Lifetime (Noncharitable) Giving

Gifting can be a powerful estate planning tool, allowing you to transfer your wealth to others during your lifetime. Lifetime gifts have many advantages over gifts you might leave in your will (these are called bequests, legacies, or devises). You might find making lifetime gifts desirable for nontax reasons (e.g., personal gratification), or perhaps you'll make lifetime gifts for tax purposes (e.g., taking advantage of the annual gift tax exclusion), or your estate planning objectives may be the outcome of both nontax and tax factors. You'll want to figure your own personal desires and the tax implications of making lifetime gifts to fully clarify your estate planning objectives. When you have selected what property to give, the process of completing the transfer may be fairly simple (e.g., giving cash) or more complex (e.g., transferring ownership of a business). Make sure that you follow through and properly transfer ownership (e.g., change name on titles).

What are the nontax advantages of making lifetime gifts?

- **You see the recipient enjoy your generosity:** Lifetime giving allows you the immediate satisfaction of seeing the recipient (the done) enjoy your generosity. For many people, this is the most important reason for gifting.

- **You give your children financial independence:** Most parents want to see their children enjoy the best possible life. Lifetime gifts to your children allow you to help them achieve financial security and a more worry-free life.

- **You are relieved of property management worries:** Giving away your property can relieve you of the responsibility of managing that property, allowing you to enjoy a more worry-free life. This may be especially important if you are an older person.

- **You control the distribution of your property:** Giving away your property while you are living allows you to decide who receives what property. If you die without a will, the intestacy laws in your state will determine how your property is distributed and you will have no say. You express how you want your property distributed after your death by executing a will. However, since you won't be around to see what actually happens (e.g., someone may disclaim your gift), you won't be able to react to any change in circumstances. Lifetime giving allows you to adjust your gifts to changing circumstances and, at the same time, provides the most control over how your estate is distributed.

- **You keep the property out of probate:** Lifetime gifts can reduce probate and administration costs because property you give away during life generally is not included in your probate estate at death. Additionally, removing property from your probate estate keeps it from being vulnerable to estate creditors or unhappy heirs.

- **You keep the gift private:** Lifetime gifts are not open to public scrutiny, unless, of course, you wish to make them so. In contrast, a will becomes a public document, available to anyone who wishes to see it. Lifetime giving assures your privacy.

What are the tax advantages of gifting?

You may enjoy significant income tax and estate tax savings with a properly structured gifting program. To understand the tax advantages of making lifetime gifts, you must understand what constitutes a gift and how it is taxed.

Generally, a gift is not taxable income to the recipient. However, any income earned by the gift property, or any capital gain on its subsequent sale, is generally taxable to the recipient. You, the donor, may be responsible for paying state and/or federal transfer taxes imposed on gifts you make. There are four transfer taxes that may affect your gift giving: (1) state gift tax, (2) state generation-skipping transfer tax, (3) federal gift and estate tax, and (4) federal generation-skipping transfer (GST) tax.

Eliminate future appreciation from your estate

One of the most common reasons for gifting is to remove an appreciating asset from your estate. An appreciating asset is one that is increasing in value over time. Removing the asset today keeps any appreciated value out of your estate later. The amount that may be subject to gift and estate tax will likely be less today than it will be in the future. Note, property that is likely to grow in value includes the cash value of life insurance, common stock, antiques, art, and real estate.

Note, lifetime giving results in the carryover of your basis (generally, basis is the property's cost) in the property to the recipient (as opposed to a gift at death that usually results in a new basis of fair market value on the date of your death). This means that the recipient may recognize a larger capital gain when the property is sold than the recipient would have if he or she received the property from you at death. Be sure this consequence is acceptable before making this type of gift.

Take advantage of qualified transfers

Qualified transfers are specific types of gifts you can make that are exempt from the federal gift and estate tax, and federal GST tax. A qualified transfer is any amount you pay on behalf of someone else, either as tuition to an educational institution or to pay medical expenses to a medical care provider. This is a great way to help your children or grandchildren through college or to help your elderly parents get the proper medical care they deserve.

