Giving to save estate taxes

This year, the federal gift tax applies at the historically low rate of 35%, when lifetime taxable gifts exceed $1 million. Next year, the rate is scheduled to zoom up to 55%, in tandem with the return of the estate tax.

This situation creates an opportunity to "prepay the estate tax," by making substantial taxable gifts this year, locking in the low rates.

Major savings are possible

In fact, the potential for transfer tax savings this year is even larger than it first appears. When the estate tax is calculated, it applies to the payment of the estate tax itself. Not so for the gift tax. An example helps make this clear.

Imagine an individual who is already in the top transfer tax brackets as a result of prior taxable gifts. He or she has $10 million to transfer. A taxable gift of $7,407,407 will trigger a gift tax of $2,592,592 at the 35% tax rate, consuming a total of $9,999,999. In contrast, at the same individual's death next year or later, the estate tax on the $10 million would come to $5.5 million, leaving just $4.5 million for heirs. The gifting approach undertaken this year delivers nearly 65% more financial assets to the heirs.

What's more, a gift in 2010 fixes the value of the transfer, and many asset values currently are depressed. Future appreciation will accrue to the heirs untaxed.

However, for the strategy to work, the donor must survive for three years. Gift taxes paid within three years of death are brought back into the estate, and the estate tax applies in full.

An important caveat

The possibility of a retroactive change to the estate and gift tax later this year cannot be entirely ruled out. Accordingly, for those who are considering major gifts to take advantage of this year's low tax rates, a delay in the completion of the gift until late in the year may be advisable. However, one downside to keep in mind is that it also delays the start of the three-year rule for estate taxation of gift taxes paid.

Will people take advantage of this opportunity to prepay their estate taxes? Only time will tell, but the Congressional Budget Office is optimistic. It projected a record $14 billion in gift tax revenue for 2010, which suggests that taxable gifts could total nearly $50 billion this year.

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