The Gift Tax / Estate Tax System

Married Taxpayers

Although we talk about the gift tax and the estate tax as if they were separate tax systems, they are actually part of a unified transfer tax system. That is, the total amount of tax ultimately paid is computed on the aggregate amount of all taxable gifts and the size of the taxable estate remaining at your death. Therefore, if John Doe has an estate of $4,500,000, he may transfer part of it by gift during his lifetime and the rest by his estate at his death. However, the ultimate tax liability will be computed on the full $4,500,000 regardless of when it is transferred. That result is affected by computing the estate tax due at death as follows:

1. Determine the value of the estate remaining at death; and
2. Add thereto the amount of all taxable gifts made during life (after 1976); and
3. Compute the tax on the total amount; and
4. Subtract the amount of any tax actually paid on the taxable gifts made during life.

As a result of this "unified tax system" approach, the making of taxable gifts does not reduce the total amount of tax paid except in the following few circumstances.

First, there are certain "exemptions" available under the gift tax laws which allow some gifts to be totally removed from the taxable estate, as discussed below.

Second, a gift of property will also transfer to the recipients all future appreciation and income on the transferred property and prevent that amount from accruing in your estate.

Third, certain types of gifts provide substantial "leverage" because they remove more from the taxable estate than the amount of the gift for which you are charged under the gift tax law.

There are some valuable exemptions and deductions available in the gift tax and estate tax arena. Much of estate tax planning, in fact, revolves around maximizing the use of these exemptions and deductions, which are generally summarized as follows:

Annual Gift Tax Exclusions - Each donor of a gift is allowed to give up to $12,000 per recipient, in each calendar year, to as many different people as he or she wishes. Such gifts may be in cash or property, and are completely removed from the computation of the donor's taxable gifts and taxable estate. Therefore, to the extent one is willing currently to part with the assets and give them to other family members, this exemption permits one to do so with no gift tax or estate tax liability. For example, if a donor has three children and six grandchildren, he or she could make annual gifts (each calendar year) totaling ($12,000 x 9 recipients) $108,000 free of any gift tax or estate tax consequences.

Gift Splitting - In addition, a married couple may agree to "pool" their exemptions and allow either spouse to give up to $24,000 per year to any recipient. That is, John could give up to $24,000 of his assets to each of their three children and six grandchildren (a total of $216,000) annually and Martha could allow him to use her $12,000 annual exclusions along with his own. This "pooling" of the exclusion is referred to as "gift splitting" because the spouses agree to "split" the gifts made by each of them and treat them as if one-half was made by each spouse.

Marital Deduction - For both gift tax and estate tax purposes, all transfers from one spouse to the other are free of any transfer tax, with no limitation as to amounts. In effect, the transfer tax system treats the "marital unit" as a single taxpayer, and all transfers within the marital unit are exempt from any tax. There are some limitations as to the manner in which these spousal transfers must be structured in order to be exempt. They can generally be either outright transfers to the recipient spouse, or transfers in trust where the recipient spouse has the exclusive right to the income from the trust for life. [Note that there are additional special rules which apply to qualification for the marital deduction where the recipient spouse is not a U.S. citizen.]

Charitable Deduction - For both gift tax and estate tax purposes, all transfers to qualified charitable organizations are exempt from tax, with no limitation as to amounts. The "qualified charitable organization" can be a public charity (your favorite school, etc.) or a charitable entity created by you (a charitable trust, family foundation, etc.) Note that this deduction for gift tax and estate tax purposes is in addition to any income tax deduction to which you might be entitled for charitable gifts.

The Unified Credit (Exclusion) - Every taxpayer is entitled to an "exclusion" for certain amounts of taxable gifts and/or a certain amount of estate value at death. Under the provisions of the 2001 Tax Act, the amount of the estate tax exclusions is scheduled to increase from time to time. The amount of the exclusions is shown in the following table:

Year(s)	Estate Tax Exclusion	Gift Tax Exclusion
2006-8	$2,000,000	$1,000,000
2009	$3,500,000	$1,000,000
2010	repeal	$1,000,000
2011>	$1,000,000	$1,000,000

Note that under the 2001 Act, the estate tax is scheduled to be "repealed" for decedent's dying in 2010, but the Act expires in its entirety at the end of 2010 and the pre-Act law is restored (as if the Act had never become law) beginning in 2011. It is expected that Congress will re-visit this well before 2010.

The available exclusion is applied first to offset any tax payable on lifetime taxable gifts. (Note that only $1,000,000 of the exclusion is available for gifts, even though a larger amount may be available for estate tax purposes at death.) Then, at death, those lifetime "adjusted taxable gifts" are added back to the estate remaining at death to compute the gross estate tax due, and the full exclusion is then applied to the tax on the full "grossed up" amount of taxable transfers.

The Income Tax Cost of Making Gifts. It is also important to recognize that some gifts can result in substantially more overall tax liability in the family than simply keeping the property and including it in the taxable estate. In general, property which is included in one's gross estate at death receives a "stepped up" income tax basis in the hands of the beneficiaries, equal in amount to the value of the property at the decedent's death. Even if the decedent had a very low basis during life and would have faced a substantial income tax on sale of the property, the estate or its beneficiaries can sell the asset after the taxpayer's death at that date of death value with no income tax cost. For instance, if you own a share of stock which cost you $1.00 and has a market value of $20.00, you would pay income tax on a $19.00 capital gain if you sold it during your life. However, if you die owning that stock, the stock is included in your estate at its $20.00 market value, and the estate's income tax cost basis is adjusted upward to that $20.00 value. The estate or its beneficiaries could then sell the stock for $20.00 and recognize no capital gain.

However, property transferred by gift during your life retains your basis. If you were to give that share of stock to your children at its $20.00 market value, you would be treated as having made a gift of $20.00, but the children would retain your cost basis of only $1.00. If they then sold the stock, they would pay income tax on the $19.00 gain. Consequently, lifetime taxable gifts of low-basis property may not remove much taxable value from the "unified" gift tax and estate tax system, but could cost the family a basis step-up at death. The result might well be an income tax cost which far exceeds any transfer tax savings.

© Lefkoff, Duncan, Grimes, Miller & McSwain, P.C.