Annual gifts: A smart way to transfer wealth

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In brief

For several years, substantial uncertainty has existed in the estate and gift tax area. Until the end of 2012, the estate and gift exemption and tax rates after 2012 were unknown. This uncertainty prompted many individuals to make substantial gifts and to take advantage of the increase in estate and gift tax exemption from $1,000,000 to $5,000,000. At the close of the 2012 tax year, the American Individual Relief Act of 2012 was signed and added a sense of “certainty” to the previously uncertain structure.

With certainty, came opportunity. While many individuals made substantial gifts in 2011 and 2012 fearing a reduction in the estate tax and gift tax exemption, others for a variety of reasons refrained from taking any action. This article discusses present and future planning opportunities that exist regardless of whether one previously took advantage of the increased gift tax exemption. Below are some basic, but highly effective techniques that serve to reduce future potential estate tax.

In detail

Lifetime exemption

Effective for 2013, an individual may transfer cash or property with a value of $5,250,000 free of estate and gift tax (the exemption amount is annually indexed for inflation, is scheduled to increase to $5,340,000 on January 1, 2014). An individual’s unused lifetime exemption amount, if any, can be used at death. As such, individuals are free to transfer substantial wealth during their lifetime for a variety of reasons and take advantage of the lifetime exemption amount. As mentioned above, many individuals took advantage of what they believed to be a one-time opportunity to transfer wealth in 2012. However, regardless of whether an individual fully utilized his or her lifetime exemption in 2012 by making transfers to family and loved ones, gifting opportunities still exist in 2013 and 2014.

Annual exclusion gifts

While there are very sophisticated ways of transferring wealth to reduce the estate tax, there are also some very simple techniques that may be employed to efficiently reduce the value of one’s estate without using their lifetime exemption. One such example is taking advantage of the annual gift exclusion. Annual exclusion gifts are a useful way to transfer assets to friends and loved ones while reducing the impact of future estate taxes. Annual exclusion gifting may be successfully used by individuals who have already used their lifetime exemption amount but would like to make further gifts without paying gift tax. For individuals who wish to preserve their lifetime exemption, annual exclusion gifts can be used to transfer wealth.

Direct transfers

The gift tax annual exclusion, when properly used, allows an individual to transfer wealth without using one's exemption of paying gift tax. Gifts under the annual exclusion are not applied against an individual’s lifetime exemption. The annual exclusion amount for 2013 is $14,000. In a given year, an individual may make as many gifts of a "present interest" as he or she desires and apply the annual exclusion against each gift or gifts to a donee, up to $14,000 per donee.

For example, in 2013, an individual may make $14,000 gifts to each of his or her three (3) children. The individual may also make $14,000 gifts to each of his or her children's spouses. Further, the individual's spouse may make $14,000 gifts to each of the individual's children and the children's spouses. Under the aforementioned example, the individual and individual's spouse, combined, could successfully transfer $168,000 without incurring gift tax or using any of their lifetime exemptions. (6 gifts [3 children + 3 spouses] x $28,000 [$14,000 each for the individual and their spouse, respectively]). Note, the individual and his or her spouse could also make annual exclusion gifts in the amount of $14,000 to each of the recipients on January 1, 2014, thereby transferring an additional $168,000 of wealth. (6 gifts [3 children + 3 spouses] x $28,000 [$14,000 each for the individual and their spouse, respectively]). One advantage of the annual exclusion is it removes the gifted property, and any subsequent appreciation related thereto, from the individual's gross estate.

In addition to direct transfers, individuals may take advantage of the annual exclusion and still maintain some control by using trusts or other custodial arrangements.

Transfers into trust

Individuals are often hesitant to make outright transfers to young children or grandchildren. There are many arrangements that allow an individual to take advantage of the annual exclusion, but limit the minor's access to the gift. Individuals with young children or grandchildren may want to consider the following: (1) Crummey Trusts; (2) Minor's Trusts; (3) UGMA/UTMA accounts; and (4) Qualified Tuition Programs.

1. Crummey trusts

An individual may not want to give his or her children or grandchildren money outright. Rather, an individual may prefer to make transfers to a trust for the annual exclusion. In a Crummey Trust, the beneficiary can withdraw the property transferred to the trust for a specified period of time after the individual makes a gift to the trust. The withdrawal right, and the documentation or Crummey Letter giving the requisite notice to the beneficiary or his or her withdrawal right, are crucial to qualify a gift for the annual exclusion. If the beneficiary does not withdraw the gift within the allotted time, the beneficiary's right to withdraw lapses and the property stays in the trust.

