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WEALTH MANAGEMENT: TRUSTS, ESTATES & FOUNDATIONS UPDATE

Maximizing the Benefits of Annual Exclusion Gifts

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Taking advantage of the opportunity to make annual exclusion gifts can reap significant tax benefits over time. If you expect to owe estate taxes at your death and can afford to give gifts to family members and loved ones, a program of regular annual exclusion giving will permit you to transfer wealth to the people you care about without paying gift tax.

The "annual exclusion" amount is the maximum amount you can give to another individual during a calendar year without incurring gift tax. Annual exclusion gifts do not use up your lifetime gift tax exemption (currently $1 million), allowing you the freedom to save your exemption for larger lifetime gifts. Each gift you make also reduces the amount of your taxable estate. In addition, when you make a gift of property that may increase in value, any future appreciation and income that the donated property might generate is removed from your estate, increasing your tax savings.

You can make an annual exclusion gift to anyone in the world, including remote family members, friends, or even strangers, though children and other descendants are the most common recipients of these gifts.

Amount of the Exclusion

The annual exclusion amount is indexed for inflation. In 2008, the annual exclusion amount is $12,000; in 2009, it will increase to $13,000. The annual exclusion amount applies to each person to whom you choose to make a gift. For example, if you decide to make gifts of the full $13,000 annual exclusion amount to 10 different people in 2009, you can remove $130,000 from your taxable estate without paying gift tax or using any of your gift tax exemption.

Increased Benefits for Married Couples

Married couples can double the benefit of the annual exclusion if both consent to treat gifts made by either spouse as made one-half by each ("gift-splitting"). Gift-splitting can be helpful in situations where one spouse owns property that the spouse wants to give to a loved one, but the value of the property is greater than the annual exclusion. If both spouses consent to split gifts, the first spouse can transfer the full value of the property to the gift recipient while minimizing the tax consequences of the gift.

For example, if you own property worth $26,000 in 2009 that you want to transfer to a child, you and your spouse can combine your annual exclusion amounts ($13,000 each) and give that child the property without incurring gift tax. Both of you are still free to use your lifetime exemptions for larger gifts.

However, you should note that any election to split gifts applies to all gifts made by either you or your spouse in that calendar year. This means that any gift that exceeds the amount of both spouses' annual exclusions will be attributed one-half to each spouse and applied to each spouse's lifetime gift tax exemption, or, if a spouse has already used his or her exemption, that spouse will owe tax on the gift.

Gifts to Minors

For a gift to qualify for the annual exclusion, the recipient must be entitled to the immediate use and enjoyment of the gift. Gifts to a custodial account held for the benefit of a minor under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act will qualify for the exclusion.

You also can make annual exclusion gifts to certain kinds of trusts. However, these trusts must contain specific provisions. The trust must allow the beneficiary a limited right of withdrawal, either when the beneficiary turns 21, or for a period after you make the gift to the trust. If the beneficiary does not withdraw the funds, then the funds can continue to be held in trust until the time you specify in the trust agreement.

Gifts for Tuition and Medical Expenses

Another easy way to make gifts to family members and others is to pay their tuition and medical expenses. If you make the payment directly to the school or health care provider, the payment is not subject to gift tax, does not use any gift tax exemption and does not "count" against the annual exclusion gift amount. For example, in 2009, if your grandchild is enrolled in a college that charges $25,000 for tuition, you could pay the full tuition and give the grandchild an additional annual exclusion gift of $13,000 without incurring gift tax or using gift tax exemption, provided you make the tuition payment directly to the college.

Front-loaded Gifts to 529 Plans

You can increase the benefits of annual exclusion giving by making annual exclusion gifts to a 529 plan. A 529 plan is a tax-advantaged savings plan that is designed to encourage savings for the cost of higher education. Earnings in a 529 plan are not subject to federal income tax (and in many cases, state income tax) as long as the money withdrawn from the 529 account is used for qualifying educational expenses.

Generally, you cannot give more than the annual exclusion amount to any individual in a calendar year without using up gift tax exemption. However, you can give up to five-years' worth of annual exclusion gifts to a 529 plan in a single year. A front-loaded gift to a 529 plan removes assets from your estate while allowing the beneficiary of the 529 plan to take advantage of the growth

of the transferred assets. For example, in a year when the annual exclusion amount is $13,000, you could give up to $65,000 to a 529 plan. If you are married and your spouse agrees to split gifts, you could give up to $130,000 to a 529 plan in a single year. Because the front-loaded gift has a longer period of time to grow, the gift can pass additional value to the beneficiary.

If you make a lump sum gift to a 529 plan of five years' of annual exclusion gifts, you cannot make gifts to the plan beneficiary for the following five-year period without incurring gift tax or using up part of your gift tax exemption. If you die within five years of making the gift, a portion of the gift may be included in your estate for estate tax purposes.

Gift Tax Returns

In some cases, you will be required to file a gift tax return even though no gift tax is due. For example, you must file a gift tax return if you and your spouse agree to split gifts. You must also file a gift tax return if you take advantage of the opportunity to make a front-loaded gift to a 529 plan.

Conclusion

With the right giving plan in place, annual exclusion gifts can be a simple and cost-effective method of transferring wealth to family and loved ones, reducing your taxable estate, and preserving your lifetime gift tax exemption.

For additional information on Mayer Brown's Wealth Management: Trusts, Estates & Foundations group please visit us at www.mayerbrown.com.

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