



Making Non-taxable Gifts to Individuals

Many individuals make gifts each year to family members and other individuals out of generosity and as part of their overall estate plan. The federal government and several states, however, impose gift taxes on such transfers unless they fall into one of the several categories which qualify as non-taxable transfers for gift tax purposes. These categories include gifts which qualify for the "annual exclusion" from gift tax and payment of certain medical and/or educational expenses on behalf of an individual.

What are annual exclusion gifts?

- Any U.S. citizen may make gifts totaling up to \$11,000 per year (other than gifts of "future interest" in property, discussed below) to each of an unlimited number of donees, without incurring federal gift tax liability. Most states which have a gift tax also exempt these "annual exclusion gifts" from state gift taxes. The Taxpayer Relief Act of 1997 provides for an automatic cost-of-living adjustment to the annual exclusion amount. As a result, the annual exclusion amount was increased from \$10,000 in 2001 to \$11,000 in 2002 and 2003.
- If the total value of your gifts to any one donee in a calendar year exceeds the annual exclusion amount, you will have to file a federal (and possibly a state) gift tax return for that year.
- If the total value of your gifts to any one donee in a calendar year is less than the full annual exclusion amount, *then*

You cannot apply the unused portion to the donee in subsequent years, because there is no carry-over of unused amounts.

You cannot apply the unused portion to a different donee to whom you made gifts during that calendar year.

- Spouses may elect to "gift-split" to permit one spouse to use the other spouse's annual exclusion amount, thus increasing to \$22,000 the total amount which may be gifted tax-free to a donee in a calendar year.
If spouses choose to gift-split, they must make that election on a timely filed federal gift tax return, even if no gift taxes are due.
If spouses elect to gift-split, they must do so for all gifts made to all donees by either of them during the calendar year.
- Gifts to spouses in any calendar year are not limited to the annual exclusion amount, provided they are not "future interest" gifts and the donee spouse is a U.S. citizen.
- There currently is an annual exclusion amount of \$112,000 per year for "present interest" gifts (see below) to spouses who are not U.S. citizens, subject to a cost-of-living adjustment.

What types of property can be transferred?

- You may make gifts of cash, stock, limited partnership interests, bonds or notes, life insurance, fractional interests in real property, etc., provided that these transfers are gifts of "present interests."

- A "present interest" for which an annual exclusion is allowable is defined as an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)."
- If non-cash gifts are made, it is important that the valuation of such gifts be established and documented in case of a challenge by the Internal Revenue Service or state tax authorities.

Can transfers in trust qualify as annual exclusion gifts?

- A transfer from a donor into a trust may qualify as an annual exclusion gift if the trust beneficiary has a "present interest" (as defined above) in the trust property.
- Gifts in trust are regarded as creating separate legal interests for income and remainder beneficiaries.

Income interests generally are considered as "present interests" eligible for the annual exclusion.

Remainder interests are considered to be "future interests" and ineligible for the annual exclusion.

- If a trust qualifies as a "Crummey" trust (named after the 9th Circuit decision in the case of *Crummey v. Comr.*), contributions to the trust may qualify for the annual exclusion from federal gift tax.

The beneficiary or beneficiaries must have an unrestricted right to withdraw all or a portion of property transferred to the trust on an annual basis. This withdrawal right or demand right is called a "Crummey" power and has the effect of transforming the gift of a "future interest" into the gift of a "present interest."

However, the "present interest" exclusion is only available if the beneficiary has actual notice of the withdrawal right and a reasonable time within which to exercise that right.

Most irrevocable insurance trusts are "Crummey" trusts.

- Transfers in trust solely for the benefit of an individual who has not yet attained age 21 are considered gifts of "present interests" and qualify for the annual exclusion (even if not a "Crummey" trust), if the following statutory requirements are met:

Both the property transferred in trust and the income from the property may be distributed to, or spent for the benefit of, the beneficiary until he or she attains age 21;

All accumulated income and principal of the trust must pass to the beneficiary when he or she attains age 21;
and

If the beneficiary dies before age 21, principal and undistributed income must be payable (under the terms of the trust) to the beneficiary's estate or pursuant to a general power of appointment exercised by the beneficiary.

