Make Gifts to Reduce Your Estate

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One thing you can do to save estate taxes, whether you are married or single, is to start giving away some of your assets now to the people or organizations who will eventually receive them after you die.

This is an excellent way to reduce estate taxes because you are reducing the size of your taxable estate. (Just make sure you don't give away any assets you may need later.) But what may be even more satisfying is that you can see the results of something that may not have happened without your help.

You can currently make annual tax-free gifts of up to $13,000 per recipient. If you are married, you and your spouse together can give $26,000 per recipient per year. (You can either give $13,000 each, or one spouse can make a $26,000 gift with the consent of the other spouse on a timely-filed gift tax return.) You can also give an unlimited amount for tuition and medical expenses if you make the gifts directly to the educational organization or health care provider.

You do not have to give cash. For example, if you want to give some land worth $52,000 to your child, you can give your child a $13,000 "interest" in the property each year for four years.

As long as the gift is within these limits, you don't have to report it to Uncle Sam. Just the same, it's a good idea to get appraisals (especially for real estate) and document these gifts in case the IRS later tries to challenge the values.

What if you want to give someone more than $13,000? You can, it just starts using up your $1 million federal gift tax exemption. If your gift exceeds the annual tax-free limit, you'll need to let Uncle Sam know by filing an informational gift tax return (Form 709) for the year in which the gift is made. After you have used up your exemption, you'll have to pay a gift tax on any gifts over $13,000 (or whatever the annual tax-free amount is at that time). The gift tax rate is equal to the highest estate tax rate in effect at the time the gift is made. In 2009, it is 45%.

Making gifts now can reduce your estate taxes later.

Note: The amount allowed for annual tax-free gifts has been tied to inflation since 1999. However, it will only increase in increments of $1,000 and it will be rounded down instead of up. So, for example, if adjustments for inflation would increase the amount to $13,999, it would remain at $13,000.

Pay The Tax Now – And Save

Remember, once your federal gift tax exemption is completely used, you will have to pay a gift tax if you make any taxable gifts (currently, those more than $13,000) while you are living. Or, you could wait until after you die and have your estate pay an estate tax. (If the transfer is made while you are living, the tax is a gift tax; if the transfer occurs after you die, the tax is an estate tax.)

The tax rate is the same, whether you pay it now or after you die. But it costs you less to pay the gift tax now than to pay the estate tax after you die.

As explained in Part Three of "Understanding Living Trusts,®" after you die, taxable gifts you have made since 1976 are added back into your estate before estate taxes are calculated. (This is so Uncle Sam can calculate your estate taxes at the highest tax rate.) The amount you have paid in gift taxes is then subtracted from the estate taxes due. (Think of the gift tax as a prepayment of the estate taxes you will owe.)

But the amount you've already paid in gift taxes is not in your taxable estate when you die. You've already paid it to Uncle Sam. Making the gift now lets you forever remove the amount paid in gift tax from your taxable estate.

If, on the other hand, you keep the asset in your estate until you die, the amount you would have paid in gift taxes is still in your estate. This makes your taxable estate larger and increases the amount of estate taxes your estate will have to pay. Keeping the asset in your estate until after you die forces you to pay estate taxes on the amount you would have paid in gift tax. In effect, you're paying a tax on the tax!

This is best explained with an example. Let's assume you have completely used your federal gift tax exemption through prior gifts and, as a result, you are now in a 45% gift and estate tax bracket.

If you give your children $1 million as a gift (while you are living), the gift tax will be $450,000 ($1 million times .45 = $450,000). You, the donor, pay the gift tax. So your children would receive the full $1 million, and an additional $450,000 would be removed from your taxable estate to pay the gift tax. In other words, it would cost you $450,000 to give your children $1 million.

If, on the other hand, you wait until after you die, it would take $1,818,182 to leave them $1 million (45% of $1,818,182 = $818,182 in taxes, leaving a net of $1 million for your children). That's $368,182 more than if you gave them the $1 million while you were living!

Which Assets Are The Best To Gift?

It can be especially smart to give away assets that are appreciating in value, because any income and appreciation that occur after the gift is made are also removed from your taxable estate.

But you also have to look at the estate tax savings compared to what the recipient may have to pay in capital gains tax if the asset is later sold. Remember, when you give away an appreciated asset, it keeps your original cost basis (plus any gift tax paid). And if the recipient decides to sell it, he/she will have to pay capital gains tax on the difference between the selling price and what you paid for it.

If, on the other hand, you don't give it away and it stays in your estate, the asset will receive a full step up in basis as of the date of your death (saving capital gains tax on the subsequent sale of the asset). But, depending on the size of your estate when you die, there may be estate taxes. So it's a trade off.

Currently, the maximum federal long term capital gains rate (for assets held longer than 12 months) is 15%, while the estate tax in 2009 is 45%. But it isn't always better to give away an asset and let the recipient pay the lower capital gains tax. Among other things, you have to consider what you paid for the asset, what it's worth now, what you think it will be worth when you die and if the recipient plans to sell or keep it.

Making Gifts From Your Living Trust

You may have heard that you should remove an asset from your living trust before making the gift. For example, if you wanted to give your son a $5,000 gift in cash and your checking account is titled in the name of your trust, you would make the check payable to yourself, cash it, then make the gift in cash or use a cashier's check.

That's because, in the past, if the grantor died within three years of making a gift directly from his/her living trust, the IRS tried to include the gift – -even annual tax-free gifts — in the grantor's taxable estate.

You don't have to play this shell game anymore. Gifts made directly from a revocable living trust are now considered the same as if they were made directly from you, even if they are made within three years of your death.

About Kevin Von Tungeln

With more than 17 years' legal experience, Kevin L. Von Tungeln serves Thompson Von Tungeln in the areas of estate planning, probate, trusts, wills, trust administration, conservatorships, guardianships and elder law. He is certified by the State Bar of California Board of Legal Specialists as a Board Certified Specialist in Estate Planning. Get to know more about Kevin's approach to estate planning by viewing his informational videos at: http://www.youtube.com/user/EstateLawyers. Kevin can also be found at LinkedIn by going to: (http://www.linkedin.com/in/kevinvontungeln)

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Antelope Valley estate planning law firm Thompson Von Tungeln (TVT) offers sophisticated estate planning and administration for the affluent, discriminating client. As Board Certified Specialists in Estate Planning, Trusts and Probate as certified by the State Bar of California Board of Legal Specialization, partners Mark E. Thompson and Kevin L. Von Tungeln are expertly equipped to serve these clients with the creative, effective and custom solutions they demand. For more information, contact TVT at 661-945-5868or visit their website at EstatePlanningSpecialists.com.