

Effectively Using the Annual Exclusion, Part One

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The annual exclusion may be one of the most effective, but least utilized techniques available to estate planners. Perhaps this is because the \$10,000 per donee seems such a small benefit. However, when utilized with other planning techniques, it can provide substantial long term tax savings. A few simple tables may help explain the overall benefits of the annual exclusion.¹

Assume a wealthy client has three married children, each of whom has one child. Like many clients, this client is unwilling to make gifts to in-laws. Shown below is the cumulative amount of \$10,000 annual exclusion gifts to 6 descendants over 30 years. In 30 years the gifts totals \$1.8 million, creating a transfer tax savings of \$990,000 to a taxpayer in the 55% estate tax bracket. If the donor included the in-laws, the total gifts would grow by 50% (i.e., to \$2.7 million in 30 years).

<u>Year</u>	<u>Value of Total Gifts of \$10,000 Annually</u>
1	\$60,000
5	\$300,000
10	\$600,000
15	\$900,000
20	\$1,200,000
25	\$1,500,000
30	\$1,800,000

But this approach ignores another important aspect of the annual exclusion: moving assets out of a taxable estate on a discounted basis. For example, assume the gifts above were of interests in a family partnership which held real estate and for which the client took a conservative valuation adjustment rate of 35%. The following table shows the net impact of this increased benefit to the same annual exclusion gifts of \$60,000 over 30 years. The left column reflects the unadjusted value of the gifts, while the right column shows the cumulative gifts when a 35% valuation adjustment has been applied. Using this relatively simple device, almost \$1.0 million more in assets are moved out of the taxable estate in 30 years, saving over \$530,000 more in estate taxes for a taxpayer in the 55% bracket.

<u>Year</u>	<u>Value of Total Gifts at</u>	
	<u>\$10,000 Annually</u>	<u>Discounted at 35%</u>
1	\$60,000	\$92,000
5	\$300,000	\$462,000
10	\$600,000	\$923,000
15	\$900,000	\$1,385,000
20	\$1,200,000	\$1,846,000
25	\$1,500,000	\$2,308,000
30	\$1,800,000	\$2,769,000

Even though almost \$3.0 million is moved out of the taxable estate, there is one even more important savings from the effective use of the annual exclusion: moving future value out of a taxable estate. This future value can be the increases in the value of the assets and/or the income generated by the gifted assets. For example, the next table assumes a conservative 5% annual growth in the assets gifted over 30 years. It also assumes that a 35% valuation adjustment is applied. Over time, it demonstrates that significant benefit can be obtained from moving

¹ All the calculations in this article are rounded.

even small amounts of assets out of the taxable estate. In this case, \$60,000 in annual gifts moved over \$6.1 million out of the taxable estate in 30 years.

Year	\$10,000 Annually	Value of Total Gifts at	
		Discounted at 35%	With 5% Appreciation
1	\$60,000	\$92,000	\$97,000
5	\$300,000	\$462,000	\$516,000
10	\$600,000	\$923,000	\$1,168,000
15	\$900,000	\$1,385,000	\$2,001,000
20	\$1,200,000	\$1,846,000	\$3,064,000
25	\$1,500,000	\$2,308,000	\$4,412,000
30	\$1,800,000	\$2,769,000	\$6,152,000

The Annual Exclusion

The rules governing the annual exclusion are fairly straightforward. The Code permits taxpayers to make annual gifts of up to \$10,000 each to as many different donees as the donor desires.² The gifts must be gifts of a “present interest” in property³. After 1998, the \$10,000 annual exclusion is inflation adjusted, but only in increments of \$1,000 each (i.e., there must be at least a 10% increase for a change to occur).⁴ Gifts covered by the annual exclusion do not reduce the unified tax credit of the donor. This article will explore in detail many of the planning opportunities available to a creative planner who uses this simple tax tool.

