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ESTATE PLANNING TOOL:
Lifetime Gifts

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Estate planning provides for orderly distribution of your assets during your lifetime and at death. Estate planning also minimizes the impact that federal and state transfer taxes can have on your estate. This guide has information on lifetime gifts as one of the various legal tools available to the estate planner.

Largely because of the rising cost of land, the net worth of farm estates has risen significantly in recent years. Higher federal estate taxes may accompany this rise in the value of farm assets. Therefore, every landowner, no matter how small the estate, should be aware of estate planning tools that can reduce the impact of estate taxes on property.

Estate planning is more than deciding how assets should be distributed at the death of the owner. Decisions to make gifts of property during the owner's life may also be part of an overall estate plan. This guide has information on the use of gifts as an estate planning tool and on some of the advantages lifetime gifts may have over inheritance under a will. Emphasis will be given to how recent tax changes, brought about by the Tax Reform Act of 1976, affect gift-giving as an estate planning tool.

More detailed information on estate planning, the objectives of estate planning, and other legal tools available to the professional estate planner are available in the University of Missouri Extension Division publication *Estate Planning for Missouri Families* (Manual 68).

Neither the manual nor this guide is a substitute for the help and guidance of a professional estate planner such as your attorney, accountant, or bank trust officer. These publications are only introductions to estate planning and are not substitutes for legal advice.

Why Make Lifetime Gifts?

One of the most important ways of reducing the impact of federal estate taxes at your death is to reduce *the size* of your estate while you are still living. You can do this in several ways, some simple and some complicated. But either way, the basic method of reducing your estate during your lifetime is making gifts. Making gifts during your lifetime reduces the amount of property you own at death and therefore the amount of property that will be subjected to the estate tax.

However, the 1976 Tax Reform Act includes taxable gifts after 1976 in the gross estate for estate tax purposes. These new rules remove some of the pre-1977 advantage of making taxable gifts, but you can still reduce transfer taxes by making lifetime gifts.

Gifts and the Federal Gift Tax

Congress enacted a gift tax largely because, if one didn't exist, property owners would probably give away all or most of their assets during their lifetimes or right before their deaths in order to reduce the size of their estates to be subjected to federal estate tax.

Gift taxes are levied on the right to give property to others during life, whereas an estate tax is levied on the right to pass property to others at death. The gift tax is paid by the one making the gift (the donor).

New Tax Credit. Before 1977, the federal gift tax rates were lower than the federal estate tax rates for passing the same amount of property. The Tax Reform Act of 1976 "unified" these two rates; in other words, federal gift tax rates are now the same as federal estate tax rates. The act also eliminated the $30,000 lifetime gift exemption and the $60,000 estate exemption, replacing both with a *unified tax credit*. For 1978, this unified transfer tax credit is $34,000, which would be equal to $134,000 in deductions from the taxable estate. The amount of unified tax credit will continue to rise over the next four years: See Table 2. The $47,000 unified credit for 1981 and later years would be equal to $175,625 in deductions.

Figuring the Gift Tax. This amount of gift tax due on any one gift depends partially on the amount of any previous lifetime gifts made. This is because of the cumulative effect of the gift tax structure and the amount of unused unified tax credit.

After 1976, the gift tax is figured by computing a tentative gift tax on the amount of all previous taxable gifts (including those made before 1977) plus the amount of the present gift. From this tentative tax, subtract the amount of tax figured on previous gifts only. The difference equals the tax due on the present gift. Of course, this tax on the present gift may be offset by the unified tax credit applicable for the year of the present gift. All taxes are figured using present unified estate and gift tax rates. (See Table 1.)

For example: Suppose John, a single man, made a gift of $133,000 to Sam in 1975 and paid any applicable gift tax. In 1978, John makes another gift to Bill of $103,000. What is the amount of federal gift tax due on this 1978 gift to Bill?

