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Understanding Gift Taxation: A Foundation to Estate Planning Techniques

Situation: If you ask any estate planning advisor to tell you the best time for estate planning, they would likely tell you it is when the amount exempted from estate/ gift tax (exemption amount) is high and asset values and interest rates are low. That is the situation we find ourselves in today. In 2020, the transfer tax exemption is $11.58 million per person and the AFR and 7520 rates are at historic lows. Never has the opportunity for estate planning been so great and with the COVID-19 pandemic still widespread, planning for one's mortality is a topic on the minds of many.

However, to take advantage of this opportunity, your clients must act now. The Tax Cuts and Jobs Act provisions are increasing the exemption to the current amount. It is expected to sunset to around $6 million ($5 million indexed for inflation) at the end of 2025. The political climate in November may cause the exemption to be reduced substantially in advance of the 2025 sunset. Additionally, the government's significant stimulus spending over the past couple of months makes the likelihood of the exemption being extended remote.

As a result of the current situation, the number of calls and questions concerning various estate planning techniques has significantly increased in recent months. Many of the questions center on gift taxation. This Counselor's Corner will provide a review of gift taxation and some of the most common questions I've received that are related to gifting to an irrevocable life insurance trust (ILIT).

Solution: Before we get into a discussion of some of the common questions that have come across my desk concerning gift taxation, a little background is in order. The gift tax is a federal tax on the transfer of money or property by an individual to another person, either directly or indirectly (like to beneficiaries of a trust), while getting less than something of equal value in return. The person who makes the gift is known as the donor and the person who receives the gift is called the donee.

For gift tax purposes, a gift is considered complete when there has been a gratuitous transfer of property that has been accepted by the recipient, and the transfer divests the donor of control, dominion, and title.[1] So, three elements must exist for there to be an effective gift: donative intent, delivery, and acceptance.

The intent to make a gift by the donor is usually determined by the words, actions, and relationship of the donor to the donee. A key element in donative intent is that the donor must have the legal capacity to make a gift. For example, minors and individuals determined to be unable to take care of their own affairs are not able to make a gift.

Delivery occurs when the donor gives up control over the property. Provided some affirmative action takes place delivery may be actual, implied or symbolic. In situation where the donee is under some legal capacity to accept delivery, as in the case of a minor, then delivery can be to an individual who will hold it such as a trustee or custodian under Uniform Transfer to Minors Account (UTMA).

The final requirement for an effective gift is acceptance. This means that the donee must know about the gift and unconditionally agree to take the gift. A gift can be revoked by a donor anytime before acceptance and a donee can disclaim or refuse to accept a gift.

Generally, gift tax is paid by the donor. The donee will only pay gift tax in special circumstances where there is an agreement to pay the tax. The donee does not pay gift tax and does not recognize income tax on the value of the gift. However, the downside of a gift is that the donee is required to take the donor's basis and the donor's family loses the benefit of a basis adjustment (often referred to as a step-up in basis) to date of death value that would have been available if the donor had not made the gift.[2] So, when the donee goes to sell or exchange the gifted asset, income taxes will need to be paid on all the appreciation. Of course, the desired result is that the reduction in estate taxes outweighs the income tax paid on the gain when the asset is eventually sold.

Many donors don't get hit with federal gift tax because the IRS generally doesn't care what a donor gives away to other people until the giving exceeds a lofty amount. Specifically, three things keep the IRS' hands out of most people's pockets: some transfers are not subject to gift tax, some qualify as annual exclusion gifts, and some are less than the lifetime exemption amount. As a result, most gift transfers fall outside the federal gift taxation. Furthermore, only one state, Connecticut, has a gift tax.

Which gifts are not subject to gift tax?

There are several transfers that fall outside federal gift taxation based on the type of gift and the recipient. You can make the following transfers without facing a gift tax or having to file gift tax paperwork:

- Anything given to a U.S. citizen spouse as long as it qualifies under the marital deduction.[3]
- Donations to qualified charitable organizations made in a manner qualifying for the charitable deduction.
- Political donations.
- Tuition payments made directly to an educational institution for someone else.
- Funds paid directly to a medical institution or health insurance provider on behalf of another.

