Rowbotham & COMPANY LLP

Executive Newsletter

Contact:
info@rowbotham.com

Website:
www.rowbotham.com

San Francisco Office:
tel: (415) 433-1177
fax: (415) 433-1653

Santa Clara Office:
tel: (408) 850-7295
fax: (415) 433-1653

The Gift of Giving

November 25, 2006

Being the end of the year, and the time for giving, some thought should be given to making gifts that benefit the recipients while also benefiting the donor. Gifting is an excellent vehicle by which a taxpayer may reduce the size of their estate, thereby reducing or even eliminating future estate taxes.

Annual Exclusion Of Gift Tax

Taxpayers can transfer substantial amounts free of gift taxes to their children or other donees through the proper use of the annual gift tax exclusion. The statutory exclusion amount, originally $10,000, is adjusted for inflation annually. For 2006 and 2007, the amount of the exclusion is $12,000.

The exclusion covers gifts an individual makes to each donee each year. Thus, a taxpayer with three children can transfer a total of $36,000 to them every year free of federal gift taxes. If the only gifts made during a year are excluded in this fashion, there is no need to file a federal gift tax return. If annual gifts exceed $12,000, the exclusion covers the first $12,000 and only the excess is "taxable". Further, even "taxable" gifts may result in no gift tax liability thanks to the unified credit (discussed below). (Note, this discussion is not relevant to gifts made by a donor to his spouse because these are gift tax-free under separate marital deduction rules.)

If the donor of the gift is married, gifts to donees made during a year can be treated as "split" between the husband and wife, even if the cash or gifted property is actually given to a donee by only one of them. By gift-splitting, therefore, up to $24,000 a year can be transferred to each donee by a married couple because their two annual exclusions are available. Thus, for example, a married couple with three married children can transfer a total of $144,000 each year to their children and the children's spouses ($24,000 for each of six donees).

Where gift-splitting is involved, both spouses must "consent" to it. Consent should be indicated on the gift tax return (or returns) the spouses file. The IRS prefers that both spouses indicate their consent on each return filed. Because more than $12,000 is being transferred by a spouse, a gift tax return (or returns) will have to be filed, even if the $24,000 exclusion covers total gifts.

For a gift to qualify for the annual exclusion, it must be a gift of a "present interest". That is, the donee's enjoyment of the gift can't be postponed into the future. For example, if you put cash into a trust and provide that donee A is to receive the income from it while he's alive and donee B is to receive the principal at A's death, B's interest is a "future" interest. Special valuation tables are consulted to determine the value of the separate interests you set up for each donee. The gift of the income interest qualifies for the annual exclusion because enjoyment of it is not deferred, so the first $12,000 of its total value will not be taxed. However, the gift of the other interest (called a "remainder" interest) is a "taxable" gift in its entirety.

If the donee of a gift is a minor and the terms of the trust provide that the income and property may be spent by or for the minor before he reaches age 21 and that any amount left is to go to the minor at age 21, then the annual exclusion is available (that is, the present interest rule will not apply). These arrangements (called Code Sec. 2503(c) gifts because of the section in the

tax code that permits them), allow parents to set assets aside for future distribution to their children while taking advantage of the annual exclusion in the year the trust is set up.

Another vehicle that bypasses the present interest rule is the Crummey Trust (called this based on the first one having been established by a taxpayer by the name of Crummey). Such trusts can be established to ultimately benefit recipients at any age chosen by the person establishing the trust. The gift to the trust qualifies as a present interest because upon transfer to the trust, the beneficiary is given a window of opportunity (typically 30 days) in which to withdraw those funds from the trust.

Even gifts that are not covered by the exclusion and that are thus "taxable" may not result in a tax liability. This is so because a tax credit wipes out the federal gift tax liability on the first $1,000,000 of taxable gifts you make in your lifetime. This credit, however, applies both for gift and estate tax purposes (that's why it's called "unified"). Thus, to the extent you use it against a gift tax liability, it is reduced (or eliminated) for use against the federal estate tax at your death.

Conclusion

Gifting your assets can improve your own financial affairs by reducing or even eliminating estate taxes. Various vehicles are available to allow the best use of your funds to benefit loved ones or even yourself, while minimizing the effect of taxes. Simple outright gifts can be made now, but a new year's resolution should be made to further your estate plan with vehicles that allow for greater reductions of your taxable estate. Future newsletters will discuss in more detail some of those vehicles available to you.

For more information, please contact Kent Lawson or Peter Truman.

Best wishes for the holiday season.

©2006 Rowbotham & Company LLP. All rights reserved.