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ATTORNEYS AT LAW

All in the Family?

Clients often ask us if they should put a child on the deed to their house as a joint tenant. Behind this question is the stated (or often unstated) idea that this would be a simple probate avoidance device that might also have the added benefit of putting the child in a position to manage the property if the parent is not up to the task. Almost without exception we recommend against this proposal. Here's why:

The transfer of title may violate the so-called "due-on-transfer" clause which is a part of most Colorado deeds of trust. The deed of trust is what lenders use to create a mortgage in Colorado. The due-on-transfer clause allows the lender to call the mortgage due if the property is transferred by the borrower in whole or in part. There are a few exceptions, but a lifetime transfer to a child would not be one of them.

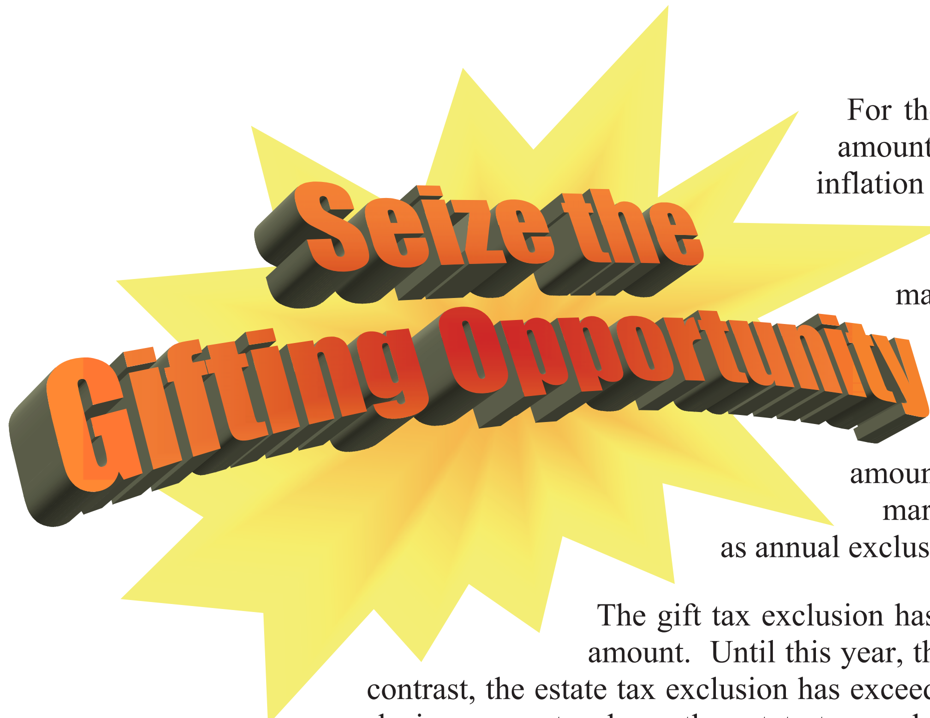
The transfer would be a gift to the child. This has two ramifications. First, if the transfer exceeds $13,000 in value, then the transferor parent must file a federal gift tax return (Form 709). Second, the child, as donee of the gift, would take the parent's cost basis in the property, meaning that any gain recognized on sale of the gifted portion would be taxable capital gain to the child, even if it is sold after the parent's death. By contrast, if the child received the property on the death of the parent (*e.g.* through the probate process, or by use of a beneficiary's deed) the child would have a new cost basis equal to the value on the parent's date of death, thus eliminating any capital gain if the property has appreciated in value since the parent acquired it.

If the child does not live in the residence, then the portion owned by the child will not be eligible for exclusion of gain that is available for the sale of a principal residence. This exclusion allows a single person to exclude up to $250,000 of gain from tax ($500,000 for a married couple). To qualify for the exclusion of gain, the seller must have owned and resided in the home as a principal residence for two of the five years preceding the sale. If the child does not reside in the house for the requisite period of time after he or she becomes an owner, his or her share of the gain will be subject to capital gains taxation.

