MONTANA STATE UNIVERSITY
EXTENSION SERVICE
MONTGUIDE

MT199105 HR 10/2002

Gifting: A Property Transfer Tool of Estate Planning

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This guide explains how to use laws that allow gifts of real and personal property to reduce income taxes and eventual estate taxes. Includes changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001.

One goal of estate planning is to ensure maximum enjoyment of the property while the owners are alive and then at death, transfer it according to their wishes. However, some people believe that they receive the greatest benefits from estate planning when they transfer property *before* their death, while they can still guide and affect the outcome. This can be accomplished through an estate planning tool called gifting.

In addition to expressing love and affection, gifts serve other purposes. They can give children an opportunity to participate in the management of a family business, help finance a college education, or pay medical costs.

Gifts reduce the size of the estate that must pass through court administration, thereby cutting probate costs and, to some extent, federal estate taxes. Gifts are an important estate planning tool for those with taxable estates. Gifts can also accomplish income tax savings. Through gifts of income-producing property, income can be shifted from one family member to another who is in a lower tax bracket.

Lifetime gifts, however, whether to a spouse, children or others, should be examined very carefully. Those making the gifts should be sure they are not depleting assets to the point they don't have enough for their own support.

Federal gift tax law

Giving away property may sound simple at first, but one must consider the federal gift tax law and changes resulting from the passage of the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Highlights of the law are summarized throughout this MontGuide.

The federal government levies a gift tax upon transfers of real and/or personal property made during the transferor's lifetime without *adequate and full consideration*. In other words, any transfer of value is subject to federal gift taxation if the person making the gift does not receive something of similar value in exchange.

The monetary value of the gift is the fair market value of the property on the date the gift was made, less the fair market value of any property received in return. The IRS definition of *fair market value* is the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or to sell, and both having reasonable knowledge of all relevant facts.

Example A: If a father gives his child land worth $50,000, the father has made a $50,000 gift. If the father sells the same land to his child for $1,000, he has made a gift of $49,000–the difference between the fair market value ($50,000) and the value received ($1,000).

There is no gift until the transfer is complete. The person making the gift must part with the property and control over it (or part of it) before it is considered a gift. This can be accomplished by title transfer.

Example B: A father purchases a section of farmland with his personal funds. He places the title to a half section in his name and his son's name as joint tenants with right of survivorship and the other half-section as tenants in common with his son. Although the son did not contribute towards the purchase price of the farmland, he has legal and/or tax interest in the property. For this reason, the interest in the farmland would be considered a gift from father to son.

If the owner maintains any right to the property, such as the ability to receive income or receive a remainder interest if the donee should die before the donor, then the gift transfer is not complete.

Example C: A father creates an irrevocable trust under the terms of which his daughter is to receive income for life. At the daughter's death, the principal passes to a grandchild. There are two gifts that result from the father's creation of the trust. The value of the income interest to the daughter is one gift. The second gift is the value of the assets that will eventually pass to the grandchild. Both gifts are subject to the federal gift tax.

Who pays the federal gift tax

The person liable for the payment of the gift tax is the individual making the gift (*donor*). If the donor does not pay the gift tax, the receiver *(donee)* of any gift becomes personally liable for the tax that is due.

The donee is not required to declare the gift amount as income. The donee, however, must pay state and federal income tax on any income produced by the property after the date of the gift.

Example D: A mother gave her adult daughter $10,000 in cash. The gift is not considered as income to the daughter. The daughter placed the money in a certificate of deposit that earned $500 during the year. The interest earned on the CD is added to the daughter's annual income of $26,000. The daughter is responsible for state and federal income taxes on her total income of $26,500 ($26,000 + $500 = $26,500).

Annual exclusion

Types of property that can be transferred as a gift include: real estate, stocks, bonds, certificates of deposit, or cash. Federal law permits an *annual exclusion* of up to $11,000 on transfers to family members or other persons without payment of the federal gift tax. Thus, a person may give up to $11,000 per donee a year to as many people as he or she desires.

Prior to 2002, the amount of the annual exclusion was $10,000. The annual exclusion has been indexed for inflation since 1998 but by regulation could not be increased until the increment reached $1,000.

Example E: A father could give each of his four children up to $11,000 in assets annually. No federal gift tax return would be required. The father could continue gifting for as many years as he desired and reduce his taxable estate by $44,000 each year. His children would not have to pay gift taxes on the amounts they received. Each child is responsible for taxes only on any income earned on the gift property following the date of the gift.

