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Some Tax-Efficient Ways of Making Gifts

For wealth transfer tax planning, it is blessed to give. It is more blessed still to give while living (rather than waiting until death) and to give early and often. For one thing, once you give an asset to a donee, the asset's subsequent earnings and appreciation in value will belong to the donee without your being treated as making additional gifts. Here are some tax-efficient ways of making gifts.

Take advantage of the gift-tax annual exclusion. For 2022, the amount of the exclusion is $16,000 per donor per donee per year. Not all gifts qualify for this exclusion. To qualify, the gift must be of a "present interest" as opposed to one that will take effect in possession only in the future. So, a gift to a trust (in which the beneficiary's access to the assets may be postponed) does not necessarily qualify for the exclusion. However, you generally can qualify gifts to a trust for the exclusion by giving the beneficiaries the right to withdraw assets that you contribute to the trust, for a limited period after you contribute those assets to the trust.

Split your gifts with your spouse. For example, you and your spouse file a gift-splitting election with the IRS in which each of you elects to be treated for gift tax purposes as having made half of the gifts made during that year by the other. Then, together you can make annual-exclusion gifts of (for 2022) $32,000 per donee per year.

Take advantage of the unlimited "ed/med" gift tax exclusion. For example, pay your children's and grandchildren's tuition and medical expenses. You must make the payments directly to the school, physician, etc.

Contribute to § 529 plans for your children or grandchildren; that is, tax-qualified savings plans designed to provide funds for the expenses of higher education for named beneficiaries. The contributed funds may be invested. The earnings and appreciation in value will not be subject to income tax, either while still in the plan or even when distributed to pay qualified higher education expenses. Contributions to 529 plans qualify for the gift-tax annual exclusion even though they don't give the beneficiary a "present interest." In fact, any contribution in excess of the annual exclusion amount can (for purposes of the annual exclusion) be treated as made in installments over five years. In other words, you can accelerate up to five years' worth of annual gift-tax exclusions. Thus (using 2022 exclusion amounts), a gift of $80,000 (or $160,000 if spousal gift-splitting is elected) can be made to a 529 plan in year 1 without current gift tax consequences: the excess over $16,000 (or $32,000 if gift-splitting is elected) can be absorbed ratably over the next four years. The 529 rules also permit the donor to retain control of the account (for example, retain the right to take back the contribution for himself or to change the beneficiary to another member of his family) without causing the account to be includible in his estate for estate tax purposes.

Transfer personally owned life insurance policies on your life to the trustee of an irrevocable trust for your spouse and your children and make annual-exclusion gifts to the trust each year to enable the trustee to pay the premiums. (Or, better, have the trustee purchase a new policy from the insurer, to avoid the risk of not outliving the three-year estate-tax inclusion period applicable to transfers of existing policies.) Purpose: to remove the proceeds of the policies from your estate for estate tax purposes.

Take advantage of lower valuation (for gift tax purposes) for interests in an asset or entity that are illiquid and non-controlling interests. The gift tax applies to the fair market value of

the asset, or the interest in an asset, transferred. Some interests in an asset have a value less than their ownership percentage of the value of the asset as a whole. For example:

Transfer real property by giving each donee an undivided fractional interest. Since few buyers want to own property jointly with another person, the fair market value (and, therefore, gift tax value) of an undivided 10% interest in a parcel of land is worth less than 10% of the fair market value of the property as a whole.

Give the donees non-controlling interests in a closely held business. The interests may be non-controlling either because each transferred block of shares represents less than a majority ownership percentage or because the shares lack voting rights. Using non-voting common stock (or its equivalent in the case of a limited liability company or other non-corporate entity) can be useful for several reasons, including: (i) the donor may be more willing to give away shares if he can retain his voting control over the entity; and (ii) the donated shares' lack of voting rights will further reduce their gift-tax value (say, by 5% to 10%), enabling the donor to give more shares (i.e., a greater percentage ownership interest) to the donees each year. Although the donor's retained voting control will cause his retained shares to be valued at premium for estate tax purposes, that control premium will be applied to a reduced percentage interest in the entity. Using voting and non-voting shares is permissible even in the case of an S corporation: it will not violate the S corporation prohibition against multiple classes of stock.

Contribute business or investment assets to a limited partnership and give the donees non-controlling interests in the partnership as limited partners (control of the partnership's activities and distributions being reserved to the general partner). In determining the value of the gifted limited-partner interests in the partnership, it should be possible to apply a discount to the pro rata value of the partnership's net assets.

