Sigma Investment Counselors

Sigma Summaries

Vol. 27, No. 9 September 2000

Estate and Gift Taxation

The following Sigma Summary is the second in a series of articles dealing with a broad range of financial and estate planning issues. As we present this information, keep in mind that we are not tax or insurance specialists and we defer to these other professionals when an action step is required. So, why should clients expect that we could add value for them in these areas? The answer is that as we manage our clients' portfolios, we recognize the interdependency among these various disciplines.

For high net worth individuals, the act of giving away a part of one's estate to another individual can often create a tax liability. If the transfer takes place while the person making the gift is living, the transfer is referred to as a "gift" and gift taxes may have to be paid. If the transfer takes place following one's death, the transfer may be subject to estate taxes. In either instance, the marginal tax rate associated with these transfers begin at 37 percent, and can be as high as 55 percent when the size of the taxable estate exceeds $3 million. (Taxable estates greater than $10 million may be subjected to a marginal tax rate greater than 55 percent.) Fortunately, there are ways in which an individual can transfer substantial wealth from his/her estate while eliminating or at least reducing the amount of taxes that must be paid as a result of this transfer. Listed below are several techniques often employed to reduce this liability. Of course, each individual has unique circumstances and one's estate plan should be tailored to these specific circumstances or the individual.

Unlimited Marital Deduction
Assets can be transferred back and forth between spouses without any tax consequences. This tax-free exchange often eliminates the payment of estate taxes on the death of the first spouse.

Lifetime Exemption
Even when the transfer is not between spouses, there are other means by which assets can be transferred from one individual to another tax-free. Under the current tax code, each individual can give away up to $675,000 during his or her lifetime or at death without any estate or gift tax consequences. This amount gradually increases over the next several years. By the year 2006, an individual can transfer up to $1 million during his/her lifetime before applicable gift and/or estate taxes become effective. (See Exhibit A) A married couple through basic estate planning, therefore, is able to transfer out of their combined estate, tax free, assets worth up to $1,350,000 this year and $2 million by the year 2006.

Exhibit A

Year	Lifetime Exemption
2000	$675,000
2001	$675,000
2002	$700,000
2003	$700,000
2004	$850,000
2005	$950,000
2006	$1,000,000

$10,000 Annual Gift Tax Exclusion
In addition to the $675,000 lifetime exemption, an individual is permitted to gift up to $10,000 annually to as many other people as he/she chooses without any gift tax consequences. If the annual gift to any individual exceeds $10,000, then the person making the gift is required to file a

gift tax return and the excess over $10,000 is applied against one's lifetime exemption. Once the lifetime exemption is fully utilized; the transfer tax beginning at 37 percent may apply. As mentioned before, in large estates, this tax can quickly rise to 55 percent.

Medical and Educational Expenses
Finally, you may be able to pay for others' medical and/or educational expenses without gift tax consequences. To qualify, the gift must be made directly to the institution rather than the individual.

Utilizing the Lifetime Exemption
In the case of a married couple, recall that at the death of the first spouse, all of the assets can pass to the surviving spouse tax-free. Recall also that each spouse can gift or bequeath up to $675,000 during their lifetime or at death in 2000 and up to $1 million by the year 2006.

The lifetime exclusion, however, does not occur automatically. Instead, proper estate planning must be in order to execute this transfer of wealth. Otherwise, the assets may simply transfer to the surviving spouse and the deceased spouse's lifetime exemption may be lost and cannot be made up by the surviving spouse.

There are several ways to insure that one's lifetime exemption is fully utilized. For example, an individual may wish to make a present day gift directly to his/her intended beneficiaries (i.e. children and grandchildren) prior to death. This provides the following benefits:

1. Enables one's beneficiaries to enjoy a portion of their "inheritance" early.
2. Reduces the taxable value of the estate.
3. Removes all future appreciation of these assets out of the estate.
4. All else being equal, a "gift" typically results in lower taxes than if these same assets are taxed at prevailing estate tax rates. (See section below titled "Gifting Now Versus Gifting at Death".)

Another method is to gift one's lifetime exemption at one's death. For purposes of discussion, it is assumed that these assets are gifted directly to the intended beneficiaries (i.e. children and/or grandchildren) and not made available to a surviving spouse.

In many instances, a married couple may not wish to make a substantial present day gift nor transfer a significant amount of their estate at the time of death of the first spouse. Rather, they would like to keep all of the assets intact for the benefit of the surviving spouse. Without proper planning, however, the unified credit of $675,000 available to the first spouse may be lost, resulting in higher estate taxes at the death of the second spouse.

Fortunately, when the first spouse dies, an irrevocable bypass trust can be created, typically funded with an amount equal to his/her available unified credit. These assets are recognized as not being part of the taxable estate of the surviving spouse although income generated from the portfolio can be made payable to that spouse. (Under certain conditions, the surviving spouse may be eligible to dip into principal, as well.) At the time of death of the second spouse, the assets of the bypass trust are distributed to the intended beneficiaries but are not subject to estate tax, even if substantial appreciation has occurred.

