Gifting and Leveraged Gifting

Just the FAQs

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Many individuals know that lifetime gifts to children and other loved ones can reduce or eliminate estate taxes otherwise due upon death. Yet many are not aware of the options to leverage their gifts to produce even greater tax savings. This FAQ will review the benefits of making gifts and describe strategies for leveraging those gifts to increase tax savings.

What gifts are subject to the federal gift tax?

All lifetime transfers to others are subject to federal gift tax, unless they qualify for (1) the annual exclusion against gift tax, (2) the marital or charitable deductions, or (3) the education and medical exclusion.

What gifts qualify for the annual exclusion against gift tax?

Every individual can transfer cash or other assets worth up to $14,000 (in 2016) to an unlimited number of recipients on an annual basis. This is known as the *annual exclusion* against gift tax. However, this exclusion only applies to "present interest" gifts (gifts made to a recipient to which the recipient has full and immediate access). Gifts to a beneficiary in trust generally do not qualify for the annual exclusion and all such gifts are taxable. Gifts that qualify for the annual exclusion are not subject to gift tax and do not need to be reported to the IRS.

What gifts qualify for the marital or charitable deductions?

All gifts to a US citizen spouse qualify for the *unlimited* marital deduction and are not subject to gift tax. The donor-spouse does not need to be a US citizen, only the recipient spouse. However, a US citizen spouse or non-US citizen spouse can only pass a limited amount tax-free to a non-US citizen spouse. This *limited* marital deduction is indexed for inflation and is $148,000 (for 2016).

Any amounts transferred to a charitable organization recognized under Internal Revenue Code (IRC) Section 501(c)(3) will qualify for the unlimited charitable deduction against gift tax. There is no phase-out for the gift tax exemption.

What gifts qualify for the education and medical exclusion?

Direct payments you make for someone's educational or medical expenses, regardless of whether they exceed the annual exclusion amount, are excluded from the federal gift tax under IRC Section 2503(e) (often referred to as the "Ed-Med Exclusion"). Educational expenses are payments for tuition made directly to an educational organization for the education or training of an individual. This does not include payments for books or other incidental educational expenses. Medical expenses are payments made directly to any person or corporation that provides medical care. This includes all medical expenses that are defined as potential income tax deductions, such as doctor and hospital bills, travel to get the medical care, prescription medicine, and health insurance premiums. However, it includes only limited amounts for long-term care coverage and it excludes certain medical care such as optional cosmetic surgery.

What happens if I transfer more than my annual exclusion and I don't qualify for any of the deductions or exclusions?

Each person has a lifetime exemption allowing him/her to transfer a certain amount of funds, tax-free, during his/her lifetime. If a person does not use all of his/her exemption during life, it becomes his/her exemption against federal estate tax at death. In 2016, the federal lifetime exemption is $5,450,000. While taxable gifts must be reported, you do not pay any gift tax until your aggregate taxable gifts exceed your lifetime exemption. For example, Bill transfers $1,028,000 to his 2 children in 2016. He will file a Form 709, *United States Gift (and Generation Skipping Transfer) Tax Return* to disclose the $1,028,000 total gift. The return will show that $28,000 of the gift was sheltered by the annual exclusion, and the remaining $1,000,000 reduced his lifetime exemption amount. While he must file the return, Bill will not owe tax. If no other gifts were made during his lifetime, the IRS would see that Bill has $4,450,000 of lifetime exemption left to shelter his estate against federal estate tax at his death.

Can I make annual gifts any time during the year?

Yes. While gifts can be made at any time it is wise to make annual gifts earlier in the year for three reasons: (1) to avoid an unexpected death occurring during the year; (2) to move the entire year's appreciation or income from gifted asset out of your estate; and (3) to avoid incomplete gifts. This last issue arises often with donors who like to make their gifts during the holiday season. Often, they give checks to their children and grandchildren in December. With holiday bank closures, travel schedules, and social gatherings, family members frequently do not deposit these checks until early the following year. In order for a gift to be complete, it must not only be given to the recipient, but it must be deposited in a bank before the end of the calendar year. If it is not deposited, it is not considered a completed gift made in the current year. Note that this rule is different for charitable gifts, which just require that the check be placed in the mail to charity by calendar year-end.

Can I use my spouse's annual exclusion to give more of my assets?

