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Gifts: Flexible Tools for Property Transfer

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During an individual's lifetime, or that of a married couple, property of all kinds is accumulated. The goal of estate planning is to insure maximum enjoyments of the property and later to transfer it according to the wishes of the owners. Through careful planning, this can be done with the least possible cost to the estate from settlement expenses and taxes.

The greatest gains from sound estate planning come when the transfer starts before death, while the owners still have the ability to guide and affect the outcome. One of the most flexible tools for property transfers during the lifetime of the owners is the gift.

Why Gifts?

In addition to expressing love and affection, gifts during life can serve these purposes:

1. They give children training in the management and conservation of property and may aid them to obtain an education.

2. The gift of an interest in the farm encourages a son to remain on and improve the farm and thereby lessens the parents' management burden as they grow less active with age.

3. They reduce the size of the estate that must pass through court administration, thereby cutting probate costs as well as estate and inheritance taxes.

4. Through gifts of income-producing property, income can be shifted from one family member to another in a lower tax bracket to accomplish income tax savings. When trusts are used, further income tax savings can be accomplished.

Although giving your property away may sound simple at first, there are definite rules that govern what you can and cannot do, as well as what you should and should not do. First, let's look at some examples of gifts and then at the rules and guidelines behind them.

Unneeded Windfall

Widow Crop Farmer is in a comfortable condition financially. She not only has enough to take care of present and predictable future expenses, but is saving a little each year. Recently, her brother-in-law passed away and willed her $100,000 in blue chip stocks. She doesn't need the money and is faced by the question of what she should do with it.

How about her four grandchildren who will be attending college in a few years? Although her two sons could provide for their children's education, it would take funds needed in their current farm business expansion program.

Solution: she utilized lifetime gifts to transfer the recently acquired stock into a trust fund to be used by her grandchildren for their education. Her windfall gain ended up helping the whole family at a time that produced the maximum benefit.

Mr. Dairyman has another use for gifts. He owns a farming operation valued after debts at about $300,000 with $100,000 of that in personal property. He has a son who, after working a year on the farm, has decided he wants to buy into a partnership arrangement. Although Mr. Dairyman wouldn't admit it, this is what he has been hoping for all along. Additional business size is needed, but the decision has been made to grow into a larger business rather than to purchase at this time.

Although Mr. Dairyman doesn't have a large estate, he wants to help his son get a good start in farming. He used the gift transfer method to begin this project by giving his son part ownership in the partnership personal property. Present plans also call for the purchase of the neighbor's farm when it becomes available. This will be put in the son's name with partnership funds used to make interest and principal payments. Over the expected 15-year life of the partnership, through his half interest in the partnership, Mr. Dairyman will be giving his son part of the land's purchase price.

Gift Guidelines

Although these examples may not illustrate all the reasons for making gifts, they do show some important principles that should be considered before gifts are made:

Financial Security — From the giver's standpoint, each was able to make gifts of property or cash without jeopardizing his/her own financial security. When a true gift is made, there can be no strings attached. Principal and interest are given up forever, thereby reducing the future security of the donor. If strings or controls are kept by the giver, the gift will be subject to estate and inheritance taxes at his death.

The size of estate needed to maintain financial security isn't known. It will vary with the individual and circumstances. However, the giver's age, earning ability, retirement income sources and amounts, inflation, and annual income needs are important considerations in arriving at this unknown.

Recipient's Judgment — Regardless of the means employed, a gift boils down to the donor transferring property, property rights, or interests to someone else. The donor has given up something, has lost control.

Before gifts are made, the donor has to accept the fact that the recipient may use the money or gifts in a manner that may not seem wise from the donor's point of view. In effect, the donor must respect the financial judgment and responsibility of the person receiving the gift. Otherwise, it could be very disheartening to see hard-earned savings used for purchases that don't meet the giver's approval.

Transfer Plan — Lifetime gifts should be part of a broader property transfer plan, and complement, not compete with, this program. This principle is illustrated in Mr. Dairyman's case. Someday, his son will be the complete owner and manager of the business. Gifts were used through a partnership business arrangement to start and carry on this eventual transfer. The gifts were one phase in the long-run plan. Other transfer methods may be needed to complete the plan.

Benefit or Burden? — The giver should make sure property transferred through gifts would be beneficial to the recipient. There are instances where gifts could create financial, mental, or emotional burdens. If these conditions exist, the donor should turn to alternative receivers, such as other relatives or charity.

Have A Reason — Donors should have a purpose or reason for making gifts. Generally, the giving produces benefits for the giver, receiver, or both.

