Gifting

Among the goals of most comprehensive estate plans is the reduction of federal and state inheritance taxes. For this reason, a carefully prepared Will or Revocable Trust is crucial to an effective estate plan and can produce substantial tax savings through the proper disposition of one's assets at death. However, because neither a Will nor a Revocable Trust reduces the total size of one's taxable estate at death, only so much can be accomplished within the confines of these documents. For those who are willing and able to take the further step of reducing their taxable estates by making lifetime gifts, far greater tax savings opportunities exist through a lifetime gifting program. Of course, there can be financial, personal and family reasons why lifetime gifts are not appropriate, and tax savings should never be allowed to dominate more important aspects of family life. For the purposes of this memorandum, however, we will assume you are willing to consider at least a modest lifetime gifting program and explore the various opportunities available to you.

I. THE BASIC TAX RULES OF MAKING LIFETIME GIFTS[1]

A. "Annual Exclusion"- The Free Gifting Privilege

Each person is allowed to give $15,000,[2] per year, per person, to as many persons as he or she wishes. No federal gift tax is due as a result of such gifts and no gift tax return is required.[3] For married couples, this amounts to $30,000 per year, per donee. If one

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[1] This memorandum is not applicable to taxable gifts of U.S. property by nonresident aliens.

[2] The $15,000 amount is effective for gifts made on or after January 1, 2018 and is scheduled to increase to reflect the effect of inflation in future years.

[3] The annual exclusion is allowed only if the person receiving the gift has the right to immediate enjoyment of the gifted property. Gifts to certain types of trusts will not qualify for the annual exclusion.

spouse gives the entire $30,000, the other spouse can consent on a gift tax return (called "gift splitting") to the use of his or her $15,000 exemption to reach the $30,000 limit.

B. "Medical and Educational Exclusion"- Additional Free Gifting Privilege for Specified Purposes

The Internal Revenue Code provides that direct payment of tuition or medical expenses of another person is not classified as a taxable gift, regardless of the amount. Accordingly, many individuals are able to significantly reduce the size of their estates by directly paying the tuition and medical expenses for their children, grandchildren and/or other loved ones.

C. Deferral of Tax on Additional Lifetime Exemption Amount

After the annual exclusion and medical/educational gift privileges are exhausted in any given year, you may still make gifts without having to pay federal gift tax on a current basis through use of the "lifetime gift tax exemption." Each individual has the ability to make up to $11,700,000 in total lifetime gifts without the imposition of any federal gift tax.[4] The use of all or part of this exemption during lifetime will result in a corresponding reduction in the donor's federal estate tax exemption at death. Nevertheless, using this lifetime exemption generally proves quite advantageous, for all income earned on the gifted property after the date of gift, and all post-gift appreciation in value, escapes inheritance taxes.

To illustrate the potential benefits of using $11,700,000 of the lifetime gift tax exemption, compare two persons, Parent A and Parent B, each of them with assets of $13,700,000. Both are considering giving $2,700,000 to their children. Parent A decides to make the gift, and gives the $2,700,000 to his children 20 years before his death. During the next 20

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[4] The federal gift tax exemption was $5,000,000 for gifts made in 2011, indexed for inflation. The 2017 tax law changes set the exemption amount at $10,000,000 for gifts made in 2018-2025, indexed for inflation to $11,700,000 in 2021.

years the gifted property earns income of $50,000 per year, for a total of $1,000,000 and also grows in value to $5,000,000. Parent B decides not to make the gift, retains the property, collects the income, and benefits from the growth in value. For purposes of this example, assume that the value of all property owned by each of them other than the $2,700,000 (gifted by Parent A or retained by Parent B) increases in value by $500,000. A simplified example of their respective federal estate tax returns follows.

Example I

	Parent A	Parent B
Original Estate	$13,700,000	$13,700,000
Taxable Gift	$2,700,000	0
Estate Assets After 20 Years	$11,500,000	$17,500,000
Approximate Federal Estate Tax (assuming 40% federal estate tax rate and a $11,700,000 federal exemption)	$1,000,000	$2,320,000
Property Received by Children	$16,500,000[5]	$15,180,000[6]
Advantage of Gift	$1,320,000	

C. Gifts Which Require Payment of Gift Tax

Clients with very significant estates may wish to continue making taxable gifts even after the annual exclusions and the lifetime gift tax exemption have been exhausted. Such gifts will require payment of a federal gift tax, but nevertheless may be advantageous since all income earned by the gifted property subsequent to the gift, and all increases in value,

[5] $10,500,000 from estate, $6,000,000 from gift (including income on gift and appreciation).

