Know Tax Angles to Lifetime Gifts

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Due to recent tax law changes, you may want to consider giving generous gifts to other family members. The gifts can reduce the size of your taxable estate. Here is a brief overview of the basic rules.

Annual gift-tax exclusion: Under the annual gift-tax exclusion, you can give away a specified amount each year to a recipient without paying any federal gift tax. The exclusion, which is indexed for inflation, is $13,000 for 2011. For example, you might give up to $13,000 to each of your two children and three grandchildren—a total of $65,000 in gifts—without triggering any gift tax.

Furthermore, the annual gift-tax exclusion is doubled to $26,000 if your spouse joins in the gift-giving. In other words, you might give away $26,000 to each of the five family members, free of gift tax. That totals $130,000 in tax-free gifts. By taking this approach for five years in a row, you can reduce your taxable estate by $650,000.

Cumulative gifts: The amount of any gifts made above the annual gift-tax exclusion may be sheltered by the lifetime gift-tax exemption (although this reduces the available tax shelter for your estate). Prior to the 2010 Tax Relief Act, the estate- and gift-tax systems were severed, with the lifetime gift-tax exemption remaining locked at $1 million. But now the new tax act reunifies the two systems with a maximum exclusion amount of $5 million per person for 2011 and 2012. (The exemptions are also portable between spouses.)

Therefore, going back to our previous example, a married couple could effectively give away up to $10 million over the next two years in addition to the amount covered by the annual gift-tax exclusion (e.g., $650,000 for five years). That provides plenty of flexibility for most families.

Educational and medical gifts: You can pay qualified expenses directly to a medical provider or educational institution on behalf of others without incurring any gift-tax liability. For instance, if your child or grandchild is attending college, pay the youngster’s tuition directly to the school. These gifts do not count against the amounts sheltered from gift tax by the annual gift-tax exclusion.

Note that your family may also save income tax when you give gifts to other family members. Typically, the income subsequently earned from the gifts is taxed to a family member who is in a lower tax bracket than you are. For instance, you might decide to transfer income-producing property to a minor child. However, don't overlook the impact of the "kiddie tax." If a child younger than 19 or a full-time student younger than 24 receives more than $1,900 in unearned income in 2011, the excess is generally taxed at the income tax rate of the child's parents—regardless of the source of the gifts.

As the end of the year approaches, you can set up a gift-giving program to maximize the tax benefits. For example, you can give $13,000 to a family member in December and another $13,000 to the same person in January. Since the gift-tax exclusion is annual, both gifts are sheltered from gift tax.

Whatever you decide to do, coordinate your lifetime gifts as part of an overall estate plan. The estate-tax laws are scheduled to "sunset" after 2012, so check to make sure that your plan is flexible enough to accommodate changes.

Chuck Inderieden, CPA, PFS, Co-Managing Partner of Henry & Horne, possesses an extensive knowledge in estate, gift and trust planning services for individuals, trusts, and small to medium-size businesses. He can be contacted at (480) 483-1170 or ChuckI@hhcpa.com.