The 709 Federal Gift Tax return does not need to filed with the Internal Revenue Service for gift amounts lower than the annual exclusion ($11,000). The annual exclusion is not cumulative. It cannot be carried over from one year to the next.

Example F: A mother gifted her daughter $5,000 in 2002. The annual exclusion is $11,000. She can not carry over the remaining $6,000 in 2003 and have $17,000 as an annual exclusion. In 2003, only $11,000 gift would fall under the annual exclusion.

Gift splitting provision for married couples

A married person, with consent of his or her spouse, can give up to $22,000 a year to as many persons as desired. No gift tax is due because of the *gift splitting provision* of federal law. For tax purposes, each spouse is considered to have made one-half of the gift, even though the entire gift was actually made by one spouse.

Example G: A father and mother can give each of their three children up to $22,000 annually. The parents can continue gifting for as many years as they wish and reduce their taxable estate by $66,000 each year. The children will not have to pay gift taxes on the $22,000 each received, but they will have to pay state and federal income taxes on any income earned on the property following the date of the gift.

Example H: A father and mother wish to transfer $40,000 worth of land to their son. If the parents utilize the gift splitting provision, they will have an exclusion of $11,000 each for a total of $22,000. The balance ($18,000) is subject to federal gift taxation ($40,000 - $22,000 = $18,000).

Example I: If the parents transfer the land to *both* their son and his wife, the amount subject to federal gift taxation is zero. By using the gift splitting provision, the parents can transfer a total of $44,000 to their son and daughter-in-law each year ($22,000 to each person).

The non-filing spouse should sign a consent on the gift tax return as well as file his or her own return reporting one-half of the gift. This will ensure that the federal gift tax on the $22,000 gift is eliminated because both the husband and wife have taken advantages of their annual exclusion of $11,000 each. Alternatively, each parent could write a check for $11,000 and avoid having to file a federal gift tax return.

Deductions and exemptions

The federal gift tax law contains several provisions for deductions and exemptions, including the gift tax marital deduction, the education and medical services exemption, and the charitable deduction.

Gift Tax Marital Deduction

Married people can make gifts of any amount to one another by taking advantage of the unlimited marital deduction provision in the federal gift tax law. No gift tax is due, and no gift tax return is required to be filed for gifts between spouses. The marital deduction is only unlimited, however, if the spouse is a U.S. citizen.

Example J: Jennifer could place her husband's name as a joint tenant on a $100,000 home that she inherited from her mother and no federal gift tax form would be required.

Education and Medical Services Exemption

Any amounts paid by a donor directly to a qualified educational organization for tuition or to a health care provider for medical services are excluded from federal gift taxation.

Example K: Merle's granddaughter is attending an Ivy League school with an anticipated cost of $30,000. Merle can write a check directly to the university for tuition and fees. The amount is not subject to federal gift taxation because the expenses fall under the education exemption. Merle could also gift $11,000 directly to his granddaughter under the annual exclusion provision.

Example L: Joe's grandson had a medical condition that was not covered by his parents' medical insurance. Joe can write a check directly to the hospital for $20,000 and not have to file a federal gift tax return because the expenses fall under the medical services exemption.

Charitable Deductions

Gifts made to qualified charitable, religious, educational, government agency and numerous IRS qualifying organizations with a tax-exempt status [501(c)(3)] are completely gift tax free.

Example M: A 4-H leader plans to gift land valued at $250,000 to the Montana 4-H Foundation for a youth camp. The amount would qualify as a charitable deduction, because the Montana 4-H Foundation is a qualifying organization with a tax exempt status.

The gift should be made directly to the organization specified. For example, if a gift is to qualify for the gift tax charitable deduction, it should be made to the church rather than to the minister. If there is any doubt whether an organization is a qualifying charitable organization under [501(c)(3)], ask the organization to provide a copy of the IRS determination letter granting exempt status.

Transferring life insurance

The transfer of ownership of a life insurance policy without retaining *incidents of ownership* constitutes a gift for federal gift tax purposes. Incidents of ownership include the right to borrow against, cash in, or change beneficiaries. The value of a gift of life insurance that is paid up at the time of the gift is equal to the cost of replacing the policy. If the policy is not paid up, the amount is approximately equivalent to the cash value. These values may be obtained from the insurance company.