[6] $15,180,000 from estate, $0 from gift.

will escape transfer taxation at death. Moreover, the gift tax paid itself becomes a deduction for estate tax purposes because it reduces the estate during lifetime.[7]

Clients contemplating making such taxable gifts must keep a few potential pitfalls in mind. First, one disadvantage of making gifts in excess of the annual exclusions and the lifetime gift tax credit is that the tax must be paid at the time of gift, rather than at the time of death, which could create a liquidity or cash flow problem for some individuals. In addition, if the estate tax ever were repealed, the payment of gift tax would have been a waste.

Even for individuals who are not residents of Connecticut, a Connecticut gift tax still applies to gifts of real estate or tangible personal property located within Connecticut. Conversely, the Connecticut gift tax generally does not apply to gifts of real estate or tangible personal property located outside of Connecticut, even if the donor is a Connecticut resident.

II. CHOICE OF PROPERTY FOR LIFETIME GIFTS

In many cases, the selection of assets to give away will be driven by nontax considerations. For example, a person with a substantial estate may be willing to gift a summer home to his or her children, but not income-producing stocks and bonds on which he or she relies for his or her lifestyle. In the absence of specific personal considerations, however, there are some basic financial and tax law principles that apply to the choice of property to be given.

- Cash is a particularly good gift. The beneficiary can invest the cash for growth, or, if needed, can use the cash for education, support, or other expenses.

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[7] This deduction is available only if the donor lives for three years after the gift.

- Property that is expected to appreciate at a high rate of return in the future generally is a preferable choice to property that is not expected to appreciate.
- Certain types of property that have a range of value, rather than a clearly defined value, may be good assets to give away. Real estate would be one example. For example, an appraiser may be likely to conclude that the value of a particular parcel of real estate might be somewhere between $500,000 and $700,000, depending upon a host of factors relating to the market for that property. A lifetime donor of such property can make the gift at the optimal time from a valuation standpoint and obtain a written appraisal from a certified appraiser that will substantiate the valuation.
- Insurance policies can be a particularly attractive asset for gifting. Apart from access to the cash value of a policy, the insured generally will derive no monetary benefit from a policy insuring his or her life. This often makes insurance a very palatable asset to give away. Moreover, the value of an insurance policy for <u>gift</u> tax purposes is the current cash value of the policy (which may be zero, in the case of term life insurance), whereas the value of the policy at death if it is owned by the insured is the death benefit payable under the policy. In effect, assuming a federal estate tax rate of roughly 40%, giving an insurance policy away rather than holding onto it until death can almost double the value of the policy to the beneficiary. Note, however, that a gift of an insurance policy already in force will not be effective for estate tax purposes unless the owner lives for at least three years after the policy is transferred. In most cases, that will not be a problem, but if the insured is in poor health or quite elderly, there may be other assets more suitable for giving. This subject is more fully discussed in Section IV of this Memorandum.
- Finally, just as some assets are particularly well suited for gifting purposes, some assets are not. The most common example is property that has a low tax cost basis and would produce a significant capital gain if sold. The reason such property is poorly suited for gift-giving is that property owned by a person at the time of death receives a "stepped-up basis" for income tax purposes - that is, all of the potential capital gains are effectively forgiven. On the other hand, if such property is given to another family member before death, the capital gains remain in place and capital gains tax will be due when the family member sells the

property. If the property is unlikely to be sold, such as family company stock or a family vacation home, the potential for capital gains is less of a problem, but remains an important factor to consider in the selection of property for gifting.

III. FEDERAL TAX RETURN REQUIREMENTS

If gifting is limited to annual exclusion gifts ($15,000 per year, per donee), generally there is no requirement to file a federal gift tax return, nor to pay any tax. However, if a married couple wishes to combine their annual exclusion amounts to make a $30,000 gift to one beneficiary, and the gift does not come equally from each spouse, gift tax returns are required. In this case, the spouse who contributes the lesser amount of property to the gift must sign the other spouse's gift tax return, giving consent to use of the balance of his or her $15,000 exemption to offset the larger gift made by the other spouse.

Also, if any gifts are made to trusts, a gift tax return may be required to make certain elections relating to the use of the donor's "GST exemption" with respect to the gifts, to determine how that trust will be treated for purposes of the federal generation-skipping transfer tax (GST).

