PUBLICATION

Gifting: A Tax-Saving Technique

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An important objective shared by most estate planning clients is to maximize the amount of cash and property available to pass to heirs at death while minimizing estate and gift taxes. But as clear as this objective may be, many clients allow a rather valuable tax benefit to be lost year after year by not taking advantage of the federal gift tax laws.

Overview

The federal gift tax was enacted to be complementary to the federal estate tax and was intended to limit the ability of individuals to transmit wealth on a tax-free basis by lifetime gifts. As a result of legislation enacted in 2001, there is no estate tax for decedents dying in 2010. Unless Congress enacts corrective legislation, the estate taxes will return in 2011 with an exemption of $1,000,000 and a top marginal rate of 55%. While it is possible that Congress will act to increase the exemption, planners should consider acting now to take advantage of the limited ability to transmit wealth by lifetime gifts. Although there is no enacted estate tax on the estates of decedents dying in 2010, Congress in 2001 left the gift tax in place indefinitely, with a life time exemption of $1,000,000 and a top marginal rate of 35%.

Both before and after the changes effective in 2010, many clients failed to take advantage of the available exemptions from the federal gift tax.

Gifting Fundamentals

Many clients believe that they receive the greatest benefits from their estate planning when they transfer property before death, so as to be able to guide and affect the outcome. In addition to expressing love and affection, transfers to family members serve other purposes. They give children an opportunity to participate in the management of family business, help finance a college education or pay medical costs.

Gifts can also reduce the size of an estate that must pass through court administration, thereby cutting probate costs and, to some extent, to federal estate taxes. Additionally, gifts can also accomplish income tax savings. Through gifts of income-producing property, income can be shifted from one family member to another who is in a lower tax bracket.

While gifting of property may sound simple at first, caution should be exercised when making gifts, as there are a myriad of rules that must be followed in order to get the maximum tax benefit from gifting. First and foremost, in order for a transfer to qualify as a completed gift, a taxpayer must relinquish control over the property that is being gifted. If a taxpayer retains direct control over a gift, the gift may not be completed and the resulting value of the subject property (and its appreciation) may be included in the taxpayer's estate for estate tax purposes on the taxpayer's death. The recipient of a gift owes no gift tax or income tax, and doesn't even have to report the gift unless it came from a foreign source. If any gift tax is due, it is paid by the donor.

Second, in each calendar year, under the current federal gift tax laws, an individual is permitted to gift up to $13,000 (which amount may increase with inflation) in cash or other property to each of an unlimited number of individuals without any federal gift tax consequences. This exclusion amount, which is indexed for inflation, is known as the annual gift exclusion, or more simply, as the annual exclusion.

Using a technique known as "gift splitting," spouses can give a total of $26,000 each year to each donee, even if only one spouse is the source of funds gifted. Gifts made within these dollar limitations do not trigger gift taxes when made, nor do they reduce the combined estate tax exemption amounts available to protect lifetime transfers of wealth exceeding annual gift exclusion limits and transfers of wealth at death. Accordingly, maximizing transfers within the limits of the annual gift tax exclusion has been and remains a prudent method to transfer wealth between generations.

It is important to note that certain transfers are not subject to the gift tax laws. First, married people who are U.S. citizens can make gifts of any amount to one another by taking advantage of the unlimited marital deduction provision in the federal gift tax law. Second, payments made directly to an educational institution for the benefit of another person are not considered taxable gifts and are not subject to gift tax rules. Likewise, payments made to a medical provider for the benefit of another person are not taxable gifts and are not subject to the gift tax rules. Finally, gifts made to charitable, religious and educational organizations, government agencies and other IRS qualifying organizations with tax-exempt status are completely gift tax free.

The annual exclusion can be an administratively easy tax benefit to use. As long as the taxpayer has not made any gifts during the calendar year to any individuals that total more than the annual exclusion, the taxpayer does not have to file a gift tax return with the Internal Revenue Service. If the taxpayer has made a gift of more than $13,000 to any one person during the course of the year, the taxpayer will have to report the taxable gift on a gift tax return (IRS Form 709). Spouses splitting gifts (see discussion above as to gift splitting) must also file Form 709, even when no taxable gift is incurred.

