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Trusts & Estates Notes

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

Factors to Consider Before Making Gifts

By Michael Curtis
mcurtis@thoits.com

This article is designed to provide you with 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", the tax imposed on various types of transfers of wealth from one generation to another.

Advantages of Making Gifts.

The major benefit of making gifts is the ability to reduce the value of your estate (and thus the estate taxes payable after your death) in a variety of ways. Annual exclusion gifts and gifts for medical and education expenses reduce estate taxes with virtually no cost because they do not utilize any portion of the gift tax or estate tax exemption amount. Gifts which utilize all or a portion of the gift tax exemption reduce estate taxes by removing the income and all subsequent appreciation of the property gifted from your estate. The estate tax exemption is $11,200,000 for persons dying in 2018, and the lifetime gift tax exemption is also $11,200,000. Inflation adjustments will increase the exemption annually but the exemption will sunset in 2026, reverting to $5,600,000 plus the 2019-2026 inflation adjustments. The law also allows a surviving spouse to use a deceased spouse's unused gift/estate tax exemption amount in addition to his or her own. Absent a change in the law, this means that gift taxes must be paid if you make gifts valued at more than $11,200,000 during your lifetime, or if you claimed a deceased spouse's unused gift/estate tax exemption, more than your combined gift/estate tax exemption amount.

Gifts can also significantly reduce the value of the property retained if you give a fractional interest in property that is not publicly traded while retaining a fractional interest in the property. Gift and estate taxes are taxes on the transfer of wealth. As a result, significant transfer tax savings can 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, including the funds that will be used to pay the taxes. Thus, gift taxes are "tax exclusive" while estate taxes are "tax inclusive." For example, if you have used up your gift tax exemption and you make a taxable gift of $1,000,000, you will pay a gift tax of $400,000 because the tax rate is 40%. The total "cost" is $1,400,000. In order to transfer $1,000,000 after death and payment of the estate tax, you would need $1,666,666.67. The estate tax on that amount at 40% would be $666,666.67, netting $1,000,000 to the beneficiary.

Disadvantages of Making Gifts.

The major disadvantages of making gifts are the potential costs incurred and the income tax on the built-in gain of the property gifted. These disadvantages may not be applicable or important in your particular situation. Legal, accounting and appraisal fees are often incurred when making gifts and, sometimes, a gifting program will require these expenses to be incurred annually. Gifts of property are generally more costly than cash gifts and gifts of publicly traded securities because of valuation issues which must be resolved and because they require more documentation to complete the gift. 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. 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.

For individuals and couples who are unlikely to use their total gift/estate tax exemptions, it may be preferable to make transfers at death rather than through gifts during their lifetime. Currently, the income tax rate and gift/estate tax rate are very similar for Californians. The donee of a lifetime gift will receive the donor's basis for the property, as discussed above, and will have to pay income taxes when that property is sold if the property value goes up. However, if the value of the donor's estate will not exceed the donor's estate tax exemption, then it is preferable to transfer low-basis property at death, because the property will receive a new basis for income tax purposes.

Annual Exclusion Gifts.

You can give up to $15,000 per year per person (subject to periodic adjustment) without using up any portion of your applicable exclusion amount. In order to qualify for the annual exclusion, a 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 do not qualify for the annual exclusion unless there are special provisions to qualify the trust for the annual exclusion. One type of trust that qualifies for the annual exclusion is a Minor's Trust. 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 authorizes him or her, within a specified period (commonly 30 to 45 days) after the gift is made, to withdraw and receive outright the full 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." The term came from the name of the taxpayer in the tax case that held that such withdrawal rights

qualified for the annual exclusion. Minor's Trusts and Crummey Trusts are described in greater detail below.

Special Exclusion for Educational and Medical Gifts.

In addition to annual exclusion gifts, there is a special rule that allows you to pay 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 and do not utilize any portion of your applicable exclusion amount.

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 an annual exclusion amount ($152,000 in 2018; subject to adjustment annually).

Gift Tax Exemption Gifts.

