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MEMORANDUM ON GIFTING

"Generally, you can gift up to $13,000 per Recipient per calendar year (for 2011 without even having to file a gift tax return. Such gift is neither income taxable to the Recipient nor deductible by the Donor."

Clients often have questions about gifts. Although this memorandum attempts to provide general answers to many of the basic gifting questions asked by clients, professional tax and legal advice should be obtained before making larger gifts and gifts which may have questionable exemption status. The IRS defines a gift as any transfer any asset for less than fair market value.

Gifts may be made for many reasons:

♦ To benefit the Recipient. He or she needs it.

♦ To remove assets from your taxable estate. Decedents with estates in excess of $5,000,000 (in 2011) are subject to estate taxes of 35% on the excess. Not only is the gift removed from your taxable estate, but so is the future income and appreciation on the gifted property.

♦ To avoid probate. Although such gifts may avoid probate, there may be negative income tax implications. Also, such gifts may be subject to the claims of creditors of the Recipient. Consider using a Revocable Living Trust to avoid probate.

♦ To preserve family assets from nursing home costs. Note, however, that large gifts will generally cause you to be ineligible for Medicaid assistance for up to 60 months from the date of the gift. You are ineligible for Medicaid for approximately one month for each $6,000 of gifts, and there is no $13,000 exemption for Medicaid eligibility purposes.

♦ To lower income taxes. For example, gifts to minor children may result in the income generated from such property being taxed at lower income rates. Consider, however, the impact of the "kiddie tax" on children under 18 years of age, and that gifts under the Uniform Transfers to Minors Act must be turned over to the child at age 21. (Often a scary thought!)

You should consider the use of trusts for larger gifts to youngsters so that the gifts can be held beyond the age of 21 years and controlled by the persons you have named.

Regardless of your motive, a gift may have significant gift, estate, and income tax implications and may affect your eligibility for Medicaid. Here are a few of the general principles with respect to such taxation:

1. The original $10,000 gift tax annual exclusion amount was increased several years ago to $11,000 for inflation and increased again in 2009 to $13,000. That means you can gift $13,000 per calendar year per person to as many individuals as you wish; and a gift tax return is not even required. Your spouse can do likewise. Example: Husband gifts $13,000 to each of his three children and seven grandchildren. Wife does likewise. No gift tax return is required and $260,000 is removed from their taxable estate.

Furthermore, you can gift up to $26,000 to each Recipient and still avoid any gift tax implications if you and your spouse file a gift tax return and your spouse consents to the gift. Remember, the $13,000 exemption is inclusive of all gifts made during the year.

I often suggest writing a check for only $12,800 so that other small gifts (such as birthday gifts) will also be exempt. Gifts need not be in cash.

A gift is defined as any transfer for less than fair market value. Transfers of shares of stock, a life insurance policy, and even fractional interests in real estate, all qualify as taxable gifts.

2. To the extent your gifts exceed $13,000 per Recipient per year, the estate tax exemption (currently $5,000,000) available on your death is reduced by such excess, dollar for dollar. Gift tax is payable only if your cumulative taxable gifts (i.e., in excess of $13,000 per person per year) exceeds $5,000,000. The tax rate on the excess is 35%.

So you can actually gift up to $5,000,000 before you have to write a check to the government for the gift tax. It is the Donor who is primarily liable for the tax, not the Recipient.

3. Although gifts made to minors under the Uniform Transfer to Minors Act are eligible for the $13,000 exemption, if you, as Donor, are the custodian of such account for the benefit of the minor, the value of such account will be included in your taxable estate upon your death. If you anticipate having a taxable estate, then have someone other than yourself (or your spouse) serve as custodian.

4. You can gift an unlimited amount to your spouse who is a U.S. citizen, but only $136,000 per year (2011) if he or she is not a U.S. Citizen.

5. Gifts are generally income tax free to the Recipient and non-deductible by the Donor unless such gifts are to a qualified charity.

However, certain assets which would generate ordinary income to the Donor on disposition (such as Series EE bonds, deferred annuities, installment notes, and the like) will trigger taxable income to the Donor upon the gifting such assets, even if they are not liquidated by the Recipient.

6. Gifts must be of a present interest in property and must be delivered. Your check payable to the Recipient would qualify. But if you die before the check clears your bank, the gift is not completed and will be includable in your estate for estate tax purposes. Your promissory note does not qualify as a completed gift.

Gifts in trust are generally not gifts of a present interest and do not qualify for the annual exclusion unless the beneficiaries are given specific withdrawal rights from the trust at the time the gift is contributed to the trust. Such withdrawal rights are usually included in Irrevocable Life Insurance Trusts.