Take advantage of the annual gift tax exclusion

The annual gift tax exclusion is a federal exclusion that allows you to give $15,000 (in 2019 and 2020) per recipient to an unlimited number of recipients without incurring federal gift and estate tax or federal GST tax. This exclusion allows you to distribute your property tax free and potentially put your estate into a lower tax bracket. The exclusion applies only to gifts of a present interest in property. For example, giving your niece cash today would qualify, but giving her the right to have your house in 3 years would not. Only certain transfers in trust qualify, and the rules are slightly different for gift and estate tax and GST tax purposes. Note, if you are married, gift splitting can double the annual gift tax exclusion. Gift-splitting rules apply.

Take advantage of the gift and estate tax applicable exclusion amount and the GST tax exemption

The federal gift and estate tax applicable exclusion amount is used to offset cumulative lifetime gifts and estates. The federal GST tax exemption works like the applicable exclusion amount for transfers made to skip persons (family individuals who are more than one generation below you and certain trusts for the benefit of such individuals). You may want to use the applicable exclusion amount and the GST tax exemption during your lifetime instead of waiting until your death because of the time value of money – money is worth more today than it will be tomorrow.

Potentially reduce state death taxes

State death taxes are generally imposed on property you own at the time of your death. Removing property from your estate during life can minimize state death taxes. Note, some states will include gifts you made during the 3 years prior to your death in your taxable estate. If death is imminent, gifting may not help reduce state death taxes.

Shift income to a lower income tax bracket

Because the income tax rate schedules are graduated, your total family federal and state income tax burden may be reduced if income-producing assets are distributed among several family members rather than being held in your hands only. Note, your potential federal income tax savings from transferring income-producing property to your children may be reduced by the kiddie tax. Unearned income above $2,200 (in 2020) is taxed at the parents' tax rates. The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed ½ of their support.

Shift capital gains to a lower income tax bracket

Federal and state capital gains tax on the sale of appreciated property may be reduced by transferring the property to someone who is in a lower income tax bracket or who has losses to offset the gain.

Remove certain assets in order to qualify for special tax treatment

You may receive special estate tax treatment if your estate meets certain percentage tests (a certain percentage of your estate consists of specific types of assets). Removing certain nonbusiness holdings may help your estate meet these tests and so qualify for Section 303 (redemption of stock), Section 2032A (special use valuation), or Section 6166 (installment payout taxes) tax treatment. Note, this technique will work only if the gift is made more than three years prior to your death.

Remove tax paid on lifetime gifts from your taxable estate

Although the tax you pay on lifetime gifts is tax exclusive, the tax paid on gift-at-death transfers is tax inclusive. This means that funds used to pay tax on gift-at-death transfers may be includable in your estate for estate tax purposes, while funds used to pay tax on lifetime gifts are not. You can save tax overall by making lifetime gifts, because the amount of the tax you pay on those gifts is removed from your estate. Note, tax that you pay on gifts made within 3 years of your death may be added back into your estate for estate tax purposes.

How can you make a gift?

Outright gifts

An outright gift is made directly to the recipient. Making an outright gift gives the recipient unrestricted control of the property. Outright gifts may present problems in 2 situations:

- Gifts to minors: Outright gifts to minor children may not be a good idea, unless it is something that is meant to be enjoyed immediately, like a car. However, if it is a substantial gift, there is some risk that the child will spend the gift foolishly instead of spending it wisely or saving it. Since the child can't sell, lease, exchange, will, or otherwise deal with the property – minors can't enter into contracts by state law – the property will be tied up until the child attains the age of majority. Thus, it may be wasted. You may want to consider making gifts to minors in the form of a guardianship under the Uniform Gifts/Transfers to Minors Act (UGMA or UTMA) or in trust (e.g., Section 2503(b) trust, Section 2503(c) trust, or Crummey trust). However, gifts made under the UGMA or UTMA may reduce the child's changes for financial aid when he or she attends college.
- Gifts to spendthrifts or those who are incapacitated: A spendthrift is someone who spends money foolishly. An incapacitated person is someone who is either physically or mentally unable to make financial decisions. You may not want to put property in the direct and unrestricted control of either a spendthrift or an incapacitated person. Gifts to spendthrifts or incapacitated persons should be made in trust.

Gifts in trust

Gifts in trust are more difficult to make than outright gifts. Gifts in trust require the preparation of a trust document and may involve trustee fees, tax preparation fees, accountant's fees, or attorney's fees. However, there are some advantages to using a trust:

- Flexibility of income distribution: You can control the distribution of the income and principal of the trust to the beneficiaries by giving the trustee sprinkling powers. Sprinkling powers give the trustee discretion over how to distribute the trust income and principal. This may be preferable if you don't want the recipient to have the entire gift all at once but only as needed.
- Professional asset management: The property can be put into the hands of a trustee who is a professional asset manager, such as a bank. This may be desirable if you don't want to assume the duties of the trustee. Professional management will ensure that the property is not wasted but wisely invested.

