

## Trusts & Estates Notes

A Series of Articles on Legal Issues Regarding Estate Planning and Estate Administration

### Factors to Consider Before Making Gifts

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This article is designed to provide a general overview of the major gift, estate, and income tax consequences of making non-charitable gifts. In this article we will refer to the gift tax exemption, the estate tax exemption and the generation-skipping transfer tax exemption even though the Internal Revenue Code uses the term “applicable exclusion amount” because the term exemption is frequently used and more generally understood conceptually. Further, gift taxes, estate taxes and generation-skipping transfer taxes are sometimes referred to collectively as “transfer taxes”, a tax imposed on various types of transfers of wealth from one person to another.

#### **Advantages of Making Gifts.**

The major benefit of making gifts is the ability to reduce the value of an estate (and thus the estate taxes payable after death) in a variety of ways. Annual exclusion gifts and gifts for medical and education expenses reduce estate taxes without any significant cost or expense to the donor because they do not utilize any portion of the gift tax or estate tax exemption. Gifts which utilize all or a portion of the gift tax exemption are advantageous because they reduce estate taxes by removing the income and all subsequent appreciation of the property gifted from the donor’s estate. Although the estate tax exemption increased above \$1,000,000 in 2004 (reaching \$3,500,000 in 2009), the gift tax exemption remained at \$1,000,000. Absent a change in the law, this means that gift taxes must be paid for lifetime gifts valued at more than \$1,000,000.

Gifts can also significantly reduce the value of the property retained when giving a fractional interest in property while retaining a fractional interest because of appropriate adjustments to value for such gifts (e.g., lack of marketability discounts for the interest given and the interest retained). Significant transfer tax savings can also be realized by making taxable gifts in excess of the gift tax exemption because gift taxes are based on the value of the gift and do not include any gift taxes payable as a result of the gift. Estate taxes, on the other hand, are based on the value of the taxable estate, which includes the funds that will be used to pay the taxes. Thus, gift taxes are “tax exclusive” while estate taxes are “tax inclusive.” Further, if the donor lives for 3 years after paying the gift tax, the gift taxes paid will not be included in the donor’s estate.

#### **Disadvantages of Making Gifts.**

The major disadvantages of making gifts are the costs and expenses incurred and the potential income tax to the donee on the built-in gain of the property gifted. These disadvantages may not be applicable or important in any given situation. Legal, accounting and appraisal fees are often incurred when making gifts and an annual gifting program can require these expenses to be incurred annually. Gifts of property are generally more costly than cash gifts because of valuation issues which must be resolved and because they require more documentation to complete the gift. Because the expenses incurred making gifts also reduce the value of the donor’s estate, there is a tax benefit associated with such expenses.

If property is held until death, it will receive a new tax basis equal to the date of death value (referred to as a step up in basis) for purposes of depreciation and determining gain or loss on sale.<sup>1</sup> When property is gifted, the donee receives the donor's basis in the property and the gifted property will not get a new stepped up basis on the donor's death.

## **Annual Exclusion Gifts.**

Each individual donor can give up to \$13,000<sup>2</sup> per year per person without using up any portion of the donor's gift tax exemption. This is referred to as an annual exclusion gift. In order to qualify for the annual exclusion, the gift must be made outright to the donee or in such a manner that the gift would otherwise be includable in the donee's taxable estate if the donee were to die. It must also be a present interest. Generally, gifts in trust are not present interests unless there are special provisions in the trust that qualify such gifts for the annual exclusion. One type of trust that qualifies for the annual exclusion is a Minor's Trust. A Minor's Trust must terminate, or provide the beneficiary with the power to terminate the trust, when the beneficiary attains age 21. Another way of qualifying a trust for the annual exclusion is to provide the donee/trust beneficiary (in the case of a minor, this can be a guardian or custodian for the donee) with a withdrawal right that grants him or her, after the gift is made, the right to withdraw and receive outright the specified amount of the gift (generally limited to the annual exclusion amount). This withdrawal power is sometimes referred to as a "Crummey power" and the trusts are referred to as "Crummey trusts."<sup>3</sup>

## **Special Exclusion for Educational and Medical Gifts.**

In addition to the annual exclusion gifts, there is a special rule that permits the payment of certain education expenses (primarily tuition) for a donee directly to the educational institution. There is also a specific provision that allows you to pay for medical expenses for a donee. In addition to medical expenses, you may pay for medical insurance on behalf of an individual. Medical expenses and insurance payments must be made directly to the providers. You cannot simply reimburse the donee for these expenses. These exclusions for tuition and medical expenses do not count as a part of the annual exclusion gift and do not utilize any portion of the gift tax exemption. Gifts to college savings accounts (commonly referred to as "529 Plans"), on the other hand, do not qualify for the special exclusion for gifts to educational institutions, but they do qualify for the \$13,000 annual exclusion.