Make gifts of a carried interest in a private equity fund. If you organize and manage private equity funds, consider (in the planning stage, before you prepare the fund's organizational documents and begin seeking investors) giving to a trust for your children and other descendants part of your economic interests in the fund, including part of the general partner's carried interest in the fund. A “carried interest” is an interest for which the GP does not have to make a capital contribution. It entitles the GP to a share of the fund's distributable cash, but only after the investors have received specified threshold returns on their contributed capital. At the outset of a private equity fund, the GP's carried interest can generally be assigned a low value for gift tax purposes. Because of various gift, estate, and income tax obstacles, the planning for a gift of such an interest is complex. But, if the private equity fund succeeds and pays the GP substantial amounts on the GP's carried interest, the transfer of wealth (with little wealth transfer tax cost) can be dramatic. Caveat: There have been proposals in Congress to adversely tax carried interests.

Take advantage of lower valuation (for gift-tax purposes) where the beneficial interests in an asset are divided temporally, such as where a donor retains a temporary interest for himself and gives a future interest to a donee or gives a temporary interest to a charitable donee and a future interest to a non-charitable donee. For example, make gifts by means of a **grantor retained annuity trust (GRAT), charitable lead annuity trust (CLAT), or qualified personal residence trust (QPRT)**:

GRAT: Contribute assets to an irrevocable trust (a “grantor retained annuity trust,” or “GRAT”) that will make payments to you each year (an annuity) for a specified number of years and then turn over the remaining assets to the other beneficiaries (for example, your children).

Because of your retained annuity, your children's interest in the assets will have a reduced value for gift tax purposes.

> Example. Parent ("P"), age 67, wishes to give Child $1,000,000 of corporate bonds that pay 8% annual interest. Instead of giving the bonds to Child outright, P transfers the bonds into a trust pursuant to a trust instrument that directs the trustee to pay P $8,000 a year for 12 years and then turn over the trust property to Child. Suppose that under tables used by the IRS to determine the value of gifts, on the date of P's transfer of the assets to the trust the assumed return on investments (the § 7520 rate) is 5%. Under these tables, for gift tax purposes, the value of P's 12-year annuity is $619,304, and the value of Child's remainder interest in the corporate bonds (which is the amount subject to gift tax) is only $380,696. These figures assume that P provided in the trust instrument that if P dies before the expiration of the 12-year annuity, all of the trust property will revert to P's estate. If P does not provide for a reversion to P's estate but instead provides that if P dies during the 12-year term P's annuity will continue to be paid (to P's estate) for the remainder of the 12-year term and then the trust property will pass to Child, the value of P's 12-year annuity will be $709,064, and the value of Child's remainder interest (which is the amount of the gift) will be only $290,936.

A GRAT depends for its success on three assumptions: (i) that the assets in the GRAT will generate sufficient cash flow to make the required annuity payments to the donor; (ii) that the assets will generate earnings/growth-in-value at a rate in excess of the § 7520 rate; and (iii) that the donor will outlive the period of his retained annuity interest. If these assumptions pan out, the donor can transfer the assets' excess return (that is the earnings and appreciation in excess of the § 7520 rate) to the children at little or no gift tax cost.

CLAT: Give a temporary annuity from the assets to a charitable organization, after which the assets will pass to your children. That is, transfer income-producing assets to a trustee of a charitable lead annuity trust, or CLAT. The trustee pays an annuity to one or more charitable organizations for a specified number of years (the "front-end" or "lead" period) and then turns over the remaining assets to your children. The value of the charity's "lead" annuity reduces the taxable amount of the gift to your children. Thus, use of a CLAT reduces the gift-tax cost of transferring the assets to your children (at the price of postponing their access to the assets). For example, Parent ("P") transfers to a CLAT $1,000,000 of corporate bonds that pay 8% annual interest. In the trust instrument P directs the trustee to pay Charity $8,000 a year for 12 years and then turn over the remaining trust assets to Child. Suppose that under tables used by the IRS to determine the value of gifts, on the date of P's transfer the assumed return on investments (the § 7520 rate) is 5%. Under these tables, for gift tax purposes, the value of Charity's 12-year annuity is $709,064, and the value of Child's remainder interest in the corporate bonds (which is the amount subject to gift tax) is only $290,936. If the IRS discount rate is 7% rather than 5%, the amount subject to gift tax will be $364,584. For a CLAT to succeed, the assets in the CLAT need to earn/grow at a rate not less than the § 7520 rate.

