Traps to Avoid in Lifetime Giving Program

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Background

There are many ways to transfer property during an individual's lifetime in a manner designed to avoid or minimize federal estate and gift tax. However, many of these opportunities can backfire if the transfer is not properly structured. With 2012's favorable estate and gift tax regime possibly going away in 2013, we expect, there will be a lot of gift giving over the remainder of 2012. With that in mind, we thought a list of do's and don'ts for lifetime giving was in order.

23 Lifetime Giving Traps and How to Avoid Them

There are numerous traps that can be encountered when advising clients in the area of lifetime giving. Here are our top 23. (The list is not all-inclusive.)

1. Avoid gifts of future interest in property if the annual gift tax exclusion (currently $13,000) is vital to the planning objective. If the donee's enjoyment of the property is postponed, the property interest is a future interest, not a present interest. For the annual exclusion to apply, the property transferred generally must be a present interest [IRC Sec. 2503(b)].

2. Do not overlook gift-splitting with a spouse. For 2012, gift-splitting allows a spouse to shelter $26,000 of gifts to any one individual with the annual gift tax exclusion if the donor's spouse consents to treat half of the gifts as made by him or her (IRC Sec. 2513). (Note that gifts of community property are automatically considered as made 50% by each spouse, and no gift-splitting consent is required.)

3. Make payments for tuition or medical care directly to the educational institution or medical care provider and not the individual who is to receive the education or medical care, or to any other person. Direct payments of tuition or medical expenses qualify for an unlimited gift tax exclusion and do not reduce the $13,000 annual exclusion [IRC Sec. 2503(e)].

4. Avoid gifting highly appreciated property shortly before the donor's death, as this will cause the done to lose the benefits of the basis step-up that would otherwise occur at the donor's death (IRC Sec. 1014). Instead, the donor's basis in the property will carry over to the donee, and the subsequent sale of the property at the appreciated price will generate a large capital gain to the donee.

5. Avoid transferring property that is likely to depreciate in value after the transfer. Adjusted taxable gifts, valued at the date of the gift, are added back to the taxable estate to determine the estate tax base. If the property's value declines after the gift transfer, the higher value (at the date of the gift) will be added back to the donor's estate.

6. Be aware of the kiddie tax rules when transferring income-producing property to a child (a) under age 18 or (b) age 18 (or 19-23 if a full time student) whose earned income does not exceed one-half of the amount of his or her support. Unearned income is taxed at the parents' marginal tax rates for these children. Therefore, assets for transfer should be selected carefully, and alternatives to direct gifts to the child should be considered.

7. Avoid gifts of mortgaged property when the mortgage balance exceeds the adjusted tax basis. The excess will be taxable income to the donor.

8. If the donee is not expected to live for more than a year, and the donor is to receive the property back when the donee dies, do not make gifts of appreciated property to that individual. Such property will not receive the step-up in basis, and the donor will have needlessly depleted his or her applicable credit amount [IRC Sec. 1014(e)].

9. Do not delay making lifetime transfers on the assumption that lifetime and testamentary transfers of the same amount have the same tax effect under the unified transfer tax system. The gift tax is tax exclusive, while the estate tax is tax inclusive, meaning that the funds used to pay the tax are included in the estate tax base but not the gift tax base. As a result, lifetime giving, even when gift tax is incurred, can result in significant overall tax savings because the amount of gift tax is removed from the taxable estate, unless the gift is made within three years of the decedent's death [IRC Sec. 2035(c)]. In addition, valuation discounts may apply to lifetime transfers of property that would not be available for testamentary transfers.

10. When structuring a *Crummey* trust (in which beneficiaries are given the right to withdraw contributions to the trust for a period of time in order to make the contributions present interest gifts eligible for the annual gift tax exclusion), be aware that the lapse of the donee's withdrawal powers may trigger a deemed gift if the current income beneficiary and remainder beneficiary are different individuals. The gift may be a future interest and will not qualify for the annual gift tax exclusion.

11. Also for *Crummey* trusts, observe the formalities of giving notice to donees of their withdrawal rights, or the annual gift tax exclusion may be lost. Do not assume a waiver of notification of future gifts will be sufficient.

12. Be aware of the Generation-skipping Transfer (GST) tax when grandchildren or other skip persons are donees of direct gifts or beneficiaries of trusts. For transfers in trust, the annual gift tax exclusion does not apply for GST tax purposes unless each grandchild or other skip person is the sole beneficiary of his or her trust [IRC Sec. 2642(c)].

13. Watch out for transfers with retained interests or powers by the donor. Generally, gifts made during the donor's life are not included in the gross estate. As long as the individual transfers his or her entire interest in the property (excluding life insurance, discussed in item 15), it will not be included in the gross estate no matter when the individual dies. However, if an individual made a transfer of property and retained a power or interest described in IRC Secs 2036-2038, the transferred property will be included in that individual's gross estate if he or she owned the power or interest at death, or disposed of the retained power or interest within three years of death [IRC Sec. 2035(a)]. Powers that would cause estate inclusion are as follows:

Section 2036: retained right to income, possession, or enjoyment of the property, or the right to designate who receives the income, possession, or enjoyment.

