

Tax-wise gifts for loved ones

One of the great joys of parenting (or grandparenting) is watching your youngsters reach milestones, large and small. Nurturing these loved ones. Offering them the emotional and financial support that they need in order to thrive.

From an estate planning perspective, making gifts is an excellent way to accomplish these goals while, at the same time, gaining an opportunity to reduce your overall estate and gift taxes. There are several traditional techniques that you may want to consider. But—and it's a big one—some techniques of long standing may be questionable in light of recent tax law changes.

Annual exclusion gifts

Generally, gifts are subject to federal tax. In addition, grandparents may be hit with a generation-skipping transfer tax for large gifts to the third generation and beyond. Certain gifts, however, may escape tax altogether. For instance, in 2008, you may give as much as \$12,000 a year to anyone and avoid both of these taxes. (This number rises with inflation.). Plus, what you give is removed from the threat of any future estate tax.

The tax code does require, however, that these gifts be of a “present interest,” that is, the right to use the money or property given *today*, not just in the future. And it's important to keep in mind that the annual exclusion gifts are perishable. An unused exclusion in one year cannot be carried forward to make larger gifts in another year.

Split gifts

The annual exclusion can be doubled to \$24,000 when married couples choose to make “split gifts” (meaning that each spouse agrees to join in making the gift). Over several years, then, your gifts can lead to substantial estate tax savings.

Example: You and your spouse make split gifts of \$24,000 in 2008 to each of your two children and three grandchildren. You have the pleasure of seeing the impact that your gift has on their lives and potentially reduce your taxable estate by \$120,000. Over five years that amount will reach at least \$600,000 dollars. (The indexed annual exclusion may allow you to give more in future years.)

Tuition and medical expense gifts

Direct payments (i.e., payments to the educational institution) of college tuition for another person are nontaxable regardless of amount. Caution: The special exclusion for tuition payments does not extend to payments for room, board, books or other expenses.

Similarly, payments of another person's medical expenses are excluded from tax without a dollar limitation, as long as payment is made directly to the health care provider. Generally speaking, the kinds of expenses that are permitted are those that you are entitled to take as deductions on your federal income tax return. However, the exclusion is not available for expenses that are reimbursed by insurance.

Using your lifetime credit

In addition to the annual gift tax exclusion, everyone has a lifetime federal gift tax exemption of \$1 million. It's your choice to have this credit apply against the estate tax after your death, or against gifts that you make during your lifetime.

The great advantage of making gifts and using all or part of your exemption is that all future appreciation in the value of the gifted assets is removed from your taxable estate. Similarly, investment income generated by the gift can accumulate for future use by your grandchildren (or anyone else, for that matter) without exposure to estate tax at your death.

Reasons to make gifts of more than the lifetime credit

Under the current rules, the gift tax exemption will be staying at \$1 million while the estate tax exemption, \$2 million in 2008, will to \$3.5 million in 2009.

Does it make sense to make current gifts that exceed your current gift tax exemption? For years many estate planners could point to many good reasons for doing so. As mentioned earlier, making a gift allows any future appreciation to escape taxation at your death. Making a lifetime gift has another tax advantage: When you make the gift and pay the tax, not only is the value of the gift removed from your estate, but so is the gift tax itself. But if you wait and bequeath the same amount in your will, your estate will be taxed on the value of the bequest, without the removal of

the amount of tax that the bequest generates. In other words, your estate actually pays estate tax on the estate tax itself.

There are more advantages to consider as well. When you make a gift of income-producing property to a child or grandchild in a low tax bracket, less income tax may be paid. What's more, watching what happens after you make the gift allows you to determine how wise a money manager your child or grandchild is, giving you some insight as to whether a future bequest should be made outright or in trust.

Reasons not to make gifts of more than the lifetime credit

On the other side of the coin, under the current tax rules, the split in estate and gift tax exemptions must be considered. The maximum exemption for gifts remains at \$1 million, meaning that you actually will have to pay tax on gift amounts that exceed your gift tax exemption. With the rising estate tax exemption in the coming years, however, transfers by will may escape tax above that \$1 million. And, should the scheduled estate tax repeal in 2010, by chance, become permanent, all bequests may avoid tax.

Then there is the issue of basis (what you paid for transferred property). Your offspring receive their gifts with a "carryover" basis—in other words, your basis becomes theirs. Thus, if you have owned the property for some time, and it has increased substantially since the time that you purchased it, you may be passing along a significant income tax bill to your loved ones. Generally, if you pass highly appreciated property in your will, your beneficiaries receive a "stepped-up" basis in the property—to its fair market value at your death. Thus, the gain on an immediate or near-term sale will generate little or no tax. (This stepped-up basis rule is scheduled to change to a carryover basis rule when the estate tax is repealed in 2010.)

The need for guidance

Considering a program of gift-giving to children or grandchildren? Given the complicated—and changing—tax rules, you should seek professional guidance prior to making any substantial gifts. There may be other ways to make gifts that may prove advantageous—specifically, gifts to a Sec. 529 plan account may be an avenue for you to explore.

Any developments occurring after January 1, 2008, are not reflected in this article.