Yes; one spouse can make a gift of twice his/her annual exclusion amount and elect to treat the gift as being made jointly by the donor and his/her spouse. This is known as gift-splitting. For example, suppose Husband would like to give $20,000 to his elderly mother, but this generosity is not shared by Wife. If Husband alone makes the gift of his separate property, $14,000 of such gift will be sheltered by his annual exclusion and the excess $6,000 will be a taxable gift. However, Wife agrees to gift-split, Husband's gift of his separate property will be treated as being made one-half by Husband and one-half by Wife. Because each would be under his/her annual exclusion limit, no taxable gift would be made. To make the gift-splitting election, Husband would need to file a Form 709 United States Gift (and Generation Skipping Transfer) Tax Return and Wife would need to co-sign.

Do gifts to 529 plans qualify for either the educational exclusion or the annual exclusion?

While gifts to 529 plans do not qualify under the "Ed-Med Exclusion" of IRC Section 2503(e)), they will qualify for the annual exclusion against gift tax. Therefore, a taxpayer can gift $14,000 to a 529 for a beneficiary annually without reporting any gift. In addition to making an annual exclusion gift, taxpayers are permitted to front-load 529 plans, by transferring up to five years' worth of annual exclusion gifts in one year. Thus, if Bill has made no other gifts to his child this year, he can transfer up to $70,000 to his child's 529 plan ($14,000 x 5 years). If Bill was married, he and his wife could transfer up to $140,000 to the plan this year. This election is made on a Form 709 *United States Gift (and Generation Skipping Transfer) Tax Return.* However, in years 2 through 5, Bill (or in the second scenario, Bill and his wife) cannot make any additional annual exclusion gifts to his child. As mentioned earlier, because the exemption is indexed to inflation, it may increase in future years. If Bill made a $70,000 gift to his child this year when the annual exclusion was $14,000 and it increases the following year to $15,000, Bill could make an additional $1,000 gift to his child in each of the following years. If a donor makes an accelerated gift and does not survive the five year period, the gifts deemed made in the years that he/she did not live will be included in his/her taxable estate.

Are death-bed gifts valid?

Yes. All completed gifts, regardless of timing, will be deemed valid. Federal estate tax is calculated by bringing all non-annual exclusion gifts made during life back into a decedent's estate and restoring his/her lifetime exemption amount. For example, if Bill gave $1,000,000 of stock to his son in 2000, and used $1,000,000 of exemption to shelter this gift, when he dies, his estate would include $1,000,000 of stock but he would also receive back the $1,000,000 of exemption. Therefore, the biggest federal tax savings will be realized by making annual exclusion gifts (including those made on a death-bed) and gifts of income-producing or appreciating assets (while the underlying gift is brought back into the estate, the income and appreciation do not come back in). Washington State does not calculate its tax by bringing back all lifetime taxable gifts. Therefore, all transfers made during life, including those made on a death-bed, can potentially produce substantial state estate tax savings. There is one exception to this rule. If a life insurance policy is gifted within three years of death, the proceeds will be included in the donor's estate as if he/she owned the policy.

How can I maximize (i.e., leverage) my gift?

There are three general ways you can leverage your gift: (1) take advantage of the timing of your gift; (2) gift certain assets rather than others; and (3) consider various gifting structures rather than a simple outright gift.

How does timing leverage a gift?

In general, you can maximize gifts by transferring funds during life, rather than waiting until death. Suppose Bill is considering giving $1,000,000 to his daughter. If he dies in 2016 with a $6,000,000 estate, he will pay federal estate tax on the excess over his federal lifetime exemption plus, he will pay state estate tax on any amounts over his state estate tax exemption. Assuming he hasn't used any exemption during his lifetime, his total tax due to his estate will be $541,360. However, suppose Bill had transferred $1,000,000 to his daughter 10 years ago. His estate would be significantly lower, as all the dividends and appreciation over the last 10 years on the $1,000,000 would be out of his taxable estate. Assuming that the $1,000,000 appreciated at 4% per year, the total over 10 years would be $480,244 that escapes tax. In addition, because Washington State does not bring lifetime gifts back into your estate at death, Bill will never have to pay state estate tax on the $1,000,000 gift and the $480,244 of appreciation, saving his estate an additional tax at rates of 10%-20% (i.e., $148,024 to $296,048) that would otherwise be due if he held onto the $1,000,000 until death.

The benefit of lifetime gifting is even more pronounced if Bill is making a gift in excess of his lifetime exemption amount. This is because the gift tax is an *exclusive tax* (where dollars other than those gifted are used to pay the tax) whereas the estate tax is an *inclusive tax* (where the dollars that are used to pay the tax are also subject to tax). If a donor is transferring funds in excess of his lifetime exemption, an exclusive tax system will always produce significantly better results than an inclusive tax system.

Are some assets better to gift than others?