2. Minor's trusts

In contrast to a Crummey Trust, gifts may be made to a Minor's Trust without giving the beneficiary notice. A Minor's Trust allows an individual to make gifts in trust for the benefit of a minor child while still receiving the benefit of the annual exclusion. The requirements for a Minor's Trust are: (1) the trust instrument must permit the trustee to expend trust assets for the benefit of the minor child before the child attains the age of majority; (2) if the minor dies prior to attaining the age of 21, the assets pass to the child's estate; and (3) once the child achieves the age of majority, the property must be distributed to the child, outright. The distribution requirement for a Minor's Trust makes them similar to a Crummey Trust.

3. UGMA/UTMA accounts

An UGMA (Uniform Gifts to Minors Act) or UTMA (Uniform Transfers to Minors Act) account is a custodianship account under state law wherein property is held by a custodian for the benefit of a minor. Generally, the account provides that the child shall not receive the property until the child reaches the age of majority -- usually 18 or 21, depending on the state's law. Under this arrangement, a parent may make annual transfers into a UGMA/UTMA account for the benefit of a minor child and the transfers qualify for the annual exclusion. Once the child reaches the requisite age, the custodianship terminates and the property is distributed outright to the child. The appeal of the UGMA/UTMA account is the simplicity. There is no need to have a trust drafted; however, similar to a Minor's Trust, these accounts are governed by state law and must be distributed at a set age.

4. Qualified Tuition Programs

For individuals and families that want to specifically set aside funds for education, a Qualified Tuition Program offers a simple alternative and significant tax advantages. Qualified Tuition Programs (529 Plans) are savings accounts that allow one to save for higher education on a tax deferred basis. If an individual's contribution to a 529 Plan exceeds the annual exclusion amount, the individual may affirmatively elect (by filing a gift tax return) to prorate the full amount contributed over a five-year period. For example, if an individual contributes $70,000 to a 529 Plan in 2013, the individual can elect to prorate the gift over a five-year period, thus qualifying for the annual exclusion ($70,000/5 = $14,000 each year for five years). (A married couple may contribute $140,000 over the five year period if they use community property or elect to gift split). If an individual chooses to make a gift to a 529 Plan equal to five times the annual exclusion amount and prorate the same over five years, the individual will be unable to make additional gifts to the beneficiary of the 529 Plan for five years without incurring a gift tax liability or using their lifetime exemption.

Other advantages to the Qualified Tuition Program include: (1) the money inside of the plan grows tax-deferred; (2) withdrawals used for qualified higher education expenses are exempt from federal income tax; (3) the account holder retains control of the assets within the program regardless of the beneficiary's age; and (4) the beneficiary of the plan can be changed at any time.

Payments outside of the annual exclusion and lifetime exemption

Finally, an individual should not forget about the opportunities available with regards to tuition and medical expenses. Reimbursing expenses does not qualify for this exclusion. There is an unlimited exclusion from gift tax for amounts paid towards another person's medical expenses or school tuition. In order to qualify for these exclusions, the payment must be made directly to the person providing the medical care or to the educational organization. There is no "relationship" requirement to qualify for these exclusions. Rather, the individual may make payments for this purpose for both relatives and unrelated parties. It should be noted these exclusions are in addition to the annual exclusion described above. Thus, these gifts would not be limited to $14,000 in 2014 and do not offset the individual's lifetime exemption.

The exclusion for tuition expenses is available for both full and part-time students, but is limited to tuition costs. Qualified education expenses do not include payments made for dormitory fees, books, supplies or living expenses. For instance, a grandparent may pay for a grandchild's private elementary school without incurring gift tax or using his or her lifetime exemption. Ever increasing tuition costs make this option extremely attractive for people of substantial wealth that desire to pay for a person's education or medical costs.

The same rationale may be applied for medical expenses. A person may pay for another's medical costs or medical insurance, directly to the provider, without incurring gift tax or using his or her lifetime exemption.

The takeaway

There are many simple, yet effective ways to transfer assets during life. By utilizing some of the aforementioned techniques, one not only reduces their estate tax during their lifetime, but also has the benefit of seeing others enjoy the gifts. Regardless of whether you have taken advantage of your increased lifetime exemption, opportunities exist.

Let's talk

For a deeper discussion of how this issue might affect you, please contact:

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