Table 1. Unified Estate and Gift Tax Rates*

If the amount with respect to which the tentative tax to be computed is:	*The tentative tax is:*
Not over $10,000	18% of such amount.
Over $10,000 but not over $20,000	$1,800 plus 20% of the amount over 10,000.
Over 20,000 but not over $40,000	$3,800, plus 22% of the amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24% of the amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26% of the amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28% of the amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30% of the amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32% of the amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34% of the amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37% of the amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49% of the amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the amount over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,290,800, plus 57% of the amount over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,575,800, plus 61% of the amount over $3,500,000.
Over $4,000,000 but not over $4,500,000	$1,880,800, plus 65% of the amount over $4,000,000.
Over $4,500,000 but not over $5,000,000	$2,205,800, plus 69% of the amount over $4,500,000.
Over $5,000,000	$2,550,800, plus 70% of the amount over $5,000,000.

*Source: Internal Revenue Code of 1954, as amended, Section 2001.

First, figure the amount of previous taxable gifts:

Total gifts in 1975	$133,000
Less annual exclusion (explained later in guide)	(3,000)
Less lifetime exemption, now repealed	(30,000)
Previous Taxable gifts	$100,000

Second, figure the amount of the 1978 taxable gift:

Total gift in 1978	$103,000
Less annual exclusion	(3,000)
Present taxable gift	$100,000

Third, figure the tentative tax:

On both previous plus present taxable gifts ($100,000 + $100,000 = $200,000), figured at the present unified tax rate	$54,800
Less the tax figured on only previous taxable gifts ($100,000) at present rates	(23,800)
Tax on present gift	$31,000
Less the unified transfer tax credit for 1978	(34,000)
Actual 1978 tax liability	$ 0

Estate Planning and Gifts

Three aspects of federal gift taxes are particularly important to the estate planner. First, there is a $3,000 annual exclusion from the gift tax *per donee* (receiver of the gift). That is, you may give up to $3,000 worth of gifts to any donee every year without paying a gift tax. For example, a father with four children could give each child $3,000 per year, or a total of $12,000 worth of gifts per year, without paying any gift tax. This of course would reduce the father's taxable estate at death.

Second, a spouse may elect to join in a gift made by the other spouse and treat it as being jointly made. Thus, in the example above, a father could make $6,000 worth of gifts to each child, or a total of $24,000 worth of gifts to four children, without worry of gift taxes, if his spouse elects to treat the gifts as jointly made. If the non-contributing spouse "joins in," the $24,000 worth of gifts can be made; the gift tax would not be triggered; and the gross estate of the contributing spouse is reduced by $24,000.

Third, the federal gift tax law allows for a gift tax martial deduction. This gift tax marital deduction is similar to the estate tax marital deduction allowed at death. Beginning in 1977, the first $100,000 of accumulated gifts above the $3,000 annual exclusion, from one spouse to the other, can be deducted when figuring taxable gifts. The next $100,000 of gifts to a spouse is not deductible as a marital deduction, and the gifts would be taxable. For spousal gifts made after 1976 totaling more than $200,000, 50 percent of the gifts are deductible as a gift tax marital deduction. This rule is nearly the same as before 1977, but now spousal gifts are entirely eligible for the gift tax marital deduction for the first $100,000.

This gift tax marital deduction may, however, reduce the available federal estate tax marital deduction by the amount of the gift tax marital deduction used in excess of 50 percent of gifts made to the spouse. For example, a first-time $50,000 gift

to a spouse would be fully deductible as a gift tax marital deduction, and no gift tax would be due. However, if no more gifts are made, the *estate tax* marital deduction at death would be reduced by $25,000.

The New Automatic *Three Year Rule.* Estate tax complications can arise if the donor of the gift dies within three years after making the gift. Under the Tax Reform Act of 1976, gifts made within three years of death are automatically included in the gross estate of the donor, along with any gift tax that may have been paid. A credit is then given for the gift tax actually paid in the three-year period before death. *However, gifts made under the $3,000 annual exclusion are not pulled back into the donor's estate, even if made within three years of his death.*

Using the Unified Credit. Under current tax law, a unified tax credit for *both* gift and estate taxes is available. Thus, making gifts greater than the annual $3,000 exclusion per donee or the gift tax marital deduction may not result in an actual out-of-pocket gift tax payment. The $34,000 tax credit for 1978 would offset about $134,000 worth of otherwise taxable gifts. For example, if lifetime taxable gifts (those above allowable deductions and exclusions) of $100,000 are made during one's lifetime after 1976, no actual out-of-pocket gift tax would be due because the tax for a $100,000 gift is $23,800 and the 1978 unified tax credit of $34,000 offsets this amount; however, a gift tax return must be filed. (A federal gift tax return generally must be filed annually, unless cumulative annual gifts total more than $25,000, in which case the return must be filed quarterly.)