Example N: A father transfers ownership of a paid-up life insurance policy to his son. The son becomes the new owner and is designated as the beneficiary of the life insurance proceeds. The father remains as the insured. The replacement value of the policy was $31,000. An annual exclusion of $11,000 was allowed. The remaining $20,000 was subject to federal gift taxation.

The transfer of a life insurance policy may also have federal estate tax consequences.

Example O: If a father lives three or more years after a life insurance policy transfer, the $300,000 death benefit will not be included in his gross estate upon his death. However, if the father dies within three years of the transfer, the $300,000 would be included in his gross estate.

Payment of a life insurance premium on a policy owned by another is considered a gift of the premium amount. The amount is subject to the annual exclusion.

Applicable credit and exclusion

Federal law allows for the deduction of an applicable credit from the tentative gift tax. The federal gift tax *applicable credit* is $345,800 during the years 2002-2009. The applicable credit is used to offset gift taxes on transfers made during life. However, when the applicable credit is used during life on gifts, the amount of credit available to offset the federal estate tax is reduced.

The applicable credit translates into an *applicable exclusion* of $1 million during the years 2002-2009. This means a person can transfer during life, in addition to the annual exclusion of $11,000, up to a total of $1 million in assets and no federal gift tax is due (Table 1, p. 4).

Under prior law, the applicable exclusion was tied to the federal estate tax exclusion that increased each year. The new law has capped the federal gift exclusion at $1 million while allowing the federal estate tax exclusion to increase to $3.5 million by 2009 (Table 1, p. 4).

Example P: A rancher has $2.5 million estate in 2003. If he transfers land valued at $1 million to his daughter, he has used up his gift tax exclusion. If he dies in 2003, he is not allowed federal estate tax exclusion because he used it all for gifting. Therefore, the remaining $1.5 million is subject to the estate tax, resulting in taxes of $555,800.

Example Q: If the Dad dies in 2009, his estate will not have an estate tax because the applicable exclusion amount increases to $3.5 million. He used up $1 million of his applicable exclusion for gifting in 2003 but since the federal estate tax applicable exclusion increases to $3.5 million in 2009, there will be no federal estate tax on his remaining $1.5 million estate.

Federal gift tax rates

The tax rates for gifts during years 2002-2011 are provided in Table 2, p. 5. Under the *Economic Growth and Tax Relief Reconciliation Act of 2001* gifts in excess of the annual exclusion ($11,000) and in excess of the $1 million applicable exclusion will have a 35% tax rate by the year 2010. This is the same rate as the top income tax rate. This change will discourage gifting to achieve income tax advantages between the donor and donee.

Another change under the law is that the accumulated lifetime taxable gifts over the $1 million applicable exclusion amount will create a gift tax liability, while the same amount transferred at death may be passed tax-free because the amount may fall under the estate tax applicable exclusion.

Example R: Bill has a business that is valued at $2.5 million. If he gifts the business to his son in 2009, there is a gift tax exclusion of $1 million plus an annual exclusion of $11,000. The remaining $1,489,000 would result in a federal gift tax of $551,070.

Example S: If Bill died in 2009 and willed the business to his son, there would be no federal estate tax because the federal estate tax exclusion is $3.5 million. Whether Bill decides to gift the business while alive and pay a federal gift tax or bequeath the business after the death and avoid the tax depends on his financial objectives.

Accumulation of gifts

Federal gift tax law requires the value of all taxable property given each year to be accumulated into one total before computing each year's gift tax. The accumulation of lifetime gifts results in higher rates of taxation on later gifts. The applicable credit amount of $345,800 is used to reduce the tax payable. When the taxes payable are larger than the unused applicable credit amount, the excess must be paid as a gift tax.

Example T: A father makes a gift of $11,000 to each of his eight children and their spouses in the years 2003-2007. He is allowed an annual exclusion of $11,000 for each gift. The amount subject to tax each year is zero. The father has reduced his estate value by $176,000 each year for five years for a total of $880,000 ($11,000 x 16 people = $176,000 x 5 years = $880,000).

Example U: In 2008, a father makes a $30,000 gift to each of his eight children and their spouses for a total of $480,000. He is allowed an annual exclusion of $11,000 for each gift for a total of $176,000. The remaining $304,000 of the total gift will reduce his gift applicable exclusion and credit. The federal gift tax on $304,000 in 2007 is $89,160. The gift tax ($89,160) is subtracted from the available applicable credit ($345,800). The remaining amount of the father's applicable credit is $256,640 ($345,800-$89,160 = $256,640).

