Annual Exclusion Gift Planning

Generally, the gift tax and GST tax annual exclusions permit an individual to give an amount equal to the annual exclusion ($16,000 in 2022) per donee without incurring any gift tax or GST tax liability, provided that the gift is of a present interest. A married donor can annually give up to double that amount ($32,000 for 2022) per donee if the donor's spouse agrees to apply his or her annual exclusion amount by gift-splitting.

Although the annual exclusion amount may seem insignificant, a lifetime giving program that takes advantage of the gift tax and GST tax annual exclusions over a period of years can significantly reduce the donor's transfer tax liability.

Benefits of Annual Exclusion Gifts

1. **Federal Transfer Tax Savings**

The use of annual exclusion gifts can result in considerable federal transfer tax savings. Generally, annual exclusion gifts are not subject to gift tax or GST tax. In addition, because the donor's annual exclusion is applied to a gift before the donor's applicable exclusion amount, annual exclusion gifts do not use up any portion of the donor's applicable exclusion amount. Accordingly, over a period of time, a planned giving program using annual exclusion gifts can remove a significant amount of property from the donor's gross estate without incurring any transfer tax or using up any portion of the donor's applicable exclusion amount. In addition, any future appreciation and income generated by the transferred property is also removed from the donor's gross estate, further reducing the donor's estate tax liability.

> **EXAMPLE:** D gives $13,000 a year in cash to each of D's 3 children, 5 grandchildren, 10 great-grandchildren and 2 friends over the five- year period before D's death. Because of the annual exclusion, none of these gifts are subject to gift tax or GST tax. In addition, D did not use any portion of D's applicable exclusion amount or GST exemption, while effectively removing $1,300,000 from D's estate. Assuming a maximum estate tax rate of 50% at D's death, these annual exclusion gifts saved D's estate $650,000 in federal estate tax. In addition, any income and appreciation generated by the transferred property between the date of gift and D's date of death was also removed from D's estate.

Leveraging the Annual Exclusion With Discounts. Structuring a gift so that valuation discounts will apply to the transfer enables the donor to "leverage" the amount of property that can be transferred via annual exclusion gifts. For example, a discount for lack of marketability can be used to reduce the value of a business interest.

> **EXAMPLE:** The concept of "leverage" can be illustrated as follows: P makes a gift of limited partnership interests to C. An appraiser determines that a 50% discount is applicable to the limited partnership interests being transferred. Accordingly, each gift of $1 of limited partnership interests represents $2 of underlying value.

Avoidance of Gross-Up Rule. Another transfer tax benefit of annual exclusion gifts is the avoidance of the IRC § 2035(b) gross-up rule. Under the IRC § 2035(b) gross-up rule, gift taxes paid by the decedent on transfers within three years of death are included in the decedent's estate. Because annual exclusion gifts are not subject to federal gift tax, the gross-up rule is avoided. The advantage of avoiding the gross-up rule is the reduction in estate taxes that would be payable on gift taxes actually paid.

Basis Considerations. In planning to make any gift, practitioners should weigh the benefit of the transfer tax savings against potential capital gain tax cost that results from the loss of the step-up in basis that would have occurred had the property been subject to estate tax in the donor's estate. Property transferred by gift retains the donor's basis, but property transferred at death gets a step-up in basis to the property's fair market value at death. IRC §§ 1014 and 1015. If the donor pays gift tax on appreciated property, however, the donee's basis increases by the portion of the gift tax attributable to the appreciation in the property. Treas. Reg. § 1.1015-1(a)(2). Accordingly, annual exclusion gifts retain the donor's basis.

> ➔ **Planning Point:** For property transferred by gift, all of the appreciation in excess of the donor's basis (plus any adjustment for gift taxes paid on appreciated property) will be subject to income tax on the sale of the property.

2. **Income Shifting**

Annual exclusion gifts can help reduce a family's overall income tax liability. This is accomplished in two ways. First, the donor can give income-producing assets to family members in lower income tax brackets. Second, the donor can transfer appreciated assets that will eventually be sold at a gain to a family member who is subject to a lower capital gains tax rate or who can offset the gain with losses.

> ➔ **Planning Point:** Practitioners should note that the income tax benefit of shifting income-producing assets to children may be reduced by the Kiddie tax. IRC §§ 1(g) and 63(c)(5).

Non-Tax Benefits

As the estate tax exemption increases in the future, the transfer tax benefits of annual exclusion gifts discussed above may not be as compelling for families of more modest wealth. These families, however, may still be compelled to make annual exclusion gifts for non-tax reasons. Some of these reasons include the following:

1. Support Children or Other Beneficiaries. One of the most common non-tax reasons for making annual exclusion gifts is to provide for the support of family members. Donors will still wish to support their children, regardless of the tax consequences.

2. Provide Financial Experience to Beneficiaries. Probably the most important non-tax reason for making annual exclusion gifts is to provide some financial experience to

less wealthy and/or less financially sophisticated family members or other individuals. This is especially true if the donor's wealth is considerable, and the beneficiary will eventually receive a significant amount of property. The donor could make annual exclusion gifts to a beneficiary in order to prepare the beneficiary for subsequent transfers of more significant amounts of property. Out of inexperience, some beneficiaries (especially minor beneficiaries) may make bad financial decisions or impulse purchases. These beneficiaries may benefit from learning from their mistakes made in investing or spending these relatively smaller amounts of property. If a beneficiary does not appear to have learned from these mistakes, the donor can adjust his or her gifting program or estate disposition accordingly.

3. Transfer Control of Closely-Held Family Business. Another non-tax reason for making annual exclusion gifts is the gradual transfer of control in a closely-held family business to the younger family generation. By making annual exclusion gifts of business interests, the donor can control which beneficiaries will have ownership interests in the business. This also allows the donor to see how these beneficiaries handle their ownership interests.

➔ **Planning Point:** Practitioners advising clients who wish to make annual exclusion gifts of business interests should be sure that the operating agreement of the business does not prevent the donees from obtaining immediate use, possession or enjoyment of the gifted business interests. A member's (or partner's) inability, under the operating agreement, to: (1) unilaterally withdraw his or her capital account; (2) independently effectuate a dissolution of the business; and (3) sell his or her business interest without the business manager's consent in the manager's sole discretion has been deemed to prevent gifted business interests from qualifying for the gift tax annual exclusion. *Hackl v. Comm'r*, 335 F.3d 664 (7th Cir. 2003).

This result might be avoided by giving a donee the unilateral right to sell his or her entire interest to third parties, subject to a right of first refusal by the entity and/or other interest holders to purchase the interest at the same price and terms as a bona fide offer from a third party. Also, the business manager's discretion to retain funds can be limited to the needs of the business with the balance of the funds being distributed to the interest holders. Alternatively, the business agreement could give each donee the right to withdraw assets from the entity. The right can be limited to the fair market value for the gifted interest and only be available for a limited period of time. Although such a provision might reduce the valuation discount, it should foreclose any argument that the donee does not have the right to the immediate use, possession and enjoyment of the

property in the economic sense.

4. Make Donor's Estate More Liquid. Another non-tax reason for making annual exclusion gifts is to shift illiquid assets in order to make the donor's estate more liquid. If the donor's gross estate is significant and is comprised mainly of illiquid assets (*e.g.*, stock in a closely-held business), the estate may have to suffer the hardships of selling these illiquid assets or borrowing funds in order to pay the federal estate tax liability attributable to these illiquid assets. To avoid this problem, the donor could make annual exclusion gifts of the donor's illiquid assets and retain the liquid assets.