

Gifts as a Strategy To Reduce Estate Taxes

In many ways, estate planning is like preparing for battle: If you don't have a well-developed strategy, you are far more likely to suffer losses. What kind of losses? The Internal Revenue Service will win a larger portion of your estate through taxes and less will be available to your children or their heirs. One of the most effective battle strategies against estate taxes is making lifetime gifts.

Part of a gifting strategy includes considering what assets to transfer. Effective estate plans remove the most likely to grow assets from your estate while controlling tax consequences. Here are some factors to consider when preparing your gifting battle plan.

Gift the Right Assets

Certain assets make better gifts than others. In general, you want to make gifts that allow you to remove the most value from your estate at the least tax cost. Here are some assets to consider.

Appreciated property. Property that will appreciate or is likely to have significant growth often makes the best gifts because the future growth is removed from your estate. Consider the nature of the property and current market conditions. Examples of these assets include interests in a closely held business (especially one that might go public or be subject to an attractive buyout), life insurance policies, real estate, publicly traded securities, high-quality artwork and collectibles.

Discounted property. Another asset ideal for gifting is property that for gift tax purposes can be discounted from full market value, because the property includes a minority interest, lacks marketability or includes a restricted use, or a combination of these problems. Property qualifying for these discounts includes:

- Interests in family investment partnerships,

- Interests in family closely held corporations or business partnerships,
- Fractional undivided interests in real estate or works of art,
- Out-of-the-money options, and
- Restricted stock in a publicly traded company.

Income-producing assets. High income-producing assets also are effective gifts. You can shift income to lower-bracket taxpayers through gifts of high-yield stocks and bonds, S corporation stock, and some partnership interests.

Tax Considerations

Through annual exclusion gifts, you can gift up to \$10,000 (\$20,000 if you and your spouse split the gift and indexed for inflation in the future) per recipient free of gift taxes. In addition, under your lifetime gift and estate tax exemption, you can transfer up to \$675,000 free of estate and gift taxes. (This amount will increase until it reaches \$1 million in 2006.) If you have property that appears to be ideal for gifting, consider the following tax ramifications:

Tax basis. Gifts of low tax basis property will shift the capital gain to the recipient. If this is not your desire, you may want to reconsider gifting the property. If you keep the property instead of gifting it, there would likely be a step-up in basis at death.

Special tax breaks. Gifting may help your estate qualify for special tax treatment. Your estate can be structured so that it qualifies for deferred payment of estate taxes, special use valuation or special treatment on redemption of closely held stock. For example, by gifting nonfarm and nonbusiness interests, the ratio of farm and business assets held by your estate can be increased so it qualifies for special tax breaks. On the other hand, gifting may result in your estate losing favorable tax benefits. Making gifts of certain business and farm interests could bring your estate below the required level of ownership for tax breaks.

Conversion of capital gain into ordinary income. Gifting some property may convert capital gain into ordinary income, which is taxed at a higher rate. Selling some assets, such as property that would be inventory for the buyer, would generate capital gain to you but become ordinary income items to the buyer.

Income tax favored property. Income tax favored property is not ideal property for gifting. Generally, retaining assets that have tax advantages, such as tax-free bonds, depreciable real estate, and oil and gas interests, is better.

Tax objectives. Don't lose sight of your tax objectives. For example, a gift of a future interest may be valued at \$10,000, but it doesn't qualify for the gift tax annual exclusion even if it is \$10,000 or less. And, rights of withdrawal gifts (Crummey gifts) that do qualify for the annual exclusion may not qualify for the generation-skipping transfer tax annual exclusion.

Gifts Traps and Nontax Considerations

Here are some nontax considerations to make when creating your gifting strategy:

Liquidity. Keep your estate liquid. Generally, your estate will need assets such as cash and marketable securities to pay obligations, expenses and taxes.

Retained rights or powers. If you retain rights or powers over gifted property, it may be brought back into your estate. Avoid keeping the power to alter, amend, revoke or

terminate. Also, avoid having the gift revert back to you and keeping a lifetime right to use or right to income.

Lifestyle considerations. Don't give away too much. Make sure to retain sufficient assets to maintain your desired lifestyle. Consider your income, expenses, probable future needs and that "something extra" in reserve.

Probate headaches. Give assets now that could create problems for your executor later. Certain assets can be difficult to administer after you're gone. Now might be the time to make a gift of that vacant parcel of land you own in another state, or to divide up your coin or stamp collection or items of jewelry that you no longer use. Interests in closely held businesses also may fall into this category.

Appropriate recipient. Remember who is receiving the gift. Don't make gifts that a recipient cannot handle. Consider age and experience in selecting the gift and determine whether a trust arrangement might be advisable. On the other hand, a gift of a stock portfolio can give a child experience in the stock market, and a gift of an interest in the family business may serve as a good training ground for the greater amount to be inherited.