Each U.S. citizen or resident may gift an amount equal to the gift tax exemption during his or her lifetime to one or more donees without incurring any gift or estate tax. This is over and above the annual exclusion and special exclusion gifts mentioned above. You may choose to give less than this full amount of your gift tax exemption. The advantage of using the full amount of your gift tax exemption during your lifetime is that all income from and appreciation on the gifted asset will also be removed from your estate. Over time, this may result in significant estate tax savings. If you are contemplating making gifts in order to use up all or a portion of your gift tax exemption, we should discuss the amount of your remaining gift tax exemption as well as the appropriate assets to be gifted. All gifts in excess of the $15,000 annual exclusion will require the preparation and filing of a gift tax return, even though there may not be any tax due.

Kiddie Tax.

To the extent the unearned income of certain children under age 24 exceeds a specified amount ($2,100 in 2018; subject to adjustment annually), the excess will be taxed to the child at the parent's marginal (highest) tax bracket for federal income taxes. 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 of the gift is determined on the date the gift is made. Your basis in the gift is not relevant for purposes of determining its value. Therefore, if you purchased stock for $1,000 and it was worth $15,000 on the date you gifted it to the donee, you would be using up your full $15,000 annual exclusion in that year for that donee. There are special rules regarding the computation of gain or loss on the sale of gifted property. In addition, where there is no public market for the asset that will be gifted, the valuation must be done by a qualified appraiser in order to start the running of the three-year statute of limitations for gifts reported on gift tax returns. If you have specific questions regarding these areas, we would be happy to talk with you about them.

Adjustments to value are made when the donor gifts a fractional interest in real property or closely-held entities to reflect the lack of marketability of the fractional interest and/or a minority interest. For interests in closely-held entities, an adjustment to value may also be made if the entity would incur a tax liability from the recognition of built-in gain in its underlying assets. Such "discounts" reduce the value of the gift.

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.

With the above as a background, the gifting alternatives that you may wish to consider are as follows:

(a) **Outright Gifts**. This should be considered for any 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 you have no control over the funds after they have been given to the donee unless you pay those funds directly to a third party (educational institution, medical care provider, etc.).

(b) **Gifts Into a Custodianship**. For any donees who are under age 21, gifts may be made into a custodianship arrangement under the California Uniform Transfers to Minors Act. This is an informal, trust-type relationship where the funds are held in the custodianship but are treated as owned by the donee for tax purposes so that no trust tax return is required. A custodianship will terminate at age 18 unless you specify that it will continue until age 21 when you create the custodianship. You cannot continue a custodianship beyond age 21 for gifts made while you are living. A tax return will be required for the donee if his or her income from the gift exceeds the amount that requires a return. (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. If you choose this option, you should not be the custodian of an asset you have gifted because it will be included in your estate if you die before the custodianship terminates. Selecting a minor's parent as custodian can also have adverse estate tax consequences so you should discuss with us the persons who are appropriate to act as custodians before you proceed.

(c) **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 $2,600 (in 2018; 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 $12,500 (in 2018; 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 child turning age 21 will not terminate the trust, but parental (or grandparental) persuasion may be utilized to convince the child of the wisdom of not terminating the trust at age 21.

(d) **Gifts Into a Crummey Trust**. The Crummey Trust is the most expensive trust to create and has the most expensive annual administration costs because of the need to file annual trust tax returns and to prepare and distribute withdrawal right notices every time a gift is made. The withdrawal rights are generally very effective because everyone understands that it is not in anyone's best interest to exercise the withdrawal right and, as a result, you may create a trust 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. We will discuss this issue with you in greater detail if you wish to consider establishing a Crummey Trust.

(e) **Gifts to a 529 College Savings Account**. 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. The 2017 tax legislation now permits distributions from 529 Plans of up to $10,000 per student, per year for tuition at an elementary or secondary public, private or religious school.

If you are going to be making annual exclusion gifts of $15,000, and these funds are likely to be used for education, we can advise you as to the least complicated method of making such gifts initially.

Bargain Sales.

If you enter into a sale transaction with a child or relative for less than the fair market value of the property, the difference between the purchase price and the fair market value will be considered a gift.

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.