- Creditor protection: A spendthrift trust is on that prohibits the beneficiary from transferring or assigning his or her interest in the trust to someone else. Putting property in a spendthrift trust keeps the property out of the hands of the beneficiary's creditors.

Note, some gifts to charity should be made in trust. Partial-interest gifts (property rights given to both charitable and noncharitable interests, such as a trust paying income to charity, with the remainder going to noncharitable beneficiaries) must be made in some form of charitable trust like a charitable lead trust, charitable remainder annuity trust, pooled income fund, or charitable remainder unitrust to qualify for the gift tax charitable deduction.

Forgiveness of a debt

You can make an indirect gift by forgiving a debt. This means that someone owes you money and you tell him or her they don't have to pay you back. You have, in effect, given him or her the money. Because the annual gift tax exclusion, forgiveness of a debt can be an excellent way to make a large tax-free gift. Note, you must clearly establish a debtor-creditor relationship. Be sure to establish evidence that your intent is to make a loan – put in writing, charge market rate interest, get security or collateral, make period demands, or let the borrower make some payment or demonstrate the ability to pay.

Interest-free or below-market loans

An interest-free or below-market rate loan is an indirect gift. The gift is the foregone interest. The foregone interest is the difference between the interest computed using the applicable federal rate and the interest computed using the stated rate.

Tilting property in joint name

If you add a joint name to your property, you may be making a gift. For example, if you add you son's name to yours on the deed to your house as a 50% owner, you have made a gift of half your house.

When the gift occurs depends on the type of property. Generally, the gift occurs when the joint name is added. However, the gift may not occur right away for some types of property where the benefit is not received until later. For example, if you add your son's name to your checking account, there is no gift until your son withdraws funds. Note, by adding a joint name, you give up control and may expose the asset to the joint owner's creditors.

To whom should you give?

Your spouse

Gifts you make to your spouse may be fully deductible from federal gift tax and federal estate tax under the unlimited marital deduction. The transfer must meet certain requirements to qualify. Special rules apply for transfers to a noncitizen spouse.

Skip persons

A skip person is an individual who is more than one generation below you (or certain trusts that benefit such individuals). Gifts to skip persons may be subject to the federal GST tax (and, if one is imposed by your state, the state GST tax). This tax is imposed in addition to the gift and estate tax.

Charitable organizations

Lifetime gifts to charity may be more advantageous than donations made at death because such gifts may be fully deductible from both federal gift tax and federal income tax. Because charitable donations are income tax deductible, you receive a double tax benefit from lifetime gifts. The gift must meet certain requirements to qualify.

Minor children

Income-producing gifts to minors may not help save federal income tax because of the kiddie tax. Unearned income above $2,200 (in 2020) is taxed at the parents' tax rates. The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed ½ of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed 1.2 of their support.

However, there are still ways to shift wealth and save taxes by giving to minor children:

- Series EE US savings bonds: If you give currently-owned Series EE US savings bonds (may also be called Patriot bonds) that won't mature until your child is over the age that triggers the kiddie tax, the income tax payable when the bond is redeemed will be taxed at your child's lower tax rate.
- Growth stocks (or mutual funds): Give currently-owned growth stocks (or mutual funds) that pay little or no current dividends. After your child is over the age that triggers the kiddie tax, any dividends will be taxed at your child's income tax rate. If the stock is sold after your child is over the age that triggers the kiddie tax, the gain will be taxed at your child's income tax rate.