Can gifts to minors qualify as annual exclusion gifts?

- Outright transfers to a minor child or to such child's parents as guardians can qualify as annual exclusion gifts to the minor.
- Gifts to a custodian for a minor child under state statutes based on the Uniform Gifts to Minors Act, Uniform Transfers to Minors Act, or the Model Gifts of Securities Act also can qualify for the annual gift tax exclusion.
- The federal government has authorized the establishment of college savings plans, known as "Section 529 plans." Contributions to Section 529 plans can qualify for the annual exclusion. In addition, a donor may contribute up to five (5) years of annual exclusion gifts per donee to a Section 529 plan and may then elect to treat the contribution as having been taken over a five-year period, allowing the donor to apply his or her annual exclusion from gift tax in each of those five (5) years. The five-year averaging election must be made on the donor's federal gift tax return for the calendar year in which the 529 plan is initially funded.

Are annual exclusion gifts included in the donor's estate?

- Gifts qualifying for the annual exclusion are generally not included in a deceased donor's gross estate for federal estate tax purposes.
- An annual exclusion gift transferred out of the decedent's revocable trust before the decedent died is not included in the decedent's gross estate, as a result of tax law changes made in 1997.
- If, however, a donor has pre-funded a Section 529 plan with more than one year of annual exclusion gifts for the donee, and the donor dies before the five-year period has expired, part of the gift to the Section 529 plan will be includible in the donor's estate.

What limitations exist on annual exclusion gifts?

- Reciprocal gifts will not qualify for the annual exclusion. Reciprocal gifts are where two donors attempt to increase the number of annual exclusion gifts to their respective family members by entering into an agreement so that each donor makes gifts to the other donor's family members.
- The number of annual exclusions cannot be increased by the use of intermediate recipients who receive the gift, but who then transfer the gift property to another donee within the same year as part of an agreement between the donor and the intermediate recipient.

Are annual exclusion gifts subject to federal generation-skipping transfer tax?

- An outright transfer to a donee who is more than one generation below the donor (e.g., the donor's grandchild) is not subject to generation-skipping transfer tax to the extent the gift qualifies for the annual exclusion.
- However, gifts made to a trust that qualify for the annual gift tax exclusion may be subject to the federal generation-skipping transfer tax.

Is there an exclusion from federal gift tax for payment of medical and educational expenses on behalf of another person?

- In addition to making annual exclusion gifts to an individual, you may pay certain medical and/or educational expenses on behalf of that individual, without incurring federal gift tax liability.
- Qualifying medical or educational payments made directly to the medical care provider or educational institution will not be treated as part of the annual exclusion amount and will not create federal gift tax liability.
- Transfers which are excluded from federal gift tax as qualifying medical or educational payments are not subject to generation-skipping transfer tax.

How do annual exclusion gifts and gifts for medical and/or educational expenses affect the \$1,000,000 exemption from federal gift tax?

- In addition to the annual exclusion gifts and gifts for medical and/or educational expenses, you may transfer assets totaling \$1,000,000 (or, combined with your spouse, \$2,000,000) during your lifetime, to your children or other designated individuals free of federal transfer taxes.
- This \$1,000,000 exemption per person is called the "applicable exclusion amount."
- Such transfers may be subject to state transfer taxes, but, in any event, must be reported on federal and state gift tax returns.

Summary

Making gifts that qualify for the annual exclusion (or otherwise do not constitute taxable gifts) may seem straightforward. Because of the intricacies involved, however, you should consult your estate planning attorney or tax advisor before making significant gifts and/or establishing a gifting pattern, in order to avoid unwanted federal (and possibly state) gift tax consequences.



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