Gifts within three years of death

Generally, the value of gifts (*other than gifts of life insurance*) made by a decedent (the person who dies) within three years of death is not included in the gross estate.

Example V: When a father learned he had cancer, he gifted his $1.6 million ranch to his son. He filed a gift tax return, used up his applicable credit and paid the required gift tax. By the time the father died four years later, the ranch was worth $1.9 million. Under current law, neither amount is included in the father's gross estate.

A gift of a life insurance policy made by a decedent within three years of death is included in the decedent's gross estate.

Example W: Assume that a father owns a life insurance policy with a face value of $500,000. In 2002 he transfers ownership to his daughter, who is the beneficiary. No other taxable gifts were made. In the year 2003, the father dies owning ranch land and securities valued at $1.8 million. While the life insurance proceeds ($500,000) pass directly to his daughter, the value is included in the father's gross estate for estate tax computation purposes because he did not live three years after transferring the policy to his daughter. The father's gross estate includes the life insurance policy proceeds

Table 1: Federal Estate and Federal Gift Tax Applicable Credits and Applicable Exclusions 2002-2011

	Federal Estate Tax*		Federal Gift Tax	
Year of Death	Applicable Credit	Applicable Exclusion	Applicable Credit	Applicable Exclusion
2002	$ 345,800	$ 1,000,000	$ 345,800	$ 1,000,000
2003	345,800	1,000,000	345,800	1,000,000
2004	555,800	1,500,000	345,800	1,000,000
2005	555,800	1,500,000	345,800	1,000,000
2006	780,000	2,000,000	345,800	1,000,000
2007	780,000	2,000,000	345,800	1,000,000
2008	780,000	2,000,000	345,800	1,000,000
2009	1,455,800	3,500,000	345,800	1,000,000
2010	Repealed	Repealed	345,800	1,000,000
2011	345,800	1,000,000	345,800	1,000,000

*For further information about the federal estate tax, see MSU Extension MontGuide 199104HR.

Table 2: Federal Gift Tax Rate Schedule, 2002-2011

Taxable Brackets			Rate Excess Over Column 1							
If the Amount is Column 1	But Not Over Column 2	Tax on Column 1 Column 3	2002 %	2003 %	2004 %	2005 %	2006 %	2007 2008 2009 %	2010 %	2011 & after prior law unless new law enacted %
$ 0	$ 10,000	$ 0	18	18	18	18	18	18	18	18
10,000	20,000	1,800	20	20	20	20	20	20	20	20
20,000	40,000	3,800	22	22	22	22	22	22	22	22
40,000	60,000	8,200	24	24	24	24	24	24	24	24
60,000	80,000	13,000	26	26	26	26	26	26	26	26
80,000	100,000	18,200	28	28	28	28	28	28	28	28
100,000	150,000	23,800	30	30	30	30	30	30	30	30
150,000	250,000	38,800	32	32	32	32	32	32	32	32
250,000	500,000	70,800	34	34	34	34	34	34	34	34
500,000	750,000	155,800	37	37	37	37	37	37	35	37
750,000	1,000,000	248,300	39	39	39	39	39	39	35	39
1,000,000	1,250,000	345,800	41	41	41	41	41	41	35	41
1,250,000	1,500,000	448,300	43	43	43	43	43	43	35	43
1,500,000	2,000,000	555,800	45	45	45	45	45	45	35	45
2,000,000	2,500,000	780,800	49	49	48	47	46	45	35	49
2,500,000 +		1,025,800	50	49	48	47	46	45	35	53
3,000,000 +										55

Example: John gifts an amount valued at $1,150,000 to his son in 2004. The tax on $1,000,000 of this gift is $345,800 (Column 3). The remaining amount ($150,000) of this gift is taxed at a rate of 41% ($61,500). The tentative tax on John's gift is $407,300. His applicable gift tax credit is $345,800. John owes a gift tax of $61,500.

($500,000) and the other property ($1.8 million) for a total value of $2.3 million. The federal estate tax would be $582,000 ($927,800 tentative tax - $345,800 applicable credit = $582,000).

Example X: If the father had lived three years after transferring ownership of the policy to his daughter, the $500,000 would not have been included in his estate. The estate tax would have been computed on $1.8 million instead of $2.3 million resulting in a tax of $344,200 ($690,000 tentative tax - $345,800 applicable credit = $344,200).