QPRT: Transfer a residence to your children by means of a qualified personal residence trust (QPRT). To illustrate: Parent ("P") irrevocably transfers his residence to a trust (a QPRT), retaining the right to rent-free personal use of the residence for 12 years (the "retention period"). At the expiration of the 12-year retention period, the property of the trust will pass to P's children. (If P dies before the expiration of the retention period, the property will revert to P's estate.) Upon transferring the residence to the trust, P is treated as making a taxable gift to his children;

but since the property will not actually be turned over to the children until after the retention period expires (and since it will not be turned over to them at all if P dies before then), the value of the gift is discounted for gift tax purposes. If P is age 67, the residence is worth $1,000,000, and the IRS discount rate is 5%, P will be deemed to have made a gift in the amount of $376,920. If the IRS discount rate is 7% rather than 5%, P will be deemed to have made a gift in the amount of $300,550.

To continue to live in the residence after the end of the retention period, P will need to pay his children rent pursuant to a bona fide, arm's length lease. P can make those payments income-tax-free to P's children, by arranging for the residence to be held in a trust (f/b/o P's children) that for income tax purposes (but not for estate tax purposes) is treated as owned by P. See "Use grantor trusts" below.

If the residence depreciates in value, the gift-and-estate-tax savings will be less than anticipated. The residence's value would have to depreciate very substantially to eliminate the tax savings of the QPRT. Unlike some other gift-and-estate-tax-reduction techniques, the success of a QPRT does not depend on the value of the residence increasing in value more rapidly than the IRS-predicted rate (the § 7520 rate). The QPRT will save taxes even if the residence stays flat in value.

If you do not survive the retention period, a QPRT will not save any taxes, because all the trust property will be back in your estate for estate tax purposes. Also, you will have wasted the transaction costs and possibly missed an opportunity to use other estate tax savings devices in the meantime. One way to cover that risk is to buy a term insurance policy the term of which coincides with the retention period. The face amount of the policy would equal the anticipated tax savings. The policy could be owned by your children or a trust for their benefit (it cannot be owned by the QPRT and should not be owned by you). That way, the financial benefit of the QPRT would be realized whether you survive the term (QPRT works) or do not survive the term (QPRT fails, but insurance policy pays off).

Make a gift of an opportunity

In general, the gift tax applies only to transfers of property. So, in some cases, a parent can, without making a taxable gift, shift substantial wealth to a child by transferring to Child, not a going business but a business opportunity. That is, Parent foregoes the opportunity in favor of Child, and Parent helps Child exploit the opportunity by various means not involving gifts of money or other property.

For example, a parent who owns and operates a business selling items through stand-alone company-brand stores might forego other channels of distribution and, instead, help Child enter those other lines of the business, providing Child with advice, lending money to Child (or helping Child obtain a loan from a third party), introducing Child to suppliers, managers, other advisors, and other key business contacts, and encouraging customers to patronize Child's business. If Child is too young to run the business himself, or if Parent for other reasons does not wish for Child to have managerial control, Parent could vest maintain managerial control (of the entity through which the new line of business is to be pursued) in a special class of shares having a small percentage of the entity's equity but carrying voting control, and arrange for those shares to be held not by Child but by a trustee for Child.

Similarly, Parent could identify an investment opportunity and forego it in favor of Child, and

help Child exploit that opportunity by giving Child advice, lending money to Child (or helping Child obtain a loan from a third party), etc.

Transfer intellectual property to business entity owned by junior generation, in exchange for royalty payments. In the case of a closely held business that depends on intellectual property such as trademarks or trade secrets, to enable the junior generation to pursue the business and benefit from its future growth in value, while providing cash flow to the senior generation, the senior generation could transfer the intellectual property to the junior-owned entity in exchange for payments to the senior generation for their life or such shorter period as desired. Treat the payments to the senior generation as royalties (deductible by junior-owned entity as a business expense, and ordinary income to senior generation) rather than as dividends on an equity interest and rather than as gifts by the junior generation.

