Planning Your Estate

Part 5

Gifts:
A Property-
Transfer Tool

During an individual's lifetime, property is accumulated. Estate planning insures maximum enjoyment of the property and later transfers according to the wishes of the owners. Through careful planning, this can be done with the least possible cost to the estate.

The greatest benefits from sound estate planning may be realized when the transfer of property starts before death. A flexible tool for property transfers during the lifetime of the owners is the gift.

In addition to expressing love and affection, gifts serve other purposes:

■ They may give children training in the management and conservation of property as well as aid them in obtaining an education.

■ The gift of an interest in the farm or other business may encourage a son or daughter to remain with and improve the farm or business and, thereby, lessen the parents' management burden as they grow less active with age.

■ Gifts reduce the size of the estate that must pass through court administration (cuts probate costs and, to some extent, estate taxes).

■ Through gifts of income-producing property, income can be shifted from one family member to another in a lower tax bracket to accomplish income tax savings.

Although giving your property away may sound easy at first, there are definite laws that govern what you can and cannot do.

Federal Gift Tax Law

The Tax Reform Act of 1976 set in place our modern Estate Tax system. The Economic Recovery Tax Act of 1981 (ERTA) and the Taxpayers' Relief Act of 1997 made substantial changes in federal gift tax laws. This publication explains the application of these new laws to gifts made after 2000.

The federal gift tax is a transfer tax designed to raise revenue by taxing gratuitous lifetime transfers of net wealth. It is an excise tax levied upon transfers of real or personal property made during the transferor's lifetime without adequate and full consideration. In other words, any transfer of value is subject to gift taxation if the person making the gift does not receive something of a similar value in exchange.

The value of a gift is the **fair market value** of the property given on the date the gift is made. There is no alternate valuation date for the federal **gift tax** as there is for the federal **estate tax**.

The fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Fair market value may not be determined by a forced sale price, nor by the sale price of the item in a market other than that in which the item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Thus, in the case of an item generally sold at retail, the fair market value is the price at which the item or a comparable item would be sold.

Example: If a father gives his child land worth $50,000, the father has made a $50,000 gift. If the father "sells" the same land to his child for $1,000, he has made a gift of the difference between the value received and the value given—$49,000. If the father sells the same land to a neighbor for $40,000, he has not made a gift of $10,000. The sale is considered an "arms length transaction," because the selling price to a neighbor or stranger is presumed to be the fair market value.

There is no gift, however, until the transfer is complete. The donor must part with the property and control of it (or a part of it) before it is considered a gift.

Who Pays the Gift Tax?

The individual making the gift (donor) is liable for the payment of the gift tax. A 10-year lien attaches upon all gifts made, and if the owner does not pay the gift tax when due, the donee of any gift becomes personally liable for any gift tax to the extent of the value of his gift. The donee is not required to pay income tax on the value of the property received. However, the donee must pay income tax on income produced by the property (if any) after the date of the gift.

Example: Mary gave her daughter Susan $50,000 in cash. The gift is not considered income to Susan. Susan placed the money in a certificate of

deposit which earned $2,600 during the year. Susan adds the interest earned to her present income of $26,000. She is responsible for income taxes on $28,600.

Annual Exclusion

The annual exclusion permits the transfer of $10,000 (adjusted for inflation after 1997 in increments of $1,000, as per TRA 97) worth of property (e.g., real estate, stocks and bonds, certificates of deposit, or cash) to family members or other persons without the payment of gift taxes and without the requirement of filing a gift tax return. In other words, an individual may give up to $10,000 a year to as many persons as he desires, and the entire amount is excluded from gift taxation.

Example: In one year, a father could give each of his four children up to $10,000 and no gift tax return is required. The father could continue the practice for as many years as he desired and reduce his taxable estate by $40,000 each year. The children do not have to pay income taxes on the amount received.

Gift Splitting

The gift-splitting section of ERTA provides that a married person (with consent of his or her spouse) can give $20,000 a year to as many persons as desired without a gift tax being due. For tax purposes, each spouse is considered to have made one-half of the gift, although the entire gift was actually made by one spouse. Since the husband and wife each have an annual exclusion of $10,000, these exclusions eliminate the gift tax on the $20,000 amount.

Example: A father and mother can give to each of their three children up to $20,000 a year. They can continue the practice for as many years as they wish and reduce their taxable estate by $60,000 each year. Each child will not have to pay income taxes on the $20,000 received. However, if they place the money in a savings account, the interest earned is subject to state and federal income taxes.

Example: Paul wishes to transfer $40,000 worth of farm equipment to his son Nathan. If Paul and his wife utilize the gift-splitting provision, only $20,000 are subject to gift taxation. If Paul and his wife transfer the farm equipment to their son and daughter-in-law, then the amount subject to gift taxation is zero.