However, at death the unified tax credit available to offset estate taxes will be reduced by the amount used to offset gift taxes. This reduction is accomplished by adding to the gross estate all taxable gifts made after December 31, 1976 *(for computation purposes only)* and by taking a full unified credit at death. The result is not double taxation of gifts, but only taxation of the gross estate at a higher estate tax rate, since the unified federal estate and gift tax rates are progressive.

Thus, remember that taxable gifts made during your lifetime affect both the amount of unified tax credit available at your death and the rate at which your gross estate will be taxed.

Tax Advantages to Gift Giving

Before 1977, when federal gift tax rates were three-fourths those of the federal estate tax rates, the tax advantage of gift giving was obvious. Now, even though gift tax and estate tax rates are the same, there are still tax saving incentives for making gifts of property during your life to those who would otherwise receive it at your death. There are primarily two incentives, explained below.

Removing Property From Your Estate. First, when you make a gift for gift tax purposes, the gift property is valued *at the time the gift is made.* If the asset is one that appreciates in value, this *gift tax value* might be much less than the value of the same property years later at your death. For estate tax purposes, the asset is valued *at the time of death or six months thereafter.* Thus, one advantage of making lifetime gifts is that you may transfer property before it appreciates in value.

For example, suppose a father has five acres of land that he wants to will to his son. Instead, the father's attorney suggests that the father give the five acres to the son now. The value of the land is now $1,200 per acre. The land would have a gift value of $6,000. If the father does not make the gift and lives for five more years and if the land appreciates in value to $2,000 an acre, the estate value of the property would be $10,000. Then at the father's death, $4,000 more value will be taxed than if a gift of the same property had been made five years earlier.

Table 2
Unified Transfer Tax Credit

1978	$34,000
1979	$38,000
1980	$42,500
1981	$47,000

Thus, even though the gift and estate tax rates are the same, lifetime gifts can reduce the total impact of property transfer taxes by subjecting less value to tax. In the example above, the $4,000 of appreciation in the property belongs to the son. The father never "transferred" the $4,000 to the son, and therefore the father's estate will not be taxed on the appreciation.

Paying the Gift Tax Actually Helps. The second tax advantage of lifetime gifts, even if a gift tax is due, is that the gift tax paid by the donor further reduces the donor's estate to be taxed at death. This is not the case with estate taxes; that is, the taxable estate at death is not reduced by the amount of federal estate tax that is going to be due.

For example, suppose that in our case above, a gift tax of $500 was due on the gift of $6,000 of property. After paying this $500 of gift tax, the father's estate would be reduced by $500, and this amount will not be taxed at his death. However, if the father dies owning the five acres and if $1,800 of estate tax is due, the $1,800 tax must be paid out of the funds and property that were just subjected to the federal estate tax.

When Is a Gift Completed?

To make a gift of property so that it will not be included in your gross estate at death, you must make a gift "effective" for estate tax purposes. An effective gift is one that removes the property from your estate so that the property will not be subjected to the federal estate tax at your death. Generally, to have an effective gift, you must give up dominion and control over the property. *You must not:*

- retain the right to live on the property or receive the income from the property for the remainder of your life,
- retain the right during your lifetime to designate who shall receive the income from the property,
- retain an interest in the property so that it may be returned to you on the happening of an event, or
- retain any power to get the property back.

The message is clear: you must give up physical and economic control over property before a gift will be considered complete for gift and estate tax purposes. In one tax court case, a donor executed and recorded deeds which purported to convey properties he owned to his grandchildren. The deeds were never delivered to the grandchildren, and the donor continued to retain complete control over the property until his death. The tax court held that no effective gift for gift and estate tax purposes had been made. The property was therefore included in the gross estate of the donor and valued *as of the decedent's death.*[1]

In another tax case, however, the court held that a gift of the family farm from *one spouse to the other,* with the donor spouse remaining on the land for the remainder of his life, was an effective gift for gift and estate tax purposes.[2]

[1] *Estate of Mortimer,* 17 T.C. (1951).
[2] *Estate of Gutchess,* 46 T.C. 554 (1966).