Maximizing the Donee Exclusions. Most clients use the annual exclusion to make gifts to children and grandchildren. But few clients have equal sized family groups. A client is often concerned that providing \$10,000 in annual exclusion gifts to each member of his or her larger families will result in a disproportionate benefit to the larger families. For example, assume a married client expresses concern that one child’s family with only four (4) potential donees would be detrimentally impacted because the family groups of the other children have eight (8) donees. The donor wants all family groups to be benefitted on a comparable basis and therefore, is discussing limiting the annual exclusion to \$40,000 per family group (i.e., the maximum annual exclusion of the smallest family).

Planning Alternative #1: Instead of limiting the annual exclusion to \$120,000 (i.e., \$40,000 to each of the three family groups) maximize the family exclusion at \$200,000 (i.e., \$10,000 to 20 family members). If the married donor and the spouse agree to gift splitting, the total annual exclusion could double to \$400,000. Make up the amount for the smaller families, using some of the donors’ unified credit, either during life or by his or her will. Although lifetime use reduces the available unified credit at death, the use of large annual exclusion gifts increases the overall tax free dispositions to the heirs and can more quickly move an appreciating asset out of the taxable estate.

Planning Alternative #2: Second, create a lifetime trust, with all descendants as beneficiaries. Contribute at least \$200,000⁵ to the trust using the annual exclusion and Crummey withdrawal rights⁶. The trust is divided into three equal trust shares for each family, even though the Crummey withdrawal rights among the family groups differ. A discretionary “spray power” could allow the Co-Trustees to make income or principal distributions to family members when needed. A special power of appointment could be used to

² IRC section 2503(b). Subject to various court and legislative limitations as the reciprocal gift doctrine.

³ A “present interest” is defined as “...an unrestricted right to the immediate use, possession or enjoyment from property.” See Treasury Regulation, section 25.2503-3.

⁴ See IRC section 2503(b)(2). As of 2001, there have been no adjustments to the annual exclusion.

⁵ The purpose of using \$200,000 is to minimize the impact of the “5&5” rule. See the later discussion.

⁶ See the later discussion on Crummey withdrawal rights.

allow the children to reconfigure the trust at any time prior to their death⁷. At the death of each of the children, all of their trust share may be distributed to grandchildren or held in trust for their benefit. The growth in the contributed assets will not be subject to estate taxes at either the parent or a child's deaths. Assets could be invested in capital gain investments to avoid and reduce income taxes to the trust or the beneficiaries.

Planning Alternative #3: What if one of the children has no descendants? To the extent annual exclusion gifts (at a potentially discounted value) are made directly to that child and possibly his or her spouse, the assets may eventually pass to unrelated parties (e.g., the surviving spouse's niece). Instead, if the assets are held for the benefit of the couple in trust for their joint lives, three principal benefits occur. First, the assets are retained in the family blood line. At the death of the second to die of the child and spouse, their trust share pours over to the trust share of the other family members. Second, even if the child and spouse intended to pass their assets to the child's family members, the passage could result in the imposition of a state or federal estate tax. Having the assets held in the trust can avoid the imposition of this tax. Last, if the trust is created as a "spendthrift trust"⁸ the assets of the trust are protected from the creditors of the childless couple. Moreover, the trust might provide that if the spouse divorces the donor's child, the spouse's benefits in the trust are terminated.

Planning Alternative #4: If gift splitting is not elected, the above trust could name the donor's spouse as an additional trust beneficiary. During the spouse's life, the trust income and principal could be used for the spouse's benefit, allowing an indirect benefit to the donor through the spouse. The spouse can be a Co-Trustee and have the ability to remove any other trustee. The spouse could be given a special power of appointment to reconfigure the trust, allowing changes in the trust's disposition by the spouse to account for future tax, legal or family changes. If such an approach is used, the donor may want to add a provision that the divorce of the spouse and donor automatically revokes any rights the spouse has in the trust and requires the spouse to resign as a Trustee. Moreover, pursuant to Revenue Ruling 95-58⁹, the grantor can retain the right to remove the spouse or others as a Co-Trustee.¹⁰

Perspective: The planner needs to view the annual exclusion available to the larger family groups as a benefit to all of the family members. For example, in the first planning example, maximizing the annual exclusion increased the annual tax-free gifts to family members by \$160,000¹¹, saving a taxpayer in the 55% tax bracket \$88,000 each year. Assume the larger annual exclusion is made over 10 years, using a 35% valuation adjustment and assuming a 5% annual growth in contributed assets. By gifting the larger amount, an additional \$2.7 million is moved out of the taxable estate of the donor in just 10 years, saving the client in the 55% bracket over \$1.5 million in estate taxes - a benefit to ALL the heirs.