Section 2037: retained reversionary interest (meaning the donor retains the right to receive property back under certain conditions).

Section 2038: retained power to alter, amend, revoke, or terminate the beneficial enjoyment of the property.

14. Do not allow the donor to name himself or herself the trustee if he or she possesses the powers that could cause the trust property to be included in the estate (at date-of-death values). (Powers that would cause estate inclusion were listed earlier in item 13.) In addition, trust property will be included in the donor's estate if he or she reserved the power to discharge a trustee and appoint himself or herself trustee pRegs.20.2036-1(b)(3) and 20.2038-(a)(3)]. Also, if a donor names himself or herself custodian of a Uniform Gifts (or Transfers) to Minors Act account, the property in the account at the donor's death will be includable in the estate.

15. Do not delay transfers of ownership or incidents of ownership in life insurance. If the insured transfers ownership (or incidents of ownership) in a life insurance policy within three years of death, the proceeds will be included in the insured's gross estate [IRC Sec. 2035(a)]. This includes transfers to irrevocable life insurance trusts. [Note that if the insured held any incidents of ownership in the policy at the time of death, it does not matter how many years have passed since the policy was transferred to a donee – the proceeds will be included in the insured's gross estate under IRC Sec. 2042(2).]

16. Avoid delaying lifetime transfers of certain assets that could help the state qualify for various postmortem estate planning opportunities. If transferred within three years of the donor's death, corporate stock that may be eligible for a Section 303 stock redemption and real estate that may be eligible for the Section 2032A special use valuation are included in the donor's gross estate for determining whether the percentage tests are met (not for actual gross estate inclusion) [IRC Sec. 2035(c)]. In addition, the estate may qualify to make installment payments of estate tax under IRC Sec. 6166.

17. Consider the income tax consequences of making gifts in trust due to the compressed income tax rate structure for trusts --- for 2012 the maximum tax rate (35%) for trusts kicks in once taxable income exceeds $11,650; it does not kick in for individuals until taxable income exceeds $388,350. Possible solutions for gifts in trust include making the trust a grantor trust (for income tax purposes) or arranging for the trust to invest in nonincome-producing assets, such as growth stocks or assets that generate tax exempt incomes, such as municipal bonds.

18. If the client creates a power of attorney and intends to allow the attorney-in-fact to make gifts, do not fail to specifically authorize this gifting power. The power can be limited (e.g., up to the annual gift tax exclusion). Other powers to consider authorizing in the power of attorney are the power to (1) consent to gift-splitting with the grantor's spouse, (2) allocate the GST tax exemption, and (3) sign gift tax returns and pay any gift tax owed by the grantor.

19. Do not forget that all transfers for less than FMV are subject to the Medicaid lookback period of 60 months.

20. While gifts often are a great way to reduce the donor's potential taxable estate, watch out for unintended consequences to the donee. Where the donee is disabled, gifts outright or into a support trust may disqualify the donee for valuable government aid. Similarly, granting *Crummey* withdrawal rights may disqualify a disabled person for government aid. In addition, gifts to or in certain kinds of trusts for an individual who may attend college can reduce his or her eligibility for financial aid. Gifts that satisfy an individual's duty of support can also trigger unexpected income tax.

21. Avoid gifts of installment notes to someone other than the spouse. A disposition of an installment obligation at other than its face value to a nonspouse donee will result in immediate gain recognition for the difference between the fair market value and the basis of the installment obligation at the time of the gift [IRC Sec. 453B(a) and (g)].

22. Be aware of the income tax consequences of transferring an interest in qualified retirement plan benefits, a traditional ARA, or Roth IRA. Lifetime gifting or assigning the rights to another is treated as a distribution to the owner/participant. As such, the owner would be required to recognize current income (for a qualified plan or traditional IRA) and perhaps be subject to the 10% premature penalty tax if the owner is under age 59 ½.

23. Avoid gifts of Section 1244 stock that would otherwise be eligible for ordinary (instead of capital) loss treatment for the sale or worthlessness of qualifying closely held stock if certain conditions are met. Because ordinary loss treatment is available only to original shareholders, a loss incurred by a donee would not be eligible for Section 1244 treatment. Thus, the loss would be a capital loss, subject to the usual capital loss limitations.

References:

IRC Secs. 453B, 1014, 2035, 2016, 2037, 2038, 2503, 2513, 2642, and 6166.

Subscriber Note: This Tax action Memo is based on material from PPC's *Guide to Practical Estate Planning*. For information on this *Guide*, visit ppc.thomsonreuters.com or call (800) 431-9025.

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