CHAPTER 34

Annual Exclusion Planning

BRIAN C. LAYMAN (Canton, Ohio)

Utilizing the annual gift tax exclusion is a simple planning technique that reduces potential exposure to federal estate taxes. You may have heard that you can give away $10,000 tax-free a year to as many people as you want. The amount was indexed to $12,000 in 2008 ($13,000 in 2009). If you are married, you and your spouse can each make annual exclusion gifts, essentially doubling the amount you can gift. A spouse can also agree to apply his or her annual exclusion amount to a gift made by his or her spouse by "gift-splitting." The annual exclusion gifts will not reduce your lifetime gift exemption amount (currently $1 million).

As with many other tax planning techniques, the benefits of annual exclusion gifting are compounded over time. The following example illustrates the power of a lifetime gifting program:

EXAMPLE

Assumptions

- **Donor's age** – 60
- **Number of annual exclusions** – 1
- **Donee's annual after-tax return on gifts** – 4% (assuming the person who receives the gift invests all of the gifted money)
- **Annual exclusion inflation adjustment** – 3% (this is the amount used to determine how quickly the annual exclusion will be increased by $1,000 increments)
- **Donor's estate tax bracket** – 50%

Calculations

- **Donor's life expectancy** – 24.2 years
- **Total gifts** $426,000
- **Estate tax savings** $213,000

- **Projected value at life expectancy** $667,905
- **Estate tax savings if donee invested** $333,952

In this example, if you are 60 years of age, the tax savings for a single annual exclusion gift over your life expectancy is significant. In addition to removing $426,000 from your estate, all future growth and income generated from the gifted assets is also removed from your estate. In this example, the projected growth of the gifted assets is $241,905 ($667,905 - $426,000). This example assumes you only make annual exclusion gifts to one person. If you make lifetime gifts to more than one person, the tax benefits are even more powerful.

For various reasons, you may hesitate to make outright gifts to your beneficiaries. Once you make an outright gift, the beneficiary has complete control over the gifted asset and you no longer have any control over it. You may be concerned that the beneficiary is too young to receive the gift. The beneficiary may have substance abuse, bankruptcy, or creditor problems, or you also may not want to establish an expectation of future gifts. However, there are additional planning techniques you can utilize to overcome these obstacles. If the gift recipient is too young, it may be best to make a custodial gift or a gift to a minor's trust, both of which are discussed in subsequent chapters. Another alternative is to make a gift to a Crummey Trust, named after a taxpayer who won a case against the IRS.

Trusts provide a great deal of flexibility. A trust can dictate who will receive benefits from the trust, at what time, and under what circumstances. This flexibility comes at a cost, however. Gifts to most trusts will not qualify for the annual exclusion. In order to qualify for the annual exclusion, the tax rules require that the gift be of a "present interest." In other words, the gift recipient must be able to access the gifted property. Most trusts do not give the beneficiary access to the gifted property because the person making the gift is not comfortable making an outright gift for the reasons discussed above. As a result, gifts to these trusts do not qualify for the annual exclusion.

To maintain the desired flexibility of the trust and at the same time, qualify it for the annual exclusion, the trust can include a Crummey withdrawal right, also commonly called a "Crummey power." The Crummey power gives a beneficiary the right to withdraw assets you gift to the trust. The courts have ruled that the Crummey power gives the beneficiary the required access to the gifted property in order to qualify it for the annual exclusion. The beneficiary must have notice of his or her Crummey power and have a reasonable amount of time to exercise the power before it lapses. It is common to give the beneficiary at least 30 days to exercise the power. Once the time period expires, the beneficiary no longer has the ability to withdraw the assets you gift to the trust.

Can the beneficiary really withdraw the assets you just gifted to the trust? Yes. Otherwise, the IRS would say that the beneficiary's right was illusory and deny your use of the annual exclusion. You cannot have an implied or express agreement that the beneficiary will not exercise the Crummey power. However, if the beneficiary did withdraw the gifted assets, you probably would not make another gift for the benefit of that beneficiary, so it would not be in the beneficiary's best interests to do so.

In addition to the annual exclusion, there is also an unlimited gift tax exclusion for direct payments of qualifying medical and educational expenses. This unlimited exclusion applies regardless of your relationship to the recipient of the medical or educational services. To qualify, the payments must be made directly to the medical provider or educational institution. Gifts to a trust will not qualify even if the trustee is only permitted to make distributions for the beneficiaries' medical and educational needs.

The IRS Regulations clearly define which payments qualify for the unlimited exclusion. Qualifying educational expenses include tuition, but not books, supplies, dormitory fees, board, or other similar expenses. The exclusion applies to any educational institution that maintains a regular faculty and curriculum, and includes grade school, high school, and higher educational institutions. Qualifying medical expenses include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation primarily for and essential to medical care. In addition, qualifying medical expenses include payments for medical insurance on behalf of any individual. However, amounts paid for medical care reimbursed by the donee's insurance are not qualifying medical expenses.

The unlimited health and education exclusion provides an extremely valuable deathbed planning opportunity. For instance, the IRS has privately ruled that negotiating and prepaying non-refundable tuition qualifies for the exclusion. While private rulings cannot be relied upon by other taxpayers, the rulings provide insight regarding the IRS's interpretation of the tax rules. Following the IRS's logic in those rulings it will be interesting to see if a donor could negotiate with a health insurance provider to prepay health insurance for a wide number of "donees." The health and education exclusions are truly unlimited. If you have a number of beneficiaries who have tuition or medical expenses, you can greatly reduce your taxable estate by utilizing these techniques.

The annual exclusion and unlimited health and education exclusion provide simple yet effective tax savings techniques. The earlier a gifting program is implemented, the more the benefits can accrue.

Layman, D'Atri & Associates protects everything you love – family, friends, and favorite charities by developing unique and innovative wealth preservation strategies for the firm's individual clients, families, and businesses.