The gift tax rate table is a progressive table like the income tax tables and, for this reason, splitting a larger gift may reduce the top bracket at which the gift is taxed. This is similar to filing a joint income tax return.

The consent of the spouse can be made only on a gift tax return. Therefore, if a gift of more than $10,000 is made to a third person (not spouse), a gift tax return is required to be filed, even though a gift tax may not be due.

The ERTA excludes from gift treatment any amounts paid in behalf of a donee directly to a qualified educational organization for tuition and to a health-care provider for medical services.

Marital Deduction

The gift tax provision set forth in the ERTA of 1981 allows married persons to make lifetime gifts to each other and take advantage of a marital deduction for any amount without a gift tax. No gift tax return is required to be filed.

Table 1. Federal estate and gift tax schedule

If taxable estate is at least ($)	Tax liability is ($)	Plus value over (%)	Of excess ($)
0	0	18	0
10,000	1,800	20	10,000
20,000	3,800	22	20,000
40,000	8,200	24	40,000
60,000	13,000	26	60,000
80,000	18,200	28	80,000
100,000	23,800	30	100,000
150,000	38,800	32	150,000
250,000	70,800	34	250,000
500,000	155,800	37	500,000
750,000	248,300	39	750,000
1,000,000	345,800	41	1,000,000
1,250,000	448,300	43	1,250,000
1,500,000	555,800	45	1,500,000
2,000,000	780,800	49	2,000,000
2.5-3,000,000	1,025,800	53	2.5-3,000,000
Over 3,000,000^	1,290,800	55	3,000,000

An additional tax is added which works to phase out the graduated rate for estates over $10,000,000.

Table 2. Unified tax credit*

Death in	Credit	Equivalent exemption
1998	$202,050	$625,000
1999	211,300	650,000
2000 and 2001	220,550	675,000
2002 and 2003	229,800	700,000
2004	287,300	850,000
2005	326,300	950,000
After 2005	345,800	1,000,000

Example: Jack gives his wife Nada property valued at $100,000 in 1990. In 1991, he gives her property valued at $250,000. The total amount of $350,000 qualifies for the gift tax marital deduction. No gift tax return is required to be filed.

Transferring Life Insurance Policies

The assignment of a life insurance policy without retaining incidents of ownership—such as the right to borrow, cash in, or change beneficiaries—constitutes a gift for gift tax purposes.

The value of a gift of a life insurance policy paid up at the time of the gift is equal to the cost of replacing the policy on the date of the gift. If the policy is not paid up, it's roughly the cash value. These costs may be obtained from the insurer.

Payment of a life insurance premium on a policy owned by another is considered a gift of the premium amount.

Example: Tom transferred a life iinsurance policy ownership to his son Dale. Its replacement value was $20,000. An annual exclusion of $10,000 is allowed. The remaining $10,000 are subject to gift taxation.

Charitable Deduction

Gifts made to recognized charitable, religious, educational, and governmental organizations are completely gift tax free. There are no limits on the amount that may be given, but there are limits on the types of gifts for which a deduction may be claimed. The gift must be made to an organization recognized by the Internal Revenue Service as a "qualifying organization."

The gift should be made directly to the organization specified. For example, if the gift is to qualify for the deduction, it should be made to the church rather than to the minister.

Example: Gene, an active 4-H leader, wishes to give land worth $65,000 to the Mississippi 4-H Foundation to provide youth with a camping area. The amount qualifies for a charitable deduction, because the Mississippi 4-H Foundation is a qualifying organization.

Gift Tax Rates

Before the Tax Reform Act of 1976, the federal estate and gift tax had separate rate schedules and the two taxes were separately administered, depending upon whether they were lifetime gifts or death transfers. The 1976 law provided a single, unified rate schedule for estate and gift taxes, and the Economic Recovery Act of 1981 provided for a reduction of the top rate. The same rate schedule is used for lifetime gifts or death transfers. The rates are progressive, starting at 18 percent and increasing to over 50 percent.

Computing Tentative Tax

Example: Taxable gift of $110,000. Line 7 in the table (taxable estate of at least $100,000) shows the tentative tax on the first $100,000 to be $23,800. The tax on the next $10,000 is $3,000 ($10,000 X 30 percent = $3,000). The total tentative tax on a $110,000 transfer is $26,800 to which the unified credit is applied.

Unified Tax Credit

The Unified Tax Credit is used to offset gift taxes on lifetime transfers. However, to the extent the credit is used on gifts, the amount of credit actually available at death is reduced.

The unified tax credit is subtracted from gift or estate taxes otherwise payable. The equivalent exemption indicates the value that may be gifted without a gift tax due or the value of an estate that may pass without an estate tax due. The TRA 97 increased the unified credit amount as shown in Table 2.

