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End-of-year gifts can save you taxes

by Alban Salaman

Before 2006 slips away, you may wish to consider whether to make gifts to gain tax advantages.

• Charitable gifts

You can mail your charitable cash gifts (or charge a credit card) by Dec. 31, and deduct the donation on your 2006 income tax return if you itemize. Generally, the deduction is limited to 50 percent of your adjusted gross income for cash gifts to public charities, such as your synagogue. If you contribute appreciated publicly traded stock you have owned for more than one year, you are generally able to deduct its fair market value without paying income tax on the gain.

The Pension Protection Act of 2006 enacted in August now allows for the first time direct contributions from IRAs to public charities. This new provision may be used only by individuals age 70 1/2 or older, is limited to $100,000 per year, and is available only in 2006 and 2007. If you use this provision, there is no charitable deduction because the gift to charity directly from the IRA is not included in income.

This provision is very favorable to eligible taxpayers who no longer itemize their deductions. Also, the funds directed from an IRA to a public charity will be counted toward the annual required minimum distribution from an IRA for a person who has attained 70 1/2.

Unfortunately, this provision is limited to contributions from IRAs.

• Annual exclusion gifts

Federal gift tax law allows you to make gifts of up to $12,000 ("annual exclusion") to any person in 2006, free of gift tax and without filing a gift tax return. You may give annual exclusion gifts to as many people as you want. If you pay a grandchild's tuition or unreimbursed medical expenses, for example, such payments do not count toward the annual exclusion limit provided they are made directly to the school or medical provider.

If you are married, and you and your spouse wish to make gifts to the same person, you may each use your annual exclusion and together give up to $24,000 to that person in 2006, free of gift tax consequences. However, if all of the funds for the gift come from you and not your spouse, your spouse must consent to "split" the gift by each of you filing a gift tax return (IRS Form 709) by April 15.

Unlike charitable gifts, a gift made by check to an individual must be deposited into that person's bank account or cashed by the donee by Dec. 31 to use the donor's 2006 gift tax annual exclusion.

If the total gifts you make to a person this year exceed the annual exclusion, you will use a portion of your $1 million lifetime gift tax exemption and must file a gift tax return by April 15.

• Estate tax advantages of annual exclusion gifts

Annual exclusion gifts can reduce the size of your estate for federal or state estate tax purposes. Federal estate tax on property passing at death in excess of the estate tax exemption ($2 million in 2006 but scheduled to increase in 2009 to $3.5 million) may be as high as 46 percent in 2006 and 45 percent in 2007.

State estate tax can effectively be as high as approximately 8 percent on your estate in excess of the state estate tax exemption. In Virginia, the state estate tax exemption is the same as the federal estate tax exemption until July 1, when the Virginia state estate tax is repealed.

In Washington, D.C., and Maryland, the state estate tax exemption remains at $1 million. Thus, a $24,000 annual exclusion gift by you and your spouse to a child in 2006 could save as much as $11,040 in federal estate taxes, as well as state estate taxes, if applicable. If you engage in a lifetime gift giving program to your children, you can reduce your estate substantially and save significant estate taxes.

Of course, you should not make gifts solely for tax savings. Make sure you do not gift funds you may need at a later date, for example, during retirement.

There is no Virginia, Washington, D.C., or Maryland gift tax. However, if you are a Maryland resident and make a gift within two years of death to a person who is not your spouse, child, sibling and certain others, your estate may incur a 10 percent Maryland inheritance tax.

• Gifts to college savings (529) plans

If you are considering making gifts to a child or grandchild, you may also wish to consider contributing to a 529 Plan. Although contributions to a 529 Plan are not deductible for federal income tax purposes, contributions to your own state's 529 Plan are generally deductible for state income tax purposes, subject to certain limits. The earnings in the 529 Plan are allowed to grow tax-free, and withdrawals for qualified higher education expenses are not subject to tax.

You can contribute up to five times the annual exclusion to a 529 Plan in a single year, without gift tax consequences. In this case, the total amount contributed will be deemed to have been made proratably in the year of the gift and in the next four years.

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