How much can be transferred without incurring a gift tax?

If the donor's transfer does not fall into one of the above categories, the donor can still make significant transfers without incurring gift tax as a result of the transfer being sheltered from tax by either the annual exclusion or the lifetime exemption amount.

Annual Exclusion

The annual exclusion lets a donor make gifts up to a certain amount per donee, per year, without needing to file or report the gifted amount. For 2020, the amount is $15,000. This amount is indexed and is increasing every few years by increments of $1,000.

The annual exclusion applies on a per donee per year basis. A donor can make $15,000 gifts to as many people desired. For example, a donor can gift $150,000 to 10 different people at $15,000 each under the annual exclusion gift. Furthermore, a donor can give the $150,000 to the 10 donees in December and turn around and give another $150,000 to the same 10 donees the next year. Clearly, a significant amount can be transferred over a period of time just using the annual exclusion gift.

To qualify as an annual exclusion gift, the gift must be of a "present interest" and not a future interest. This means that the donee must be free to use, enjoy, and benefit from the gift immediately – no strings attached. It's a future interest gift if the donee doesn't have use or enjoyment until some future point in time. Future interest gifts don't qualify for the annual exclusion, regardless of how small the transfer is. For example, a gift of insurance premium to an ILIT would be a gift of a future interest because the trustee controls the amount if it were not for the Crummey right given to the trust beneficiary(s) to take the premium given.

If a donor gives more than the annual exclusion amount to a donee, or the transfer restricts the donee's use over the gift, the donor will need to file a gift tax return (Form 709) and disclose the excess amount. The donor will not have to pay taxes on the excess amount as long as the amount given is within the lifetime exemption.

Lifetime Exemption

Most donors will not pay gift tax because the IRS allows a donor to give up to the exemption amount over their lifetime or at death without paying tax. For 2020, the exemption is $11.58 million. This amount is indexed, increasing every year. However, the current exemption is scheduled to expire on January 1, 2026. At that time, the exemption will decrease to $5 million per person (indexed).

The lifetime exemption for gift tax is shared with the federal estate tax. So, lifetime gifts reduce the amount of exemption left to shield an estate from estate tax. In other words, the IRS lumps together all lifetime gifts (over the annual exclusion) and bequests from the individual's estate. Eventually, at the end of life when an estate is settled, all the lifetime gifts exceeding the annual exclusion are added up and applied to the exemption. If this cumulative gift amount exceeds $11.58 million, taxes will apply.

For example, in 2020 a donor could give $315,000 to a friend. The gift is $300,000 over the annual exclusion. That means the donor will need to report and file a gift tax return for the $300,000. However, assuming no other large gifts have been made during the donor's lifetime, no gift tax will be due because the $300,000 reduces the $11.58 million exemption, leaving $11.28 million of the exemption that can be used to shelter future gifts or assets held at death. If over a donor's lifetime s/he exceeds the annual exclusion by a cumulative amount of $1 million, s/he will have $10.58 million left to shelter estate from estate tax.

Furthermore, under the portability rules, a surviving spouse can inherit any unused exemption remaining at the death of a spouse so long as the portability election is made on a timely-filed federal estate tax return. Continuing the example, if the donor dies having a $5 million estate, this would leave an unused exemption of $5.58 which his surviving spouse can elect to add the $5.58 million (referred to as the deceased spousal unused exemption DSUE) to her own lifetime exemption. Thus, portability can increase the amount that the surviving spouse can transfer by gift or at death without being subject to tax.

How much can be transferred by gift if the donor is married?

Since the annual exclusion and exemption amount is per donor, if the donor is married (and the spouse is either a citizen or resident) each spouse is entitled to the annual exclusion and exemption. Technically, a donor and spouse can gift $30,000 to one donee on an annual basis under the annual exclusion and an additional one-time amount of $23,160,000 (using both exemption). So, in one year, a donor and spouse could gift $23,190,000 to a single donee and not pay gift tax.

