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A Primer on Annual Exclusion From Federal Gift Tax

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Each year, taxpayers have the opportunity to transfer assets free of gift taxes to their family members or other individuals by using their annual exclusions from the federal gift tax. As long as the gifts remain within the annual exclusion amounts, the value of the assets gifted will not reduce any remaining portion of a taxpayer's exemption from federal gift and estate tax. Thus, making gifts with the proper use of the annual gift tax exclusion decreases one's taxable estate at death (and the corresponding federal estate tax payable) without using any of the taxpayer's available credit against potential gift and estate taxes.

The annual exclusion amount for 2013 is $14,000 (a $1,000 increase from last year) or twice that amount, $28,000, for a married couple. The exclusion covers gifts that an individual makes to each donee in any given year. Thus, an individual taxpayer with two children can transfer a total of $28,000 to those children every year ($14,000 per child), or a married couple can transfer up to $56,000 to the children every year without eroding their gift and estate tax exemptions. Gifts can be made to as many individuals as desirable – there is no limit. The key to qualifying a gift for the annual gift tax exclusion is to ensure that the donee receives a "present interest," which is the "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." Reg § 25.2503-3(b).

Below are some of the ways to utilize the annual gift tax exclusion.

- <u>Outright gifts</u>. The simplest way is to write checks to the intended gift recipient. This could work if the recipient is an adult and not a minor (i.e., over 18 years old).

- <u>Gifts to UGMA/UTMA custodial accounts</u>. If the gift is intended for minors, one can set up a custodial account under the Uniform Gifts (Transfers) to Minors Act (UGMA/UTMA) and contribute funds to that account each year. The drawback with UGMAs/UTMAs is that the beneficiary can withdraw all of the assets when he or she reaches the age of

majority (generally 18 or 21, depending on the state in which the beneficiary resides).

- Section 2503(c) minor's Trusts. A taxpayer can set up a trust for a minor beneficiary which complies with Sec. 2503(c) of the Internal Revenue Code, so that the annual contributions will qualify for the "present interest" rule, and, therefore, will qualify for the annual gift tax exclusion. The key requirement under Sec. 2503(c) of the Code is that the beneficiary has access to the trust assets upon reaching the age of 21. The trust can be set up so that the beneficiary has this withdrawal right at 21 only if the beneficiary elects so in writing, and that if the beneficiary does not provide a written request to terminate the trust within the permissible window of time after his or her twenty-first birthday, then the trust can be continued. (Where the grantor is the grandparent of the minor beneficiary, in many cases the trust should be carefully structured to also qualify for a parallel annual exclusion from the federal generation-skipping transfer tax.)

- Crummey Trusts. An individual can create a "Crummey" trust (named after the famous *Crummey v. Comm'r, 397 F2d 82 (9th Cir. 1968)* case). This may be desirable for beneficiaries who are no longer minors, or, even potentially for minor beneficiaries if the donor of the gift wants to minimize the chance of a beneficiary withdrawing the trust assets at age 21. Crummey Trusts are used frequently to help facilitate the payment of premiums on life insurance policies held by a trust. In order for a Crummey Trust to qualify for the "present interest" rule, the beneficiaries must be aware each year that contributions are being made to the trust and that they have the right to withdraw the contributions from the trust for a limited period of time. To the extent that the beneficiaries do not exercise their rights to withdraw the additions to the trust, the assets (and ultimately the life insurance proceeds at the grantor's death, in many cases) will remain in trust for their benefit.

- 529 accounts/qualified tuition programs. A qualified tuition program (also known as a 529 plan) allows you to make contributions to an account set up to meet a child's future higher education expenses or buy tuition credits for a child. Qualified tuition programs can be established by state governments or by private education institutions. Contributions to these types of programs are eligible for the annual gift tax exclusion and contributions can be front-loaded so that a donor who contributes more than the annual exclusion limit for the year can elect to treat the gifts as if they were spread out over a 5-year period. This election should be reflected on a timely filed gift tax return, and each subsequent year (for a period of 5 years), the 1/5 portion should be taken into account when determining what gifts to make.

The earnings on the contributions to a qualified tuition program will accumulate tax-free until the college costs are paid from the funds, and distributions are tax-free to the extent the funds are used to pay qualified higher education expenses.

- Gifts of fractional interests in entities. For individuals who own interests in closely held business entities, such as limited liability companies, limited partnerships, or corporations, each year, the individual can gift a portion of his or her interest in the entity to family members or others (it is important to review the transferability rules in the governing instruments to ensure that the assignment of the interest is permissible and not subject to consent or other restrictions). By gifting a non-controlling interest in a closely held entity, the value of the gifted interest can generally be discounted for lack of marketability and/or lack of control/minority interests, so that ultimately the donor can transfer a greater percentage of his or her ownership interest to the gift recipient.

  To illustrate this effect using a simple example, if a limited partnership has a net worth of $100,000 and a limited partner wishes to transfer a portion of his or her limited partnership interest, assuming that a 35% discount was applicable due to lack of marketability and lack of control, that limited partner would be able to gift a 21.5% limited partnership interest to each gift recipient: $100,000 less $35,000 discount = $65,000; $14,000 exclusion/$65,000 = 21.54%).

  In a recent Tax Court decision, *In Estate of Wimmer v. Comm'r*, TC Memo 2012-157, (June 4, 2012), guidance was provided for qualifying gifts of interests in a closely held limited partnership as "present interests" for purposes annual exclusion gifting. The court determined that a present interest exists if the partnership (i) will generate income, (ii) some of which would flow steadily to the recipients of the gifts and (iii) that portion of the income could be readily ascertained. In the *Wimmer* case, the assets of the partnership consisted of publicly traded and dividend paying stock and the partnership agreement allocated (and regularly distributed) partnership profits proportionally to partnership interests. Therefore, all three requirements were met, and the gift tax exclusion was available.

The above examples of gifting only represent some of the opportunities that are available when utilizing the annual gift tax exclusion. Certain gifts require that gift tax returns be filed, even if no tax is due. It is therefore important for clients to consult with their attorneys when structuring these annual exclusion gifts to make sure that they are complying with any reporting requirements, properly structuring the gifts to qualify for

the annual exclusion, and selecting the option for doing so that is best suited to their circumstances.

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