Taxes — You shouldn't make gifts without first considering the federal gift tax. But even with the gift tax, you may be able to legally reduce or avoid income tax, capital gains tax, and/or federal estate tax and achieve estate planning goals through the wise use of gifts.

Take for example Mr. High Income, who is in the 50 percent tax bracket and has an obligation to support his aged mother. He must earn two dollars from an investment in order to give his mother one dollar. By transferring investments to his mother, her exemptions might make the two dollars earned all available for her care, support, and maintenance.

An estate subject to large federal estate taxes may benefit tax-wise from a scheduled transfer of property through gifts. Federal gift taxes would have to be considered, but, in general the gift tax exemptions allow for large amounts of tax free transfers. Gifts to minimize taxes need to be handled correctly to accomplish this objective.

Gift Tax

The federal gift tax applies to everyone, although the rules for nonresidents are somewhat different than for U.S. residents. Responsibility for gift tax payment is imposed on the donor, but the recipient may be called upon to pay the tax if the donor doesn't pay.

A distinction is made for gifts under the federal gift tax law between a present interest in property and a future interest. Present interest means immediate possession, enjoyment, and use of the property given. Complete ownership and control is transferred to the recipient. Future use refers to a situation where use, possession, or enjoyment are put off to some future date.

A transfer of property for the benefit of a minor who is not 18 years old on the date of the gift is not considered a future interest in property if the terms of the gift satisfy the following conditions:

1. Both the property itself and its income may be expended by or for the benefit of the donee (recipient) before he/she attains the age of 18;

2. Any portion of the property and its income not disposed of under (1) will pass to the donee when he/she attains the age of 18; and

3. Any portion of the property and its income not disposed of under (1) will be payable either to the estate of the donee or as he/she may make a general power of appointment if he/she dies before attaining the age of 18 years.

Gift Tax Return

The gift tax applies to a transfer of property by way of a gift whether the gift is in trust or otherwise, whether the gift is direct or indirect, or whether the property is real or personal, tangible or intangible.

The tax also applies to property transfers under a sale agreement where the value of the property sold is greater than the amount received for the property. The difference between the market price and the selling price is considered a gift. If the gift is large enough, federal gift tax is due. Reduced purchase price, low or no interest rates, and easy terms could be considered in the nature of a gift if they differ markedly from normal business transactions. If a combination sale and gift is used, the agreement should be carefully worded in writing to prevent misunderstandings between heirs at a later date.

A gift tax applies to property transfers when the gift is complete. A gift is considered complete if the donor has parted with possession and control over the property so that he has no power to change its use or condition, either for his own benefit or that of others.

It takes three elements to make a taxable gift: Intention on the part of the donor to make the gift; delivery of the subject matter of the gift; acceptance of the gift by the donee.

Completion of Gift

If a person gives a stock certificate to someone, the gift is considered completed, for tax purposes, on the date of delivery.

However, if two people (not spouses) have a joint bank account from which either the original owner or another can draw, the gift is considered complete when the noncontributing individual withdraws for his or her own benefit and is not obligated to pay the money back to the original owner.

The same is true of savings bonds. If one person buys a savings bond and has it made payable either to himself or someone else, not a spouse, there is a gift when that second person cashes the bond without an obligation to account for the money to the original purchaser of the bond.

The transfer of a life insurance policy is subject to gift taxes the same as the transfer of any other kind of property. If the insured gives up his rights to the policy, a gift has been made when the policy ownership has been reassigned. The value of the gift is the cash value of the policy. This is an effective way of transferring large amounts of money into your spouse's estate without payment of federal estate tax on the face value of the policy when you die. If your spouse should die before you, the policy could be left in trust to your children. That way when you die the full amount of the policy goes into the trust and is not subject to tax as part of your estate.

Valuation of Gifts

Valuation of property, in general, for purposes of the gift tax return refers to the fair market value at the time of the gift. It is the value at which such property would change hands between a willing buyer and a willing seller. The value must be determined in a market where the public would commonly purchase that item.

Gifts of real estate create a problem in valuation because, generally, there is no established market price. Expert appraisals are desirable in most cases to provide the primary means of establishing the value for tax purposes. Other supporting evidence can be obtained from local tax assessment values, market activity, local sales, rentals, and recent mortgages.

Similarly, the value of an interest in a business should be based on a fair appraisal of all the assets of the business. In addition, other aspects such as dividend-paying capacity, goodwill, and earning capacity should be taken into consideration.