Planning: Donors of annual exclusion gifts do not have to just be parents and grandparents. For example, assume two married brothers have inherited significant assets from their deceased parents. One brother has three (3) children who are married and five (5) grandchildren. The other has six (6) descendants. Each of the brothers has a significant estate of their own. The brothers have decided that it is in the best interest of the family not to have their respective children have common ownership of the various family assets; that is, they do not want their children to have common ownership with each other. Have the brothers decide which properties will be conveyed to each family group. Have the brothers create family limited partnerships to hold their respective interests in the properties. Each brother may be a general partner of

⁷ See: William S. Forsberg, "Special Powers of Appointment: The Key to Flexibility in Planning," Est. Plan., Jan. 2000. But see the later discussion on the generation skipping and the annual exclusion.

⁸ See the later discussion in this article.

⁹ 1995-2 CB 91

¹⁰ See: "Trustee Removal and Replacement Powers," ALI-ABA Estate Planning Course Materials Journal, April 1999.

¹¹ If gift splitting is elected, the maximum gifting is \$400,000, while the "equalization" approach only gifts \$240,000.

the partnership holding the properties to be held by his family group. The brothers then gift family limited partnership interests (with applicable discounts for minority ownership and lack of marketability) to the other brother's family members.¹² Assuming both brothers are in the top transfer tax bracket, each gift would save up to \$6,000.¹³

“I May Need the Money.” Elderly clients are often concerned that the assets they gift may be needed in the future. One of the first priorities for any planner is to deal with both the real and perceived fear that there are not sufficient funds to provide for long term care.

Planning: Assume an elderly widow does not want to make significant gifts, because she is concerned that she may need the assets for her long term care needs and she believes the stock market could crash any day. Propose to the client that either she purchases a long term care policy or the children/donees use the first dollars from any annual exclusion gifts to pay the premium on a long term care policy for their parent.

Planning: If the interest being transferred is a business interest, review the possibility of providing deferred compensation to the donor/parent. The deferred compensation pays income after retirement to the parent and, at death, terminates. In effect, the donor is making gifts in return for an assured future income stream.

Planning: In the above case, review having the business obtain a long term care policy as a fringe benefit for the donor/business owner. If the policy is a tax qualified policy, the premiums paid by the business are deductible.¹⁴

Purposeful Gifting. In many cases the client is unwilling to make gifts because the donee has not “properly” used the money in the past or the client wants to delay the donee’s access to the benefits of the gift (e.g., a gift to a spendthrift 18 year old).

Planning: Parents can make annual exclusion gifts to minors who may qualify for the Roth IRA and are in lower tax brackets, but do not have the funds to make the contributions. For example, have a client match the earned income of a child’s summer job to fund a ROTH IRA. As guardians, the parents will control the funds. Obviously, the parent loses direct control over these funds when the child reaches majority.

Planning: Because of their “spendthrift” ways,” a married client is reluctant to make annual exclusion gifts to family members. Have the client make gifts of a family partnership interest (which owns the assets), with the spouse and/or the donor being general partners who control the underlying assets. In the alternative, make gifts to a Crummey trust.¹⁵

Planning: A husband is substantially older than his wife and the long term marriage is stable. The husband has 15 descendants from a prior marriage. He wants to reduce estate taxes, but does not want to benefit descendants to the detriment of his wife. Create a lifetime trust, with his spouse and descendants as vested beneficiaries. To avoid the impact of the 5&5 rule¹⁶, the husband contributes at least \$200,000 to the trust using the annual exclusion (e.g., 16 donees using Crummey withdrawal rights and \$40,000 using unified credit). Gift splitting is not elected because the spouse is a beneficiary of the trust. Name the wife as primary beneficiary during her life. Provide that when the wife dies, benefits accrue to all of the Crummey power holders. Effectively, the client used \$160,000 in annual exclusion gifts to remove assets from the taxable estate without reducing the lifestyle of the couple or depleting the donor’s unified credit. Obviously, when the spouse dies, this indirect benefit ceases because a reversionary right in the spouse

¹² However, take a careful look at the reciprocal gift doctrine as discussed later in this article..