Example: Assume Ed makes a gift of $10,000 to each of his eight children in the years 1996-2000. Ed is allowed an annual exclusion of $10,000 for each child each year. The amount subject to tax is zero. Ed has reduced his estate value by $80,000 each year for a total of $400,000. In 2001, Ed makes a $30,000 gift to each of his eight children. He is allowed an annual exclusion of $10,000 for each child. Only $160,000 of the total gift of $240,000 is subject to tax. Ed does not owe a gift tax, because the Internal Revenue Service allows Ed to use $160,000 toward his current $675,000 equivalent exemption. He can still pass $515,000 to his heirs free of estate tax.

Accumulation of Gifts

Federal gift tax law requires the value of all gift taxable property given each year to be accumulated into one total before computing each year's gift tax. The accumulation of lifetime gifts results in increasing rates of taxation on later gifts. The unified tax credit is used to reduce the tax payable. When the taxes payable are larger than the credit, the remainder must be paid as a gift tax.

Example: Assume Zephie made gifts to his daughter of $110,000 in 1998, $290,000 in 1999, $90,000 in 2000, and $150,000 in 2001. He had made no gifts prior to 1998, so the total unified credit is available. Table 3 shows the accumulating effect of his gifts from 1998-2001.

Zephie can make up tp $100,000 in gifts to his daughter in 2002 and 2003. If he makes larger gifts, he will have to pay gift taxes, since the unified credit would be reduced to zero.

Gifts Within 3 Years of Death

Before 1982, gifts for more than the annual exclusions were taxed in the estate of the donor if he died within 3 years after making the gifts. Beginning in 1982, the 3-year rule no longer exists for most property transferred. Exceptions to this include life insurance proceeds and transfers where the option to control the property has been maintained as powers of appointment, revocable transfers, retained life estates, or transfers that become effective at death.

Example: Assume that in August 1997 George learned he had terminal cancer. He immediately filed a gift tax return and gave his farm worth $600,000 to his son Sam. In July of 2000 when George dies, the farm has increased in value to $620,000. Under previous law, the $600,000 would have been included in George's gross estate, plus the amount of appreciation in the land value during the time from August 1997 to July 2000. Under the new law, neither amount is included in the gross estate. However, the $600,000 would be included in calculating the estate tax as an adjusted taxable gift.

Example: Assume that in 2000 Robert, a widower, owned a life insurance policy with a face value of $100,000. In 2001, he transfers ownership to his daughter Sara. No other taxable gifts had been made. In 2001, Robert dies. The $100,000 is included as a part of his $850,000 estate, resulting in estate taxes of $66,750. If Robert had lived 3 years after transferring ownership of the policy to Sara, the $100,000 would not have been included in his estate. The estate tax would have been $27,750. Robert's ownership of the policy cost his estate an additional $39,000 in taxes.

Federal Gift Tax Return

A donor is required to file a gift tax return to report gifts of present interest amounting to more than $10,000 to any one donee (other than spouse) in any one year and to report gifts of "future interest" of any amount. Future interest is a complex legal term that includes reversions, remainders, and other interests or estates that are to commence in enjoyment at some future date. A trust is an example of a gift of future interest.

If a gift tax return is required, it must be filed on Form 709 by April 15th following the close of the calendar year.

Example: Dan makes a $30,000 gift to his daughter Marla in November 2001. He must file a gift tax return by April 15, 2002, even though by utilizing his unified credit he does not owe gift taxes.

Gifts for My Situation?

It is recommended that you contact an attorney or a tax accountant to learn what effect these new laws may have on your present or future estate planning objective of gift giving.

Remember, every lifetime gift, whether to a spouse, children, or others, should be examined carefully before it is made to avoid depleting the estate to the point where the donor does not have enough for his or her lifetime support.

Table 3. Example of gift-giving program from 1998-2001

	1998	1999	2000	2001
Current gross gift	$110,000	$290,000	$90,000	$150,000
Annual exclusion	-10,000	-10,000	-10,000	-10,000
Taxable gift	100,000	280,000	80,000	140,000
Add taxable gifts from previous years	0	100,000	380,000	460,000
Total taxable gifts	$100,000	$380,000	$460,000	$600,000
Tentative tax on total taxable gifts	23,800	115,000	142,200	192,800
Subtract tentative tax on prior taxable gifts	0	-23,800	-115,000	-142,200
Gift tax	$23,800	$91,200	$27,200	$50,600
Subtract available unified tax credit	-202,050	-187,500	-105,550	-78,350
Gift tax payable	0	0	0	0

This publication is not designed as a substitute for legal advice. Rather, it is designed to help families become better acquainted with some of the devices used in planning an estate and to create an awareness of the need for such planning. Future changes in laws cannot be predicted, and statements in this publication are based solely on the laws in force on the date of printing.

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