Annual Exclusion

The gift tax law allows an annual exclusion from taxable gifts of $3,000 for each person to whom a gift is made. There is no limit to the number of annual exclusions that can be taken by each donor or as to the number of years the annual exclusion can be taken for any one recipient.

In addition, each giver or donor is granted a unified tax credit equivalent of $175,625 which can be used at any time. This is a lifetime credit and can be used in one year or over a number of years for gifts and the individual's estate. The annual exclusion and unified credit are independent of each other. Use of one in no way affects the other.

If the donor and his or her spouse elect to treat gifts by one spouse to a third party as being one-half from each, they can pool their annual exclusions. This may be done even though only one of them owned the money or property given. This would enable married couples who have made no previous gifts to make tax-free gifts up to $6,000 per year to any number of recipients.

In case of gifts made in trust, the trust beneficiary rather than the trustee is regarded as the donee. Thus an annual exclusion is allowable on the account of each beneficiary who receives a present interest.

There is no annual exclusion for a gift of a future interest in property. No gift tax is imposed on charitable transfers. All gifts to public, religious, charitable, or educational organizations may be subtracted from "total amount of gifts" to arrive at taxable gifts.

Marital Deduction

The gift tax also provides for a marital deduction. This is similar to the marital deduction of the estate tax and simply means that half or more of the gift from one spouse to another is tax free. A donor is allowed an unlimited marital deduction for the first $100,000 of lifetime gifts made to a spouse, no exemption for the next $100,000 and, thereafter, a marital deduction for one-half of the aggregate lifetime gifts made to a spouse in excess of $200,000. The $3,000 annual exclusion can still be applied to offset the part of the gift to the spouse that is subject to tax.

Gifts between spouses are especially important to efforts in estate planning. For large estates, there are advantages of having property divided in separate estates for husband and wife with a smaller amount of it held jointly. The gift can be an effective tool for accomplishing this reorganization of your property.

Even though they are tax free, marital and charitable deductions must be listed in gifts reported during the year.

Tenancy by the Entirety

Tenancy by the entirety is the same as joint tenancy between husband and wife with the right of survivorship. There are special regulations that prevail between husband and wife regarding real property transfers. You should seek the advice of a lawyer or CPA regarding specific transactions.

Briefly, the creation of tenancy-by-the-entirety property is not a gift at the time of creation, regardless of the proportion of the amount spent for the property by each spouse—during calendar years after 1954. However, the donor spouse can elect to treat the transaction as a gift—before the property appreciates—in the calendar year in which the transaction took place.

There is a gift when the tenancy is terminated other than by the death of a spouse, if the proceeds received by either spouse is greater than the proportion that would be due them considering their original amount of investment. This rule also applies to contributions made for the purpose of making additions in the form of improvements and reductions in indebtedness.

As part of your estate plan you should figure out whether you would be better off making the gift at the time new property is purchased, to give your spouse a full share, or whether you should wait until the property is sold or passed at your death.

Filing Requirements

A gift tax return (IRS Form 709) is due from the donor when gifts are made to any one donee of more more than $3,000 for present interest in property and gifts of future interest of any amount. Penalties are provided for willful failure to file a return on time or for willful attempt to evade payment of the tax.

If a gift tax return is required, it must be filed in a quarter in which cumulative taxable gifts made during the calendar year exceed $25,000. Quarterly returns are due 15 days after the second month following the close of the quarter. If gifts do not exceed $25,000 in a calendar year, only one gift tax return need be filed on April 15 following the end of the calendar year.

The return is filed with the District Director of Internal Revenue in the district in which the donor resides. Any gift tax due is payable at the time a return is filed.

Computing the Tax

The rate schedule is the same for lifetime gifts and death time transfers through an estate. If gifts larger than the annual exclusion are made, a tentative gift tax is calculated from taxable gifts using the unified rate schedule (Table 1). After 1981, each individual has a unified credit of $47,000 (or $175,625 property value equivalent) which can be subtracted from the tentative gift tax before gift taxes are paid. A gift tax is paid only if the unified credit has been used for prior gifts. In this case, the tax rate for the estate starts at the rate where lifetime gifts stopped and if all the unified credit was used for lifetime gifts, no unified credit would be available for the estate.

Notice in Table 1 that the tax rate is graduated. The tentative tax rate on the first $10,000 of the lifetime gifts or taxable estate is 18%. The taxable lifetime gifts or estate from $10,000 to $20,000 will result in a tax of $1,800 on the first $10,000 of property transferred and a 20% tax rate for a transfer of more than the first $10,000, but less than $20,000.

