

Reducing Your Taxable Estate Through Lifetime Gifts Of The Annual Exclusion Amount



By Heidi E. Royal

If your estate passing to your children is likely to exceed \$3,500,000 (the amount sheltered by your federal exclusion amount), you should consider making lifetime gifts to reduce the size of your estate. For 2009, the federal estate tax rate on the amount in excess of \$3,500,000 left to your children and grandchildren is 45% and the combined federal and North Carolina estate tax rate is about 50%. In 2010 the federal estate tax is repealed but is reinstated in 2011 with a federal exclusion amount of \$1,000,000 unless new legislation is enacted.

One way to reduce the size of your taxable estate is to make gifts of the gift tax annual exclusion amount to your children and grandchildren each year. You may give up to \$13,000 to any person in any calendar year free of federal gift tax. You may also give up to \$13,000 to each grandchild free of federal generation-skipping transfer tax. If you are married, you and your spouse may give jointly \$26,000 to each child and grandchild. No North Carolina gift tax would be due on your gifts as that tax was repealed effective this year.

If you have children or grandchildren in a lower income tax bracket than you, making gifts to younger generations can be an effective way to shift income. Thus, in addition to reducing your taxable estate, annual exclusion gifts may also contribute to lower taxable income during your lifetime.

A program of lifetime gifts of the gift tax annual exclusion amount to children and grandchildren can dramatically reduce the size of your taxable estate at death. The following example illustrates the substantial estate tax savings.

Example – Assume husband and wife have a combined estate in excess of \$7,000,000 (the amount sheltered by two applicable exclusion amounts for 2009) and, at the death of the survivor, a portion of the survivor's estate passing to children or grandchildren will be taxed at 50%. Assume also that the couple makes gifts of \$26,000 for just 2009 to each of their two children and four grandchildren. Total gifts of \$156,000 in one year to the children and grandchildren could save \$78,000 in federal and North Carolina estate tax (\$156,000 x 50% combined estate tax rate). If this program were continued for another four years, a total of \$390,000 in federal and North Carolina estate tax would be saved. The gifts can save even more by removing from the estate of the surviving spouse the income and appreciation attributable to the gifted property after the date of the gift.

Only gifts of a "present interest" in property qualify for the gift tax annual exclusion. Outright gifts to children and grandchildren are considered present interest gifts but may be ill advised if the child or grandchild has not reached an age that he is capable of dealing with the property.

Several other alternatives exist for making your gifts to a child or grandchild that will qualify for the federal gift tax annual exclusion and, in the case of gifts to a grandchild, for the federal generation-skipping transfer tax annual exclusion:

Gifts to a Custodian Under the Uniform Transfers to Minors Act

The simplest way to make gifts to a child is to make the gift to a custodian for the child under the North Carolina Uniform Transfer to Minors Act. The custodian has the authority to pay or not pay funds to the child while the child is under age 21.

The main disadvantage of using this method is that when the child reaches age 21, he is entitled to the funds remaining in the custodianship.

Another disadvantage is that the taxable income in excess of \$1,900 earned by the funds in the custodianship may be subject to the “kiddie tax.” Under the revised kiddie tax rules, unearned income in excess of \$1,900 generally will be taxed to the child at the highest marginal rate of the child’s parents while the child is under age 18. If the child has not reached age 19 and does not have earned income that is more than half of the child’s support, unearned income over \$1,900 will continue to be taxed at the parents’ rate. In addition, so long as the child is under age 24, is a full-time student and does not have earned income that is more than half of the child’s support, unearned income over \$1,900 will be taxed at the parents’ rate.

Gifts to a Code Section 2503(c) Trust

Another alternative is to establish a trust known as a “Code Section 2503(c) Trust.” Under this trust the trustee has the discretion to pay funds to the child until the child reaches age 21. When the child reaches age 21, the child must have the right to withdraw the funds in the trust for a limited period of time, such as 30 days. If the child does not withdraw the funds in the trust, the funds remain in trust until the child reaches an older age which you have selected in the trust agreement.

While the child is under age 21, the income earned on the trust funds will be taxed to the trust to the extent that it is accumulated. The first \$2,300 of accumulated trust income is taxed at 15% so that accumulation of income in the trust may result in some income tax savings. If the trust income is paid to the child, it would be taxed to the child and may be subject to the kiddie tax described above, meaning it may be taxed to the child at the child’s parents’ highest marginal rate.

Gifts to a “Crummey” Trust

Under this alternative you establish a trust known as a “Crummey Trust” which allows the child (or a parent on behalf of a minor child) to withdraw your \$13,000 gift to the trust within 30 days *after the date the gift is made*. If the gift is not withdrawn during that period, then the property can be retained in trust until the child reaches an age which you have designated in the trust agreement.

It is not clear under current law whether the undistributed income earned on trust funds would be taxed to the trust or to the child. If taxed to the child and the child is within the age and income limitations of the kiddie tax, the income generally would be taxed at the child’s parents’ highest marginal rate.

If you feel strongly about not giving a child the right to withdraw funds at age 21, we recommend the use of the Crummey trust. The possible income tax disadvantage in using this trust, as compared to the Section 2503(c) trust, may be a small price to pay for the assurance that the child will not have automatic access to the property at age 21.

Gifts to a Qualified Tuition Program

A gift to a qualified tuition program, commonly referred to as a “Section 529 plan” due to the revenue code section establishing such plans, for a child or grandchild has many features and advantages that other forms of gifts do not have. Earnings on your contributions to a Section 529 plan are exempt from federal and state income tax while the funds remain in the plan account. If you are a North Carolina resident, you may receive an income tax deduction for a portion of your contribution if your adjusted gross income falls below a certain threshold.

Distributions from a Section 529 plan are also exempt from federal and state income tax if the distribution is used for qualified higher education expenses of the child or grandchild. Such expenses generally include tuition, room, board, fees, books, supplies and equipment required for attendance at an eligible educational institution, which includes most accredited two-year colleges, four-year colleges, graduate schools and professional schools. For 2009 and 2010, the definition of qualified higher education expenses has been expanded to include computer technology and equipment and Internet access and related services to be used by the designated beneficiary of the Section 529 plan.

One attractive feature of the Section 529 plan is that you may contribute to the plan in a single year up to five times the annual exclusion amount, or \$65,000. If you are married, your spouse may contribute a similar amount. If you make an election on your gift tax return to treat the gift as made over five years, your gift will be treated as having been made ratably each year. Provided your gift does not exceed this exclusion amount, your gift qualifies for the gift tax annual exclusion and, if the gift is for the benefit of grandchildren, will be excluded from the generation-skipping transfer tax as well. The ability to make a larger gift in one year provides a larger base of investments to grow going forward.

Conclusion

If you will have a taxable estate for federal estate tax purposes, planning should begin now to reduce the size of your estate. Annual exclusion gifts to children and grandchildren are a relatively simple way to reduce the value of your estate and should be considered if you can comfortably make such gifts during your lifetime.

Robinson, Bradshaw & Hinson, P.A. is a corporate and commercial law firm with more than 125 attorneys. The firm has offices in Charlotte and Chapel Hill, North Carolina, and Rock Hill, South Carolina. For over forty years, the firm has consistently provided innovative solutions to its clients' business needs from both a legal and practical perspective. The firm serves as counsel to public and closely held corporations operating in domestic and foreign markets; limited liability companies; limited and general partnerships; individuals; municipal, county and state agencies; public utilities; health care institutions; financial institutions and tax-exempt organizations. For more information on Robinson, Bradshaw & Hinson, please visit our Web site at www.rbh.com.