

info sheet

Gifts: Shower your kids, shelter your estate

As most parents know, care giving doesn't end once your children leave home — it continues in one form or another for the rest of your life. When you're old and gray, chances are you'll still be worrying about your kids, and your kids' kids.

Later in life, your impulse to button their sweaters to keep them warm evolves into a need to make sure they're taken care of financially. You can always leave them something in your will, but everything they inherit will be subject to estate taxes. Few people realize there's a way they can provide for their children without exposing them to large tax liability. And it can be summed up in one word: gifting.

One of the easiest ways to provide for your loved ones while you're still alive is to make them the recipients of annual gifts. Gifting offers you two potential rewards. First, it reduces the value of your estate as well as the taxes that will eventually have to be paid on it. Second, it gives you the kind of personal satisfaction that only comes with gift giving.

According to the Internal Revenue Service (IRS), taxpayers may give away up to \$10,000 a year to each of their children, grandchildren, nieces, nephews, etc. While you can technically give \$10,000 a year to anyone you choose, we'll focus on relatives for the purposes of discussing estate planning. If you're married, the amount you can gift each year essentially doubles. For example, Mike and Lynda have four children and three grandchildren. This means that

Mike may gift \$70,000 ($\$10,000 \times 7$ beneficiaries = \$70,000) each year if he has the inclination or the means. Lynda may do the same. Together, then, the couple may give away \$140,000 a year under this scenario (they may give away more if they start gifting to other family members or friends).

As with any gift, there are no taxes due on the amount gifted in this way. And while the amounts used in the example above seem rather extravagant, gifting is a quick and smart way to ensure your heirs don't have to "sell the farm" to pay the taxes on your estate after you're gone.

Do I have to file a federal gift tax return?

If you are simply gifting one-to-one as in the illustration above, it is not necessary to file a federal gift tax return. That is, if Lynda earmarked \$10,000 a year to each of the seven beneficiaries, and Mike did the same on his own, each strategy would fall within the federal gift tax annual exclusion allowed by the IRS. Neither spouse would have to file a gift tax return.

If, on the other hand, Mike chose "gift splitting," wherein he uses Lynda's annual exclusion to personally give \$20,000 to each of the seven beneficiaries, the couple would be required to file a federal gift tax return. On that return, each spouse must "consent" to the gift splitting. Although the same amount (\$140,000) is being gifted in each scenario, the IRS treats the "one-to-one" and "splitting" strategies differently.

What if I give away more than \$10,000 to a child?

Should you exceed in a given year the \$10,000 that's exempt from gift tax, the first \$10,000 will continue to be exempt, but the overage might be subject to gift taxes. Such taxes are similar to estate taxes and can climb as high as 55%.

Instead of paying the gift tax, however, you might want to consider having any amount over \$10,000 apply toward your Applicable Credit — a credit that applies both for gift and estate tax purposes (thus the term “unified”). According to the IRS, each taxpayer is entitled to an Applicable Credit of \$675,000 for tax year 2001, increasing over the next several years to \$1 million in 2006. This simply means an individual would have been exempt from paying taxes on the first \$675,000 of his or her estate if he or she died in 2000.

So, for example, if you were to give one of your children \$25,000 in a calendar year, only \$10,000 of that amount would be free from gift taxes. Rather than pay what might be a hefty gift tax on the remaining \$15,000, however, you are allowed to subtract that amount from your Applicable Credit, which would be reduced to \$635,000. The good news is the entire \$25,000 gift to your child would be free and clear of taxes.

What's more, annual gifts to one person in excess of \$10,000 are not subject to gift tax — nor must they be deducted from the donor's Applicable Credit — if they are paid directly to the provider for the recipient's tuition or medical expenses.

Will the exemption amount ever change?

With the passage of the Taxpayer Relief Act in 1997, Congress began raising the \$10,000 limit annually. However, the advantages of this increase may not be realized for several years. According to Congress, the

maximum amount you can gift will rise with inflation. The only catch is that the minimum will be rounded down to the nearest thousand.

For example, if inflation for 1998 was 3%, the gifting limit technically would have risen in the year 1999 to \$10,300 but have been rounded down to \$10,000. If in 1999 inflation was again 3%, the limit would have risen in 2000 to \$10,609, but have been rounded down to \$10,000. Not until the year 2002 would the limit actually change based on an annual inflation rate of 3% (\$11,255 rounded down to \$11,000).

How can I maximize my gifting strategy?

Although the tax-free gifting limit will be slow to rise, this should have little effect on those who are intimately familiar with the gifting laws and how to use them to their full potential. Recall that earlier we mentioned that by law each taxpayer is allowed to give a maximum of \$10,000 to as many people as he or she chooses — including friends and other individuals outside the family. Technically, then, in addition to giving \$10,000 a year to each of your children, you can protect even more of your estate by also giving the maximum amount to your children's spouses.

Let's return to Mike and Lynda's situation for a moment. Assuming all three of their children are married, the couple could conceivably increase their annual gifting maximum from \$140,000 to \$200,000 by simply gifting \$20,000 each to their three “kids-in-law.” Individuals thinking of gifting as a way to reduce their taxable estate should also keep in mind the following:

- A married donor can transfer an unlimited amount of property to his or her spouse without having to pay a gift tax or file a gift tax return.
- Most gifts to charities qualify for the charitable gift tax deduction and do not result in the payment of a gift tax.

- Under the terms of the Applicable Credit in 2001, an individual should not have to pay a gift tax until he or she makes taxable gifts totaling more than \$675,000 during his or her lifetime. Of course, for this to happen, all gifts to one person in excess of \$10,000 in a single year must be subtracted from the donor's Applicable Credit.

What's the catch?

As liberal as the laws governing gifting may seem, there really is no catch. Aside from a "present interest requirement" — which states that for a gift to qualify for the annual exclusion, the enjoyment of that gift by the recipient cannot be postponed into the future — gifting really is as straightforward as it seems. As long as individuals follow the guidelines summarized here, the amount someone can ultimately gift each year is capped only by his or her means and by the number of people they feel comfortable gifting to.

Please keep in mind that individual circumstances will differ, and it's best to check with your financial and/or tax adviser before adopting any gifting strategy. For many, however, gifting offers a legitimate, charitable, convenient way to pass on more of your estate to the people and causes near and dear to you.

Resources for Further Information

Berg, Adriane. **Gifting to People You Love: The Complete Family Guide to Making Gifts, Bequests, and Investments for Children.** Newmarket Press, 1996, 208 pages.

Clifford, Denis; Phillips, Michael; Jordan, Cora; Randolph, Mary (editor). **Plan Your Estate: Absolutely Everything You Need to Know to Protect Your Loved Ones (4th edition).** Nolo Press, 1998, 496 pages.

Duff, Richard W. **Preserving Family Wealth Using Tax Magic: Strategies Worth Millions.** Berkley Publishing Group, 1995, 368 pages.

Haas, Richard E. **Advanced Wealth Transfer Under New Tax Laws: Case Studies Simplify Sophisticated Strategies to Reduce Estate Taxes.** Bonus Books, 1998, 240 pages.

Contact your investment professional for more information or to construct a personalized Heritage Planning Profile to help your parents, your children, or yourself.

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