GIVING - A FEW CONSIDERATIONS

Your children have been telling you that - it is better to give than to bequeath.

And you read “Die Broke” ......

Prior to the current change in the law, from a tax perspective it was true. With the change in the law and when it is anticipated that you will live to 2010 with the possibility of dying when there is no estate tax, it is much less likely that a gift should be made which results in a gift tax.
However, tax free gifts are still a significant part of an estate plan and are advisable in this transition environment. I do not recommend doing anything that would be inadvisable if we knew the estate tax would be repealed *permanently* in 2010, nor do I recommend doing anything relying on the estate tax *ever* being repealed. We simply should not have the tax tail wag the dog. We never should have, but the current situation makes that premise even more important.

Tax Aspects

In the chapter titled "Transfer Taxes - An Overview", I have included a more complete discussion of the estate, gift and generation skipping tax. This section summarizes some of the relevant aspects of the gift tax.

The tax rates for gifts and bequests at death are currently the same. You have one schedule for both, a “unified” tax. The “unified tax” continues as long as the estate tax remains in effect. Each person has an exemption from estate and gift tax. The exemption from estate tax is $1 million in 2003, $1.5 million in 2004, $2 million in 2006, $3.5 million in 2009, is unlimited in 2010 and drops to $1 million in 2011. Since the exemption is $1 million in 2003 and again in 2011, I will illustrate tax consequences assuming a $1 million exemption. The exemption from gift tax increased to $1 million in 2002 and will remain at that level. During 2010 when there is no estate tax, the gift tax rate is equal to the maximum income tax rate.

> If you give your child $1 million during your lifetime, the gift will cost you $1,500,000....If you want to leave your child $1 million on your death it will cost you $2 million ... (assuming a 50% estate tax)

In computing your tax, all of your prior taxable gifts are added together to determine the amount of tax which will be owed on the current gift. If the rate is the same, then why is the tax on a gift less than a tax on a bequest at death? You avoid the tax on the tax. You pay a tax on the tax on your death but you do not pay a tax on the tax on a gift. Let me give you an example. Assume that you are in the 50% estate/gift tax bracket (the top bracket in 2002) and want to give your child $1 million. If you give your child $1

million during your lifetime, the gift will cost you $1,500,000 - the gift of $1 million plus the gift tax of $500,000. If you leave your child $1 million on your death, it will cost you $2 million, because the 50% estate tax is imposed both on the $1 million going to your child and the amount used to pay estate taxes. With a 50% estate tax rate, it takes $2 million to pay $1 million in estate taxes (50% of $2 million) and leave your child $1 million.

With a lifetime gift, you avoid the transfer tax on the subsequent appreciation and income on the asset. If you had retained the asset, the appreciation on the asset and the income earned on the asset would have been included in your estate and taxed. For example, let's assume you have an asset valued at $500,000, and you give it to your children. Let's assume that you use part of your $1 million exemption, so that there is no gift tax paid on the transfer.

If the asset appreciates in value at the rate of 10%, the asset will be worth about $4.8 million in 20 years. If there is an estate tax in 20 years, you will have saved the estate tax on the appreciation in that asset. If we have no estate tax in 20 years, you have not saved any transfer tax. Keep that in mind. Do not make any transfers *solely* for tax purposes. If you want your children to have this money available to them, then you have accomplished your purpose, even if there is no estate tax in 20 years. And let's consider the converse situation. What if you gave your children $500,000 and there was an estate tax, but the gift was very inadvisable in terms of its impact on your children. In that situation, the tax savings is not worth the negative impact on your children.

Gifts continue to be advisable as long as they are consistent with your objectives other than saving transfer taxes. As I said earlier, plan so that you have no regrets if they eliminate the estate tax and no regrets if they reinstate the 55% estate tax. The limit on the gift tax exemption serves a dual purpose. First, it prevents people from avoiding the impact of reinstating the estate tax by giving all of their property away during a transfer tax free period. Second, it prevents people from shifting the ownership of their property among their family members in order to lower their *income* tax.

Back to gifts. They do continue to be beneficial, provided that you ...

— Keep your gifts tax free —

You do have an additional gift tax "exclusion" (distinguished from an "exemption"). Gifts up to $11,000 per year made to an individual (the donee) are excluded from gift tax. The annual exclusion from gift tax is indexed for inflation and increases by $1,000 when inflation has increased by at least 10%. The only qualification on this exclusion is that the individual (donee) must have a present right to the money. The requirement that the donee have a right to the money when the gift is made is called the "present interest" requirement. As is discussed more fully in the "Transfer

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Taxes - An Overview" chapter and in this chapter in the “gift to minors” discussion, this requirement necessitates some special planning when gifts are made to a trust.

