

16. Tax on Lifetime Gifts

Let's suppose you have reviewed your estate and determined that you are subject to federal estate tax. (Under normal circumstances, your individual estate is taxable if it exceeds \$1,500,000 in 2004, increasing to \$3,000,000 by 2009.) Now what do you do? Did you know that gifts made during your lifetime can help reduce that tax? Giving away property while you are alive reduces the amount of your estate that is subject to federal estate tax.

Gift Tax Exclusions

You can give away \$11,000 per year (in cash or property of equivalent value) to each of any number of people without paying any gift taxes. These \$11,000 gifts are often referred to as "annual exclusion" gifts. You and your spouse together can give \$22,000 in annual exclusion gifts per year to any person. This applies even if the transferred property is the separate property of only you or your spouse. Prior to 2002, the annual exclusion amount was \$10,000. For years beginning after 1998, the annual exclusion gift amount will be increased in \$1,000 increments for inflation that occurs after 1997. The first \$1,000 adjustment was effective in 2002. Inflation after December 31, 1997 would have to increase by 20% before the annual exclusion amount will be increased by another \$1,000 to \$12,000.

In addition to the annual exclusion from federal gift tax, you can directly pay an unlimited amount, on behalf of another individual, to the provider of certain medical or educational services without incurring a gift tax liability.

A gift is not deductible by you (the donor) for federal income tax purposes, but it also is not included in the income of the individual receiving that gift (the donee). If the donee later sells the property, he or she will use your income tax cost basis in determining the gain. (Your income tax cost basis is generally the amount you paid for the property.)

The annual and the direct payment medical and educational expense exclusions allow sizable amounts of wealth to be transferred tax-free to family members or friends. In addition, the donees (children, grandchildren, etc.) may often have lower income tax rates than you. The income earned from the "gifted" property is thus subject to lower

income tax rates, resulting in an overall and ongoing tax savings for your family. However, the tax laws now require certain types of income for children under 14 to be taxed at their parents' tax rate.

Consider an estate planning situation in which you have three children, each of whom is married and has two children. A gift of \$22,000 per year (\$11,000 from you and \$11,000 from your spouse) may be given to each child, grandchild, and son- and daughter-in-law (a total of twelve people). Each year 264,000 could be removed tax free from your and your spouse's combined estate.

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The Applicable Credit Amount

Gifts to any one person in excess of \$11,000 (other than direct payment of certain medical and educational expenses) will create a gift tax liability for you. Initially, no tax will actually be paid because of what is now called the "applicable credit amount." Prior to 1998, the credit was called the "unified credit." The credit effectively excludes a portion of your lifetime taxable gifts (those exceeding the annual gift tax exclusions discussed previously) from taxation. The excluded amount is called the "applicable exclusion." Your spouse is also entitled to the same applicable exclusion. However, once these lifetime exclusions have been fully used, gifts above any available annual gift tax exclusion will required an actual tax payment. In addition, you will have a smaller applicable exemption amount and smaller applicable credit left for estate taxes at your death. (See related chapter on estate taxes.

The 2001 Tax Act increased to \$1,000,000 the lifetime gift exemption (formerly referred to as the "applicable exclusion amount"), effective in 2002. In addition, the maximum gift tax rate will decrease from a maximum rate of 55% in 2001 to 50% in 2002, decreasing by one percentage point per year thereafter until the rate reaches 45% in 2008. In 2010, the maximum rate is adjusted again to the maximum individual income tax rate, which will be 35%. The gift tax is not repealed by the 2001 Tax Act.

Beginning in 1998 and ending in 2002, the "applicable exclusion amount" and the corresponding applicable credit amount were increased annually as follows:

In the case of gifts, made, and estates of persons dying, during:	The applicable exclusion amount is:	Applicable credit amount
1998	\$625,000	\$202,050
1999	\$650,000	\$211,300
2000 and 2001	\$675,000	\$220,550
2002 and thereafter	\$1,000,000	\$345,800

For example, assume you have never given in prior years but during 2002 you give \$11,000 to Tim and \$25,000 to Bob. The \$11,000 gift to Tim falls under the annual \$11,000 exclusion. Of the \$25,000 gift to Bob, \$11,000 also falls under that exclusion. The additional \$14,000 will count against your \$1,000,000 lifetime exemption, leaving \$986,000 for future lifetime gifts and for transfers at your death.