¹³ i.e., 60% times \$10,000

¹⁴ See IRC section 7702B.

¹⁵ See the later discussion in Crummey trusts.

¹⁶ Id.

would pull the gifted assets back into his estate.¹⁷

Deathbed Gifting. Deathbed annual exclusion gifts are a significant planning tool. However, in Revenue Ruling 96-56¹⁸, the IRS ruled that if the donor dies before a gift check clears the donor's account, the gift is not removed from the estate. In Estate of Newman,¹⁹ the Tax Court agreed with the IRS's position. The law distinguishes between charitable and non-charitable death-bed payments. In general, charitable death bed checks do not have to clear the decedent's accounts before death, while non-charitable gifts do have to clear.²⁰

Planning: A client is in a 55% estate tax bracket and is terminally ill. She has four married children, 20 grandchildren and 4 great-grandchildren. Maximizing the available annual exclusions could move \$320,000 out of her taxable estate each year, saving the family up to \$176,000 annually.²¹ Even if the gifted assets have a zero basis (which will be carried over to the family), the gifting generally makes sense.²²

Planning: A terminally ill client has no descendants, but does have a taxable estate. In her will she has made 10 special bequests of \$10,000 to friends, with the balance going to nieces and nephews. The will provides that the residue pays any estate tax. Have the client make the special bequests during life and revise the will to eliminate those bequests. Such an approach could save the nieces and nephews \$37,000 to \$60,000 in estate taxes.²³

Planning: Make sure any living trusts specifically authorize the trustees to make gifts of the client's property. Powers of attorney²⁴ should have similar provisions.

Crummey Powers. The \$10,000 annual exclusion²⁵ applies only to gifts of a "present" interest - i.e., the donee must have the present use and enjoyment of the property. By nature, a gift to a trust is a future interest, because the beneficiary's access to the unfettered control of the gifted asset is delayed. A "Crummey Right"²⁶ is a provision placed in a trust to convert the contribution from a "future" interest to a "present interest" by giving beneficiaries the right to withdraw trust contributions for a limited period of time (generally 30 days). Crummey powers are often used to fund annual premiums to irrevocable life insurance trusts. Among the planning issues with Crummey powers are:

- X If the annual exclusion changes as a result of any inflation adjustment or tax law changes, specific dollar withdrawal rights can create problems. Instead any document should reference: "*the annual exclusion amount permitted by IRC section 2503(b).*"
- X To avoid having a beneficiary be treated as an additional grantor to the trust under the 5&5 provisions of IRC section 2038, the withdrawal right should be the greater of \$5,000 or 5 percent of the trust principal, but not more than the annual exclusion amount. Using a straight \$10,000 withdrawal right will violate the

¹⁷ IRC section 2033.

¹⁸ 1996-2 CB 161. See also Estate of Metzger, 100 T.C.204 (1994).

¹⁹ 111 T.C. No. 3 (July 28, 1998). See also R. Rosano, 99-2 USTC para.60,354 (D.C.NY) and Estate of Swanson, 85 AFTR2d 2000-1196 (Ct CL. 2000).

²⁰ See: "*Annual Exclusion Gift Checks and the Relation-Back Doctrine*," Estate Planning, November 1998, and "*Relation Back Doctrine Applied to Annual Exclusion Gift Checks*," Estate Planning, January 2000.

²¹ \$320,000 times the estate tax bracket of 55%.

²² i.e., the federal capital gains rate is 20%, while the federal estate tax savings is 55%.

