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Fundamentals of Tax Wise Gift Giving

After the preparation of a comprehensive will, tax wise gifting to your heirs during your life is the principal technique reducing the bite of current and potential transfer taxes on the inheritance. If we focus on family gifting (as opposed to Charitable Giving), there are four particular tax benefits that a gifting program should take advantage of¹:

1. For married clients, the marital deduction allows unlimited gifting between spouses, without gift tax. Your wills are normally configured to take advantage of this.
2. The Applicable Estate Tax Exclusion in 2006 allows the transfer of \$2 million per spouse to the heirs without tax, increasing to \$3.5 million by 2009. This benefit should be used as soon as practicable if assets are growing in value. It should also be leveraged. In English, leveraging the credit means seeing if we can legally pack a lot more assets into this loophole than the government originally intended.
3. The Applicable Gift Tax Exclusion, allows up to \$1 million of gifts during your life without tax, per spouse. This amount is not increasing.
4. The annual exclusion allows the transfer by each spouse of \$12,000 per year to anyone without any gift taxes. Gifts in any year exceeding \$12,000 to any person (or \$24,000 for married couples) would use up unified credit if that was not previously used up, or if the unified credit is used up, all gifts over the \$12,000 threshold are subject to tax at an approximate rate of one half, usually paid by the donor.
5. The Generation Skipping Tax ("GST") Exemption allows each of you to protect \$2 million of property from estate taxes on your children's inheritance, when THEY pass what's left (hopefully lots) at their death to your grandchildren, and then again when the grandchildren pass it on, and so on. This Exemption is increasing in the same way as the Estate Tax Exclusion (see 2. above). In this way, the protected property is NOT included as part of the children's own taxable estates, preventing Uncle Sam from getting his portion. Of course, this might not protect all of the inheritance, but if it is used during life or later at death and if it is leveraged (and it should be) it may protect a great deal of wealth. Modern estate planning emphasizes the protection and special care of this special family asset, and Dynasty Trusts are perfect for this role. Separate Trusts would be created for any property with this special advantage. This Exemption is indexed for inflation.

The foundation of an effective gifting strategy often begins with gifts that are used to acquire life insurance on your life. Depending on how you choose to view it, such insurance can act as 1) a savings vehicle, 2) a method of providing tax free funds for the liquidity needed at the time estate

¹ Based on current tax law, which is likely to be amended as a result of legislative changes now being negotiated in Washington, and which might be effective in 2006 or 2007.

taxes are due, 3) an investment hedge to protect against the risk of your death before your other holdings can bear fruit, or 4) a way of assuring the appropriate inheritance for your children which allows you to be more generous to yourselves or to take more risks with your capital, without impairing the inheritance which your family needs and expects.

Another key to an effective gifting strategy is the optimized valuation of the gifted assets. Recent trends in the discounting of what might normally be considered the market value of the family assets have been very favorable to the taxpayer. Gifts to your children of shares (representing a minority interest) in your closely held businesses would represent a particularly effective use of these discounts. You should keep in mind, however, that the IRS requires the certification of the value of gifts claimed on any gift tax return, by current appraisals. These can cost thousands of dollars.

The principal factors involved in the selection of property for gifting include:

- The income tax cost basis of the property (since cost basis is transferred to the donee, but capital gains on property held until death are eliminated)
- The potential post gift appreciation of the gifted property
- The form in which the gifted asset is held (whether individually owned, corporate, partnership, LLC, etc.)
- Cash gifts are rarely planned, outside of cash used for gifted life insurance premium payments.

The use of trusts for the receipt of gifts is often strongly recommended for any significant or long term gifting programs, since they offer many tax and non tax advantages, including creditor and divorce protection, along with maintaining appropriate control over the management and disposition of the gifted property.

As our wealth has increased, charitable donations have increased. America's commitment to charitable causes is the envy of the world. Of course, there are income and estate and gift tax advantages that accompany charitable gifts, and they can be quite powerful. For most clients, the most effective mechanism for wise charitable giving is either the gift funds now maintained by major investment organizations (see for example <http://www.charitablegift.org/>, and <http://www.vanguardcharitable.org/>, or contact your financial advisor for others), and the many local and regional community foundations (for example, the Long Island Community Foundation and the New York Community Trust). Each have good web sites which explain the wonderful benefits provided. For very large gifts other techniques abound, including charitable trusts and private foundations. These should be used very selectively, and with careful consideration to future costs and administrative burdens.

The establishment of private family foundations now, can have many advantages as a charitable gifting mechanism for selected family members over many generations. These are now surprisingly easy to create and administer. Among the best of the services which have helped this trend to gather strength, and to allow more of your money to get to the charitable goal, instead of to lawyers and accountants, is foundationsource.com.

As always, we must balance the cost of making gifts by the anticipated benefits, and emphasize simplicity.