The primary tax advantage of making annual exclusion gifts is that both the value at the date of the gift and any appreciation after that date will not be included in your estate. These values are not subject, therefore, to federal estate tax. For example, if the \$11,000 you give to Tim in the above example is worth \$31,000 at your death (i.e., \$20,000 of appreciation), the entire \$31,000 escapes federal estate tax.

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In contrast, the portion of the gift which counts against your \$1,000,000 lifetime exemption (e.g., the \$14,000 of the gift you make to Bob in the above example) is reported on your estate tax return and is taken into account in computing your estate tax. Any appreciation after the date of the gift, however, is not included in your estate.

Disadvantages of Gifts

The 2001 Tax Act increases the exemption for estate tax during the period from 2004 through 2009 to amounts that exceed the lifetime gift tax exemption. The Act repeals the estate tax for the year 2010. The difference in the gift and estate tax exemption amounts and the repeal of the estate tax highlight one disadvantage of making taxable gifts - which is that the gift tax must be paid shortly after the gift while the estate tax is deferred until you die. Combining the deferral period for paying the tax with an increasing estate tax exclusion, lower tax rates, and a possibility of complete repeal means that if you wait until death to transfer assets there may be no transfer tax at all.

As far as taxes are concerned, there are two disadvantages to making gifts. The first is that if a tax is due on a gift, the tax must be paid soon after the property is transferred, not after your death (many years in the future), which would be the case if the property remained in your estate.

For example, assume that property worth \$30, which cost you \$10, is given to Bob and a gift tax of \$3 is paid. Bob's basis will be \$12, determined as follows:

Your basis	\$10.
Gift tax on appreciation (3 x 20/30)	<u>+ 2.</u>
Bob's basis	\$12.

Bob sells the property for its value of \$30. The gain is as follows:

Sales price	\$30.
Bob's basis	<u>- 12.</u>
Gain	<u>\$18.</u>

On the other hand if Bob had received the property from you upon your death, Bob's basis would be \$30, the value of the property. If Bob then sold the property his gain would be as follows:

Sales price	\$30.
Bob's basis	<u>- 30</u>
Gain	<u>\$ 0</u>

As you can see, if appreciated property is to be later sold by the donee, it may be better

to inherit the property rather than receive it as a gift. However, if gift tax would be example, for Bob to inherit \$3,000 after taxes, the decedent's estate would need to have \$1,761 of other assets to pay the estate tax. (Estate tax on \$4,761 equals \$1,761, leaving \$3,000 for Bob after payment of estate tax.) If the decedent had instead made a lifetime taxable gift to Bob of \$3,000, the gift tax payable on the gift would have been only \$1,110, a savings of \$651.

Donors with estates of \$1,000,000 or more should consider the potential income tax for the donee and compare the gift tax with the potential estate tax when determining whether to make a gift or a bequest.

Unlimited Marital Deduction

You have an *unlimited* exclusion from gift tax for transfers of property to your spouse, if your spouse is a U.S. citizen. This rule presents a planning opportunity that may allow U.S. citizen spouses to bring an estate below the critical applicable exemption amount. (See table under *Applicable Credit Amount* for subsequent years' critical amount.) If one spouse has more than that amount and the other has less, equalization of the two estates by lifetime gifts will reduce the estate tax liability.

Transfers of property to a spouse who is not a U.S. citizen are not covered by the unlimited marital deduction. However, a \$100,000 *annual* exclusion applies to gifts to spouses who are not U.S. citizens. (This exclusion is adjusted for inflation. For 2003, the amount of the exclusion is \$112,000.) Transfers upon death to spouses who are not U.S. citizens must be made through a Qualified Domestic Trust (QDOT). This topic is further discussed in the chapter entitled "A Cost of Dying: Estate Taxes."

Conclusion

Giving property can be a valuable estate planning tool but should be considered as only one element of an overall plan. Also, in making any gift, you need to consider that when property is gifted—it's gone. Careful thought should be given before a gift is made as to whether or not you or your spouse may need those assets in the future.