Gifts to corporations and partnerships generally do not qualify for the exclusion, but when they do, such gifts are aggregated with the other annual gifts made to the shareholder or partner which indirectly benefits from such gifts.

There must be delivery. Merely signing a deed gifting your farm to your children is an incomplete gift unless the deed is actually delivered to them or filed in the county records (constructive delivery).

7. In calculating capital gain on gifted property, the Recipient of the gift is generally not entitled to a step up in basis on the death of the Donor.

The Recipient's basis ("cost" for calculating capital gain) in gifted property is the Donor's basis if the property is later sold at a gain, or the lesser of the Donor's basis or fair market value on the date of gift if sold by the Recipient at a loss.

What this means generally is that your Recipients may pay considerably more in capital gains taxes on appreciated property than if you had left them those assets as part of your estate.

If such assets had passed to your Recipient not as a gift, but as a result of your death, and such assets were includible in your taxable estate (even if no estate tax is due), then your Recipient's basis would be the fair market value of the property on your date of death.

This new basis is sometimes referred to as a "step up in basis" (or "step down in basis.") Thus, the general rule is to <u>not</u> gift property with a large built-in gain, but to leave it to them on your death. For property with a large loss, the recommendation is to sell it before you die, and gift the proceeds.

You can deduct the loss against other capital gains, plus an additional $3,000 per year against ordinary income.

8. If you retain any interest in gifted property, whether legally binding or by informal arrangement, the entire value of the asset may be included in your estate.

Example: You gift your home to your children, but continue to live there rent-free. The IRS will include your home in your taxable estate even though you have no legal right to live there. Your informal agreement with your children (evidenced by your living there rent-free) is treated as a retained interest.

This principal can actually be used to your advantage in some situations. You wish to make a gift of your home to obtain Medicaid eligibility (after 5 years), but you want your children to get a step up in basis on your death. You gift them the house with the understanding (in writing - just to be sure) that you can live in the home rent free as long as you wish. If you die before the home is sold, your children should get a step up in basis.

9. A "Qualified Disclaimer" of property is not treated as a gift. Example: Your mother's will left you $500,000, and if you are then deceased, to your only child. You have a taxable estate and would rather see that $500,000 (or a portion of it) pass to your child.

You "disclaim" any interest in the inheritance before receiving it and your mother's executor distributes it pursuant to your mother's will to your child. Your disclaimer is not treated as a gift if prepared properly.

Disclaimers are very technical and should be handled through a competent estate planning attorney.

10. In addition to the $13,000 annual exemption, you can also make unlimited gifts for qualified "medical expenses" and "educational tuition." Note that to rely on this exemption, you cannot reimburse the Recipient; you must make your check payable to the hospital, doctor or educational institution. "Tuition" does not include living expenses. Paying for your child's health insurance also qualifies if the check is payable to the insurance company or HMO.

11. Although most gifts - when completed before your death - are not drawn back into your taxable estate for estate tax purposes, there are a few exceptions - most notably, gifts of life insurance. If you die within 3 years of transferring all ownership rights to a policy which insures your life, the death benefit is still includable in your taxable estate.

If the Recipient of a cash gift (for instance, your daughter or the trustee of your irrevocable trust) uses the gift to apply for a new policy and is the original owner and beneficiary of that policy, then the proceeds are not includible in your estate even if you die the day after the policy is issued.

The Internal Revenue Service has taken the position that the outright gift of an insurance policy to more than one person is NOT eligible for the annual exclusion, nor is the payment of the annual premium on a policy so owned eligible for such exclusion. Why? Because a child cannot unilaterally liquidate his or her share of the gift, it is not a gift of a present interest.

12. Because there is no longer a "3 year in contemplation of death" rule for most gifts, completed gifts made from your death bed will successfully reduce your taxable estate. But what if you are incapacitated? Gifts made under a Power of Attorney generally will be drawn back into your taxable estate, unless the power of attorney (or state law governing powers of attorney) has specific gifting provisions.

Consult your attorney for appropriate language including limitations of such gifting powers.

13. One of the most effective gifts you can make is to an irrevocable life insurance trust. Structured properly, your gifts to the trust qualify for the $13,000 annual exclusion (for each of multiple beneficiaries) and the death proceeds will be outside of your taxable estate. Such a trust can allow you to leave the funds necessary to pay estate taxes for literally pennies on the dollar, and all outside your taxable estate.

Consult with a competent estate planning attorney or insurance agent for more information regarding this extremely effective method of increasing the after tax dollars which will pass to your family upon your death.

I hope this memorandum has provided you with useful information concerning the tax and other implications of gifting. Although small gifts (under $13,000) can generally be made without professional assistance, you should consult with a tax professional before making larger gifts for estate tax planning or to accelerate Medicaid eligibility.