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Last-Minute Gift Traps

By Kelly Greene – November 9, 2012

The rush is on to give away assets to family members before the $5.12 million gift-tax exemption reverts to $1 million at year-end.

But investors need to take care that their tax-saving strategies don't backfire.

The timing is appealing for taking advantage of what many experts consider to be a shrinking tax break.

James Kaczman

Last year, the federal gift-tax exemption climbed to $5 million for individuals and $10 million for married couples filing joint tax returns, from $1 million and $2 million, respectively, while the top tax rate fell to 35% from 45%. For 2012, the inflation-indexed limits climbed to $5.12 million and $10.24 million. (Estate-tax limits were changed as well, to the same amounts.)

Congress could well tackle the issue now that the election is over, but few experts expect the gift-tax exemption will be kept at its current level.

"It's a good time to get rid of a lot of assets that are just hanging around," says Charles Rubin, a tax lawyer and managing partner at law firm Gutter Chaves Josepher Rubin Forman Fleisher in Boca Raton, Fla.

But before you give away the vacation compound or the family business, it is important to step back and take a look at potential pitfalls. Here are some strategies for avoiding gift-making mistakes:

Maxing out. First, don't go to extremes just because you can. "People are plunging in with big gifts rather than dipping in their toes," says Jonathan Forster, national wealth-management chairman at law firm Greenberg Traurig in McLean, Va. That might not leave them with enough assets to maintain their standard of living.

For married couples worth, say, $15 million, giving away $10 million "means you've probably compromised what you need in retirement to solve a tax problem that might not even be there," he says, if Congress restores the exemption, or a big chunk of it, after you have made a large gift to your kids.

Real estate. Don't give away the house that is now worth 10 times its cost. Instead, give away the condo for which you paid top dollar—or that your family won't sell.

If a property originally priced at, say, $100,000 now is worth $1 million, the recipients of your gift would owe capital-gains tax on $900,000, assuming they sell it. If inherited as part of your estate, the home's value would be "stepped up" to $1 million, wiping out any capital-gains taxes.

The best candidate for a real-estate gift is a property you bought recently that hasn't appreciated much—or one that your family plans to keep, such as a beloved beach house.

Kenneth Brier, a lawyer in Needham, Mass., made an elderly client planning to give two houses to his sons this year bring them to the office for a meeting so he could explain that to them.

"The sons agreed they're definitely not going to sell the houses, but I wanted to make sure," Mr. Brier says.

In some cases, it makes sense to give away an asset, despite a potential gain, to get it out of your estate, Mr. Rubin says, pointing out that the estate tax could rise to 55% next year, while the capital-gains tax is set to top out at 20%.

"But if you have other assets that have not appreciated, or that you expect to appreciate, those are the ones to give," he says. "We're looking for hidden costs."

The right trust. So-called grantor-retained annuity trusts, or GRATs, have been popular vehicles in recent years for passing along battered stocks in publicly traded companies, especially because they work best when interest rates are low.

They might not make sense right now for stocks that already have run up in price.

When you give an asset to a GRAT, you also retain the right to regular payments from the trust's assets for a set time period. So what you actually are giving away is any future appreciation on the asset tax-free, says Mr. Forster, the estate-planning lawyer.

The asset also has to appreciate more than the Internal Revenue Service's "hurdle rate," currently 1%, for the GRAT to work. If you are giving stock that already has appreciated significantly, even that low a bar might be tough to clear, he says.

"People come in and say, 'I want to give away McDonald's MCD -0.46%stock,' and it's around an all-time record high," Mr. Forster says. Instead, he recommends that they give away assets with more growth potential.

Couples concerned about needing access to their assets at some future date—particularly after one spouse dies—often fall into another trap, experts say. They set up trusts funded by gifts to each other that could be classified as "reciprocal," meaning they resemble each other so closely as to be virtual mirror images.

The problem: "If I set up a trust for you, and you set up a trust for me with similar terms, the IRS could say we really set up a trust for ourselves" and disqualify the gifts, Mr. Rubin says.

Some planners setting up these trusts are relying on a U.S. Tax Court case in which one spouse had the power of appointment in one trust, but the other spouse didn't have the same power in the other.

But other experts—including Mr. Rubin—contend that the nonreciprocal trust issues weren't fully analyzed in that ruling and people "shouldn't give it as much weight as they have been," he says.

Couples who go this route should make the trusts different enough from each other to avoid that problem, he advises.

Family businesses. Be careful if you make a gift using a property, partnership or limited liability company that carries debt. If the size of that loan is larger than the value of your investment—your so-called cost basis—you would have to report the difference as a gain and pay tax on it, Mr. Rubin says.

"When you give away your membership interest and there's a debt allocated to it, you're treated as if you have sold it," he says. The reason: "The new owner is going to be responsible for that debt, not you."

One possible fix: Make the gift to a grantor trust, in which the donor is still treated as the owner for tax purposes. That way, Mr. Rubin says, there would be no gain.