Let's return to the case of the dairyman who gave his son a present interest in one-half of a $100,000 partnership. If he had never used his unified credit of $47,000, he would use it at this time. Subtracting the annual exclusion of $6,000 from the $50,000 gift leaves $44,000 (assume Mr. Dairyman is married and each use their $3,000 annual exclusion). The tentative gift tax on $44,000 is $9,160 ($8,200 tentative tax on $40,000 plus $4,000 times 24% tax rate or $960, for a total of $8,200 + $960 = $9,160). Subtracting the $9,160 tentative tax from the $47,000 unified credit leaves $37,840 of unused unified credit and no gift taxes are paid. If the $50,000 had been given over an eight year period, the annual exclusions could be used each year and none of the unified credit would be used.

Table 1 — Federal Estate and Gift Tax Rate Schedule

	Taxable estate and lifetime gifts From:	To:	Tax $	+ %	Of excess over:
1	$ 0	$ 10,000	$ 0	18	$ 0
2	10,000	20,000	1,800	20	10,000
3	20,000	40,000	3,800	22	20,000
4	40,000	60,000	8,200	24	40,000
5	60,000	80,000	13,000	26	60,000
6	80,000	100,000	18,200	28	80,000
7	100,000	150,000	23,800	30	100,000
8	150,000	250,000	38,800	32	150,000
9	250,000	500,000	70,800	34	250,000
10	500,000	750,000	155,800	37	500,000
11	750,000	1,000,000	248,300	39	750,000
12	1,000,000	1,250,000	345,800	41	1,000,000
13	1,250,000	1,500,000	448,300	43	1,250,000
14	1,500,000	2,000,000	555,800	45	1,500,000
15	2,000,000	2,500,000	780,800	49	2,000,000
16	2,500,000	3,000,000	1,025,800	53	2,500,000
17	3,000,000	3,500,000	1,290,800	57	3,000,000
18	3,500,000	4,000,000	1,575,800	61	3,500,000
19	4,000,000	4,500,000	1,880,800	65	4,000,000
20	4,500,000	5,000,000	2,205,800	69	4,500,000
21	5,000,000	—	2,550,800	70	5,000,000

What To Give

An important consideration in gift giving is what property to give. In most cases, this is related to the reasons for gifts, property available to give, and the results desired.

Widow Crop Farmer gave property that would produce educational funds through dividends or the sale of a few stock shares. A gift of land would not have returned enough rental income for the educational needs. Also, this could have resulted in high capital gains taxes from the sale of the land and would have taken use of the land away from the sons' business.

Gifts of property to avoid or minimize taxes should be considered carefully so the objective is accomplished. If the objective is a reduction in income taxes, give the investment that returns a relatively high ordinary income.

Generally speaking, property with a high cost basis in relation to market value should be given first. For example: A 40-acre tract that cost $350 an acre and is now worth $400 an acre should be given in preference to a tract purchased for $100 and now worth $400 an acre. The reason is that the tax basis (cost plus improvement less depreciation taken) carries over to the receiver of the gift. If the basis is low, depreciation deductions will be small, and if the property is later sold by the recipient of the gift, income tax will be high because of high capital gains.

Leaving low basis property in the owner's estate has the advantage of creating a new higher tax basis at his/her death. The fair market value at that time becomes the new basis, and a subsequent sale by the heirs incurs little or no income tax.

Precautions

Property owners sometimes are reluctant to give up complete control of property. They occasionally use deeds in escrow or deeds with retained life estates to retain possession and control of the property during their lifetime. Neither of these provides tax advantages and is not recommended in estate planning to reduce death taxes. In special circumstances, however, they may be useful. If power or control is retained when the gift is made, or if a life estate is reserved by the giver, the gift will be subject to estate and inheritance taxes. Another problem is gifts of over $3,000 annually for any receiver made within three years of death are subject to federal estate tax.

Just A Start

Due to exclusions and credits allowed by the gift tax law, a program of gifts over a period of years can transfer a sizable amount of property with no gift tax. Even if gift taxes are incurred, there are three reasons why lifetime gifts still save estate and inheritance taxes, especially for gifts of appreciating property:

1. the future capital appreciation accrues in the receiver's estate,
2. earnings from the gift property is income to the receiver, and
3. the gift taxes paid are removed from the donor's estate.

Properly used, gifts can be an extremely important tool in your overall estate plan. To get maximum benefit from gifts, they should be considered as one method of reaching your overall objectives and should be carefully planned out with your lawyer and/or CPA to avoid unexpected and undesirable consequences.

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