- Gifts made under the Uniform Gifts/Transfer to Minors Act: Generally, gifts made in trust are gifts of future interest. Gifts of future interest are generally denied the annual gift tax exclusion. However, gifts made under the Uniform Gifts/Transfers to Minors Act (UGMA or UTMA) are eligible for the annual gift tax exclusion (and a custodian is allowed to maintain control over the property until the child reaches the age of majority). Note, custodial laws vary by state, so it is important to check with your own state's laws.
- Gifts made to a Section 2503(b) Trust: The Section 2503(b) Trust (Income Trust) can be used to make a gift in trust that qualifies for the annual gift tax exclusion.
- Gifts made to a Section 2503(c) Trust: The Section 2503(c) Trust (Discretionary Trust) can be used to make a gift in trust that qualifies for the annual gift tax exclusion.
- Gifts made to a Crummey trust: The Crummey trust can be used to make a gift in a trust that qualifies for the annual gift tax exclusion.
- Employ your minor children: A minor child's earned income is not subject to the kiddie tax. The amount will be taxable at your child's income tax rate. Additionally, your business will have a deduction at its tax bracket. Note your state's child labor laws. The deduction may also be limited or somewhat disallowed if the compensation paid to the minor child is unreasonably high, taking into account the services actually performed by the child.

When should you make a gift?

Some gifts you make, such as life insurance or certain retained interests, may be brought back into your estate for federal estate tax and state death tax purposes. Any property you gave away more than 3 years ago is now safely out of your estate.

So, the sooner you start taking advantage of the annual gift tax exclusion, the gift and estate tax applicable exclusion amount, the GST tax exemption, and any other exclusions your state may allow, the better. For example, the lower the value of the property, the less use of the applicable exclusion amount. Additionally, you can't save up the annual gift tax exclusion from year to year. So, what you don't use, you lose. Of course, you should generally make gifts of property that widely fluctuates in value when the market value is at its lowest because property is generally valued at its fair market value on the date the gift is made for tax purposes. Otherwise, only you can decide when the best time is to make a gift based upon your particular circumstances.

What property should you give?

Selecting what property to give may be your most difficult decision. The best property depends on your circumstances and objectives. You should choose property that maximizes your personal goals and/or offers tax advantages.

Are there any gifting traps you should avoid?

If you want to minimize or avoid taxes, your gifts must be properly structured. All your efforts may be for naught if you should fall into common traps:

The kiddie tax rules

Beware of the kiddie tax rules when transferring income-producing property to children. Unearned income above $2,200 (in 2020) is taxed at the parents' tax rates. The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed ½ of their support, and (3) those ages 19-23 who are full-time students and whose earned income doesn't exceed ½ of their support.

Gifts of retained interests or powers

Beware of making gifts of property in which you retain some financial interest (e.g., life estates, right of reversion, right of revocation) or powers (e.g., power of appointment). This property may be includable in your estate for estate tax purposes.

Income taxation of gifts in trust

A trust is a taxpaying entity. Be sure to consider the consequences of paying income tax on trust income.

Delays in making a gift of life insurance

Do not delay in making a gift of a life insurance policy on your life. Transfers of policies on your life may be includable in your taxable estate if made within 3 years of your death.

Delays in planning your estate to meet percentage tests

Do not delay in removing certain nonbusiness holdings to help your estate meet the percentage tests to qualify for Section 303 (redemption of stock), Section 2032A (special use valuation), or Section 6166 (installment payout of taxes) tax treatment. This technique will only work if the gift is made more than 3 years prior to your death.

Payments for tuition or medical care are made to the recipient

Do not make payments for tuition or medical care to the recipient (the beneficiary). You must make the payments directly to the educational institution or medical care provider in order to qualify the gift as tax exempt as a qualified transfer.

Overlooking gift splitting

Do not forget the gift-splitting privilege for spouses who qualify. This can double the annual gift tax exclusion.

“Reverse” gifts made within 1 year of the recipient’s death

Don’t make a gift of appreciated property to a recipient within 1 year of death if you will receive the property back. There will be no step-up in basis, and you may have needlessly paid gift tax and/or used your applicable exclusion amount.

Overlooking the tax-exclusive nature of making lifetime gifts

Don’t assume that lifetime gifts and transfers made at death result in the same tax effect. Remember that the tax-exclusive nature of lifetime gifts results in overall tax savings because the tax is removed from your estate.

Selecting property that does not attain your tax-savings objectives

There are some types of property that you should avoid giving if you want to enjoy tax savings.

What else should you know about gifting?

If you are married and live in a community property state, gifts of community property you make to third persons may be limited by state law. For example, you may need the express or implied consent of your spouse, or you may be limited by the amount you can give each recipient.

The IRS may consider transfers made by your attorney-in-fact (agent or representative) to be revocable transfers. That means that those gifts may be includable in your estate for estate tax purposes. If you want your attorney-in-fact to make gifts on your behalf, make sure that you give express written authority in a power of attorney.