²³ The reduction of the estate means that the residuary beneficiaries receive the tax savings, at a 37% to 60% estate tax rate. However, if non-cash assets are gifted, the donees will take the basis of the donor and the resulting potential tax on the gain in the asset's value.

²⁴ See the later discussion.

²⁵ IRC section 2503(b)

²⁶ From Crummey v. Comr., 397 F.2d 82 (9th Cir. 1968); See also Cristofani Est. v. Comr., 97 T.C. 74 (1991) and L. Kohlsaat Estate, TC Memo 1997-212. For an excellent discussion of the nuances of Crummey withdrawal rights see: Zaritsky & Leimberg, Planning with Life Insurance (WG&L) section 5.03[3] and "*Obtaining the Annual Exclusion for Gifts*," Trusts and Estates, May 1998.

5&5 power when the trust holds less than \$200,000 (i.e., 5% of the trust is less than \$10,000). In such case, the beneficiary whose right has lapsed is deemed another grantor of the trust - creating all sorts of potential tax problems.²⁷

- X In order to simplify the notice process, provide that any beneficiary who is also a trustee has the first right of withdrawal and is deemed automatically to have notice of withdrawal rights upon any contribution. This will eliminate the need to provide actual notice to beneficiaries if the withdrawal rights of Trustee/Beneficiaries exceed contributions (e.g., any insurance premium cost).
- X Provide in the document that a minor's withdrawal right can be exercised by a parent or legal guardian.
- X Provide withdrawal rights only to vested beneficiaries.²⁸
- X To avoid the argument that the withdrawal right is contingent upon the powers of others involved with the trust, provide that it is superior to all other trustee powers and authority.
- X If a spouse of the donor or a descendant is to be a beneficiary of the trust, consider providing that his or her rights as a beneficiary and/or trustee are automatically terminated upon divorce or legal separation.
- X The IRS and the Courts have in many cases held that the gift of a non-income producing assets (i.e., a closely held business which does not pay dividends) is either a future interest that does not qualify for the annual exclusion²⁹ or is an asset which cannot be valued.³⁰ Beware of using such assets to fund a Crummey withdrawal right.

The IRS does not like Crummey withdrawal rights. Make sure to always comply with the existing rules governing Crummey rights, including:

- X Giving actual notice by certified mail and keeping the copies of the return receipts.
- X Maintaining sufficient assets to fund the withdrawal rights of all beneficiaries.
- X Making contributions before December 1st each year and not making any life insurance premium payments until after the withdrawal periods have lapsed.³¹
- X Having the grantor make contributions to the trust, with the trust, not the grantor making any life insurance premium payments.
- X Having the trust contributions differ from any life insurance annual premium cost to afford having the IRS argue that the trust was the alter-ego of the grantor. For example, round the trust contribution to the nearest hundred dollars.
- X Having no agreements with beneficiaries that they will not exercise their rights and do not allow beneficiaries to waive their rights in advance.

In a recent ruling³², the IRS showed how not to construct a Crummey withdrawal right. In the ruling a husband created a trust and give his wife the right to withdrawal 10% of the trust each year. The withdrawal right violated the 5&5 rules of IRC section 2514(e).³³ The result was that for each year that the spouse failed to make the withdrawal she was treated as though she made a taxable gift to the trust and the gift was not considered an annual exclusion gift because Crummey withdrawal rights were not granted to the remaindermen of the trust, the couple's

²⁷ e.g., the beneficiary/donees must reflect the deemed gift of not exercising their withdrawal on a gift tax return, reducing their unified credit and may be required to include part of the trust in their estate upon death as a retained interest pursuant to IRC section 2036.

²⁸ Although Cristofani allows the use of contingent beneficiaries, the IRS has asserted that remote beneficiaries may not have sufficient interests in the trust to qualify their withdrawal rights a present interest annual exclusion gifts. c.f., PLR 9141008. But see: "Annual Exclusion Allowed for Contingent Trust Beneficiaries," Tax Advisor, September 1997.

²⁹ c.f., Revenue Ruling 69-344, 1969-1 CB 225.