Make gifts to a long-term trust for your descendants, designed to stay intact throughout the generations of your children and grandchildren and possibly beyond (take advantage of your GST exemption). The transfer of assets to the trust would be subject to gift tax (which tax can be reduced by various gifting techniques mentioned elsewhere in this list). But, for as long as the assets remain in trust (which could be 90 or 100 years or even longer), the assets should be exempt from further gift, estate, and generation-skipping transfer taxes. In particular, the assets kept in the trust would avoid estate tax at the generation of your children even though your children will have benefited from the assets' earnings (and from use of tangible assets) during their lives. The trust can also be operated to protect the assets from the beneficiaries' creditors. For example, rather than distributing cash to a beneficiary to enable her to buy a house, the trustee could buy a house to be held as an asset of the trust, for the beneficiary's use. The beneficiary could then use her own money to pay for consumable or depreciable assets such as food, automobiles, and vacations. Keeping the trust assets intact in this manner (that is, shielding the assets from wealth transfer taxes at each generation and avoiding dissipation by spendthrift beneficiaries or creditors) could result in astonishing growth of the trust assets. Because Congress is aware of these benefits, you can't contribute to such trusts without limit. But consider doing this up to the amount of your and your spouse's GST exemptions ($12,060,000 per donor in 2022).

Make your gifts to charitable organizations qualify for income-tax benefits

If you have decided to make a gift to a charitable organization, consider making the gift while you are living, since a gift to charity that you make during life may qualify for an income tax deduction.

Consider giving the charity assets other than cash. In particular, consider giving the charity assets that carry a built-in income tax liability, such as highly appreciated (low-basis) publicly traded stocks, bonds, land, and other assets that, if sold by you, would cause you to incur a substantial taxable gain. You may be able to claim a charitable income tax deduction for the full fair market value of the asset, unreduced by the built-in tax liability (depending on the nature of the asset and the type of charitable recipient). The charity, being a tax-exempt organization, can sell the asset and keep the entire proceeds (whereas if you sold it you could keep only the proceeds in excess of the income tax liability).

Use grantor trusts

Generally. When you create an irrevocable trust for your children, grandchildren, etc., consider making the trust one that for income tax but not estate tax purposes is treated as owned

by the donor (grantor) (a "grantor trust"). Because of incongruities between income tax and estate tax rules, a grantor, by retaining certain non-beneficial powers (or granting certain powers to the trustee), may cause himself to be treated as still owning the trust's assets for income tax but not estate tax purposes. The grantor, rather than the trustee or beneficiaries, will be liable for the income taxes on the trust assets' income and gains. From a gift-and-estate-tax point of view, the grantor's paying those income taxes will be a very good thing. The grantor will be paying the income taxes on what is ultimately the beneficiaries' income, and yet those payments by the grantor will not be treated as additional gifts to the trust's beneficiaries. Suppose John contributes to an irrevocable trust for his descendants $3,000,000 worth of assets that each year yield 3% ordinary income and 4% appreciation in market value. The trustee sells and reinvests the trust's investments from time to time. Assume the grantor, trust, and beneficiaries are subject to income tax on realized appreciation (capital gain) at a combined federal and state rate of 20% and on ordinary income at a combined federal and state rate of 40%. In ten years, the trust assets will have a value of approximately $4,886,684 if the trust is not a grantor trust or $5,901,454 (that is, $1,014,770 more) if the trust is a grantor trust. This is because in a non-grantor trust the assets' after-tax yield will be only 5% [that is, (3% x 60%) + (4% x 80%)], whereas in a grantor trust, since John is paying the income taxes, the yield to the trust will be a full 7% (that is, 3% + 4%).

Sell an asset to a grantor trust in exchange for an installment obligation. For example, after having contributed some seed money to an irrevocable trust for the benefit of John's children, John sells a 30% interest in Business LLC to the trustee at a price equal to the asset's fair market value determined taking into account discounts for minority interest, lack of marketability, etc., payable over a specified number of years pursuant to an interest-bearing promissory note. John retains no beneficial interest in the trust but retains certain non-beneficial powers that will cause John to continue to be treated as the owner of the trust's assets for income tax purposes but not for estate tax purposes. Because for income tax purposes John is still considered the owner of the assets, (i) the sale to the trustee will not trigger recognition of any taxable gain (the trustee will take a carryover basis in the purchased asset), (ii) the trustee's interest payments to John pursuant to the note will trigger no income tax, since for income tax purposes they will be considered to be payments by John to himself, (iii) if the trustee sells the asset to a third party, any taxable gain realized on that sale will be taxable to John rather than to the trust or the children, and (iv) any earnings (such as interest, dividends, rent) generated by the trust's assets will be taxable to John rather than to the trustee or the children. To the extent the trust's assets' total return (income plus growth in value) -- which total return will be unreduced by income taxes, since the income taxes are being paid by John -- exceeds the interest rate on the trustee's note to John, the children will benefit. That excess total return (even the part attributable to John's paying the income taxes) will not be considered a gift by John and will not be subject to estate tax in John's estate.

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