Split Gift. In addition to each spouse being able to make a gift of their own property, for gift tax purposes, under IRC §2513, a spouse can consent to split gift a transfer made by the other spouse. Once elected, all gifts made by either spouse during the calendar year will be considered to be one-half from each spouse. Spouses cannot pick and choose which gifts to split in a particular year. Gift splitting is only permitted if the following conditions are met:

- Both spouses consent to the split gift.
- At the time of the gift, both spouses are either US citizens or residents.
- The spouses are married at the time of the gift and if they subsequently divorce (or one dies) neither spouse remarries prior to the end of the calendar year.
- The donor spouse does not create in his/her spouse a power of appointment over the gifted property.

If spouses elect to split gift, each spouse will have to file his/her own gift tax return for the calendar year.

Will there be a clawback of gifts made during life if the exemption amount is lower at death than at the time the gift was made?

The 2017 Tax Cut and Jobs Act temporarily increased the exemption amount for gift, estate, and generation skipping tax purposes from $5 million per person to $10 million per person (indexed in 2020 $11.58 million). This increased exemption is scheduled to sunset/end on January 1, 2026. Because of the way the estate tax is calculated, there was concern that to the extent a taxpayer made gifts during life, sheltered by a larger exemption than what is available at the time of death, those gifts could be brought back (clawed back) into his/her taxable estate and subject to estate tax.

Fortunately, the IRS issued regulations to clarify and confirm that taxpayers making gifts made during the period of increased exemption do not need to be concerned about those gifts becoming taxable at death.[4] For example, assume a donor makes a lump sum gift of $10 million in 2020 when the exemption is $11.58 million to an irrevocable trust. Further assume the gift is a future interest gift because the trust did not include Crummey withdrawal rights. So, the full amount transferred is sheltered from tax by the exemption. Further assume that the donor dies after 2025 with an estate of $8 million when the exemption returns to $5 million indexed. Assume at the time of death the exemption is $7 million. To calculate the estate tax due the exemption gifts made during life are added back, resulting in an estate of $18 million ($10 million gift + $8 owned at death). Without the regulation clarifying the clawback issue, the $18 million would be subject to estate tax with only a $7 million exemption (exemption available at death). However, under the regulations, the estate is reduced by the higher of (1) estate tax exemption available at death ($7million) or (2) exemption used to make gifts during life that resulted in no gift tax being due ($10 million in our example). So, in this example, the $18 million estate is reduced by $10 million, leaving $8 million subject to estate tax.

All this means that ultra-wealthy individuals should give serious consideration to making gifts of at least their exemption amount before they lose this benefit. Furthermore, some wealthy families may want to consider making taxable gifts – gifts exceeding the exemption amount.

Why would an ultra-wealthy individual make taxable gifts? How does lifetime gifting work to reduce total transfer tax exposure?

Once an individual's cumulative gifting exceeds the exemption amount, federal gift tax will be due. Gift tax returns are due on or before April 15th. The gift tax schedule is the same as the estate tax schedule. Rates start at 18% and grade up to 40%. Once the exemption amount is exceeded, the tax rate is a flat 40%. Since the gift and estate tax rates are the same, one question that comes up with some frequency is, "why would an individual accelerate the payment of tax by triggering gift tax?" Why not wait until death and pay the same rate in the form of an estate tax? There are several reasons why an ultra-wealthy individual might consider making a gift in excess of the exemption.

First, gifting decreases the total estate by removing not only the asset itself, but any appreciation and income on the gifted asset from the estate. Over time, this can result in removing a significant amount from estate tax. For example, if a donor gave $5 million to a trust for the benefit of children in 2020, assuming a 6% annual growth rate, in 20 years the trust would be worth $16 million, excluding $11 million more from estate taxes than if the donor waited until death to use the exemption. However, the trade-off to avoiding estate taxes is that the appreciation will normally be subject to income taxation at the time the asset is sold or exchanged. If property has appreciated significantly in value, taxpayer should consult with their legal or tax advisor to determine if the estate tax benefits of making a gift outweigh the income tax benefit of retaining the asset until death and receiving a step-up in basis.