Yes. While gifts of cash or marketable securities might seem like the most logical assets to transfer, noncash gifts are generally more advantageous. Life insurance is one of best assets to transfer and can result in the most leverage. Other noncash assets, such as real estate and interests in a closely held business are common assets used to leverage gifting due to *valuation uncertainty* and/or *fractionalization of ownership* to obtain value discounts.

Why is life insurance a common asset used for leveraged gifting?

Many taxpayers own life insurance policies on their own lives. Unfortunately, if these taxpayers have taxable estates, they may lose up to 40% of the insurance proceeds to taxes. Because the insured will never receive the proceeds (since, by its nature, the insured needs to die in order for the proceeds to be realized), it is a great asset for the insured to gift. In addition, the policy is always worth less while the insured is alive, creating the leverage. For example, if Bill has a life insurance policy with a death benefit of $1,000,000, and a fair market value of $100,000 (the interpolated terminal reserve value), Bill can give the policy to his daughter, using $100,000 of his lifetime exemption. By doing so, he has effectively moved $1,000,000 from his estate at death.

Often, a donor will gift funds to an Irrevocable Life Insurance Trust (ILIT) for the benefit of a spouse and/or children to allow the trust to purchase a policy on the donor's life. These policies are often used as replacement income for the spouse and/or children, or as a source of liquidity to pay estate taxes upon the donor's death. Each year, the donor makes gifts to the trust to provide the trust with funds to pay the premiums. Upon the donor's death, the proceeds in the trust are not subject to estate tax. Therefore, the donor has removed a large life insurance death benefit out of his/her estate for only the "cost" of the annual premium amounts.

How does valuation uncertainty provide leverage?

Unlike a stock traded on an exchange which has a readily-determinable value, illiquid assets such as real estate or interests in a closely-held business can have some valuation flexibility. For example, a house can be appraised at a value of $400,000 to $425,000, allowing the taxpayer to decide whether to use the average or the low end of the value range. Essentially, the donor can exploit the valuation uncertainty to pass extra value to his/her beneficiaries.

How does fractionalization provide leverage?

Even greater leverage can be obtained by fractionalizing ownership of a hard-to-value asset. This rationale is that if you have 100% of an asset, you have full control. Without anyone else's consent, you can decide to sell, transfer, or lease the asset. However, if you do not have full control (e.g., you only own 50% of the asset), then the asset isn't as valuable. In other words, if you own 100% of a $400,000 house, it is deemed to be more valuable than 50% of an $800,000 house. In Washington, your 50% of the $800,000 house can be discounted by at least 15% (from $400,000 to $340,000). By combining valuation uncertainty and fractionalization of ownership, you can leverage the amount that you transfer.

How can I structure my gift to provide maximum leverage?

Depending on the asset, your desire to control the asset, and your need for income from the asset, there are different structures that you can use. These include (1) a limited liability company (LLC), a partnership, or similar entity; (2) a Qualified Personal Residence Trust (QPRT); and (3) a Grantor Retained Annuity Trust (GRAT).

1 Under the Internal Revenue Code, all tax paid on gifts made within three years of death are included in the decedent's federal taxable estate.

How can a family LLC help me leverage my gift?

One way to take advantage of the valuation uncertainty and the fractionalization of ownership is with a family LLC. A family LLC is generally an entity that is established and funded by the parents. It is usually funded with a large asset that is difficult to divide, such as an apartment building. The family LLC will have an operating agreement which contains restrictions on the members' interests. For instance, these agreements usually prohibit a member from transferring his/her interest to a non-family member without consent of all other owners. These types of restrictions create a *lack of marketability.* Again, if you had full control of an asset the asset would be worth its full value. Once restrictions are placed on an asset, it loses value for tax purposes. In addition, the operating agreement will generally contain provisions stating that certain decisions are made by majority vote. Therefore, if you have a minority interest in the family LLC, you lack control. The value of the family LLC interest can usually be discounted for both *lack of marketability* and *minority interest.* Combined with the valuation fluctuation of the underlying asset, these discounts can significantly reduce the taxable value of the family LLC interest that is being transferred.

For example, suppose Bill and Sue wish to transfer $250,000 of value to each of their two children. If they transfer cash, they would have used $500,000 of their combined lifetime exemptions. However, now suppose that instead of cash, they transfer an apartment building valued at roughly $1,000,000 (taking advantage of the valuation uncertainty which may put the apartment building value in a range of $1,000,000 to $1,200,000) to a family LLC. Then they transfer a 25% interest in the family LLC to each child. Each 25% interest would be appraised, with discounts for lack of marketability and minority interest. Assuming a 35% discount on these transfers (published cases report discounts ranging from 15% to 70% depending on the facts, but in our experience, the common range is generally between 15% and 45%), Bill and Sue are deemed to have transferred $162,500 to each child, saving themselves a total of $325,000 of their lifetime exemptions.