## **Lifetime Gift Tax Exemption.**

Each U.S. citizen or resident may gift an amount equal to the lifetime gift tax exemption to one or more donees without incurring any gift tax. This is over and above the annual exclusion and special exclusion gifts mentioned above. The advantage of using all or a portion of the gift tax exemption during one's lifetime is that all income from and appreciation on the gifted asset will also be removed from the donor's estate. Over time, this may result in significant estate tax savings. All gifts in excess of the annual exclusion amount will require the preparation and filing of a gift tax return, although there will not be any tax due unless the taxable gifts cumulatively exceed the lifetime gift tax exemption.

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<sup>1</sup> During 2010 only, the law eliminates the basis step up and replaces it with a more limited adjustment to the basis immediately prior to death.

<sup>2</sup> This amount has been in effect since 2009 and changes periodically based on inflation adjustments.

<sup>3</sup> The term originated from the 1968 tax case, *Crummey vs. Commissioner*, that held that such withdrawal rights qualified the gift in trust for the annual exclusion. Far from being a bad provision to use in a trust, such withdrawal rights are widely used when planning for gifts into irrevocable trusts.

## Gifts to Spouses.

Gifts to spouses who are U.S. citizens are not subject to gift tax and do not use any portion of the gift tax exemption. Gifts to spouses who are non-U.S. citizens are subject to gift tax but qualify for a larger annual exclusion amount.<sup>4</sup>

## Kiddie Tax.

To the extent the unearned income of certain children under age 24 exceeds a specified amount,<sup>5</sup> the excess will be taxed to the child at the parent's marginal (highest) tax bracket for federal income tax purposes. This is referred to as a "kiddie tax." In California, the kiddie tax applies to unearned income only of those children under age 14 for state tax purposes. When making gifts to children under age 24, the investment strategy for the funds given must take into account income that will be produced in order to keep it below the amount which would cause it to be taxed at the higher bracket. Investments in growth assets or those which would produce tax-free income may be advisable.

## Valuation of Gifts.

The value ("fair market value"<sup>6</sup>) of the gift is determined on the date the gift is made. The basis of the property given is not relevant for purposes of determining its value. Therefore, if publicly traded stock was purchased for \$1,000 and it was worth \$10,000 on the date it was given to the donee, \$10,000 of the annual exclusion amount would be used in that year for that donee. There are special rules regarding the computation of gain or loss on the sale of gifted property.

Numerous tax cases (beginning in 1969) have permitted various adjustments to the value of property that is not publicly traded. The most common adjustments to value are discounts for lack of marketability, discounts for minority interests and valuation adjustment for built-in capital gains. When making gifts of property where such adjustments to value are appropriate, it is required that an expert appraisal be obtained to quantify the appropriate adjustment. This typically results in two appraisals for the property gifted: one for the value of a 100% interest in the property; and one for the appropriate discount.

Adjustments to value are also made when the donor retains an interest in the gifted property for a period of time. In such cases, the value of the gift is the actuarially determined value of the donee's right to receive the property after that period of time has passed, often a small fraction of the current fair market value of the property. Examples of gifts to trusts that use this technique include Grantor Retained Annuity Trusts ("GRAT"), where the donor makes a gift of an asset to the trust and retains a fixed dollar annuity for a period of time, and Qualified Personal Residence Trusts ("QPRT"), where the donor makes a gift of a personal residence (or a partial interest in the residence) to the trust and reserves the right to use the residence for a period of time.

## Alternative Methods of Making Gifts.

(1) **Outright Gifts.** These types of gifts should be considered for adult donees. Outright gifts are simple and straightforward, there are no administrative or tax complications involved and legal and accounting fees are generally minimized. The primary disadvantage of outright gifts is that the donor does not have any control over the funds or property

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<sup>4</sup> The amount is \$134,000 in 2010 and changes periodically based on inflation adjustments.

<sup>5</sup> The amount is \$1,900 in 2010 and is subject to annual adjustments.

<sup>6</sup> The IRS definition of fair market value is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Reg. §25.2512-1.

once given to the donee unless the gift is paid directly to a third party (educational institution, medical care provider, etc.) for the donee's benefit.

