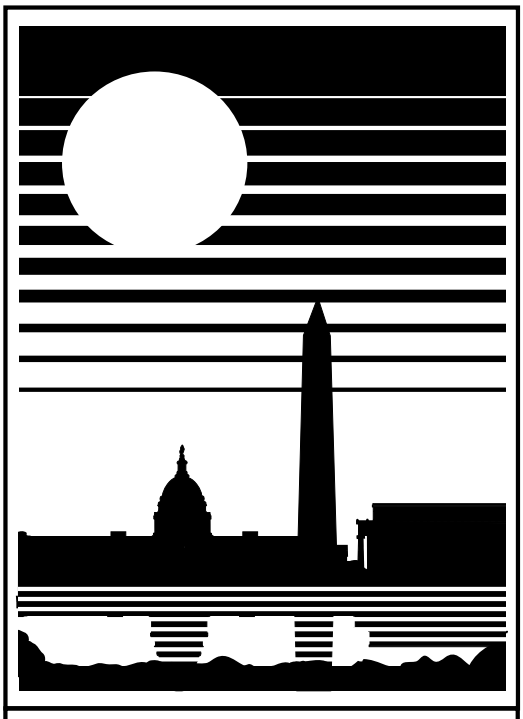
Department of the Treasury
Internal Revenue Service

Publication 950
(Rev. June 1997)
Cat. No. 14447X

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 to the first $10,000 you give that person each year.

Even if tax applies to your gifts or your estate, it may be eliminated by the unified credit. This credit eliminates any tax on the first $600,000 of your lifetime taxable gifts or your taxable estate.

No return needed. Generally, you do not need to file a gift tax return unless you give someone, other than your spouse, money or property worth more than $10,000 during a year. An estate tax return generally will not be needed unless your estate is worth more than $600,000.

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 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. If you need more information, see the following forms and their instructions:

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

- **Form 709-A,** United States Short Form Gift Tax Return

To order these forms, call 1–800–TAX–FORM (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

A credit is an amount that eliminates or reduces tax. You are automatically given a unified credit of $192,800 to use over your lifetime. You subtract the unified credit from any gift tax that you owe. If you do not use the entire $192,800 to eliminate the gift tax, your estate can use the rest to eliminate or reduce estate tax.

Credit's effect. The credit of $192,800 eliminates taxes on a total of $600,000 of taxable gifts and taxable estate.

You use the credit to eliminate gift tax on up to $600,000 of taxable gifts you give during your lifetime. If you give less than $600,000 of taxable gifts during your lifetime, any remaining credit is used to eliminate or reduce tax that may be owed on your taxable estate.

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:

1) The first $10,000 you give someone during a calendar year (the annual exclusion),
2) Tuition or medical expenses you pay for someone (the tuition and educational exclusions),
3) Gifts to your spouse,
4) Gifts to a political organization for its use, and
5) Gifts to charities.

The annual exclusion. A separate $10,000 annual exclusion applies to each person to whom you make a gift. Therefore, you generally can give up to $10,000 each to any number of people each year and none of the gifts will be taxable.

If you are married, both you and your spouse can separately give up to $10,000 to the same person each year without making a taxable gift. If one of you gives more than $10,000 to the same person during a year, see *Gift Splitting,* later.

Example 1. 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 $10,000 annual exclusion.

Example 2. You pay the $11,000 college tuition of your friend. Because the payment qualifies for the tuition exclusion, the gift is not a taxable gift.

Example 3. You give $25,000 to your 25-year-old daughter. The first $10,000 of your gift is not subject to the gift tax because of the $10,000 annual exclusion. The remaining $15,000 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 $15,000. However, you do have to file a gift tax return.

More information. Get 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 $10,000 annual exclusion for your part of the gift.

Gift splitting allows married couples to give up to $20,000 to the same person annually, without making a taxable gift.

If you split a gift you made, you must file a gift tax return to show that you both agree to use gift splitting. You must file a return even if half of the split gift is less than $10,000. If you split a gift, see the instructions for either Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* or Form 709–A, *United States Short Form Gift Tax Return.*

Example 4. Harold and his wife, Helen, agree to use gift splitting so that each of them can give more than $10,000 during the year without making a taxable gift. Harold gives his nephew, George, $17,000, and Helen gives her niece, Gina, $12,000. Although each gift is more than $10,000, by gift splitting they can make these gifts without making a taxable gift.

Harold's gift to George is treated as one-half ($8,500) from Harold and one-half ($8,500) from Helen. Helen's gift to Gina is also treated as one-half ($6,000) from Helen and one-half ($6,000) from Harold. In each case, because one-half of the split gift is not more than the $10,000 annual exclusion, it is not a taxable gift.

Applying the Unified Credit to Gift Tax

As stated earlier, the unified credit eliminates the gift tax on the first $600,000 of taxable gifts you make during your lifetime.

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 of $192,800.

