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# Introduction to Estate and Gift Taxes



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## Introduction

If you give someone money or property during your life, you may be subject to federal gift tax. The money and property you own when you die (your estate) may be subject to federal estate tax. The purpose of this publication is to give you a general understanding of when these taxes apply and when they do not. It explains how much money or property you can give away during your lifetime or leave to your heirs at your death before any tax will be owed.

**No tax owed.** Most gifts are not subject to the gift tax and most estates are not subject to the estate tax. For example, there is usually no tax if you make a gift to your spouse or if your estate goes to your spouse at your death. If you make a gift to someone else, the gift tax does not apply until the value of the gifts you give that person exceeds the annual exclusion for the year. See *Annual exclusion* under *Gift Tax*, on page 4.

Even if tax applies to your gifts or your estate, it may be eliminated by the unified credit, discussed later.

**No return needed.** Gift tax returns are filed annually. However, you do not need to file a gift tax return unless you give someone, other than your spouse, money or property worth more than the annual exclusion (discussed on page 4) for that year. An estate tax return generally will not be needed unless the estate is worth more than the applicable exclusion amount for the year of death. This amount is shown in the table under *Unified Credit (Applicable Exclusion Amount)*, on page 3.

**No tax on the person receiving your gift or estate.** The person who receives your gift or your estate will not have to pay any federal gift tax or estate tax because of it. Also, that person will not have to pay income tax on the value of the gift or inheritance received.

**No income tax deduction.** Making a gift or leaving your estate to your heirs does not ordinarily affect your federal income tax. You cannot deduct the value of gifts you make (other than gifts that are deductible charitable contributions).

**What this publication contains.** If you are not sure whether the gift tax or the estate tax applies to your situation, the rest of this publication may help you. It explains in general terms:

- When tax is not owed because of the unified credit,
- When the gift tax does and does not apply,
- When the estate tax does and does not apply, and
- When to file a return for the gift tax or the estate tax.

This publication does not contain any information about state or local taxes. That information should be available from your local taxing authority.

**Where to find out more.** This publication does not contain all the rules and exceptions for federal estate and gift taxes. It does not contain the rules that apply to nonresident aliens. If you need more information, see the following forms and their instructions:

- Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and
- Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.

To order these forms, call 1-800-TAX-FORMS (1-800-829-3676). If you have access to TTY/TDD equipment, you can call 1-800-829-4059. To get these forms with your personal computer or by fax, see the first page of this publication.

## Unified Credit (Applicable Exclusion Amount)

A credit is an amount that eliminates or reduces tax. A unified credit applies to both the gift tax and the estate tax. You must subtract the unified credit from any gift tax that you owe. Any unified credit you use against your gift tax in one year reduces the amount of credit that you can use against your gift tax in a later year. The total amount used during life against your gift tax reduces the credit available to use against your estate tax.

Under prior law, the same unified credit amount applied to both the gift tax and the estate tax. Under current law, however, the unified credit against taxable gifts will remain at \$345,800 (exempting \$1 million from tax) through 2009, while the unified credit against estate tax increases during the same period. The following table shows the unified credit and applicable exclusion amount for the calendar years in which a gift is made or a decedent dies after 2003.

Year	For Gift Tax Purposes:		For Estate Tax Purposes:	
	Unified Credit	Applicable Exclusion Amount	Unified Credit	Applicable Exclusion Amount
2004 and 2005	345,800	1,000,000	555,800	1,500,000
2006, 2007, and 2008	345,800	1,000,000	780,800	2,000,000
2009	345,800	1,000,000	1,455,800	3,500,000

For examples of how the credit works, see *Applying the Unified Credit to Gift Tax* and *Applying the Unified Credit to Estate Tax*, later.

## Gift Tax

The gift tax applies to the transfer by gift of any property. You make a gift if you give property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If you sell something at less than its full value or if you make an interest-free or reduced interest loan, you may be making a gift.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule.

Generally, the following gifts are not taxable gifts:

- Gifts that are not more than the annual exclusion for the calendar year,
- Tuition or medical expenses you pay directly to a medical or educational institution for someone,
- Gifts to your spouse,
- Gifts to a political organization for its use, and
- Gifts to charities.

**Annual exclusion.** A separate annual exclusion applies to each person to whom you make a gift. For 2004, the annual exclusion is \$11,000. Therefore, you generally can give up to \$11,000 each to any number of people in 2004 and none of the gifts will be taxable.

If you are married, both you and your spouse can separately give up to \$11,000 to the same person in 2004 without making a taxable gift. If one of you gives more than \$11,000 to a person in 2004, see *Gift Splitting*, later.

**Inflation adjustment.** After 2004, the \$11,000 annual exclusion may be increased due to a cost-of-living adjustment. See the instructions for Form 709 for the amount of the annual exclusion for the year you make the gift.

**Example 1.** In 2004, you give your niece a cash gift of \$8,000. It is your only gift to her this year. The gift is not a taxable gift because it is not more than the \$11,000 annual exclusion.

**Example 2.** You pay the \$15,000 college tuition of your friend. Because the payment qualifies for the educational exclusion, the gift is not a taxable gift.