When gifts in any one year exceed the available annual exclusion, a gift tax return must be filed even if no gift tax is due. If you have part or all of your lifetime gift tax exemption available, then no federal gift tax will be due, but the tax return will show the use of a portion of the lifetime gift tax exemption to offset the tax which otherwise would be due.

Federal tax returns are due no later than April 15 of the year following the date of gift.

The federal gift tax rate is 40% after the annual exclusions and lifetime gift tax exemption are fully utilized.

IV. GIFTS AND TRUSTS

Most smaller gifts, particularly one-time gifts, are made directly to the individual beneficiaries. There are exceptions where the beneficiaries are minors, in which case it is common to make gifts to their parents, who serve as Custodians under the Uniform Transfers to Minors Act. This state statute amounts to a very simple trust, whereby the parents will manage and use the money for the child's benefit until age 21, at which time the remainder of the gift (if any) must be turned over to the child.

Where more substantial gifts are contemplated, or smaller gifts will be made each year over a period of many years, parents and grandparents will commonly create trust funds for the management of the gift property. Very careful consideration must be given to the terms of the trust, the ages at which the beneficiaries will become entitled to receive the trust funds, and the choice of trustees to manage the trust.

Listed below are some of the most common forms of trusts used to reduce estate taxes and control the management of the trust funds for the family.

A. Life Insurance Trusts

Life insurance trusts, whether funded by the transfer of an existing policy, or by the transfer of cash which is used by the trustee to purchase a new policy, are perhaps the single most effective vehicle for making lifetime gifts. This is due to the nature of life insurance and its extremely favorable treatment under federal tax law. Unlike most other investments, the difference between the amount paid for life insurance and the amount received at death is not subject to capital gains taxes.

It is common to establish trusts containing insurance policies and to pay the annual premiums on such policies in a manner that will qualify for annual gift tax exclusions. For example, if a married couple has three children and two grandchildren, a total of $150,000 can be given to a properly drafted trust each year without the payment of gift tax. This cash could be used to purchase life insurance, perhaps as much as $5 million to $10 million, depending upon age and health.

Another popular use of insurance trusts satisfies the need of many of us to begin a gifting program at a modest level so as not to jeopardize our own retirement income, yet provide our children with a sizeable potential trust for their long-term needs. A married couple in their 50's might find they are comfortable giving $20,000-$40,000 yearly to an insurance trust, knowing the gifts could be stopped whenever they chose. This trust could purchase fully tax-sheltered survivor life insurance of several million dollars, depending on their age and health. If it is necessary to discontinue the annual gifting program before the insurance is paid up, usually the policy can be converted to a lesser amount.

B. Simple Estate Reduction Trusts

The individual who wishes to transfer securities, real estate or other property interests to his or her family, in order to reduce eventual estate taxes, often will use an "estate reduction trust." The reasons for using a trust instead of making an outright gift could include:

- "Disability" - one or more family members are minors or otherwise legally incapable of dealing with property
- "Lack of Experience" - the recognition that an experienced hand at the financial wheel can be critical
- "Creditors" - to protect the family against outside claims
- "Spousal Influence or Claims" - concern over inheritance being mismanaged by a spouse, or taken by divorce
- "Predators" - to protect against the gifted property falling into the wrong hands.

C. Qualified Personal Residence Trusts

An individual may place a family residence (either primary or vacation) in a trust that expires after a stated period of years. At that point, ownership passes to the remainder beneficiaries, children, or a trust for their benefit. This is an extremely effective way of reducing estate taxes. A more detailed Cummings & Lockwood client memorandum is available on this topic.

D. Grantor Retained Annuity Trusts

A trust known as a Grantor Retained Annuity Trust, or "GRAT," is particularly useful when the donor has an asset that is expected to increase substantially in value over a relatively short period of time. The terms of the GRAT require the trustee to pay an annuity of a specified dollar amount to the donor or "grantor" for a specified number of years. At the end of the term, the trust terminates, and the remaining trust property is distributed to the grantor's selected beneficiaries, often the grantor's children (or a trust for their benefit). The advantage is that the transfer tax value of the gift effectively can be eliminated by calculating the amount of the annuity and the term of the trust so that, according to the Internal Revenue Service's actuarial tables, there should be little left to the children when the trust ends. In reality, if the actual performance of the trust assets exceeds the IRS assumptions used to value this gift, there may be substantial property left in the trust when it ends. For example, if a GRAT were created in a month in which the IRS assumes an interest rate of 3.0% and is funded with $1,000,000, and if the grantor of the GRAT received a payment of $220,000 each year from the GRAT for 5 years, under the IRS tables there would be no taxable gift. This is because the IRS tables project that payment of the $220,000 annuity to the grantor each year for 5 years would exhaust all of the trust principal and income, leaving nothing at the end for the children. However, to the extent the trust in fact produces significantly more than 3.0% of annual income or the principal value grows, then the trust will not have to be fully invaded, and a substantial amount will pass tax-free to the children. A more detailed Cummings & Lockwood client memorandum is available on this topic.

