Executive summary. Under federal gift and estate tax rules, individuals can potentially make significant gifts that are exempt from federal transfer tax. The American Taxpayer Relief Act of 2012 (ATRA) made this opportunity permanent, by exempting $5.25 million from the gift tax for gifts made in 2013. By making a gift while living, donors may reduce their future estate tax exposure not only by the amount of the gift but also on the future appreciation of that gift. Additionally, ATRA made portability of the exemption permanent, in many cases allowing a surviving spouse to use the unused exemption of a deceased spouse.¹ Under current rules, portability would push the lifetime exemption to $10.5 million for a married couple. Given the new tax laws, individuals would be wise to consider maximizing the gift tax exemption available while also maintaining sufficient assets to use during retirement years. It is also important for those who have an existing estate plan to review it regularly in light of any changes in personal circumstances or law.

¹ Portability may be subject to certain limitations and does not apply to the generation-skipping transfer tax (GST). The GST may apply to gifts during life or transfers occurring at death made to “skip persons”—persons two or more generations below that of the donor. A discussion of the GST is beyond the scope of this paper.
The purpose of this paper is to review opportunities for gifting under current federal gift and estate tax rules. Through careful gift and estate planning, individuals can maximize their available gift tax exemption while also maintaining sufficient assets for their retirement years. Although we focus on the gift and estate tax exemption, lifetime gifting can be appropriate for those with varying levels of net worth, depending on their estate planning goals and objectives, financial circumstances, and tolerance for complexity, as well as federal and state tax laws. Of course, an estate planning attorney should be consulted to advise on each particular situation. This paper is not intended to and does not constitute legal or tax advice, and it cannot be used for the purpose of avoiding tax penalties that may be imposed under the Internal Revenue Code.

How the gift and estate tax rules are applied

The federal gift tax applies to a donor whenever a transfer of property by gift is made, unless certain exclusions apply. The tax does not apply to certain gifts, such as charitable gifts that, if qualified, may also be tax-deductible for income tax purposes. The federal estate tax is a tax imposed on the transfer of assets (the “taxable estate”) of a deceased person. In estate planning, it is wise to consider these two taxes together, because the amounts exempted from them are “unified”: To the extent someone uses the gift tax exemption during life, he or she reduces virtually dollar-for-dollar his or her available estate tax exemption at death.

The lifetime exemption from the federal gift tax has never been higher. Currently, donors do not owe this tax as long as the total value of their gifts is less than or equal to $5.25 million (see Figure 1). Amounts given above that level are subject to transfer tax at the highest marginal transfer tax rate, after certain exclusions are made.

Additionally, ATRA preserved the ability of married couples to combine the exemptions of both spouses if one spouse passes away without fully using his or her exemption—a feature known as “portability.”

**Figure 1.** Current gift and estate tax exemptions and rates

<table>
<thead>
<tr>
<th>Year</th>
<th>Gift tax exemption</th>
<th>Gift tax maximum rate</th>
<th>Estate tax exemption</th>
<th>Estate tax maximum rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>$5.12 million</td>
<td>35%</td>
<td>$5.12 million</td>
<td>35%</td>
</tr>
<tr>
<td>2013</td>
<td>$5.25 million</td>
<td>40%</td>
<td>$5.25 million</td>
<td>40%</td>
</tr>
</tbody>
</table>

Source: Internal Revenue Service.

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2 Please note that state tax laws may differ from federal laws. This note focuses on federal gift and estate tax law and does not take into account state rules, which may vary by state.

3 The highest marginal transfer tax rate is currently 40%.
Essentially, if the election is timely made, a surviving spouse can use the unused exemption of his or her last deceased spouse. Under current rules, portability would push the lifetime exemption to $10.5 million.

Figure 2 illustrates portability between spouses. Suppose a husband dies in January 2013 and is survived by his wife. He has used $2 million of his $5.25 million estate tax exemption. Upon the wife’s subsequent death or during her lifetime, she has a total gift and estate tax exemption of $8.5 million (her $5.25 million plus $3.25 million, the unused portion of her husband’s exemption).

