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Gifts and Gift Taxation

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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 general information on lifetime gifts as one of the various tools available to the estate planner. See your attorney for legal advice.

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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 should be aware of estate planning tools that can reduce the impact of estate taxes on property.

Estate planning involves more than deciding how assets should be distributed at the death of the owner. An overall estate plan may include decisions to make gifts of property during the owner's life. This Guide provides information on the use of gifts as an estate planning tool and highlights some of the advantages lifetime gifts may have over inheritance under a will. The Guide also tells how recent tax changes, brought about by the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981, affect gift-giving as an estate planning tool.

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

But neither Manual 68 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 estate taxes at your death is to reduce **the size** of your estate while you are still living. The simplest way to do this is to spend your money before you die. Another 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 subject to the estate tax. However, large gifts are taxable and certain types of gifts may be included in your gross estate for estate tax purposes. Whether a gift is advantageous from this standpoint depends upon several factors. This Guide explains these factors and describes the circumstances under which a gift is advantageous.

Gifts and the federal gift tax

Congress enacted a federal gift tax because, if there wasn't such a tax, 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 taxable estates.

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 on to others at death. The gift tax is an obligation of the one making the gift (the donor). Gifts to charities, religious organizations, and government agencies are usually tax free. Although Missouri does have an estate tax, there is no Missouri gift tax.

Changes in 1977 and 1981. Before 1977, federal gift tax rates were lower than federal estate tax rates for passing the same amount of property. The Tax Reform Act of 1976 *unified* the two rates. The 1976 act also eliminated the $30,000 lifetime gift exemption and the $60,000 estate exemption and replaced both with a unified tax credit. The Economic Recovery Act of 1981 establishes the unified tax credit for 1982 at $62,800, which is equal to $225,000 in deductions from the

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.
1982	
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	$1,880,800, plus 65% of the amount over $4,000,000.
1983	
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	$1,575,800, plus 60% of the amount over $3,500,000.
1984	
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	$1,290,800, plus 55% of the amount over $3,000,000.
1985 and thereafter	
Over $2,500,000	$1,025,800, plus 50% of the amount over $2,500,000.

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

taxable estate. The amount of this credit will continue to rise until 1987 when the unified tax credit will be $192,800, which corresponds to $600,000 in deductions from the taxable estate. (See Table 2.)

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

After 1976, you figure the gift tax 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 unified estate and gift tax rates applicable for the year of the gift (See Table 1).

Example. Suppose John, a single man, made a gift of $103,000 to Sam in 1978 and used a portion of his unified credit to offset the taxes. In 1982, John makes a gift to Bill of $110,000. What is the amount of federal gift tax due on this 1982 gift to Bill?

First, figure the amount of previous taxable gifts:

Total gifts in 1978	$103,000
Less 1978 annual exclusion (explained later in Guide)	(3,000)
Taxable gift in 1978	$100,000

Second, figure the amount of the 1982 taxable gift:

Total gift in 1982	$110,000
Less 1982 annual exclusion	(10,000)
Taxable gift in 1982	$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 available for 1982 ($62,800 minus $23,800)	(39,000)
Actual 1982 gift tax liability	-0-

Note that while the same amount ($100,000) of taxable gift was made in 1978 and 1982, the cumulation process made the gift tax larger on the 1982 gift.

Estate planning and gifts

Three aspects of federal gift taxes are particularly important to the estate planner. First, the Economic Recovery Tax Act of 1981 increased the annual exclusion from the gift tax to $10,000 *per donee* (receiver of the gift). The annual exclusion before 1982 was $3,000. In other words, you may give up to $10,000 worth of gifts to any donee every year without paying a gift tax. For example, a father with four children could give each child $10,000 per year, or a total of $40,000 worth of gifts per year, without paying any gift tax. This, of course, would substantially reduce the father's taxable estate at his death.

Second, a spouse may elect to join in a gift made by the other spouse and treat it as being made jointly. Thus, a father could make $20,000 worth of gifts to each child, or a total of $80,000 worth of gifts to the four children, if his spouse elects or consents to treat the gifts as being jointly made. If the non-contributing spouse *joins in,* the $80,000 worth of gifts can be made free of any gift tax, and the gross estate of the contributing spouse is reduced by $80,000.

Third, both the federal gift tax law and the federal estate tax law allow a marital tax deduction. The Economic Recovery Tax Act of 1981 establishes a 100 percent marital deduction for property transfers, either by gift or inheritance, to your spouse. Beginning in 1982, a gift or bequest to a spouse can be fully deducted when figuring applicable gift or estate taxes. Thus, transfers of property between spouses are now tax-free. For example, a husband gives his wife a gift of $100,000 in 1982. The husband subsequently dies in 1983 bequeathing his entire estate of $200,000 to his surviving widow. Both of the above transfers will not be taxed. However, the 100 percent marital deduction is **only** applicable to transfers between spouses who are married at the time of the transfer.

The old three-year rule. Estate tax complications used to arise for certain gifts if the donor (giver) of a gift died within three years after making the gift. Under the Economic Recovery Tax Act of 1981, the new general rule is that gifts of property made within three years of death are **not included in the estates of decedents dying after 1981.** However, there are specific exceptions to this general rule. These exceptions are transfers of property where:

- the decedent retained a life estate in the property;
- the transfer involves a power of appointment;
- the transfer involves life insurance policies;
- the transfer is revocable;
- the transfer is to take effect at death; and
- certain other specific exceptions for complicated eligibility determinations, such as installment payment of federal estate taxes and current use valuation.