The father's ownership of the life insurance policy within three years of his death cost his estate an additional $237,800 in federal estate taxes ($582,000 - $344,200 = $237,800). The calculation assumes that the value of the life insurance policy at the time of the gift was less than that annual exclusion amount ($11,000) so none of the applicable credit was used up.

Basis of property

All property (real estate, stocks, bonds) that a person owns has a *basis* for tax purposes. For example, land purchased in 1977 for $47,000 has a basis of $47,000 even though its current market value is $900,000.

Property received by a donee as a gift from a donor has a *carryover basis*. This means that the basis in the hands of the donee is the same as it was in the hands of the donor.

Property that is received from a person who died (decedent) has a *stepped-up basis.* This means the value is stepped-up to the fair market value at date of the decedent's death or stepped-down if the property is worth less than the decedent paid for it.

Example Y: In 2003, a father gifts land to his daughter that is currently worth $1 million. The father paid $100,000 for the land. The daughter assumes her father's $100,000 basis in the property. If she sells the property, she is responsible for capital gains tax on the difference ($900,000) between the basis ($100,000) and the fair market value ($1 million). Thus, the daughter would owe federal capital gains taxes of $162,000 on the $900,000 profit (Assuming a rate of 18%).

Example Z: If the father had died and willed the land to his daughter, she would have received a stepped-up basis in the property. This means the value in the land will be stepped-up from the $100,000 to $1 million. If she sold the property for $1 million after her father's death, there would be no capital gains tax because she sold it at the stepped-up basis value. There was no federal estate tax on the property because of the applicable exclusion of $1 million in 2003.

Federal gift tax return

A donor is required to file a gift tax return (IRS form 709) to report gifts amounting to more than $11,000 (adjusted annually by the consumer price index after 1998) to any one donee (other than a spouse) in any one year.

Gifts of future interests (certain gifts in trust) of any amount are required to be listed on a gift tax return. Future interest is a complex legal term that includes reversions, remainders, and other interest or estates that the donee can "enjoy" at some future date. A remainder interest in a trust is an example of a gift of future interest.

Future interest gifts do not qualify for the annual gift exclusion. In other words, a gift of the future remainder interest in an irrevocable trust to grandchildren is fully taxable. The amount is not reduced by $11,000 for each grandchild. The annual exclusion per donee applies only to gifts of a present interest.

If a gift tax return (Form 709) is required, it must be filed by April 15 following the close of the calendar year in which the gift was made. For example, if a mother makes a taxable gift to her daughter in November 2002, she must file a gift tax return by April 15, 2003.

Gifts for my situation?

Gifting is usually combined with other estate planning tools as individuals and families develop and implement their estate plans. Farm and ranch families with family farm partnerships and corporations often make annual gifts of stock or partnership shares to their descendants. This can be a very effective means of making incremental shifts in ownership and control. However, if the number of intended heirs is large, gifts of stock also can result in the corporation having many owners, with each having a small ownership interest.

Cash gifts to intended heirs can be used to pay the premiums of life insurance on the donor. The policy may be owned by the gift recipient. Upon the death of the donor, the life insurance proceeds can be used to pay estate taxes, to implement a buy-sell agreement, to pay the remaining balance of a sales contract for land purchased from the donor, or for other similar uses. Life insurance policies owned by beneficiaries are not included in the donor's estate unless the policy was gifted within three years of the donor's death.

Changes are continual in federal gift and estate tax laws. Contact an attorney and/or a certified public accountant to learn what effect these changes may have on your present or future estate planning objective of gift giving particularly in light of the *Economic Growth and Tax Relief Reconciliation Act of 2001.*

Acknowledgments

Representatives from the following reviewed this MontGuide and recommend its reading by all Montanans.

- Business, Estates, Trusts, Tax and Real Property Section—State Bar of Montana
- Montana Society of Certified Public Accountants
- Montana Association of Insurance and Financial Advisors

Appreciation is expressed to the following for their helpful reviews:

- Montana Extension agents
- Students in the spring (HDFP 530) Estate Planning for Families distance education course, Great Plains-IDEA.

Disclaimer

This publication is not a substitute for legal advice, rather it is designed to help persons become better informed of the basic provisions of the Federal gift tax law. There are numerous exceptions and conditions to some of the concepts discussed. Future changes in laws cannot be predicted and statements in the MontGuide are based solely on the laws in force on the date of publication.

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File under: Consumer Education
D-12 (Estate Planning)
Revised Oct. 2002 (20001002 ST)