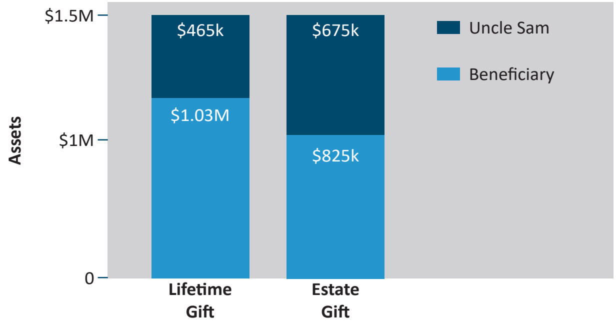
Second, several states have estate or inheritance taxes that apply to property owned at death, but only one state, Connecticut, has a gift tax. Consequently, by making lifetime gifts that are only taxable for federal tax purposes, the donor avoids federal and state death taxes.

Finally, there are enormous tax benefits to a taxable gift because the gift tax is tax exclusive while the estate tax is tax inclusive. Meaning the property used to pay the gift tax by the donor is not subject to gift tax, while the property used to pay estate tax is subject to estate tax – basically a double tax. The best way to understand this impact is through an example.

Assume a wealthy client has made cumulative lifetime gifts using their entire exemption amount so all future transfers will either be subject to gift or estate tax. Let us assume that the client has a budgeted $1.5 million to cover the gifted amount, as well as the federal tax that will be paid upon the gift's transfer. Also, let us assume that transfer taxes were raised to 45% to help pay for the COVID stimulus. How much money will the beneficiaries receive verses Uncle Sam if a gift is made during life verses as an estate transfer?

Gift Transfer	Left in Estate
Gift to Heirs: $1,034,000	Estate Value: $1,500,000
Gift Tax (1,034,000 X 45%): $465,300	Estate Tax (1,500,000X 45%): $675,000
Total: $1,499,300	**Net to Heirs: $825,000**

Give More to Your Beneficiaries vs.
Uncle Same with a Taxable Lifetime Gift



The arithmetic is compelling. Taxable gifts are more tax efficient than taxable estate transfers.

What are the best assets to gift?[5]

Property is gifted for several reasons, many of which are not tax motivated. For gift and estate tax planning purposes, the best assets to gift are those most likely to appreciate – those with small gift value today.[6] Property that may qualify for discounts such as lack of marketability or lack of control as an interest in a small business may also be ideal property to gift. Unfortunately, no one can predict the future, so choosing the right asset is more of an educated guess.

One of the best assets to gift is life insurance owned by an ILIT because the gifted premium amounts are relatively small in comparison to the death proceeds that are removed from the estate. Also, the death proceeds are generally received income tax-free, unlike the appreciation on other assets which is usually subject to income taxation. Finally, the death benefit for most policy types is a predictable amount and not subject to the fluctuations of the market.

What is the disadvantage of making a lifetime gift?

The primary disadvantage of a gift is that the donor must give up the asset. Another disadvantage of a gift is if the asset depreciates in value between the date of the gift and the time of the donor's death, then the donor would have been better off, for transfer tax purposes, if you had not made the gift. The third downside of a gift is that the donor's family loses the benefit of a basis adjustment (often referred to as a step-up in basis) to date of death value that would have been available if the donor had not made the gift. Most cases the reduction in estate taxes outweighs the increased gain when the asset is eventually sold.

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When are gifts subject to the generation-skipping transfer (GST) tax?

The GST tax applies when a transfer is made to a "skip person" – a person who is two or more generations below the donor. For example, a gift from a grandparent directly to a grandchild is both a gift and generation skipping transfer. The GST tax also applies to transfers at death and transfers to, or distributions from certain trusts benefiting skip persons.