Example 5. You give your niece, Mary, a cash gift of $8,000. It is your only gift to her this year. You pay the $11,000 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 this year, 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 is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.
2) Apply the $10,000 annual exclusion. The first $10,000 you give someone during a year is not a taxable gift. Therefore, your $8,000 gift to Mary, the first $10,000 of your gift to Lisa, and the first $10,000 of your gift to Ken are not taxable gifts.
3) Apply the unified credit. The gift tax on $30,000 ($15,000 remaining from your gift to Lisa plus $15,000 remaining from your gift to Ken) is $6,000. You subtract the $6,000 from your unified credit of $192,800. The result, $186,800, is the amount of unified credit that you have left for future use.

You do not have to pay any gift tax this year. 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:

1) You gave more than $10,000 during the year to someone (other than your spouse),
2) You and your spouse are splitting a gift,
3) You gave someone (other than your spouse) a gift that he or she cannot actually possess, enjoy, or receive income from until sometime in the future, or
4) 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, gifts to charitable organizations, and gifts made by paying someone's tuition or medical expenses.

You may use Form 709–A if you and your spouse are splitting a gift and that is the only reason you must file a gift tax return. This form is shorter and simpler than Form 709.

More information. If you need to file a gift tax return, you should get Form 709 and its instructions or Form 709–A and its instructions.

Estate Tax

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

If you have not used any of your unified credit to eliminate gift taxes, no estate tax will have to be paid unless your taxable estate is more than $600,000.

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 will also include:

1) The value of property you sold (or otherwise transferred) for less than its full value while you were alive, if you kept any interest in the property,
2) The value of property you owned jointly with another person,
3) Life insurance proceeds payable to your estate or, if you owned the policy, to your heirs,
4) The value of certain annuities payable to your estate or your heirs,
5) The value of community property to the extent of your interest under local law,
6) The value of any other property which you have the power to give to yourself or someone else,
7) Gift taxes paid by you or your estate on gifts made by you or your spouse within 3 years before your death, and
8) The value of certain other property you transferred within 3 years before your death.

Taxable Estate

Your taxable estate is your gross estate reduced by:

1) Funeral expenses paid out of your estate,
2) Expenses of administering your estate,
3) Debts you owed at the time of death,
4) Casualty and theft losses that occur during settlement of your estate,
5) Charitable contributions made by your estate, and
6) The marital deduction (generally, the value of the property that passes from your estate to your surviving spouse).

More information. If you think that your taxable estate plus the total amount of taxable gifts you give during your lifetime will be more than $600,000, you may want to consider consulting a qualified estate tax professional. You may also want to get Form 706 and its instructions.

Applying the Unified Credit to Estate Tax

As explained earlier, any of the $192,800 unified credit not used to eliminate gift tax can be used to eliminate or reduce estate tax.

Example 6. Ed Beech gave his son John $100,000, which was Ed's first taxable gift. Ed filed a gift tax return. He subtracted the $10,000 annual exclusion from the $100,000 gift to figure the amount of his taxable gift, $90,000. The gift tax on $90,000 is $21,000. Ed used $21,000 of the unified credit to eliminate the tax on the gift.

If Ed made no other taxable gifts and his taxable estate is not more than $510,000 ($600,000 – $90,000),

his remaining unified credit will eliminate any estate tax. If his taxable estate is more than $510,000, the credit will reduce the estate tax by $171,800 ($192,800 – $21,000).

Example 7. John Oak gave each of his five children $10,000 per year for 10 years. Since none of the gifts were more than the $10,000 exclusion, none of the gifts were taxable. He was able to give $500,000 tax free without using any of his unified credit.

If John makes no other gifts that are taxable and he leaves a taxable estate of $600,000 or less, the unified credit will eliminate any tax on the estate. If John leaves a taxable estate of more than $600,000, the estate will have to pay the estate tax only on the value of the estate that is more than $600,000. The unified credit will reduce the estate tax by $192,800.

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 $600,000.

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.

Example 8. Donna's gross estate was worth $1,300,000. She left a total of $600,000 to her children and the remainder, $700,000, to her husband, Bill. The amount that passed to her husband qualified for the marital deduction and, therefore, was not included in the taxable estate. The taxable estate was $600,000. Neither Bill nor Donna had ever made a taxable gift.

An estate tax return had to be filed because the **gross estate** was more than $600,000. However, because Donna's **taxable estate** was not more than $600,000, Donna's unified credit eliminated all of the estate tax.

In the years following Donna's death, the total of Bill's gifts to his children was large enough so that, when he died, his gross estate was not more than $600,000. He never gave more than $10,000 to any one child in any one year, and none of the gifts were of future interests. Bill did not need to file any gift tax returns. Any tax on Bill's taxable estate is eliminated by Bill's unified credit.

Donna and Bill were able to pass all of their financial worth on to their children without having to pay either gift or estate tax.

More information. If you think you will have an estate on which the tax must be paid, or if your estate will have to file an estate tax return even if no tax will be due, get 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.