A few more important points:

- Individuals can make gifts of up to $14,000 per recipient per year without affecting their federal gift tax or estate tax exemption. This amount is indexed for inflation, in $1,000 increments. Amounts over $14,000 per year may incur gift tax unless the donor has an exemption available.

- Payments of qualifying medical or tuition expenses (for example, payment of someone else’s hospital bill or college tuition) are not subject to the gift tax and do not affect the federal exemption amount as long as they are made directly to the provider.

- Unlimited tax-free gifts to a spouse can be made for any purpose. Certain limitations may apply if the spouse is not a U.S. citizen.

The impact of gifting during one’s lifetime

The potential impact of the gift and estate tax rules can be shown in a very simple example. We emphasize that this example is hypothetical only; an estate planning attorney should be consulted to consider personal circumstances.

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4 As mentioned, portability may be subject to certain limitations. It must be affirmatively elected by the deceased spouse’s executor on his or her estate tax return. It is important to stress that portability applies only to the unified gift and estate tax exemption amount—it does not apply to any unused generation-skipping transfer tax. Loss of portability from the estate of a first spouse is possible if the surviving spouse remarries. Individuals should consult their estate planning attorney to discuss use of a deceased spouse’s exemption.

5 See also “Trusts and other gifting options” on page 5.
a. Net assets to heirs from gift to trust

1. Amount of gift in 2013 $5,250,000
2. Ten years of growth at 5% $3,301,697
3. Value in 2023 (1 + 2) $8,551,697

Net assets to heirs $8,551,697

b. Net assets to heirs from amount not gifted to trust

(a) Amount not gifted $4,750,000
(b) Ten years of growth at 5% $2,185,553
(c) Ten years of spending $250,000 per year $2,500,000
(d) Value in 2023 (a + b – c) $4,435,553
(e) Adjusted taxable estate (d) $4,435,553
(f) Adjusted taxable gifts made $5,250,000
(g) Tentative tax base (e + f) $9,685,553
(h) Tentative tax (g x 40%) $3,874,221
(i) Gift tax paid $0
(j) Applicable exclusion amount $5,250,000
(k) Unified credit (see notes) $2,045,800
(l) Net federal estate tax (h – k) $1,828,421

Net assets to heirs (d – l) $2,607,132

Total to heirs under Option A: $8,551,697 + $2,607,132 = $11,158,829

Notes: This hypothetical example is provided for the purpose of illustration only. It makes the following assumptions:

- A single individual with total net worth of $10 million.
- A growth rate of 5% per year.
- Personal spending at $250,000 per year.

(g) The tentative tax base equals the amount of the adjusted taxable estate plus the taxable gift of $5.25 million that was assumed.

(h) The tentative tax equals the tentative tax base times the applicable marginal transfer tax rate. For the purpose of illustration only, we calculate the transfer tax rate at a flat rate of 40%.

(i) For 2013, individuals do not owe federal gift tax as long as the total value of their gifts is less than $5.25 million.

(j) This example assumes an applicable exclusion amount of $5.25 million, the current exclusion amount for 2013. It should be noted that if the estate tax exemption is lower at the time of the grantor’s death, the lower exemption could potentially lessen the advantages of lifetime gift-giving. This issue, known as “clawback,” is beyond the scope of this paper.

(k) A credit is an amount that reduces or eliminates tax. The unified credit equals the tax on the applicable exclusion amount. This example assumes a unified credit of $2,045,800 for 2013 (exempting $5.25 million from tax).

(l) Net federal estate tax is calculated by subtracting the unified credit from the tentative tax, as per IRS Publication 950 (October 2011).

This example also assumes no additional taxable gifts that use the donor’s exemption are made by the individual during his or her lifetime, no administrative expenses, no debts of decedent, and no other deductions or credits are available to the estate. Finally, this example assumes no personal income tax and no state death tax implications.

Note that personal income tax may be due on appreciation on trust assets when they are withdrawn (Option A), whereas if no gift is made, assets to heirs may be subject to a step-up in basis for tax purposes (Option B, as shown in Figure 5).

Source: Vanguard.

Now suppose the individual passes away in ten years, in 2023. Figure 4 shows the potential amount of transfer tax he or she may have saved by making the gift of $5.25 million to a trust in 2013.

