CHAPTER 36

Avoiding Estate Tax With Lifetime Transfers: Gift Splitting

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A BRIEF OVERVIEW OF THE ESTATE AND GIFT TAX

When you die, the government will impose a tax on your estate if its value exceeds the applicable exclusion amount for the year of your death. For example, in 2008 the applicable exclusion amount is \$2 million. In 2009, the applicable exclusion amount is \$3.5 million. If you die in 2009, the first \$3.5 million of your estate will be sheltered from taxation, but the portion of your estate in excess of this amount will be subject to estate tax.

Therefore, if you anticipate that upon your death the value of your estate will exceed the applicable estate tax exclusion amount, there are a number of planning techniques you should consider that could allow you to avoid this potential tax liability.

A simple method to reduce the value of your estate is by making gifts to another party during your lifetime. However, the government limits the amount you may gift during any given year (the annual exclusion is \$12,000 per year per recipient in 2008, and \$13,000 in 2009) as well as the total amount you may gift during your lifetime (\$1 million). If you exceed the lifetime exemption, you will be forced to pay a gift tax.

For example, suppose you have two children. In 2008, you can gift \$12,000 to each child (\$12,000 x 2 = \$24,000 total) and not be subject to any gift tax liability. However, if later that same year, you gift an additional \$5,000 to each child, the additional amount (\$5,000 x 2 = \$10,000 total) must be reported on a federal gift tax return. However, you would not incur any gift tax liability since the excess can be deducted against your \$1million lifetime gift exemption (\$1million - \$10,000 = \$990,000 remaining).

Also, it should be noted that the estate and gift tax is "unified" such that any amounts deducted from your lifetime gift exemption are also, in effect, deducted from your estate tax exclusion amount. Thus in the above example, if you were to die in 2009 and had used \$10,000 of your lifetime gift exemption, you would have \$3,490,000 remaining as your estate tax exclusion amount.

Despite these limitations, gifting remains a common and valuable estate planning strategy and the concept of gift splitting makes the strategy even more effective.

GIFT SPLITTING

Gift splitting is a technique available to married individuals that allows spouses to agree to classify gifts made to a third party as made one-half by the donor and one-half by the donor's spouse. The primary benefit of gift splitting is that it allows a married couple to take full advantage of both spouses' exemptions despite any economic disparity between the two spouses. The wealthy spouse does not have to transfer assets to the other spouse (which may be an undesirable option, particularly in a second marriage) in order to accomplish the couple's gifting intentions.

Moreover, the actual process of gift splitting is relatively straightforward. After you make a gift, your spouse consents (on your timely filed gift tax return) to treat your transfer as having been made one-half by each party. Once filed, this election is irrevocable for the year in question and will apply to all gifts made during that year (i.e. you cannot elect on a gift by gift basis). The only requirements are that the spouses must be married at the time the gift is made, and both must be either U.S. citizens or resident aliens.

Consider the following example: You are married and have two children from a prior marriage. Using the principles of gift splitting (and with your spouse's consent), in 2008 you are now able to gift $24,000 to each child ($26,000 in 2009) without triggering any tax consequences. Note that in this example, despite the fact that the gifts did not exceed the annual exclusion amount, a gift tax return indicating the election to gift split is still required. Thus, one minor disadvantage of gift splitting is that it requires a gift tax return to be filed regardless of the amount in question.

Nevertheless, the advantages of gift splitting become even more apparent in the following scenario: you wish to make a gift of $1.5 million to your child. Without the use of gift splitting, the $500,000 above the lifetime exemption ($2 million in 2008) would be subject to gift tax (payable by you, the donor). Instead, your spouse agrees to gift split, and accordingly, $750,000 is allocated against the exemption of each spouse. Each spouse has a sufficient lifetime exemption to cover this amount; consequently you avoid potential tax liability.

While the preceding examples present relatively basic applications of gift splitting, the fundamental principles can be extended to more advanced scenarios. Gift splitting is often employed to pay premiums on life insurance policies owned by Irrevocable Life Insurance Trusts. In another context, if you can obtain a discounted valuation on an asset (such as a closely held business interest), then you can use gifting splitting to maximize the interests being transferred.

Ultimately, gift splitting allows you to leverage the annual exclusion and the lifetime exemption to transfer significant amounts of wealth.

A. Richard Redgrave provides clients with comprehensive legal solutions to matters involving estate planning, asset protection, taxation, and business planning.

Strategies to Minimize Gift Taxes

STRATEGY USED	EFFECT
Gift-splitting	Value of gift is split with consenting spouse.
Annual exclusion	Donor can give $12,000 in 2008 ($13,000 in 2009) to each individual without gift tax consequences. Gift splitting allows a married couple to give $24,000 in 2008 ($26,000 in 2009) per donee without gift tax consequences.
Unified credit	Allows taxpayer to gift $1 million during lifetime without gift tax consequences.
Qualified transfers	Allows taxpayer to directly pay educational institutions and providers of medical care on behalf of others without gift tax consequences.
Gifts to a spouse	Marital deduction eliminates gift tax for U.S. citizen spouses.
Gifts to charity	Charitable deduction eliminates gift tax.
Bargain sales	Gift is bargain element (FMV less sales price).
Net gifts	Donee is required to pay gift taxes, which reduces amount of the gift.
Partial-interest gifts (GRATs, GRUTs, QPRTs, etc.)	Grantor retains an interest so assets are transferred at reduced gift tax values.
Valuation discounts	Discounts for lack of marketability and minority interests can be used for family limited partnership interests and stock in closely held corporations.
Gifts of life insurance	Small premiums can be leveraged into large death benefits.
Trusts	Gifts to Crummey trusts and 2503(b) and (c) trusts for minors are eligible for the gift tax annual exclusion.

What to Do with Various Types of Properties

Highly Appreciated Property	Gift to a person in a lower tax bracket.
Property Likely to Appreciate	Gift to remove future appreciation from donor's estate, especially if there is a concern about higher estate taxes in the future.
Loss Property	Do not gift. Sell the property, take the loss, and gift the proceeds.
Income-Producing Property	Gift to a person in a lower tax bracket.
Depreciable Property	Keep in order to take advantage of depreciation.
Depreciated or Cost-Recovery Property	May be good for using the gift-leaseback technique.
Life Insurance	Gift that will have a high value at the date of death and a low value (replacement value) for gift tax purposes.
Out-of-State Real Property	Gift to avoid ancillary probate.
Closely Held Stock	Use caution in gifting. Estate may be disqualified from using Section 303 or 6166.