TOPIC: GIFTING STRATEGIES

For larger estates, a basic estate plan can reduce but not eliminate estate taxes. For example, a couple with an estate of $15,000,000 can eliminate taxes on $10,860,000 (two times the 2015 estate tax exemption of $5,430,000) by use of by-pass ("credit shelter") trusts. However, the remaining $4,140,000 will be subject to estate tax unless further action is taken.

Annual Gifting

The simplest and often most effective, mechanism for further reducing estate taxes is through lifetime gifts. Each year, an individual can gift up to the annual gift tax exclusion amount ($14,000 in 2015) to another individual without any income, gift or estate tax consequences. The only requirement is that the gift must be of a present interest, in other words, a gift of an asset one currently owns, rather than the right to receive an asset in the future.

If an individual (the donor) gifts more than the annual gift tax exclusion amount in any one year to another individual, then the amount in excess of the exclusion amount reduces the donor's lifetime estate tax exemption amount ($5,430,000 in 2015). Although no tax must be paid, a gift tax return must be filed. If the donor has depleted his or her lifetime estate tax exemption amount, then the excess amount over the annual gift tax exclusion is subject to gift tax.

A couple, by joining together in a gift, can gift $28,000 (in 2015) annually to any one individual without any tax consequences (as long as the gift is of a present interest.) If a couple has assets in excess of both their needs and the current estate tax credit, then they may be able to substantially reduce their taxable estate by making annual gifts during their lifetimes to their heirs. For example, a couple with three children could gift $84,000 annually ($28,000 per child in 2015) without any tax consequences. In addition, such a couple might also make gifts to grandchildren. For example, a common gifting strategy is to make gifts to an UTMA account (Uniform Transfers to Minors Act account) for the benefit of a grandchild. An UTMA account is controlled by an adult custodian (normally the parent) until the child reaches age 18 or 21. Often, the assets of UTMA accounts are used to pay for college education.

Using the Estate Tax Credit Immediately

In some instances, an individual with excess assets may desire to use up their estate tax credit during their lifetime by immediately making annual gifts with values in excess of the annual gift tax exclusion. For example, an individual could gift to his or her children in a single year an amount equal to the annual gift tax exclusion plus the estate tax exemption. This amount will not result in any taxation but will completely use up the individual's estate tax exemption. When the individual dies, all remaining assets in his or her estate will be subject to estate tax (ignoring any potential increase in the lifetime estate exemption amount in future years).

Gifting Appreciating Assets

How does an individual decide whether to use up the estate tax credit during his or her lifetime or only at his or her death? The answer often depends on whether the individual holds assets which he or she expects to appreciate substantially before his or her death. If an asset is expected to appreciate rapidly, it is often better to gift it now at a low value even if the gift uses up the estate tax credit.

Indeed, the idea of gifting currently those assets which are expected to appreciate most rapidly in the future is a significant consideration in most gifting strategies, including annual gifts which make use of the annual gift tax exclusion. If a major purpose of your estate plan is to reduce your taxable estate at the time of your death, then you want to make gifts which allow you to gift the greatest amount of potential future appreciation.

For example, assume you hold a money market fund worth $10,000 which yields 5% annually but does not appreciate, and a stock worth $10,000 with no dividend yield but which is expected to appreciate 10% each year. You wish to make a $10,000 gift to a child. Should you gift the stock or the money market fund? If you gift the money market fund and then die ten years later, the stock will have grown to $25,937. All of that value will be included in your estate. If you gift the stock instead of the money market fund and then die ten years later, the money market fund plus all accrued interest will have grown to approximately $16,289. All of that value will be included in your estate. This means that by gifting the stock instead of the money market fund, the value of your estate will be $9,648 less. That incremental value will belong to your child without being subject to estate taxes.

Of course, this strategy assumes that you can reasonably predict which assets will appreciate most rapidly in the years ahead. In many cases you can make reasonable predictions. For example, over long time periods stocks in general can be expected to appreciate more rapidly than bonds. In other cases, however, it is not so easy. Even though stocks in general may rise, the stock in a particular company may fall. Also, a family business that has grown rapidly in the past may suddenly run into business setbacks in the future and lose value. Sometimes, the vagaries of the market can thwart the best designed gifting strategies.

Gifts and Income Taxes

Another important consideration in developing gifting strategies involves income taxes (as distinct from estate taxes.) At your death, all of your assets receive a step up in their tax basis to their value as of the date of your death for purposes of determining future capital gains. For example, assume you own $10,000 of XYZ stock for which you paid $1,000. If you sell the stock you will realize $9,000 of capital gains income subject to capital gains tax. However, if you die holding the stock, and your heirs subsequently sell it for $10,000, then they will realize no capital gains income on the sale, since they will be treated as having paid $10,000 for the stock.

On the other hand, if you gift the stock to your heirs during your lifetime, then for purposes of determining gain they take over your tax basis in the stock. This means that if they sell the stock for $10,000 after having received it from you as a lifetime gift, then they will realize $9,000 in capital gains income subject to capital gains tax.

This means that for people with short life expectancies and highly appreciated assets, they may decide not to gift the highly appreciated assets. Rather, they will retain those assets in their estates in order to minimize income taxes, and instead, gift other assets with no or low unrealized capital gains.

Alternatively, someone with a relatively long life expectancy and highly appreciated assets may decide to gift the highly appreciated assets to heirs who currently are in a significantly lower tax bracket; for example, grandchildren without significant income. The grandchildren can then sell the assets and may pay no or only a small amount of capital gains tax.

These examples illustrate that the interplay of both estate and income taxes in gifting strategies can become relatively complex. The important thing is not to know all of the technical intricacies of the tax laws, but rather, to be aware of basic tax issues so you can make sure they are being considered in your gifting strategies.

For general information on additional gifting strategies, please read our White Papers on Grantor Retained Annuity Trusts (GRATs), Charitable Remained Trusts (CRTSs), and Charitable Lead Trusts (CLTs).

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