(2) **Gifts to a College Savings Account (529 Plan).** A donor can make gifts to a College Savings Account that will be used to pay qualified higher education expenses incurred by a beneficiary in the future. The donor can decide when and by whom the funds are received and has the right to reacquire the funds, subject to penalties. Gifts to a College Savings Account do not qualify for the special exclusion for qualified gifts to educational institutions, but they do qualify for the annual exclusion. Donors are allowed to make up to 5 years' worth of annual exclusion gifts at once by making an election on a gift tax return.

(3) **Gifts Into a Custodianship.** For donees who are under age 21, gifts may be made into a custodianship arrangement under the California (or other state) Uniform Transfers to Minors Act. This is an informal, trust-type relationship where the funds are held by a person other than the donee in the custodianship where the donee is treated as the owner for tax purposes so that no trust tax return is required. A custodianship will terminate at age 18 unless it is specified that it will continue until age 21 when the custodianship is created. You cannot continue a custodianship beyond age 21 for lifetime gifts. A tax return will be required for the donee if his or her income from the gift and any other sources exceeds the amount that requires a return to be filed. The gift is not treated as income, only the interest, dividends, etc., generated from the gift is treated as income. The kiddie tax discussed above will apply to any donee under age 14 for California tax purposes and to certain donees under age 24 for federal tax purposes. Donors should not act as the custodian for gifts they make because the value of the assets in the custodianship attributable to the gift by the donor will be included in the donor's estate if the donor dies before the custodianship terminates. Selecting a minor's parent as custodian can also have adverse estate tax consequences that must be discussed with the donor's tax advisers before establishing the custodianship.

(4) **Gifts Into a Minor's Trust.** A Minor's Trust provides similar benefits to the custodianship but is more expensive to create and a separate trust tax return must be filed annually. The kiddie tax can be avoided to the extent that income is accumulated and not spent (which generally means that none of the funds in the trust would have been spent). As long as trust income does not exceed \$2,300 (in 2010; adjusted annually), the federal tax rate will be at 15% or the lower federal tax rate applicable to individuals. To the extent that income is considered distributed to the minor (e.g., because, for example, funds were used to pay for the minor's educational costs), the kiddie tax must be taken into consideration. Finally, to the extent trust income that was taxable at the trust level and not passed through to the minor exceeds \$8,200 (in 2010; adjusted annually), the trust would begin to approach the highest tax rates that income would be taxable for individuals. One benefit of a Minor's Trust over a custodianship arrangement is that the trust can provide that it will continue until a specified age (e.g., 30) if the minor does not elect to terminate the trust within a 30 or 60-day period after reaching age 21. There is no guarantee that a beneficiary turning age 21 will not terminate the trust, but parental (or grandparental) persuasion may be utilized to convince the beneficiary of the wisdom of not terminating the trust at age 21.

(5) **Gifts Into a Crummey Trust.** The Crummey Trust is a more complex type of trust to create than a Minor's Trust and has more annual administration costs than other types of gifts because of the need to file annual trust tax returns and to comply with the withdrawal rights granted each time a gift is made. Crummey Trusts permit the creation of trusts that will continue beyond age 21 and still qualify for the annual exclusion. The tax rules that affect the donee and the trust are the same as are applicable to the Minor's Trust. There are also very complex potential estate tax consequences to the beneficiary of the trust if the withdrawal rights exceed \$5,000.

## **Bargain Sales.**

Sale transactions with a relative for less than the fair market value of the property treat the difference between the purchase price and the fair market value as a gift. Care should be taken to avoid bargain sales in most instances. A full discussion of ways to structure sales to family members is beyond the scope of this article.

**Below-Market Interest Rate Loans.**

Loans with below-market interest rates are generally considered to be “gift loans” because the lender is considered to have made imputed transfers of the forgone interest to the borrower. The amount of the gift depends on the type of loan made, and there are certain de minimus and other exceptions to “gift loan” treatment. A full discussion of ways to structure loans to family members is beyond the scope of this article.

*Note: Because of Congressional inaction, there is currently in effect a one year moratorium of the federal estate and generation-skipping transfer tax for 2010. As a result, many of the benefits of gifting must be weighed against the uncertainty surrounding the future federal estate and generation-skipping transfer tax laws. This article has been prepared on the assumption that through Congressional action or inaction the moratorium will be lifted or will expire and the estate and generation- skipping transfer taxes will be reinstated.*

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