Under Option A, as shown in Figure 4a, if the gift appreciates in value tax-free inside the trust for ten years at a rate of 5% per year, then its value will total $8,551,697 in 2023 (the $5.25 million gift plus appreciation of $3,301,697). To calculate the total value that passes to heirs in Option A, we add the 2023 trust value to the net assets remaining from the $4.75 million the individual retained after making the lifetime gift in 2013. Figure 4b shows the $4.75 million adjusted for 5% annual growth and spending at a rate of $250,000 per year, after factoring in estate tax. After estate taxes of $1,828,421 are paid on the $4.75 million not gifted, an additional $2,607,132 will
be distributed to the heirs (net assets to heirs, as shown in Figure 4b). The total to heirs under Option A would thus be $11,158,829: the $8,551,697 from the trust (as shown in Figure 4a) plus $2,607,132 remaining from the $4.75 million that was not gifted to the trust (as shown in Figure 4b).

Under Option B, as shown in Figure 5, we suppose that the full $10 million is retained and no gift is made. The value of the $10 million grows at 5% per year for ten years, and the individual also spends $250,000 per year. At his or her death, the effects of the estate tax exclusion of $5.25 million are applied, and $3,149,100 is due in federal estate taxes. Thus, the total amount to heirs under Option B is $9,838,149.

In comparing these two hypothetical options (see Figure 6), we find that the individual is able to transfer a larger amount to his or her heirs by maximizing the lifetime exemption and gifting in 2013 to a trust, thus removing the appreciation on gifted assets from the taxable estate.

Note that the total available to heirs can change if the amount of the gift and estate tax exclusions changes and if transfer tax rates change. The outcome of either scenario can also be affected by the donor’s expected longevity, his or her personal spending patterns, and changes in the expected growth rate. If the individual is expected to live for a great while longer, he or she may want to consider whether there will be enough remaining assets from which to spend during his or her lifetime.

Finally, this example does not take into account personal income tax, which may also affect the final total to heirs. For example, there may be capital gains tax on the appreciation on trust assets when they are withdrawn (under Option A), whereas if no gift is made, assets to heirs may be subject to a step-up in basis for tax purposes (under Option B). The effects of personal income tax could make the total to heirs under Option A lower than that under Option B. These are all issues to review with an estate planning attorney.

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**Figure 5. Option B. No gift made**

<table>
<thead>
<tr>
<th>Net assets to heirs</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Total net worth in 2013</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>2. Ten years of growth at 5%</td>
<td>$5,487,249</td>
</tr>
<tr>
<td>3. Ten years of spending $250,000 per year</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>4. Value in 2023 (1 + 2 – 3)</td>
<td>$12,987,249</td>
</tr>
<tr>
<td>5. Adjusted taxable estate</td>
<td>$12,987,249</td>
</tr>
<tr>
<td>6. Tentative tax base</td>
<td>$12,987,249</td>
</tr>
<tr>
<td>7. Tentative tax (6 x 40%)</td>
<td>$5,194,900</td>
</tr>
<tr>
<td>8. Gift tax paid</td>
<td>Not applicable</td>
</tr>
<tr>
<td>9. Applicable exclusion amount</td>
<td>Not applicable</td>
</tr>
<tr>
<td>10. Unified credit (see Note (k) below Figure 4)</td>
<td>$2,045,800</td>
</tr>
<tr>
<td>11. Net federal estate tax (7 – 10)</td>
<td>$3,149,100</td>
</tr>
<tr>
<td>12. Net assets to heirs (4 – 11)</td>
<td>$9,838,149</td>
</tr>
</tbody>
</table>

Total to heirs under Option B: $9,838,149

Source: Vanguard.

**Figure 6. Hypothetical comparison of gift made to trust versus no gift made**

<table>
<thead>
<tr>
<th>Total to heirs</th>
<th>Option A: Gift made to trust</th>
<th>Option B: No gift made</th>
</tr>
</thead>
<tbody>
<tr>
<td>$11,158,829</td>
<td>$9,838,149</td>
<td></td>
</tr>
</tbody>
</table>

Difference between A and B: $1,320,680

Source: Vanguard.

