GIVING DURING LIFE OR GIVING AFTER DEATH:

Understanding Federal Gift Taxes, Estate Taxes, And The Unlimited Marital Deduction

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The differences between federal gift taxes and federal estate taxes confuse many. Taking a step-by-step approach helps to clarify these concepts.

TYPES OF GIFTS

U.S. tax laws recognize two principal categories of gifts. A gift made during one's lifetime is called an inter vivos gift. A gift made after death (normally through a will or some other instrument like a trust) is called a testamentary gift.

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WEALTH TAXES

The gift tax and estate tax are the only "wealth taxes" prescribed by the federal government.

States may levy another "wealth tax" called an inheritance tax in addition to, or in substitution for, a state estate tax. The federal government does not levy inheritance taxes. Most states, including North Carolina, have repealed their inheritance and estate taxes. And very few states still levy a gift tax.

HISTORY AND PURPOSE

The first U.S. federal estate tax was enacted in 1916 in order to gain revenue from wealthy individuals at death in addition to their income taxes collected during life.

The gift tax was first enacted in 1924, so that the government could reduce the avoidance of estate taxes through giving inter vivos gifts. Without the gift tax, a wealthy citizen could reduce his or her family's estate tax burden at death by making gifts to others while alive, which would reduce the size of his or her taxable estate at death. The gift tax serves as a "backstop" to the estate tax by also taxing the gifts made during life, making it more difficult for a wealthy citizen to escape federal wealth taxes.

UNIFICATION, THE LIFETIME GIFT TAX EXCLUSION, THE ANNUAL GIFT TAX EXCLUSION, AND THE ESTATE TAX EXEMPTION

There are several similarities between the federal gift tax and the federal estate tax which invite confusion. In 1976, the federal gift tax was "unified" with the federal estate tax, which created a common tax rate schedule for both types of taxes.

Recent updates have equalized the lifetime gift tax exclusion and the estate tax exemption, so that they are now the same number. For example, in 2014, no gift tax is owed to the IRS until the giver exceeds the 2014 lifetime gift tax exclusion of $5.34 million for all gifts made during the giver's lifetime in excess of the annual gift tax exclusion amount (discussed below). And the 2014 federal estate tax exemption allows the individual "testator," or giver, in a will to leave his heirs up to $5.34 million free of estate tax. The $5.34 million gift tax exclusion and estate tax exemption are indexed annually for inflation. In 2015, both the federal individual gift tax exclusion and estate tax exemption will rise to $5.43 million.

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UNIFICATION EXAMPLE

Suppose Laura, who is single, makes a $1 million gift to her nephew Ken in 2011, then dies in 2014. How much federal estate tax exemption would be available to her estate at death?

First, we must determine how much the lifetime gift tax exclusion has been reduced by Laura's 2011 gift.

First, we must determine how much the lifetime gift tax exclusion has been reduced by Laura's 2011 gift. To calculate this, we subtract the 2011 annual gift tax exclusion amount, which was $13,000 in 2011, from the amount of the gift, as follows: $1,000,000 - $ 13,000 = $987,000.

Because of unification, the amount of the total $5.34 million federal estate tax exemption available to Laura's estate at her death in 2014 would be reduced by the countable portion of her gifts during life, or $5,340,000 - $987,000 = $ 4,353,000 estate tax exemption available to Laura's estate at death to shield her assets from estate taxes.

Even though Laura would not have had to pay gift taxes in 2011 on the amount of her gift, $987,000, in excess of the $13,000 2011 annual gift tax exclusion amount, she does have to report any gifts in excess of the annual gift tax exclusion amount to the IRS so the IRS can keep track of the lifetime total.

Note that Ken, the 2011 recipient of the $1 million gift, does not have to pay any tax on the gift, because gifts are not included as taxable income to the recipient.

Unification dictates that if some of an individual's 2014 $5.34 million lifetime gift tax exclusion is used up by making a taxable gift during life, the estate tax exemption used to shield testamentary bequests (transfers of property by will or trusts at death) will be reduced accordingly.

In addition to the lifetime gift tax exclusion, it is important to understand its annual counterpart, the annual gift tax exclusion. In 2014, the annual gift tax exclusion allows a taxpayer to give away up to $14,000 each to as many individuals as he wishes without those gifts counting against his or her 2014 $5.34 million lifetime gift tax exclusion.

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THE UNLIMITED MARITAL DEDUCTION AND PORTABILITY

The federal unlimited marital deduction provides that an individual may transfer an unlimited amount of assets to his or her spouse at any time, in life or at death, free from any tax (including gift and estate tax).

The concept of estate tax exemption portability allows a surviving spouse to use a deceased spouse's unused estate tax exemption (up to $5.34 million in 2014).

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For example, suppose Henry and Anne are married. Henry dies in 2013 (when the estate tax exemption was $5.25 million), leaving all of his assets to Anne. Because of the unlimited marital deduction, Henry's 2013 testamentary bequest to Anne is tax-free for both parties; neither Henry's estate nor Anne are taxed on this bequest at all in 2013. If Anne then dies in 2014, federal estate tax portability rules provide that both spouses' combined estate tax exemptions may be used, so that $5.25 million (2013 federal estate tax exemption amount for Henry) + 5.34 million (2014 federal estate tax exemption amount for Anne) = $10.59 million total combined estate tax exemption could be utilized by the couple's estate, which would shield $10.59 million of Anne's bequest to her heirs from estate taxes at Anne's death.

In order to take advantage of portability, a federal estate tax return must be filed at the first spouse's death, even if not otherwise required.

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Estate planning for large estates typically takes full advantage of both spouses' estate tax exemptions. In addition to portability, this could also be done, for example, by funding a Family Trust at the first death using the estate tax exemption amount of the first-to-die spouse, then utilizing the unlimited marital deduction to protect the transfer of the remaining assets to the surviving spouse. The Family Trust, which may benefit the surviving spouse, can pass to the heirs without tax at the death of the surviving spouse.

TAX-EXEMPT GIFTS

In addition to the annual gift tax exclusion, the following types of gifts are tax-exempt. The taxpayer may make unlimited gifts of any amount to these categories without any gift tax or estate tax consequences, and without having to file gift tax returns:

- Gifts to IRS-approved charities
- Gifts to a spouse (if the spouse is a U.S. citizen)
- Gifts made to cover another person's medical expenses (must be made directly to the medical service providers)
- Gifts covering another person's tuition expenses (must be made directly to the educational institution).

Understanding how the federal government treats gift and estate taxes should allow the taxpayer to make better gift planning and estate planning choices.

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