With married couples, if one of the above strategies is not employed, there stands a good chance that one of the two spouses will lose their ability to transfer their portion of the unified credit amount to intended beneficiaries, tax-free.

Generation Skipping Trusts
Due to the high marginal tax rates on the non-spousal transfer of assets, individuals with substantial net worth may wish to "skip" a generation or two and transfer assets directly to

grandchildren, great grandchildren, etc. In this manner, the property isn't subject to the transfer tax each time it passes through a generation. This can be especially beneficial when the children are expected to have sizable estates of their own, which will also be subjected to significant tax liabilities at their death. While there are limits on the amount of assets that can be "skipped" from transfer taxes, this can be a very effective tool to transfer assets out of large estates, where the objective is to provide for the financial security of multiple generations, and insure that the assets are utilized in a manner consistent with the wishes of the grantor of the trust.

Gifting Now Versus Gifting at Death
There are compelling reasons why individuals may wish to make substantial present day gifts rather than wait until death before these same assets are transferred. (This assumes, of course, that there are sufficient assets to maintain one's desired standard of living and therefore, the assets to be gifted are in excess of this minimum requirement.) One reason is that by making a gift today, all future appreciation (assuming that there is a reasonable probability that the asset will indeed appreciate over time) is also removed from the estate. Over a period of years, this wealth appreciation could be substantial.

Exhibit B		
Present Value of Gift $1,000,000		
Time Horizon	Future Value	Cumulative Appreciation
5 Years	$1,610,510	$610,510
10 Years	$2,593,742	$1,593,742
15 Years	$4,177,248	$3,177,248
20 Years	$6,727,500	$5,727,500

Removing Future Appreciation Out Of Taxable Estate
To better illustrate this point, Exhibit B highlights the future value of a $1 million gift over a 5, 10, 15, and 20-year time horizon, assuming a 10 percent annual rate of return. This appreciation, if left within one's estate, may be taxed at a marginal estate tax bracket as high as 55 percent. Since these assets are deemed to be in excess of one's minimum requirements, the rational is to get both the assets and the anticipated future appreciation of these assets out of the estate before estate taxes erode much of this value. Presumably the assets would be gifted to individuals with a much longer life expectancy and therefore have much longer to appreciate before being taxed.

In the above example, one can see that a $1 million gift grows to $6.7 million over 20 years. If the owner of the assets dies at the end of the twenty-year period, the appreciation of $5.7 would be subjected to estate taxes, presumably at 55 percent, if left in one's estate. Such taxation can be delayed and possibly reduced, by gifting to younger beneficiaries.

Differences Between Estate and Gift Taxation
The second reason one may wish to gift today rather than at death has to do with the manner in which gift and estate taxes are calculated. Recall that gift taxes and estate taxes use the same tax table where the marginal tax rate begins at 37 percent and reaches 55 percent for assets above $3 million. However, even though the tax table is the same for both types of transfers, the manner in which the tax is calculated is different, leading oftentimes to significantly higher estate taxes versus gift taxes, all else being equal.

To better illustrate this point, assume that an individual makes a present day gift of $1 million after fully utilizing his/her lifetime exemption and $10,000 annual exclusion. Let's also assume that the estate is quite large and the marginal transfer tax rate is 55 percent.

When making a gift, the individual making the gift will pay an additional $550,000 gift tax. Therefore, it costs $1,550,000 to make an after-tax gift of $1 million.

Alternatively, let's assume that no gift is made and shortly thereafter, the individual dies. As in the previous example, a marginal tax rate of 55 percent applies. In order to insure that the beneficiary receives $1 million, the taxable estate must have a pre-tax value of $2,222,222. This amount, taxed at a rate of 55 percent, generates $1 million after-tax. (Please see Exhibit C.)

In both circumstances, the intended beneficiary receives $1 million. One can see that all else being equal, an additional tax of $672,000 is required ($1,222,222 less $550,000) if the person making the gift transfers these assets after death rather than before death. Keep in mind that this only applies to very large estates where the lifetime exemption has already been utilized and there are still substantial assets available for gifting purposes.

Exhibit C	
Gift Tax Analysis	
Amount of Present Day Gift	$1,000,000
Gift Tax @ 55 Percent	+ $555,000
Total Outlay	$1,550,000
Estate Tax Analysis	
Amount of Taxable Estate	$2,222,222
Estate Tax @ 55 Percent	-$1,222,222
After-tax Inheritance	$1,000,000

In cases such as this, present day gifting can have a substantial impact in maximizing the amount of after-tax wealth that can be transferred, due to the removal of future appreciation in the estate as well as the more favorable tax treatment applied to a gift.

Last thoughts regarding Gifting

There are many manners in which gifts can be made. Family limited partnerships, LLC's, irrevocable trusts, insurance, and charitable giving are but a few examples. The key is to remember that when a gift is made, the grantor loses some or complete control of these assets. An individual needs to be willing to lose this control before making such a gift. Perhaps of greater importance, one should make sure that his/her personal needs are taken care of first. It is best to assume a long lifetime for planning purposes.

Written by Christopher J. Kress, CFA