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Going, Going, Gone? Gifting Under the Soon-to-Expire Tax Law

Myths About No Contest Clauses

ASK AN EXPERT

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While California law currently does not permit same-sex couples to marry, same-sex couples are eligible to register as domestic partners. Opposite-sex couples also may choose domestic partnership over marriage if one member of the couple is age 62 or older. As a matter of state law, registered domestic partners basically have the same rights as married couples. Federal law, however, still treats married persons and domestic partners differently. Hence, domestic partners must consider this evolving area of the law in completing their estate planning.

A common estate plan for a married couple includes the use of the marital deduction in passing assets outright or in a qualified trust to the surviving spouse. Transfers between spouses during life or at death that qualify for the unlimited marital deduction pass free of estate tax. Domestic partners do not qualify for the marital deduction as federal law requires that a couple be married to qualify for the marital deduction, and marriage is defined as a union between a man and a woman.

Domestic partners can create an estate plan that includes the use of the first deceased partner's lifetime exemption against estate and gift tax (currently $5,120,000 but subject to change in 2013) similar to married and non-married persons. However, unlike married couples who qualify for the marital deduction, any portion of the deceased partner's estate exceeding the lifetime gift and estate tax exemption will be subject to estate taxes at the current rate of 35%. This tax must be paid within nine months of death and may cause unanticipated financial issues for the surviving partner.

The lack of an unlimited marital deduction affects not only bequests at death, but also lifetime gifts and transfers between domestic partners. For example, if a domestic partner owns a home in Sacramento, then transfers a half interest in the house to her partner, the transfer will be treated as a gift. Any gift to a domestic partner over $13,000 (the current annual gift tax exclusion) must be reported on a gift tax return. When filing the gift tax return, the partner must utilize his or her lifetime gift tax exemption against the gift and, if the gift exceeds the exemption amount, pay gift tax on the gift at the applicable rate. A spouse, in contrast, may perform the same transaction without triggering any gift tax through use of the marital deduction.

If their estate will have gift and estate tax issues, partners can create liquidity to ease the estate tax burden upon the surviving partner by implementing an irrevocable life insurance trust (ILIT). To form an ILIT, Partner A sets up the trust with a third party acting as trustee and Partner B as the beneficiary. Partner A gifts funds to the trust each year under the annual exclusion or as a lump sum which the trustee uses to purchase a life insurance policy on Partner A's life. Upon Partner A's death, the insurance benefit is paid to the ILIT and distributed to Partner B without any estate tax consequences.

Domestic partners also must pay attention to retirement and health care. Current federal law in these areas does not treat domestic partners and married couples equally. It is also important to remember when traveling in other states that medical personnel may not understand or recognize the rights of a domestic partner and instead give priority to a family member. A power of attorney for financial decisions and an advanced health care directive naming the partner will assure that the partner's authority as the financial and health care decision maker is recognized in the event of incapacity or grave illness.

New laws may further close the gap between domestic partners and married couples, or allow same-sex couples to marry. For now, however, domestic partners should consult with counsel to develop a sound estate plan.

–Sabrina Schneweis-Coe

The general information in this newsletter may or may not be appropriate for your particular situation. Before taking any action based on this newsletter, you should consult with your estate planning attorney.

Going, Going, Gone? Gifting Under the Soon-to-Expire Tax Law

We're getting inquiries from our clients as to whether they should make large gifts by the end of 2012 to take advantage of current federal tax law. It's a good question and there's no easy answer.

Many observers believe that Congress will take some action (probably after the November election as part of a larger tax bill) to avoid the reversion to the 2001 tax regime. However, even if Congress does act timely to avoid the "sunset" of current law, it is not clear whether Congress will retain the existing exemption amount and rate. Some believe that the exemption amount will go down and that the rate will go up.

The "opportunity" presented by this uncertain state of the law is for full use of the $5,120,000 exemption amount before its possible demise at the end of this year. Most experts believe that if one makes full use of the maximum exemption amount this year, the resulting tax benefit will be permanent, even if the law becomes less favorable after 2012. (It is theoretically possible, through practically unlikely, that the Government could "claw back" at the time of the taxpayer's death, whatever gift tax would have been charged on the difference between $5.12 million and whatever lower exemption amount is in effect at the time of death.)

Also, gifts of interests in family-owned entities made this year may be valued in a much more favorable way for gift tax purposes than they will be after 2012. The Government has for several years been advocating an elimination or reduction of valuation discounts for gifts of interests in closely-held family entities. Many believe that this is the year when that change will finally be enacted.

When deciding whether to make a substantial lifetime gift, one must consider the income tax consequences as well as the transfer tax consequences. The key rule is that the recipient of a lifetime gift must adopt the donor's existing income tax basis and that when the donor later dies, there will be no adjustment of income tax basis on gifted assets to fair market value at the time of death, as would otherwise occur if those assets had remained part of the donor's estate.

Therefore, where a donor gives away highly appreciated assets, the donee will "inherit" a sizable potential capital gains tax liability if the donee later disposes of the gifted assets. That potential income tax liability must be weighed against the potential transfer tax savings produced by the lifetime gift. This potential income tax downside to lifetime giving could become greater if, as many predict, Congress increases the capital gains rate.

If your estate is large enough to enable you to make taxable gifts significantly in excess of $1 million (when added to your prior taxable gifts), or $2 million per couple, making those gifts this year may enable you to "hedge" against the possibility of an unfavorable change in the law. However, this sort of hedging will ultimately produce an estate tax benefit only if the estate tax exemption is later reduced to a level below the amount of your combined lifetime taxable gifts. You must weigh this fairly speculative potential benefit against the possible negative income tax consequences of the gift for the recipient.

We suggest that you carefully consider whether to make taxable gifts in 2012. If you would like to discuss your gift and estate tax planning with a Downey Brand attorney, please contact one of us in the near future.

–Jim Deeringer

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Myths About No Contest Clauses

It's easy to take no contest clauses at face value. An elder understandably aims to discourage a challenge to her will or trust by specifying in no uncertain words that anyone who steps forward to challenge the document will be disinherited. Yet no contest clauses, especially under the current version of the California Probate Code, often have little deterrent value. They may look fearsome, but they breathe no fire.

One common situation is that the elder leaves little or nothing to the potential contestants. If there's $10 million in the estate, leaving $10,000 to one of the children does not provide much of a disincentive to litigate. Johnny may risk losing a relatively small sum in the hopes of obtaining a share of the whole estate.

Another limitation on the utility of no contest clauses is that California courts generally will not enforce them if the contestant had probable cause to invalidate the will or trust based on the facts known at the time of filing the contest. So, for example, if there is credible evidence that an elder had substantial cognitive impairment when she signed her will, such as an advanced stage of Alzheimer's disease, the contestant may have probable cause to proceed with a will contest in the Superior Court even if that contest ultimately proves unsuccessful. After rejecting the contest, the court would take up the issue of whether the contestant had probable cause. Hence, despite a sternly-worded no contest clause, a losing contestant may still enjoy whatever benefits come to him under the will.

What to do? Usually it is clear that the elder has testamentary capacity and is operating of her own volition such that there is little prospect of a contest. However, if Aunt Jane in Sacramento has serious mental health issues and decides to make a substantial change in the identity of her beneficiaries, careful documentation of her testamentary capacity may be much more effective in discouraging or defeating a contest than a no contest clause in her will. –Jeff Galvin

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