

## Fluid federal estate, gift taxes can pose problems

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By Julian Gray and Frank Petrich

Nothing incites (a correct term, we think) more discussion than taxes, as evidenced by the responses to our last column about the Pennsylvania Inheritance Tax. That's only half the story. Let's take a look at what the IRS imposes on U.S. citizens in the form of federal estate and gift taxes.

Unlike the state tax, which is imposed at death, the federal tax can be levied both during one's lifetime (the gift tax) and at death (the estate tax). However, the two federal taxes are "connected" to a certain extent and are considered separately from the state inheritance tax (although there are some federal tax credits available to a decedent for the payment of the state tax.)

The current federal estate and gift taxes are presumably fixed through Dec. 30, 2012. This is due to the extension of a law enacted during President George W. Bush's administration beginning in 2001 and which was set to expire at the end of 2010. As it stands, Congress implemented an extension (and expansion) of the tax changes.

What does this mean in real numbers to us? First, let's review the very basics, keeping in mind that these taxes are also in addition to individual income taxes paid annually during one's lifetime.

**The federal estate tax:** This tax (which had been paid by fewer than 2 percent of all estates) is levied by the IRS on the value of assets transferred from the taxable estate of a deceased person to another party. There are certain exemptions from this tax, such as transfers to a spouse or to a charitable organization. If not exempt, assets are taxed at a marginal rate, currently topping out at 35 percent. Yes, that's 35 cents on every dollar transferred to children, grandchildren, etc.

However, there is some good news. Currently, an individual's first \$5 million is not taxed. At first, this might seem as though the tax is reserved for quite wealthy folks, as many of us would only hope to have such assets to pass on to our heirs. Yet, this significant exclusion is only temporary through the end of 2012. In fact, had Congress not changed the previous law, the exclusion would have "sunset" (reverted) to its previous level of only \$1 million on Jan. 1, 2011. As it sits now, the law will cause the lifetime exclusion to revert back to \$1 million on Jan. 1, 2013. And, to make matters worse, the top marginal estate tax rate will revert back to 55 percent. (That makes the current top rate of 35 percent look a little better.)

While no one has a crystal ball to determine if Congress will act before the end of next year to address this change, given the current state of our economy (and our Congress) and the need for raising revenue, many experts say the \$5 million lifetime exclusion will again be a difficult issue with which to deal especially since Congress will need to take up this issue just about the time when we will be electing a new president and Congress. For the sake of discussion, let's examine what a reversion back to the \$1 million exclusion amount may do to the average citizen.

Let's say Nancy Smith, a retired public-school teacher, owns her home worth \$150,000. In addition she has savings and investments of \$150,000 and an IRA worth \$300,000. She had also purchased a \$500,000 life insurance policy payable to her children at death. From an estate tax perspective, upon her death, these assets would be countable in her estate at a value of \$1.1 million and taxed accordingly. If the law reverts to a \$1 million exclusion that leaves \$100,000 exposed to a 55 percent tax (we're assuming no deductions). So, Nancy's estate will owe \$55,000 in federal estate taxes (and this is independent of any income taxes owed on her IRA as it is distributed in the future).

You may think, "Wait a minute, my life insurance agent said life insurance is not taxable." This is correct as life insurance proceeds are exempt from state and federal income tax and Pennsylvania Inheritance Tax, but not federal estate tax if the policy is owned by the decedent at death. Think also how many younger individuals may have a relatively inexpensive term insurance policy with a \$1 million death benefit.

So, why can't I just give my stuff away before I die? Well, the IRS has thought of everything -- almost. Let's look at the gift tax to see why.

**The federal gift tax:** The gift tax is imposed upon completed transfers (gifts) during one's lifetime. The federal estate and gift tax deductions are unified, so that if Nancy Smith gives away \$250,000 during her lifetime, she has used 25 percent of her lifetime \$1 million exclusion, and at her death she will have only a \$750,000 credit remaining. There is also an available annual exclusion amount that increases the lifetime exclusion. Currently, a U. S. citizen can give away \$13,000 each calendar year to as many people as he/she wishes without using up any of her/his lifetime exclusion. So, if Nancy gave away 10 checks of \$13,000 each, totaling \$130,000 during her lifetime, she would still have a \$1 million exclusion at death

resulting in an overall tax-free transfer of \$1,130,000. Remember, however, once she gives away whatever she decides to give away, she has lost control over those assets, which she may need at some future time.

While this example is a simplification of a very complex tax, it illustrates the value of understanding the federal estate and gift tax rules and the need to investigate options prior to death with qualified legal and tax advisers, as there are numerous planning techniques available to minimize this tax exposure.

It will certainly be interesting to see how Congress acts (or refrains from acting) in the next year in dealing with this tax and the uncertainties Congress has presented to those trying to plan their financial futures.

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