The child's problems can become the parent's problems, as what is owned by the child can now be reached by the child's creditors, or possibly become entangled in a divorce. An unscrupulous (or desperate) child could encumber his or her share of the property for a loan. If you want the property back, the child doesn't have to give it to you.

The parent will no longer have the exclusive right to make decisions about the property. The child would need to consent to a sale or a new mortgage.

In Colorado, the residence is not a countable resource in determining Medicaid eligibility. In other words, it is an exempt asset. The gift of the residence is not only unnecessary for Medicaid qualification, but will probably trigger an ineligibility period if transferred during the so-called "look back" period of five years prior to institutionalization. ♦



For the years 2011 and 2012, the gift tax exclusion amount is $5,000,000 (and it will be indexed for inflation in 2012) . This amount is scheduled to drop to $1,000,000 in 2013. This two year window presents a unique opportunity for making substantial gifts.

The exclusion amount is the amount that can be given away without payment of gift tax. This is in addition to the unlimited amount that can be given to your spouse using the marital deduction and amounts that can be given as annual exclusion gifts.[1]

The gift tax exclusion has never been as high as the current $5,000,000 amount. Until this year, the highest level it reached was $1,000,000.[2] In contrast, the estate tax exclusion has exceeded $1,000,000 since 2004.[3] Using the gift tax exclusion amount reduces the estate tax exclusion available at death. However, gifting has always been useful for several reasons.

One advantage of gifting is that, if structured properly, gifting an asset removes subsequent appreciation of that asset from your estate. For example, if you make a gift of an asset worth $100,000, the gift uses $100,000 of your gift tax exclusion amount (if the annual exclusion does not apply). As a result, the amount of estate tax exclusion amount available at your death will be reduced by $100,000. If the $100,000 asset triples in value between the time of the gift and the time at the time of your death, the $200,000 of appreciation will benefit the donee without use of any more of your gift or estate tax exclusion. In contrast, if you did not make the gift, then the full $300,000 asset would be included in your estate at your death, and would use $300,000 of your exclusion amount.

For wealthy individuals, one reason this is a good time for gifting is that much larger gifts can be made free of gift tax with a $5,000,000 exclusion amount than with a $1,000,000 exclusion amount. The exclusion amount is scheduled to drop to $1,000,000 in 2013, so you should consider making substantial gifts now.

Estate Tax Implication of Gifts

There is an unresolved question about how gifts will be treated at your death if the exclusion amount at your death is less than the current level *(e.g.* if it drops to $1,000,000, or even $3,500,000 as President Obama has proposed) and if you make gifts during your life totaling more than the exclusion amount available at death. For example, if you make gifts totaling $5,000,000, and the exclusion amount at your death is $1,000,000, does the full $5,000,000 gift escape estate and gift tax?

Gifts you make during life are taken into account in determining the amount of estate tax due on the assets included in your estate at death. This is required, in part, in order to determine how much estate tax exclusion amount was used with lifetime gifts. The law is not clear as to exactly how gifts will be taken into account for estate tax purposes if the gifts utilize the $5,000,000 exclusion amount, and then the exclusion amount drops to a lesser amount. One interpretation is that if a $5,000,000 gift is made, and the exclusion amount drops to $1,000,000, the $4,000,000 difference would escape gift and estate tax. If this is the result, it adds an incentive for wealthy individuals to make gifts utilizing the $5,000,000 exclusion amount.

Hot off the presses . . .

the gift / estate / GST exclusion / exemption amounts for 2012, as indexed for inflation, will be

$5,120,000.

Learn more in our special January 2011 newsletter available online at:
www.stoverlawcolorado.com

Portability Requires A Timely Filed Estate Tax Return

For the years 2011 and 2012, any estate tax exclusion amount that remains unused at a spouse's death may be available for use by the surviving spouse, as an addition to the surviving spouse's own estate tax exclusion amount. This benefit is commonly referred to as "portability."

