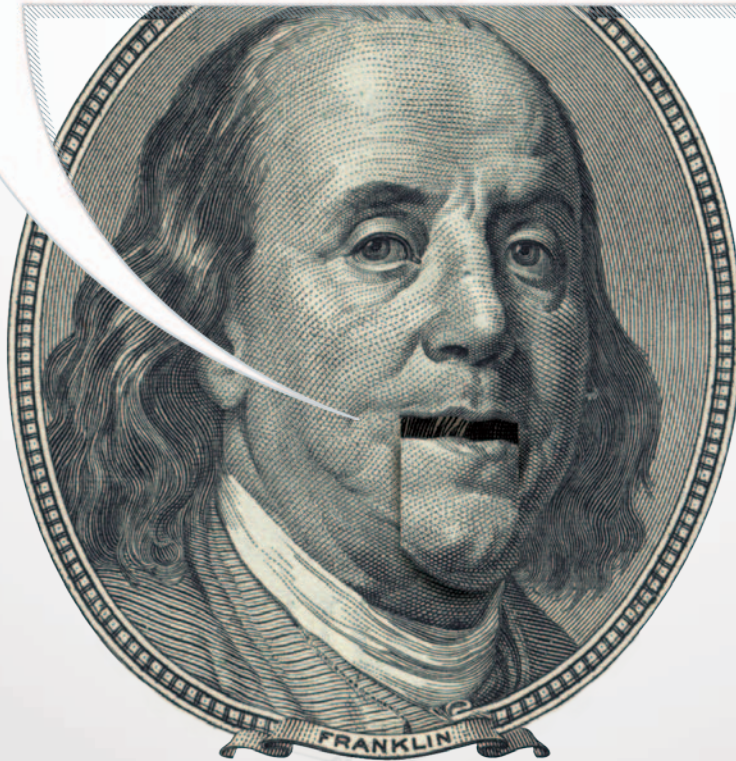


# “GIFT WISELY”

Timing is Everything with Taxation



BY TOM VIRKLER

**I**t would seem a universal truth that it is always better to delay the payment of taxes as long as possible. But this practice is only beneficial when the circumstances under which the tax will eventually be paid bring about the same or better results than if paid now.

So before delaying to avoid taxable gifts, consider the difference between paying federal gift tax now versus paying federal estate tax on the same asset at the time of death.

The administration, application and effect of the two are in fact significantly different. All examples used to demonstrate this will assume fully taxable gifts or bequests in a 50 percent bracket. Currently, the highest gift tax bracket is 35 percent and there is no estate tax, but the likelihood is that even if Congress raises the lifetime gift and/or estate tax credit for years beyond 2010, the highest bracket will not be 35 percent. Some predict it could be 55 percent, the same level that would result if Congress did nothing. We'll use 50 percent to make an illustration of the concepts easier on the brain. We will also use small amounts.

The gift tax is an *exclusive* tax. This means that when the transfer tax is calculated on a taxable gift, the amount that will be used to pay the tax is not included in the calculation. For example, Dad leaves a \$100 taxable gift to his daughter, Sarah. He owes the IRS \$50 (\$100 times the 50 percent gift tax). The total transaction involves \$150 (the \$100 gift and the \$50 tax). Although the gift tax was 50 percent, only 33 percent of the transactional value was actually paid in tax.

However, the estate tax is *inclusive*. The transfer tax calculation at death also includes the amount that will eventually go to the IRS. Assume Dad neither gifts the \$100 nor pays the \$50 gift tax, but leaves the \$150 in his estate for Sarah when he dies. At that time, the full \$150 is in his estate and generates a \$75 tax (\$150 times the 50% estate tax). The tax on the full transactional value of \$150 is a true 50 percent. What could have been a \$100 gift has become after tax a \$75 inheritance. Poor Sarah.

The reason we often advise delaying taxation is that it allows the full use of the money between now and the time the tax will eventually be paid. Sounds good, but the inclusive nature of estate taxation steals the advantage every time. Consider the growth of an after-tax gift versus the pretax gift at the same rate that is then taxed in the estate at the end of the accumulation period at death. (See FIG A.)

Paying the gift tax now always proves numerically more beneficial. No matter what rate of return or time until death is assumed The current tax environment may offer an even better opportunity to take advantage of the exclusive nature of the gift tax. If, whether through the action or inaction of Congress, the highest estate tax bracket starting in 2011 is higher than 35 percent, then the ability to leverage will be even more powerful between now and the bowl games. If dad gives Sarah a \$100 gift today in the real world, he must pay a \$35 gift tax (an effective 25.9 percent tax on the entire transactional value of \$135). If he dies next year with a 55 percent bracket, the \$135 left in his estate will be taxed at a true 55 percent rate, resulting in a tax bill of \$74.25. Sarah as an heir, will receive \$60.75 instead of the \$100 she would have received as a donee. The estate just got hammered! Poorer Sarah, richer IRS!

**Annual Exclusions** – Always use all available annual exclusions. These provide a complete escape from taxation, not just a delay. Take advantage of them every calendar year.

FIG A. - Growth of Taxed Gift vs. Inheritance After Estate Tax

Years until death	\$100 Gift after tax @ 4%	\$150 in the estate @ 4% after 50% estate tax
10	\$148	\$111
20	\$219	\$165
30	\$324	\$244

**Best Use of the Unified Credit:** Conventional wisdom has always been to use the lifetime credit to cover gifts. Depending on your assumptions, it may be more beneficial to pay an exclusive tax on gifts now and use the credit to shelter assets that will be taxed inclusively in the estate. Do the math and see.

**Where are Assets Needed Most?** Tax considerations are not always the most important factor in the planning process. If assets are needed in the estate, they should remain in the estate.

**Psychology, It's All in Your Head!** Some clients just don't want to pay taxes until they must. You've fulfilled your duty by alerting them to the advantages of gifting – there's nothing more you can do for now.

**The Year of Gifting Dangerously Part I:** The possibility of change, even dramatic change, in the tax law is always the dicey element in the planning process and is not unique to this concept. Prepare your client for the unexpected, even the unlikely, especially as we approach the end of 2010 and the sunset provisions of EGTRRA threaten to kick in. If your client has a potentially taxable estate of around \$3.5 million (or \$7 million for married couples), you may want to adopt a wait-and-see attitude as the end of the year nears, poised to make large gifts if Congress permits reinstatement of the \$1 million lifetime credit, but ready to hold back if the credit is raised to an amount that might render the entire estate nontaxable.

**Part II:** Sometime in the future, Congress may even lower tax brackets below current levels or eliminate the transfer tax altogether. Congress' increasing propensity to consider applying tax law changes retroactively should also be considered.

Author Margaret Mitchell wrote only one book, but it was a doozy. *Gone With the Wind* has been in print continuously and has sold consistently since it was published in 1936. Its movie adaptation has achieved more tickets sales than has any other motion picture. Ms. Mitchell once observed, "Death and taxes and childbirth! There's never any convenient time for any of them!" Perhaps, but you can demonstrate to your client that there may be a more convenient time for at least one of them. [INN](#)

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