If a gift made within three years of death does not fit into one of the above exceptions, then it will not be included in the donor's gross estate for estate tax purposes. However, even if a gift within three years of death is to be included in the donor's gross estate, the gift may avoid being taxed if its value is less than the annual exclusion, which is $10,000 beginning in 1982.

Using the unified credit. Under current tax law, a unified tax credit for both gift and estate taxes is available. (See Table 2 for the credit amounts for 1982-1987.) Thus, making gifts greater than the annual $10,000 exclusion per donee may not result in actual out-of-pocket gift tax payment. The $62,800 tax credit for 1982 would offset about $225,000 worth of otherwise taxable gifts. For example, if lifetime taxable gifts (those above allowable deductions and exclusions) of $200,000 are made during one's lifetime, no actual out-of-pocket gift tax would be due because the gift tax for a $200,000 gift is $54,800, and the 1982 unified tax credit of $62,800 fully offsets this amount. However, a gift tax return must be filed.

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 because the unified federal estate and gift tax rates are progressive.

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.

Annual exclusion. The most obvious reason for making gifts is to take advantage of the $10,000 annual

Table 2. Unified transfer tax credit.

Year	*Tax credit*	*Corresponding estate deduction*
1981	$ 47,000	$175,625
1982	$ 62,800	$225,000
1983	$ 79,300	$275,000
1984	$ 96,300	$325,000
1985	$121,800	$400,000
1986	$155,800	$500,000
1987 and later	$192,800	$600,000

exclusion per donee. The donee need not be a relative. A sustained program of making gifts over a number of years can reduce the potential estate tax without incurring any gift taxes.

Removing property from your estate. 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 10 acres of land that he wants to will to his son. Instead, the father's attorney suggests that the father give the 10 acres to the son now. The value of the land is now $1,200 per acre. The land would have a gift value of $12,000. 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 $20,000. Then at the father's death, $8,000 more value will be taxed than if a gift of the same property had been made five years earlier.

Paying the gift tax actually helps. Another 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, a gift tax of $500 was due on the gift of $12,000 of property. After paying this $500 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 10 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 (tax on a 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 subject 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]

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 viewed 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,* the gift property will be included in the gross estate at its value at the time of the decedent's death.

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

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 possibly you cannot economically afford to do that. Whether you can make large gifts depends upon the circumstances.

Also bear in mind that even after 1981, some gifts made within three years of death and exceeding the annual $10,000 exclusion per donee may be pulled back into the estate for estate tax purposes. This may influence the advisability of making certain large gifts during retirement years.

Income tax consideration of gifts

Before making lifetime gifts, consider the possible income tax consequences to the donee if the donee plans to sell the gift property soon after its receipt. Because taxable capital gains are 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 gains. Therefore, donees and potential heirs would like to receive the property with as high a basis as possible.

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, let's say $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, a *step-up* in basis is allowed to the fair market value of the property as of the date of the decedent's death. For example, a father buys land in 1970 for $500 (the land's basis). The father dies in 1980, and his son inherits the land. If the fair market value of the land upon the father's death in 1980 is $1,000, the son's basis in the land will be $1,000. This is commonly referred to as a stepped-up basis rule.

The income tax differences between the carryover basis for gifts and the stepped-up basis for inherited property can be quite large. Let's assume that the decedent buys land in 1965 which has a basis of $1,000, and the land has a fair market value of $2,500 in 1982. If the decedent gives the property away in 1982, then the donee's carryover basis is $1,000. If the decedent dies in 1982, then the heir's stepped-up basis is $2,500. The difference between these two bases will become crucial when the receiver of the property eventually sells that property. Assume the receiver of the property sells that property in 1984 for $2,800. If the receiver had obtained the property by gift, then he would have a taxable capital gain of $1,800 ($2,800 - $1,000). If the receiver had obtained the property by inheritance, then he would only have a taxable capital gain of $300 ($2,800 - $2,500). Thus, for income tax purposes, there is a $1,500 difference between gifts and inheritances in this example.

As this example indicates, a person who owns property, which is greatly appreciated in value, will often be wise to bequeath the property by will, rather than give away the property by gift. However, a person must remember that once the property is given away, the new owner becomes liable for the property taxes which accrue every year. When property is bequeathed by will, the decedent (or his estate) must pay the property taxes accruing during his lifetime. No blanket rule is possible, but due to greatly appreciated land values, most persons owning large tracts of land should discuss with their attorneys whether to bequeath the land by will to take advantage of the stepped-up basis rule.

Summary

This Guide has explained lifetime gifts as a *tool* of the estate planner. If 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, consider these questions:

- Can I economically afford to completely give up control over gift property during my life?
- Will this gift fit within the $10,000 annual gift exclusion per donee? If not, how much unified tax credit do I have available to offset the tentative gift tax?
- Am I giving property with a low basis which might better be transferred by will?
- 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 *Estate Planning for Missouri Families*, Guide 504 "Marital Trusts," and Guide 505 "Farmland Valuation for Federal Tax Purposes." Then, visit with your attorney to get your ideas carried out.

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