Like the gift and estate tax, GST only applies once the GST exemption is exhausted. The GST exemption in 2020 is $11.58 million like the estate and gift exemption. Transfers exceeding this amount are subject to 40% tax on top of any gift/estate taxes that are due. Clearly, this is a tax to avoid.

How can a gift to an ILIT qualify for annual exclusion?

Whether the gift tax annual exclusion is available for a gift of a policy or premium payments to a trust depends on the terms of the trust. Unless there is an identifiable beneficiary with a present interest in the trust, such gifts will be gifts of future interest which does not qualify for the $15,000 annual exclusion.

Since gifts to ILITs or trusts do not typically satisfy the present interest requirement, most ILITs will include Crummey powers that allow designated trust beneficiaries to withdraw all or part of the gift to the trust, up to the annual exclusion amount for each beneficiary, for a specified period of time. If not exercised within that time frame (e.g., 30 days), the Crummey power ends (technically referred to as lapses) and the transferred property/gift remains in the trust to be invested or used by the trustee to pay policy premiums. For example, if a trust has three beneficiaries with Crummey withdrawal rights $45,000 ($15,000 X 3) can be transferred to the trust by the donor as an annual exclusion gift.

Although the Crummey power is a simple concept, it requires careful attention in administration. Failure to abide by best practices in handling Crummey powers may result in limits on the amount of annual exclusion gifts a client may make to the ILIT beneficiaries, characterizing all transfers to the ILIT as future interest gifts.

Can an ILIT beneficiary make gifts to a trust?

Usually it's not a good idea for a trust beneficiary to make a gift to the trust for several reasons:

1. The gift may not be considered a completed gift for annual exclusion purposes.
2. Gifts to a trust in which the person is both the donor as well as a beneficiary may cause inadvertent estate tax inclusion and/or result in the beneficiary becoming a transferor for GST tax purposes
3. The beneficiary may potentially lose creditor protection over the trust assets.

There may also be inadvertent income tax consequences if the donor is treated as the grantor of the trust for income tax purposes.

Can Crummey gifts be split? Can a trust in which a spouse is a beneficiary be split?

Yes, but if the spouse has an interest in the trust the gifts should not be structured as split gifts. However, if the spouse's interest is ascertainable and severable from the interest of others gift splitting is allowed for the amount deemed to benefit the other trust beneficiaries. For example, if a spouse has a mandatory income interest in the trust for life with the remainder interest passing to the other trust beneficiaries, the spouse's interest is ascertainable and severable from the rights of the other beneficiaries and gift splitting on the value of the remainder should be allowed.

In Summary

Taking advantage of lifetime gifts can significantly reduce an otherwise taxable estate. It's important to keep in mind that many donors will not get hit with federal gift tax because the IRS generally doesn't care what an individual gives away to other people until the giving exceeds a lofty amount between gifts that are excluded from tax, annual exclusion gifts, and lifetime exemption gifts. That being said, wealthy clients will want to take advantage of the current high exemption amount before the exemption sunsets on January 1, 2026, if not sooner.

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[1] Treas. Reg. §25.2511-2

[2] Generally, a donor does not recognize income tax when gifts are made, however there are some exceptions such as when a gifted asset is subject to a loan in excess of the donor's basis, or when gifting specific asset type triggers income (such as a gift of a deferred annuity that is in gain position).

[3] No unlimited marital deduction is allowed for gifts to a noncitizen spouse. However, there is a limited exemption if the transfer would otherwise qualify for the marital deduction. For 2020 a maximum of $157,00 per year (indexed) spousal gifts can be given to a noncitizen spouse without being subject to gift tax.

[4] Treas. Reg. §20.2010-1

[5] Taxpayer will also want to take into consideration the donee's situation prior to making a gift, such as if the donee may be subject to creditor or divorce claims.

[6] Before gifting property subject to a loan, taxpayers should consult with legal or tax counsel to be sure that such a gift does not have unintended consequences.

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