What is a QPRT and how can it help me leverage the gift of my residence?

If you are considering transferring your primary residence or a vacation home to your children, a qualified personal residence trust (QPRT), otherwise known as a House Trust, should be considered. With this technique, a donor establishes a trust and contributes his/her residence to the trust. However, he/she retains a right to live in the residence for a term of years, after which the house passes to the donor's beneficiaries, usually the donor's children. Essentially, the donor is making a gift of the *remainder interest* in the house, and that amount will be considered a taxable gift. This can be offset by the donor's lifetime exemption. The IRS views the gifted remainder as having a value equal to a fraction of the current fair market value determined based on the length of the trust term. The longer the trust term, the smaller the value of the remainder interest deemed gifted to the donor's beneficiaries when the trust is established. If the donor lives until expiration of the trust term, the beneficiaries become owners of the house without having to pay any further tax. Following the term of the trust, the donor may continue to live in the residence, but he/she must pay fair market value rent to the beneficiaries, which can be viewed as an additional gifting opportunity.

The benefit of this technique may be illustrated as follows: assume a 60 year old donor has a home worth $750,000 that is likely to appreciate at a rate of 5% per year. If the donor puts the home into a trust for 15 years, the donor is treated as making a gift of the remainder valued at $398,827. If the donor survives the trust term and dies in the 16th year, the house is no longer included in the donor's estate and the children receive an asset worth $1,559,196 tax-free while the donor has used only $398,827 of the donor's lifetime exemption.

However, if the donor dies within the 15 years, he/she is treated as if he/she never set up the trust. The house, at its appreciated value, is brought into his/her taxable estate and the $398,827 of lifetime exemption that he/she used to shelter the initial gift is restored. It is a “heads I win, tails I break even” type of technique.

What is a GRAT and how can it help me leverage my gift?

Many donors wish to gift assets, but are afraid that they might need the asset in future years. *Freezing* the size of their estate rather than reducing it, is the goal and a Grantor Retained Annuity Trust (GRAT) is often the right gifting technique. A GRAT is a Trust to which a donor transfers assets and retains the right to receive a fixed annuity for a set term of years. At the end of the term, the remaining trust principal and income is transferred to the remainder beneficiaries. During the Trust term, the Grantor pays the Trust income taxes which will reduce his/her gross estate by the amount of the tax paid without the payment of the tax being treated as a gift itself. Gift taxes are generally due when the Trust is created; however, most taxpayers often establish “zeroed-out” GRATs, which have no gift tax liability. A zeroed-out GRAT is a GRAT to which a donor makes a contribution and the annuity is fixed to return the entire contribution to the donor. For example, Bill establishes a 2-year GRAT for the benefit of his children, and transfers $1,000,000 of closely held business stock to the GRAT. Bill sets the annuity payment so that on the first year’s anniversary date, he receives 50% of his contribution back, plus a minimal amount of interest required by law (2.2% in January 2016), and on the second year’s anniversary date, the trust terminates and pays him the remaining 50% of his initial contribution plus the minimum amount of interest. Anything in excess of his initial contribution and the minimum amount of interest (i.e., any dividends and appreciation), passes to his children, tax free. This technique can allow you to pass hundreds of thousands of dollars, tax-free, but allow you to retain the underlying asset. Many taxpayers are so happy with their returns that they set up *rolling GRATs*. In other words, the set up their initial GRAT, and when the first distribution pays out, they set up a second GRAT for that distribution. Any time they receive a distribution, they place it into another GRAT so that the money isn’t tied up for very long, but the benefits keep accruing.

Can I use any of these leveraged gifting techniques without giving up control of the assets?

Yes. Leveraged gifting tools like family LLCs, House Trusts, and GRATs allow a donor to retain some amount of control over gifted property. With a family LLC, the donor can serve as the Manager of the entity and have control over the underlying investment asset. With a House Trust, the donor can serve as Trustee of the trust. Finally, with a GRAT, the donor can use short term trusts so that the assets are not out of his control for more than 1-2 years. However, if control of the assets is desired because the beneficiary’s immaturity or incompetency is a concern, the recipient of any of these techniques can be a trust for a beneficiary rather than an individual beneficiary. A trust will allow someone who is financially responsible (a Trustee), to manage the trust assets while making principal and income available to the trust beneficiary.

How do I get started with an annual gifting plan or learn more about leveraged gifts?

For more information about annual gifting or leveraged gifting, please contact any one of the attorneys in Helsell Fetterman’s Estate Planning & Probate Group.

To learn more, contact our

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