 2008 (when the exemption was only \$1 million), she must use the 2011 gift tax credit for purposes of calculating the “deemed” gift taxes due on her estate tax return. Because her \$1.5 million lifetime gift is more than covered by the 2011 exemption (which is \$ 5 million), she is “deemed” to have paid no gift taxes during her life.

Although the decedent receives no credit for “deemed” gift taxes paid during life in Example 3, her estate is better off than it would have been had she died in 2009 because the Unified Credit against Estate Tax in 2011 is larger than it was in 2009 (\$1,730,800 for 2011 vs. \$1,455,800 for 2009).

WHAT IF THIS SAME DECEDENT MADE A GIFT IN 2011 RATHER THAN A GIFT IN 2008?

Example 4: Death in 2011, Estate of \$1,000,000, Gift of \$5,000,000 in 2011

Assume our decedent, still having a \$1,000,000 estate, had made a gift of \$5 million in 2011 (rather than the \$1.5 million gift in 2008) and died in 2011. How does the 2010 Act impact the amount of estate taxes she would pay if she used up her full exemption during her lifetime?

Tentative Taxable Estate	\$1,000,000
Adjusted Taxable Gifts Made After 1976	\$5,000,000
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate	\$2,080,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$0
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,080,800
Maximum Unified Credit against Estate Tax	\$1,730,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$350,000

As you can see, the estate taxes owed under Examples 3 and 4 are the same. This is because the 2010 Act requires, for purposes of calculating the “deemed” gift taxes to arrive at the net estate tax due, that the rate of tax and unified credit utilized for lifetime is the tax rate and credit as it exists at *date of death*.

NOW, WHAT IF THE DECEDENT, WITH HER \$1,000,000 ESTATE AND THE \$5,000,000 GIFT SHE MADE IN 2011 DIES IN 2013 WHEN THERE IS A FULL SUNSET OF THE 2010 ACT?

A full sunset of the 2010 Act will mean that the tax law reverts to a \$1,000,000 estate exemption with a maximum tax rate of 55%. The prior law also includes the requirement that, for purposes of calculating the estate tax, the gift tax credit in effect as of the *date of the gift* and the gift tax rates in effect as of the *date of death* have to be used. This changes the estate tax as follows:

Example 5: Death in 2013, Estate of \$1,000,000, 2011 Gift of \$5,000,000 – Date of Gift Credit

Tentative Taxable Estate	\$1,000,000
Adjusted Taxable Gifts Made After 1976	\$5,000,000
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate	\$2,940,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$660,000
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,280,800
Maximum Unified Credit against Estate Tax	\$345,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$1,935,000

Would this result be any different if decedent died in 2013 with a \$1,000,000 exemption amount and a tax rate of 55%, but a change was made to the tax law, requiring that for purposes of calculating the estate tax, the decedent has to use the gift tax rate and the gift tax credit amount in effect as of her *date of death* in order to determine the “deemed” gift taxes that would have been due on her date of death? Let’s take a look:

Example 6: Death in 2013, Estate of \$1,000,000, 2011 Gift of \$5,000,000 – Date of Death Credit

Tentative Taxable Estate	\$1,000,000
Adjusted Taxable Gifts Made After 1976	\$5,000,000
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate	\$2,940,800
Total “Deemed” Gift Tax Due on Post-1976 Gifts	\$2,045,000
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$895,800
Maximum Unified Credit against Estate Tax	\$345,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$550,000

As Examples 5 and 6 demonstrate, there is a dramatic difference in the amount of estate taxes owed, even though the sole difference between the two estates is the amount of credit used to calculate the gift taxes that would have been due. This is because under the Example 5, the estate tax reduction possible because of “deemed” gift taxes paid relies on the much higher gift tax exemption amount available under 2011 laws. Because the estate had a larger gift tax exemption amount it was “deemed” to have paid a smaller amount of overall gift taxes. This smaller “deemed” gift tax amount resulted in less of a reduction in the estate tax bill, which generated a larger net estate tax owed.