**Example 3.** In 2004, you give \$25,000 to your 25-year-old daughter. The first \$11,000 of your gift is not subject to the gift tax because of the annual exclusion. The remaining \$14,000 is a taxable gift. As explained later under *Applying the Unified Credit to Gift Tax*, you may not have to pay the gift tax on the remaining \$14,000. However, you do have to file a gift tax return.

**More information.** See Form 709 and its instructions for more information about taxable gifts.

## Gift Splitting

If you or your spouse make a gift to a third party, the gift can be considered as made one-half by you and one-half by your spouse. This is known as gift splitting. Both of you must consent (agree) to split the gift. If you do, you each can take the annual exclusion for your part of the gift.

In 2004, gift splitting allows married couples to give up to \$22,000 to a person without making a taxable gift.

If you split a gift you made, you must file a gift tax return to show that you and your spouse agree to use gift splitting. You must file a Form 709 even if half of the split gift is less than the annual exclusion.

**Example.** Harold and his wife, Helen, agree to split the gifts that they made during 2004. Harold gives his nephew, George, \$21,000, and Helen gives her niece, Gina, \$18,000. Although each gift is more than the annual exclusion (\$11,000), by gift splitting they can make these gifts without making a taxable gift.

Harold's gift to George is treated as one-half (\$10,500) from Harold and one-half (\$10,500) from Helen. Helen's gift to Gina is also treated as one-half (\$9,000) from Helen and one-half (\$9,000) from Harold. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift. However, each of them must file a gift tax return.

## Applying the Unified Credit to Gift Tax

After you determine which of your gifts are taxable, you figure the amount of gift tax on the total taxable gifts and apply your unified credit for the year.

**Example.** In 2004, you give your niece, Mary, a cash gift of \$8,000. It is your only gift to her this year. You pay the \$15,000 college tuition of your friend, David. You give your 25-year-old daughter, Lisa, \$25,000. You also give your 27-year-old son, Ken, \$25,000. Before 2004, you had never given a taxable gift. You apply the exceptions to the gift tax and the unified credit as follows:

1. Apply the educational exclusion. Payment of tuition expenses is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.
2. Apply the annual exclusion. The first \$11,000 you give someone during 2004 is not a taxable gift. Therefore, your \$8,000 gift to Mary, the first \$11,000 of your gift to Lisa, and the first \$11,000 of your gift to Ken are not taxable gifts.
3. Apply the unified credit. The gift tax on \$28,000 (\$14,000 remaining from your gift to Lisa plus \$14,000 remaining from your gift to Ken) is \$5,560. You subtract the \$5,560 from your unified credit of

\$345,800 for 2004. The unified credit that you can use against the gift tax in a later year is \$340,240.

You do not have to pay any gift tax for 2004. However, you do have to file Form 709.

## Filing a Gift Tax Return

Generally, you must file a gift tax return on Form 709 if any of the following apply.

- You gave gifts to at least one person (other than your spouse) that are more than the annual exclusion for the year.
- You and your spouse are splitting a gift.
- You gave someone (other than your spouse) a gift that he or she cannot actually possess, enjoy, or receive income from until some time in the future.
- You gave your spouse an interest in property that will be ended by some future event.

You do not have to file a gift tax return to report gifts to (or for the use of) political organizations and gifts made by paying someone's tuition or medical expenses.

You also do not need to report the following deductible gifts made to charities:

- Your entire interest in property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use; or
- A qualified conservation contribution that is a restriction (granted forever) on the use of real property.

**More information.** If you need to file a gift tax return, you should see Form 709 and its instructions.

## Estate Tax

Estate tax may apply to your taxable estate at your death. Your taxable estate is your gross estate less allowable deductions.

### Gross Estate

Your gross estate includes the value of all property in which you had an interest at the time of death. Your gross estate also will include the following:

- Life insurance proceeds payable to your estate or, if you owned the policy, to your heirs;
- The value of certain annuities payable to your estate or your heirs; and
- The value of certain property you transferred within 3 years before your death.

## **Taxable Estate**

The allowable deductions used in determining your taxable estate include:

- Funeral expenses paid out of your estate,
- Debts you owed at the time of death, and
- The marital deduction (generally, the value of the property that passes from your estate to your surviving spouse).

**More information.** For more information on what is included in your gross estate and the allowable deductions, see Form 706 and its instructions.

## **Applying the Unified Credit to Estate Tax**

Basically, any unified credit not used to eliminate gift tax can be used to eliminate or reduce estate tax. However, to determine the unified credit used against the estate tax, you must complete Form 706.

## **Filing an Estate Tax Return**

An estate tax return, Form 706, must be filed if the gross estate, plus any adjusted taxable gifts and specific gift tax exemption, is more than the filing requirement for the year of death.

Adjusted taxable gifts is the total of the taxable gifts you made after 1976 that are not included in your gross estate. The specific gift tax exemption applies only to gifts made after September 8, 1976, and before 1977.

**Filing requirement.** The following table lists the filing requirement for the estate of a decedent dying after 2003.

<b>Year of Death:</b>	<b>Filing Requirement:</b>
2004 and 2005 . . . . .	1,500,000
2006, 2007, and 2008 . . . . .	2,000,000
2009 . . . . .	3,500,000

**More information.** If you think you will have an estate on which tax must be paid, or if your estate will have to file an estate tax return even if no tax will be due, see Form 706 and its instructions for more information. You (or your estate) may want to get a qualified estate tax professional to help with estate tax questions.