These cases do not decide the issue of a father deeding land to his children and then remaining on the land to farm it for the remainder of his life. Even a leaseback arrangement from the children to the father may be attacked by the Internal Revenue Service as an ineffective gift for estate tax purposes. Such arrangements *should not* be entered into without the advice of legal counsel.

Take care to insure that lifetime gifts are complete and therefore effective for gift and estate tax purposes. If a gift is "incomplete" for estate tax purposes, the gift property will be included in the gross estate at its value at the time of the decedent's death. This, of course, defeats the estate tax advantage of making the lifetime gift.

Should You Make Gifts?

Even though making lifetime gifts may have tax advantages in terms of saving estate taxes at death, making large gifts during your life may not be right for you. Remember that for a gift to be effective for estate tax purposes, you must relinquish dominion and control over the property. You may not care to do that, or you possibly cannot economically afford to do that. Whether you can make large gifts depends upon the circumstances of each case.

Also bear in mind: All gifts made within three years of death and exceeding the annual $3,000 exclusion per donee will automatically be pulled back into the estate for estate tax purposes. This may influence the advisability of making large gifts during later years.

Income Tax Considerations of Gifts

Before making lifetime gifts, consider possible income tax consequences to the donee if the donee plans to sell the gift property soon after its receipt. The income tax consequences from such gifts flow primarily from the *different income tax carry-over basis* for lifetime gifts as contrasted to the tax basis for inherited property.

When property is a gift, the income tax basis is the same in the hands of the donee as it was in the hands of the donor. For example, if a son receives land from his father, the father's basis in the land, which might be $500 (basically, the cost of the land), would be carried over to the son in the same amount. This is commonly referred to as a carry-over basis rule.

When property is inherited upon someone's death, the income tax basis of the property is stepped-up to a "fresh start basis." This fresh start basis is the property's fair market value as of December 31, 1976, computed according to a formula, if the decedent owned the property on that date.

Before 1977, a complete step-up in basis was allowed to the fair market value of the land on the date of the decedent's death. Thus, property costing $500 but having a fair market value of $800 on the date of the decedent's death would have yielded a basis when inherited of $800 *under the pre-1977 rules*. However, under current tax law, the $500 basis would only receive a limited stepped-up basis to the fair market value of the property on December 31, 1976. The fair market value of the property must be computed by use of a mandatory formula called the "fresh start rule" (see Manual 68). An appraisal of property as of December 31, 1976, is unnecessary.

Because taxable capital gain is computed by subtracting the tax basis of the property from the money realized on the sale of such property, a higher basis yields less capital gain. Thus, even a limited stepped-up basis for inherited property will yield less taxable income upon sale than would a carry-over basis for gift property.

If farm operations are to be discontinued and the farm property sold after the death of the original property owner, postponing the transfer of land until his death (to take advantage of the step-up basis rule) may be wise. However, there is no fresh start basis step-up in an heir's tax basis if the property was not owned on December 31, 1976, by the decedent.

Summary

This guide has explained lifetime gifts as a legal "tool" of the estate planner. The federal gift tax was reviewed in light of recent changes in the tax law brought about by the Tax Reform Act of 1976. The tax advantages of gift giving were also listed. If lifetime gifts are made with professional advice, lifetime gifts can be an effective tool for reducing the size of an estate.

When discussing gifts as a possible estate planning tool with your attorney, these are some of the questions you should be considering:

- Can I economically afford to completely give up control over gift property during my life?
- Will this gift fit within the $3,000 annual gift exclusion per donee? If not, how much unified tax credit do I have available to offset the tentative gift tax?
- How will making lifetime gifts to my spouse affect my federal estate tax marital deduction at death?
- Have I made previous taxable gifts that will affect the rate of tax for this gift?
- Am I giving appreciating assets that would otherwise have a higher value subject to the estate tax at my death?

For further general information on estate planning, refer to Manual 68; Guide 504, "Marital Trusts," and Guide 505, "Farmland Valuation for Federal Estate Tax Purposes" Then visit with your attorney to get your ideas carried out.

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