E. Charitable Remainder Unitrusts

In its simplest sense, a Charitable Remainder Unitrust is a trust which pays back to the grantor, each year, a stipulated percentage of the trust assets.

At the end of the trust, whatever trust property remains is distributed to charity. This has a number of beneficial results:

- There is an immediate income tax deduction for the future value of the gift to charity.
- The trust itself generally is exempt from income taxes. Accordingly, most types of appreciated property can be placed in the trust, and then sold, without having to pay any immediate capital gains tax. A portion of the capital gain is deemed distributed each year as part of the grantor's annuity, thus spreading the tax liability over several years. This means that the grantor will continue to enjoy the income earned by the money which otherwise would have been paid in taxes.
- Similarly, capital gain property producing relatively little current income (valuable land, for example) can be sold, and reinvested in property producing significant income, including tax-free income. The net effect can be to significantly increase cash flow. The grantor may wish to purchase life insurance with a portion of the increased cash flow, in order to provide family members with an amount equal to the value of the property which is now going to charity at death. This insurance can be placed in an insurance trust in order to keep it out of the grantor's estate for tax purposes.

V. GENERATION-SKIPPING TRUSTS

While this subject is beyond the scope of this memorandum, it is worth noting that federal tax law contemplates that an estate tax will be imposed at each generational level; that is, upon the death of any individual (or, in some cases, upon the death of his or her spouse), an estate tax will be due; when that person's children die, the property which they inherited will be taxed again; when the grandchildren die, there is another round of tax; and so on. When people try to avoid this result by "skipping" generations, a separate equally onerous generation-skipping transfer tax applies. There is one exception to this rule. Each person can leave a lifetime total up to $11,700,000 (as indexed for inflation in 2021) in trust for succeeding generations without triggering a generation-skipping transfer tax. This amount is measured at the time the trust is created, either during lifetime or at death, as the case may be. For example, a husband and wife can create a trust and fund it with $23,400,000 during their lifetimes, paying whatever gift taxes may be due. If at their deaths the trust funds are worth $26,500,000, only the original $23,400,000 will have been subject to tax. If the property then grows to $50,000,000 by the deaths of the children, it still passes tax-free to the grandchildren. If it grows to $100,000,000 by the deaths of the grandchildren, it still passes tax-free to the great-grandchildren. These generation-skipping trusts are sophisticated devices that offer potentially significant tax savings. They require careful planning and discussion prior to implementation.

The benefit of the GST exemption can be increased, or "leveraged," by allocating it to lifetime gifts of appreciating property. For this reason, life insurance is a popular funding vehicle for generation-skipping planning. For example, assume Mr. Jones funds a trust with a $1,000,000 life insurance policy on his life that costs $13,000 a year to keep in force and, each year that Mr. Jones pays the $13,000 premium, he allocates $13,000 of his $11,700,000 GST exemption to the trust. If Mr. Jones dies five years after he first funded the trust, then the entire $1,000,000 of death benefit is protected from GST tax at a cost of only $65,000 of his GST exemption.

VI. A FEW FINAL OBSERVATIONS

Gifts are the keystone to effective estate planning, particularly for those whose assets which, if retained until death, may be taxable at rates of 40% (or more, if state estate taxes also are due). However, all gifting programs to reduce taxes must first be examined in the light of personal circumstances. A person with a modest estate who lives frugally and has adequate medical insurance may very well make significant gifts, whereas a much wealthier person with a different standard of living may choose not to make gifts at all.

Concern about loss of control over the gifted funds should not be an insurmountable issue. In almost all cases, a trust can be designed so that a trusted advisor will be on hand to make the necessary decisions after consulting with the person making the gift. A great deal of flexibility can be built into modern trusts, including allowing trustees to take a "second look" in later years and modify the provisions of the trust (or even terminate the trust, if advisable) as family circumstances change.

The costs of managing a trust, both monetary and otherwise, should not be a significant concern. Trustees' fees generally are the same or often less than similar fees paid to professional investment advisors for similar services. While an income tax return must be filed by the trustee, this is a relatively modest and inexpensive undertaking in most cases.

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