What is a taxable gift?
A gift is considered taxable if it is in excess of the annual exclusion. The annual exclusion amount is currently $13,000 per recipient and is indexed by the government for inflation. Despite the fact that a gift may be taxable, it does not mean that gift tax will be due. Gift taxes are due when the total gifts made exceed your lifetime exemption amount. The lifetime exemption amount for gifting for the remainder of 2012 is $5.12M, and this is set to revert to $1M on January 1, 2013. Taxable gifts over the exemption amount will be taxed at the maximum gift tax rate then in effect. For example, if you were to make a gift of $6.12M this year to trusts for the benefit of your children, the gift tax would be applied only to $1M, which is the amount in excess of your available lifetime exemption (assuming you had not previously made any taxable gifts). The maximum gift tax rate is currently 35%; however, this is set to increase to 55% on January 1, 2013.

It is important to note that each person can use her or his lifetime gift exemption amount in addition to the annual exclusion amounts and/or choose to make a gift and pay gift tax if appropriate.

When does a gift tax return have to be filed?
A gift tax return must be filed for any taxable gifts by April 15 of the year following the gift, whether or not any taxes are due.

What is an irrevocable gift trust?
An alternative to gifting outright is using an irrevocable gift trust. This is a trust that anyone may create to serve as a vehicle to receive and manage gifts made to the trust for the benefit of the grantor’s selected beneficiaries, including children, or whomever else the grantor may choose. As the name indicates, an irrevocable gift trust is not revocable once established, nor can any transfers made to a gift trust be returned once they are completed.
What is a Crummey gift trust?
Transfers made to an irrevocable trust will qualify for the annual exclusion only if they are gifts of a “present interest.” This means that the trust must give the beneficiary(ies) some immediate right to benefit from the gift. This requirement is satisfied if the trust gives the beneficiary(ies) the right to withdraw the annual exclusion amount within a certain time frame, usually no less than 30 days. This is often referred to as a Crummey power. Including Crummey provisions in trusts provides the donor with the ability to contribute to the trust on an annual basis (or less frequently) and take advantage of the annual exclusion amount, whether or not the donor has already used her or his lifetime exemption amount.

What assets should be transferred to gift trusts?
Since the value of each gift for gift tax purposes is based on its current fair market value, the gift trust structure is perfect for transferring assets that have a high potential for appreciation, such as the shares from a business or real estate. Once a transfer is complete, the gift trust will be treated as the “owner” of the transferred asset so that any future appreciation of the asset will also be “owned” by the gift trust, and will not be includable in the donor’s estate for purposes of determining estate tax liability at the donor’s death.

What are the benefits of gifting assets in trust to children rather than outright?
By establishing irrevocable gift trusts for children now, the grantor can: (i) set the terms under which the children can access principal and income; (ii) choose whether the donor or the trust will bear the income tax liability for the trust and for how long; and (iii) protect the gifted assets from creditors and against inclusion in the children’s estates for estate tax purposes. This is not true if the gifts were made outright.

Who pays the income taxes?
The grantor of the trust may choose to pay the income tax, so that the trust serves as a vehicle to transfer additional wealth, or the trust itself can pay the income taxes. This depends on how the trust is structured.

If the trust is a “non-grantor trust,” meaning that it is a separate tax-paying entity for income tax purposes, any income generated within the trust will be taxed either to the trust or to the beneficiary, if income is actually distributed to the beneficiary.

However, if the grantor retains certain powers maintaining the trust as a “grantor trust” for
income tax purposes, the grantor will continue to be responsible for the income tax liabilities of the trust. The Internal Revenue Service does not currently treat the payment of income taxes by the grantor as an additional gift. Therefore, for individuals with a sizeable estate, it can be beneficial to continue to be responsible for the income taxes, further reducing the value of the grantor’s taxable estate, while simultaneously allowing the gift trust to grow more rapidly by relieving those trusts – or the trusts’ beneficiary(ies) of the income tax liability. While there are a number of different ways to create a grantor trust that works this way (sometimes called an “intentionally defective grantor trust”), it is important to choose a method that can be “turned off” at a later date in order to ensure that the “defect” that shifts the income tax burden to the grantor at the outset can be reversed so that the grantor can ultimately be relieved of that income tax obligation at some future point in time.

Can gift trusts exist in perpetuity?
Not in California. California has a rule against perpetuities which prohibits trusts from existing indefinitely. However, there are certain states that have abolished the rule against perpetuities. If it makes sense, the gift trust can be established in one of those states. These types of trusts are commonly referred to as dynasty trusts, and allow for assets to pass to future generations without ever being subjected to estate taxes.

What are generation skipping transfer taxes?
Since gift trusts often will allow for multi-generational transfers, we often recommend that the provisions of the gift trusts allow the trustee to allocate the donor’s generation skipping transfer (GST) tax exemption to some or all of each gift trust. The GST tax is a tax that may be applicable in addition to any estate taxes. The GST tax was enacted to ensure that property transfers are taxed at least once at each generation, and to prevent the use of multi-generation trusts, which are often created to avoid estate tax in perpetuity. There is a per-person GST tax exemption, however, that can be allocated to all or a portion of any trust. Currently, the GST tax exemption amount is $5.12M. In 2013, that exemption amount will be reduced to $1.12M, as adjusted for inflation, unless Congress implements a law to the contrary. If a donor’s GST tax exemption is allocated to all or some portion of the gift trusts, any of that GST-exempt property that is transferred to future generations will not be subject to any estate tax or GST tax potentially indefinitely, subject to the rule against perpetuities, if any, as described above.
Who can be trustee?
It is possible for the grantor to serve as the trustee of gift trusts. However, we strongly recommend against this, because any retention of the “beneficial enjoyment” of trust assets – or any appearance of such beneficial enjoyment by the grantor – can cause the trust assets to be includable in the donor’s estate, entirely defeating a primary purpose for establishing the gift trust in the first place.

If an independent person – someone who is not related or subordinate to the grantor – serves as trustee, the distribution terms of the trust can be broad. If the named trustee is someone who is related or subordinate to the grantor, then the discretionary distribution power must be limited by an ascertainable standard – for example, a standard allowing distributions for a beneficiary’s health, education, maintenance or support.

What would the distribution terms of the trust look like?
The distribution terms of a trust can vary based on the donor’s intent. In general, however, a trustee has discretion to distribute assets from the gift trust to pay for the beneficiary’s health, education, maintenance, and support during the beneficiary’s lifetime. Finally, it is important to note that the trustee is barred from making distributions that would satisfy the grantor’s legal obligation to support her or his child.

Often, the trust will include provisions that specifically allow the beneficiary to appoint the trust assets via her or his will, essentially allowing the beneficiary to redirect the trust assets after her or his death. This is called a “Power of Appointment”. If the beneficiary does not exercise her or his Power of Appointment, either partially or fully, any trust assets not appointed will pass to the remainder beneficiaries the grantor has named in the original trust, commonly including distributions to other family members, friends and/or charitable beneficiaries.

What are other gifting options?
Depending on the type of assets being gifted and the client’s goals there are many other efficient ways of gifting for both tax and non-tax reasons. Some of the methods that have been commonly used for many used, may very well expire at the end of 2012. Should you have questions or want to explore other options, please contact our office at (415) 693-0550.