³⁰ c.f., F.A. Berzon, 63 TC 601, aff'd 534 F2d 528 (2nd Cir 1976); L.H. Stark, 477 F2d 131 (8th Cir. 1973).

³¹ c.f. PLR 9628004.

³² PLR 9804047.

³³ See: Zaritsky & Leimberg, Planning with Life Insurance (WG&L) section 5.03 and "Obtaining the Annual Exclusion for Gifts," Trusts and Estates, May 1998.

children.

Planning: Where a withdrawal right is granted, it should also be limited to the greater of 5% of the value of the trust's assets or \$5,000, to assure that the lapse of the withdrawal right does not result in adverse tax consequences to the beneficiary.

Tuition and Medical Gifts. In addition to the annual exclusion, any amounts paid on behalf of any individual for the education or training of the person or for medical care is not subject to a gift tax.³⁴ Therefore, parents and grandparents³⁵ should consider making tax-free gifts of tuition and medical costs for family members without incurring a gift tax, or using any of their unified credit or annual exclusions.

The payments should be made directly to the qualifying medical or educational provider.³⁶ The tuition exception is limited to tuition costs and does not apply to amounts paid for room, board, books, or supplies. The unlimited exclusion for medical expenses is not permitted for amounts that are reimbursed by insurance.

Two related income tax issues should be noted. First, unless the donee is a dependent of the donor, the donor will not be entitled to an income tax deduction for payment of medical expenses.³⁷ Second, the amount of the gift could constitute taxable income to a parent who had the obligation to provide that support.

Planning. In a recent private letter ruling³⁸, the IRS agreed that a grandmother's advance payment of her grandchildren's tuition at a private secondary school were excluded from her gift tax pursuant to IRC section 2503(e). This ruling offers an opportunity for clients (especially those who may die before the tuition comes due) to reduce their taxable estate.

Planning: Gifts may also be made to a qualified state tuition program ("QSTP" or "529 Plan") as prepaid tuition³⁹. However, these gifts do not qualify for the tuition gift exclusion⁴⁰ and will instead be covered by the annual exclusion or unified credit. The donor can elect to have the gift be treated as made over a five year period in certain circumstances.⁴¹

³⁴ IRC section 2503(e). See: "Using the Gift Tax Exclusion for Tuition Payments," Accounting Today, November 1999.

³⁵ But there is no relationship requirement in the statute. Therefore, even non-relatives could make the tax excluded payments. See Treasury Regulation 25.2503-6(a).

³⁶ IRC section 2503(e)(2); Revenue Ruling 82-98, 1982-1 C.B. 141.

³⁷ But payments qualify for the gift exclusion without regard to the relationship of the parties.

³⁸ PLR 199941013. See also "Prepayment of Tuition Expenses: Planning Prospects," Estate Planning January 2000.

³⁹ For more information on the various state sponsored programs see: "College Funding: New Kid on the Block (Qualified State Tuition Plan) Challenges Traditional Techniques (Crummey Trusts and Minor Trusts). And the Winner is..." Miami Insti. Est. Plan., 2001. See also: http://embark.wiredscholar.com/paying/content/pay_state.html and <http://www.savingforcollege.com/>

⁴⁰ IRC section 2503(e)(2)(A).

⁴¹ IRC section 529(c)(2)(B).

Basis. In general, the donee of an asset takes over the tax basis of the donor. IRC section 1015(a) provides: “If the property was acquired by gift ..., the basis shall be the same as it would be in the hands of the donor ... except that if such basis ... is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.” The result of this rule is that the donor’s appreciation in the asset will normally be taxed to the donee.

Planning: If a low basis asset is transferred to the donee, the value of the gift is effectively reduced by the income tax or capital gain tax the donee will ultimately pay upon the sale of the asset. For example, if a zero basis stock worth \$10,000 is transferred to a child, the real value of the gift may only be \$8,000.⁴² Instead, consider selling the asset and gifting cash of \$10,000 to the child. Not only is a higher value transferred out of the estate, but the payment of the capital gains tax effectively reduces the donor’s estate. If the donor is concerned about losing future appreciation in the asset as a result of the sale, the donee could always buy the same stock using the cash received in the gift.