For example, assume Husband dies in 2011 with a $3,000,000 taxable estate having made no taxable transfers during life. An election can be made on Husband's timely filed federal estate tax return (Form 706) to permit Wife to use Husband's unused estate tax exclusion amount. Then, assuming that Wife has made no taxable transfers during her life, Wife's estate tax exclusion amount in 2011 will be $7,000,000 (Wife's $5,000,000 basic estate tax exclusion amount, plus $2,000,000 of Husband's unused estate tax exclusion amount).

Portability of the deceased spouse's unused estate tax exclusion amount is only available if an election is made on a timely filed Form 706 following the death of the first spouse to die, regardless of whether the estate of the deceased spouse is otherwise required to file a Form 706. The Form 706 is due nine months after death, with an additional six month extension available.

When one spouse dies, serious consideration should be given to filing a Form 706 to take advantage of portability.

However, the other interpretation is that the $4,000,000 difference will essentially be subject to estate tax at your death. This is sometimes known as a "clawback." In that case, you will not be any worse off, for estate and gift tax purposes, having made the $5,000,000 gift, but it will not be as great a windfall as under the alternative reading of the law (where $4,000,000 escapes transfer tax).[4] Any appreciation on the $4,000,000 would still escape estate taxation.

Gifts to Trusts

When making any gifts, you may want to make the gifts to a trust rather than outright. Trusts can be structured so that they are not subject to estate tax or generation-skipping transfer (GST) tax at the beneficiaries' deaths. Trusts can offer significant protection for the trust assets against the beneficiaries' creditors and claims by the beneficiaries' spouses in the event of divorce.

There are also some specialized trusts you may have heard of that can be utilized to leverage your gift, such as:

- GRAT (grantor retained annuity trust);
- ILIT (irrevocable life insurance trust); and
- QPRT (qualified personal residence trust).

We are available to discuss these various types of trusts with you, and work with you to determine the best approach for making gifts. ♦

[1] The gift tax annual exclusion amount is currently $13,000 per donee, per year. Gifts that qualify for and utilize the gift tax annual exclusion do not use any of your lifetime gift tax exclusion. The unlimited marital deduction does not apply to gifts to a non-U.S. citizen.

[2] The gift tax exclusion amount was $1,000,000 from 2002 through 2010.

[3] The estate tax exclusion amount was $1,500,000 in 2004 and 2005; $2,000,000 from 2006 through 2008; and $3,500,000 in 2009.

[4] A potential downside with making gifts is that the donee receives your basis in the gifted asset, whereas if the asset is included in your estate at death, it is eligible for a step-up in basis to current fair market value. This loss of step-up with gifted property should be considered before making any gifts.

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Autumn 2011 Newsletter

★ ★ ROLL CALL ★ ★

Thomas L. Stover and **Jennifer M. Spitz** have once again been selected by their peers for inclusion in The Best Lawyers in America® in the practice area of Trusts and Estates. The Best Lawyers In America® is widely regarded as the preeminent referral guide to the legal profession in the United States.

Jennifer currently serves as Chair of the Trust and Estate Section of the Colorado Bar Association (CBA). The Trust and Estate Section is one of the most active Sections in the CBA, with many ongoing projects including working on proposed new Colorado legislation, trust and estate publications and continuing legal education programs. Jennifer will also be presenting in November on the topic of Basic Estate Planning for Families at a seminar sponsored by The Boulder County Estate Planning Council.

Tom had a productive and challenging summer. He hiked a long sixty miles on the Appalachian Trail through parts of Georgia and North Carolina enjoying beautiful weather and the blossoming of the Azaleas in June. On his return to Colorado, he participated in several challenging bicycle rides, not the least of which was a ride to the summit of Trail Ridge Road in Rocky Mountain National Park and the arduous Triple Bypass which is 110 miles of climbing over 10,000 vertical feet from Avon to Evergreen, Colorado. Fall saw a return to business including his chairmanship of a subcommittee of the Trust and Estate Section of the Colorado Bar Association which is considering a new Domestic Asset Protection Statute for Colorado.

This publication is intended ONLY to provide general legal information. The information contained herein should not be acted upon without professional advice related to specific situations.
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