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Annual gifts: An effective way to transfer wealth

With the federal estate tax rate at 40 percent, generous clients with taxable gross estates often look to make gifts to family members as a means to transfer wealth. The federal government allows for unlimited gifts to be made between spouses. However, for all others (family and friends), the government imposes limitations.

The annual gift exclusion this year is $14,000 per person (or $28,000 for a married couple) and may continue to be adjusted for inflation. In addition, the American Taxpayer Relief Act of 2013 increased the lifetime gift exemption to $5.43 million this year.

When clients make gifts in excess of the annual gift exclusion, no gift tax is owed but a federal gift tax return must be filed to notify the Internal Revenue Service that you have utilized a portion of your lifetime gift exemption.

Upon death, the lifetime gift exemption then decreases proportionately. For example, say Hillary Clinton elects to gift $1,014,000 to her daughter Chelsea. From that, $14,000 would be considered an annual gift and the additional $1 million must be reported on a gift tax return. Clinton's exemption upon death would also decrease by $1 million.

Annual gifts made on a consistent basis prove to be a very effective way to transfer wealth. However, if the gifts are not made in a particular calendar year, the opportunity is lost.

In addition, many clients elect to use portions of their lifetime gift exemption by gifting assets that are expected to appreciate in value.

If Clinton had stock in a closely held family business valued at $1 million but expected it to increase to $3 million in the next several years, by gifting the $1 million today she can move the current value of the stock and all appreciation outside of her taxable gross estate.

When clients embark on gifting strategies, it is critical that they plan accordingly. Rather than make gifts directly to individuals, clients are strongly encouraged to consider making gifts to trusts for the benefit of designated individuals.

No one knows what the future has in store, but by gifting assets in trust they can be asset-protected from the beneficiary's creditors, including a future ex-spouse.

While assets gifted during a marriage are still considered individual or nonmarital assets, if the recipient comingles the assets with marital funds or routinely uses the funds to benefit the marriage, the assets can quickly become tainted or transmuted to marital property.

Assets that are gifted outright to a beneficiary are also included in the beneficiary's estate. This may pose issues if the beneficiary is later diagnosed with medical issues and has special-needs considerations or if the beneficiary is struggling financially and wishes to apply for financial aid.

Where the beneficiary has assets of her own or is expected to inherit more, by gifting assets in trust the assets can be structured so they are excluded from the beneficiary's taxable gross estate and pass estate tax-free from generation to generation.

Trusts can easily be established for the benefit of a child or grandchild. Annual gift exclusions of $28,000 to each grandchild over the course of a few years can quickly reach $100,000 in assets. Thus, it is important to be strategic in how funds are transferred.

If the assets were gifted to Uniform Transfers to Minors Act (UTMA) or custodian accounts, the minor beneficiary would have the ability to withdraw the funds upon reaching age 18.

Clients are also encouraged to consider making the trusts "intentionally defective." This feature makes the trusts defective for income tax purposes whereby the grantor is treated as the owner of the trust property for income tax purposes and all the tax attributes flow back to the grantor.

THE BUZZ

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When Clinton is the grantor who created the trust for the benefit of her children or grandchildren, she is responsible for paying any tax liabilities associated with the trust assets. Furthermore, the payment of tax liabilities are not considered gifts and additional wealth is transferred.

Language can be added to the trust allowing the trustee the ability to distribute funds to the grantor to cover tax liabilities if there is a cash flow concern in a given year. Ideally, if the grantor has the liquidity to pay the tax liability it is a very effective estate tax minimization technique.

When a 17-year-old has $200,000 in a custodian account, parents often inquire whether the funds can be put into a trust. The funds can be transferred to a trust for the benefit of the child. However, the trust must be structured as a 2503(c) trust and the child beneficiary must have the right to withdraw all of the assets from the trust upon reaching age 21.

If the beneficiary fails to exercise such right, the funds stay in the trust. This helps to provide asset protection for the funds. However, the funds are included in the beneficiary's taxable gross estate.

In contrast, if the assets were gifted to a trust directly from inception, the beneficiary is not required to have a right of withdrawal and the assets could potentially pass estate tax free from generation to generation.

Many clients wish to make gifts but are reluctant to do so. Despite a high net worth, they fear a financial reversal that would require asking their children for money. In these situations, a spousal-access trust proves to be a wonderful planning tool.

A spousal-access trust is an irrevocable trust for the benefit of a spouse (or spouse and descendants) during the spouse's lifetime. In our example, assume Clinton creates a trust for the benefit of her husband Bill and their descendants. Spouses can make unlimited gifts to one another outright. However, if Hillary gifted money to Bill, those funds would then be included in his taxable gross estate.

In contrast, when Hillary makes a gift to a trust for Bill's benefit the transfer would utilize a portion of her lifetime gift exemption and the value of the gift (as well as the appreciation) would be excluded from both of their estates.

If necessary, distributions can be made from the trust for Bill's benefit but those funds should be used on expenses associated with Bill only. The assets transferred to the irrevocable trust are also asset protected from their respective creditors and spousal access trusts are considered intentionally defective trusts.

Before writing a check to a loved one, clients are encouraged to take the time to make a plan and gift in a strategic manner.

With proper planning, trusts can be invaluable tools to provide asset protection and facilitate the transfer of wealth from generation to generation.

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