As easy as it can be to take advantage of the annual exclusion, many individuals with sizeable estates fail to take advantage of such exclusion. And, unlike the lifetime gift tax exemption amount of $1 million, any annual exclusion not used in the calendar year is lost.

Lifetime Gift Exemption

When estate taxes become effective again, taxpayers will be limited to lifetime and death transfers totaling $1 million without being subject to estate or gift taxes. This will be in addition to the annual gift tax exclusion limitations.

Gifting Techniques

Taxpayers desiring to make gifts of cash or property have a myriad of options available when making gifts.

Outright Gift. An outright gift with no strings attached is the simplest method of making a gift. The donor must simply deliver the assets directly to the donee. Upon the transfer of the asset, the donor must relinquish control over the subject asset so that control vests solely in the donee. Many clients are reluctant to make outright gifts to donee such as a son or daughter, as the gift may be taken away from the donee through a divorce, lawsuit or bankruptcy. More commonly, the gift may be squandered because the donor has no further control of the gifted property once delivery is made, especially when the donee is immature or financially irresponsible. If the possibility of divorce, bankruptcy or other such event is a real and present concern, the donor should certainly consult with a tax advisor as to potential options.

Transfers to Minors. Custodial accounts established under the Uniform Gifts to Minors Act (UGMA) or Uniform Transfers to Minors Act (UTMA) are very popular methods of transferring funds to minors. They are convenient and inexpensive to create. Almost all financial institutions offer such arrangements. However, the account becomes an unrestricted asset of the beneficiary when the beneficiary reaches the age of maturity, such as 18 or 21 depending on state law.

Present Interest. In order to be entitled to the annual gift exemption, the donee must receive a present interest in the property gifted. A gift to a Crummey Trust described below accomplishes this result.

To have a present interest, the donee must have a presently exercisable right to some tangible economic benefit. The Internal Revenue Service closely scrutinizes arrangements in which the donor in effect retains control over the property given. An example of impermissible retained control is the gift of a nontransferable interest in a limited partnership owning real estate where the partnership pays no periodic distributions.

Crummey Trusts. Gifts in trust can present problems in qualifying as a present interest. An exception to the general rule that a donee must have complete and unrestricted control over a gift is the Crummey Trust, which was sanctioned by the U.S. Ninth Circuit Court of Appeals. A Crummey Trust is an irrevocable trust (i.e., you cannot change the terms) that gives the beneficiary certain withdrawal powers. When such a Trust is created, a taxpayer can include in the Trust all of the strings he or she wishes to attach to the future gifts to the Trust as long as the taxpayer relinquishes control over the Trust and gifts made to that Trust. Generally, the trustee must provide written notice to each beneficiary (or legal guardian, if the beneficiary is a minor) each time a gift is made to the Trust, giving the beneficiary a period of time (usually not less than 30 days) to exercise their right to withdraw all or part of the gifted amount. If the beneficiary does not exercise this withdrawal right, then the gift lapses and the trustee administers the gift for the beneficiary according to the strings attached in the Trust.

Valuation Issues. When properly documented, it is possible to discount the valuation of certain gifted property, such as ownership interests in closely-held businesses and fractional interests in property, among others. The purpose of this alert is not to fully address the circumstances in which valuation discounts may be available. As with so many gifting issues, donors should consult their tax advisor regarding the availability of such discounts.

State Laws Applicable to Gifting

This Alert has focused on federal laws related to gifting. It is important to remember that many states have their own laws related to gifting. For example, Tennessee classifies donees as either Class A or Class B and imposes a gift tax based on the donee classification. Please consult your estate planning advisor to learn more about gift tax laws in your particular state.

Conclusion

Before undertaking a gifting program, it is important to focus first upon your needs. Review your future needs, retirement planning and be sure that you are comfortable giving away assets. Donors should never give cash or other property they may need in the future. As a result, it is also important to consult with a tax advisor before undertaking a substantial gifting program. But, if you are comfortable with a gifting program, the gifting of property prior to death is an excellent way to maximize the amount of cash and property to be passed to your loved ones while minimizing estate and gift taxes.

If you have any questions regarding the gifting information in this Alert, or if you desire to discuss a gifting program, please contact any attorney in the Firm's Tax Department.