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**Trusts and other gifting options**

Many planning techniques could potentially make use of all or a portion of the gift tax exemption. Although gifts can be made outright to a beneficiary, many high-net-worth individuals use irrevocable trusts in gift planning to maximize the use of their gift tax exemptions. Generally, there are two main reasons why they may wish to consider this: (1) to endeavor to protect the assets (and the appreciation on those assets) from a beneficiary’s future creditors, and (2) to attempt to minimize, if not eliminate, the amount of gift, estate, and generation-skipping transfer taxes a family would have to pay on these assets.

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6 As noted earlier, discussion of the GST is beyond the scope of this paper.
Generally, irrevocable trusts may be designed to be as flexible or restrictive as desired and may last for the lifetime of a beneficiary or some shorter period.

For example, individuals may use what are known as Generation-Skipping Transfer Trusts (also referred to as Dynasty Trusts), which are designed to last for multiple generations. Depending on the tax laws in place, assets in a Generation-Skipping Transfer Trust may potentially be shielded from future gift, estate, and generation-skipping transfer tax for many generations, possibly in perpetuity.

Another option is a Spousal Lifetime Access Trust (also referred to as a SLAT), in which the spouse is a permissible beneficiary, meaning that the assets or income from the trust could be paid to the spouse. This trust could be considered if there are concerns about a spouse having sufficient assets for the remainder of his or her lifetime, or if there is a desire to possibly alter the ultimate disposition of the trust assets. Upon the spouse’s death, the trust may continue for the benefit of the descendants, similar to a Dynasty Trust.

Other reasons families consider making gifts to irrevocable trusts may include:

- To attempt to direct the financial management of the assets, especially if the beneficiary does not have the experience or desire to manage them;
- To delay the beneficiary’s full access to and control of a large inheritance; and
- To try to preserve assets for future generations rather than give them to beneficiaries whom the original donor would not have included in the bequest.

Individuals should speak with their estate planning attorney to discuss the many possible alternatives for making lifetime gifts. The appropriateness of any given technique depends on the donor’s estate planning goals, personal circumstances, and tolerance for complexity, as well as federal and state tax laws.

Key considerations in lifetime gifting

Several factors should be evaluated before using the gift tax exemption:

- Estate planning goals.
- Size of estate/net worth.
- Personal spending patterns.
- Age and expected longevity.
- Comfort level with the amount gifted.
- Available estate planning techniques, preferred method of gifting, and tolerance for complexity.

In addition, donors should remember to review their estate plan regularly to monitor changes in personal circumstances as well as in federal and state tax laws. Finally, they must keep in mind that unless certain types of trusts are used, in order for a gift to be exempted from federal transfer tax, the donor generally must have given up ownership completely and retain no interest in the gift.

Definitions:

- **Trustee**: A person or entity with the responsibility of managing property held in a trust.
- **Beneficiary**: The person or entity who is to receive assets or profits from a trust.
- **Donor**: The party who transfers property or a gift to another.
- **Irrevocable trust**: A trust that cannot be amended or revoked by its creator.
- **Completed gift**: A gift of which the owner has completely given up ownership (i.e., dominion and control) and in which he or she generally retains no interest.
Conclusion

Federal gift and estate tax rules can allow individuals to make significant gifts that are exempt from federal transfer tax. By making lifetime gifts, donors can potentially reduce their future estate tax exposure not only by the amount of the gift, but also on its future appreciation. Those with significant assets may consider whether they wish to maximize the use of their gift tax exemption while also maintaining sufficient assets to use during their retirement years. Because portability of the exemption is now permanent, a surviving spouse may be able to use the unused exemption of his or her deceased spouse.

Several estate planning techniques, including various trusts, can potentially be used to gift to future generations. These options should be evaluated in light of the donor’s estate planning goals, estate size, personal spending patterns, age and expected longevity, comfort level with the amount gifted, preferred method for gifting, and tolerance for complexity. In consultation with their attorney, individuals should review their estate plan regularly to monitor changes in their personal circumstances as well as in federal and state tax laws.
This information does not constitute legal or tax advice. We recommend that you consult a tax professional about your individual situation.