Planning: If a taxpayer dies, the basis in most assets steps up to their fair market value. Part of the determination of which assets should be gifted should be a review of the relative basis of each asset. All other factors being equal (e.g., appreciation potential and income benefits), the gifting of higher basis assets is better, because the lower basis assets may step up to fair market value at the donor’s death. For example, assume a terminally ill client may gift \$10,000 in cash or \$10,000 in marketable stock having a zero basis. If the cash is used to fund the gift, upon the donor’s death, the step-up in basis saves the family up to \$2,000 in federal capital gains taxes and any applicable state and local taxes.

However, if the donor’s basis in the asset exceeds its fair market value, the rules get a little more complicated for the donee. If the donee subsequently sells the asset for a gain, the donee uses the donor’s basis in the property.⁴³ If the donee sells the asset for a loss, the fair market value of the donated assets is used as the basis.⁴⁴ Thus, if the donee sells for a price between the fair market value and the donor’s basis, neither a loss or a gain is incurred.⁴⁵ Unlike a gift, the basis of an asset transferred at death is the asset’s fair market value, even if the fair market value is lower than the asset’s date of death basis.⁴⁶

Planning: The client has a marketable stock she purchased for \$14,000 which now has a value of only \$10,000. If the stock is gifted to a child and the child sells it for \$10,000, the capital loss in value will be effectively lost. Instead, have the client sell the asset for \$10,000 and take a \$4,000 capital loss. The \$10,000 in cash could then be gifted to the child.

Gift Splitting. The law permits a spouse to elect to be treated as the donor of a gift, even when the other spouse is the sole transferor.⁴⁷ In order for “gift-splitting” to apply the donor must file a gift tax return, on which the

⁴² \$10,000 less a 20% capital gains tax.

⁴³ T.R. section 1.1015-1(a)(1).

⁴⁴ Id.

⁴⁵ T.R. section 1.1015-1(a)(2).

⁴⁶ IRC section 1014.

⁴⁷ IRC section 2513. See: “How Should the Option to Split Gifts be Chosen?” Estate Planning, November/December 1994.

spouse consents to the treatment of the gifts as made one-half by the spouse.⁴⁸ Gift splitting for any year applies to all gifts and cannot be made on a gift-by-gift basis. If gift splitting is elected, the spouses have joint and several liability for any gift tax which may be due.⁴⁹ If neither spouse has filed a gift tax return for the applicable year, the consent may be filed late, without any adverse impact.⁵⁰

Planning: A widow has three married children and five grandchildren. Four grandchildren are married. She has remarried and has a sizable estate. She can make annual exclusion gifts of up to \$150,000 to her family, saving estate taxes of \$55,500 to \$90,000 per year.⁵¹ If her new spouse elects to have gifts made by him, the tax savings doubles, without any adverse impact to his tax planning. His estate is unaffected by her gifts of \$300,000 per year.

Planning. The spouses have been married before and both are wealthy. One spouse has 5 potential donees and the other has 9 potential donees. If they both elect gift splitting, each of them can double the non-taxable gift of the other, without any adverse impact to either spouse's estate planning, while saving both families significant estate taxes.

Summary

This article has attempted to demonstrate the significant long term benefits the annual exclusion provides to a client. The next article will focus on other issues and planning opportunities available in using the exclusion.

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⁴⁸ T.R. section 25-2513-2(a). The return must be filed by the donor spouse, even if a gift tax return was not otherwise required (e.g., only annual exclusion gifts were made).

⁴⁹ T.R. section 25-2513-2(a). Because of this rule, consenting spouses should be very careful to assure that the value of the gifts are accurate.

⁵⁰ IRC section 2513(b) and Revenue Ruling 80-224, 1980-2 CB 281. Because of this rule many married taxpayers ignore the filing requirements for gift splitting, assuming that if audited, the returns can be filed later.

⁵¹ \$150,000 times the lowest applicable tax rate (37%) or the highest rate (60%).