Under Example 6, the estate has a much smaller gift tax exemption amount (\$345,800 for 2013 versus \$1,730,800 for 2011), which means that the estate is “deemed” to have paid a much larger gift tax. This significantly larger “deemed” gift tax allows the estate to reduce the overall estate taxes paid, resulting in a smaller tax bill.

DOES THIS MEAN THAT THE DECEDENT IS BETTER OFF NOT MAKING ANY GIFTS?

Given that the 2010 Act is only going to be in effect for two years and that it’s currently impossible to predict what January 1, 2013 will bring in terms of a gift and estate tax, many people are tempted to wait out the next two years. Those individuals are not comfortable with the uncertainty provided under the current two-year law, and are hoping that 2013 will bring a more permanent resolution to the estate and gift tax laws. For those considering a wait-and-see approach, look at the following example:

Example 7: Death in 2013, Estate of \$6,000,000, No Gift

Assume decedent, with a \$6,000,000 estate, made no gifts and died in 2013 when there is a full sunset of the 2010 Act, returning us to prior tax laws. The calculation would now be:

Tentative Taxable Estate	\$6,000,000
Adjusted Taxable Gifts Made After 1976	\$0
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000
Tentative Tax on Total Estate	\$2,940,800
Total "Deemed" Gift Tax Due on Post-1976 Gifts	\$0
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,940,800
Maximum Unified Credit against Estate Tax	\$345,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$2,595,000

As Example 7 clearly illustrates the wait-and-see approach results in the largest amount of estate tax liability. Compare this with Example 5, where the decedent was able to transfer a large amount of her estate out at a 35% tax rate. Despite the fact that the decedent in Example 5 had her lifetime gift pulled back into her estate, resulting in a larger estate tax than she would have paid if parts of the 2010 Act had been carried into 2013 (as illustrated in Example 6), she still received a benefit from the reduced gift tax rate. Moreover, Example 5's calculation does not take into account the fact that a gift in 2011 means that she avoids paying income taxes on the \$5,000,000 asset's annual income. It also cannot account for the fact that by making a gift in 2011, the decedent managed to shift two-year's worth of appreciation in the \$5,000,000 asset out of her taxable estate.

LET'S REVIEW

Although we cannot predict what the law will actually be in 2013, here is a helpful summary of the scenarios discussed in Examples 5, 6 and 7 above depending on a couple of variations of the law that might be applicable in 2013.

Summary of Possible 2013 Estate Taxes			
	2013 Death, \$1M in Estate, \$5M Gift in 2011		2013 Death, \$6M Estate (Sunset Rates) – No Prior Gifts
	(Sunset Rates) Credit as of Date of Gift	(Sunset Rates) Credit as of Date of Death	
Tentative Taxable Estate:	\$1,000,000	\$1,000,000	\$6,000,000
Adjusted Taxable Gifts Made After 1976	\$5,000,000	\$5,000,000	\$0
Sum of Tentative Taxable Estate & Gifts after 1976	\$6,000,000	\$6,000,000	\$6,000,000
Tentative Tax on Total Estate	\$2,940,800	\$2,940,800	\$2,940,800
Total Gift Tax Paid or Payable on Post-1976 Gifts	\$660,000	\$2,045,000	\$0
Gross Estate Tax (Total Estate Tax less Gift Tax)	\$2,280,800	\$895,800	\$2,940,800
Maximum Unified Credit against Estate Tax	\$345,800	\$345,800	\$345,800
Estate Taxes Owed (Gross Estate Tax less Credit)	\$1,935,000	\$550,000	\$2,595,000

CONCLUSION

Despite the confusion surrounding the 2010 Act and the subsequent estate tax calculations, a simple examination of the numbers illustrates that even if the decedent did not get quite the result in 2013 that she expected, she still received a better tax result than she would have gotten had she not made the gift at all.

1. In 2009, the maximum rate of tax under the 2001(c) rate table was 45%.
2. In 2009, the “Maximum Unified Credit against Estate Tax” was based on an applicable exclusion amount of \$3,500,000.
3. For 2011 and 2012, the maximum rate of tax under the 2001(c) rate table is 35%.
4. For 2011 and 2012, the “Maximum Unified Credit against Estate Tax” is based on an applicable exclusion amount of \$5 million.

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