In general, as long as there is an estate tax, gifts can substantially reduce the taxes on transfers to your children. However, even when there is an estate tax there are some disadvantages to making gifts - other than the obvious one of not having the property for one’s own use. There is an income tax disadvantage to making a gift.

The disadvantage arises when appreciated assets are given away. For example, if the donor bought stock for $10 a share and now the stock is $100 a share, the donor’s basis for determining gain is $10. If the donor sold the stock, he would recognize a $90 capital gain. The basis for recognizing gain is carried over from the donor to the donee so that the donee has the same basis as the donor.

If the donor holds the stock until his death, under current law as long as there is an estate tax, his heirs receive a new “stepped-up” basis equal to the fair market value of the stock at the time of the donor’s death. In our example above, the donee would have a basis of $100, and if the stock was sold the next day, no gain would be recognized.

The top estate tax bracket is 50% in 2002 and the capital gains rate is only 20%, so there is still a benefit in the gift; however, the benefits are not as great, and other assets which have not highly appreciated should be given, if possible. When the estate tax is repealed, the ability to gain a new basis is more limited. A $1.3 million step-up in basis is available upon death when the estate tax is repealed. In addition, another $3 million step-up is allowed for property given to one’s spouse. Whether there is an estate tax or there is not an estate tax, it is most beneficial to give property which has a high basis.

Since we do not know whether Congress will ultimately decide to eliminate the estate tax, retain the $3.5 million exemption but keep the estate tax, or allow the current law be reinstated, taxable gifts should only be made in special circumstances.

However, the cumulative benefits of giving $11,000 per year should not be overlooked. Giving $11,000 per year results in a very significant transfer over time. For example, assume every year you give $11,000 of property which is yielding a 5% return. In 20 years you have transferred $380,000 out of your estate; in 30 years, $765,000; and in 40 years, $1,390,00. If the property is long-term capital gain stock with a 10% annual net return, the transfer is $690,000 over 20 years, $1.99 million over 30 years, and $5.35 million over 40 years.

In addition to the cumulative effect of the $11,000 per year gifts, the impact of making gifts can be dramatically increased by the type of property you give and/or the manner in which the property is given. Property whose value is artificially depressed or is subject to some type of

restriction which reduces its value can dramatically increase the benefits of giving. Some examples of this type of giving are gifts of:

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- undivided interests in property. An undivided interest in property is reduced in value by 5%-40%.
- property which is likely to experience substantial appreciation.
- A residence which is subject to your right to use the property for a term of years. See the discussion of Qualified Personal Residence Trusts.
- Property held in trust which pays you an annuity for a term of years. See the discussion of Grantor Retained Annuity Trusts.

Some of the most significant wealth I have seen transferred has been through gifts of stock in a business upon formation or prior to the time of substantial appreciation. The gift can be structured where all of the value of the business over a certain level is transferred to the children so that the parents can retain all of the business if the business is not as profitable as anticipated. The most effective method of transferring wealth to one's children depends on a number of individual factors, including the nature of your assets, your risk tolerance (in terms of potential for appreciation in those assets), the amount you desire to transfer, and the control you want to retain.

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Personal Considerations

If you want to give your children a substantial portion of your wealth during your lifetime, you can do it. Do you want to? Would you do it only to save taxes or do you want your children to actually have the use and control over the funds? Do you have certain uses of the funds which are acceptable to you and others which are not? Are you concerned with the impact of receiving the money on their incentive to make their own living? How would you feel if your children were wealthier than you? Do you feel that keeping control of your wealth ensures a close relationship with your children as you age? If your children used the funds

> If your children used the funds to increase their standard of living, would it bother you?

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I have a number of clients who regularly make gifts of the $11,000 annual exclusion amount. I have a much smaller number who give their exemption amount

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(all when the exemption was under $1 million) to their children. Even when the tax benefits of prior law were available for taxable gifts, I rarely had a client who would make a gift of a size sufficient to require payment of gift tax on the gift. Part of it is an abhorrence of paying taxes and part of it is a reluctance to completely let go of the funds. Generally speaking, substantial gifts made as a part of an estate plan are made to trusts.

Several years ago I read the best selling book, *The Millionaire Next Door*. The discussion in the book on the impact of giving was very interesting. The authors surveyed the children of wealthy individuals and compared the net worth of the children who receive regular annual exclusion gifts to those who do not receive gifts. The survey held age constant and compared the children by profession. Please note that these children are self-supporting, productive individuals. In eight of the ten occupational categories, the gift receivers had a lower net worth than the children who did not receive gifts. For example, the children who were accountants and received gifts had 57% of the net worth of those children who were accountants and did not receive gifts. The gift receiving children also had only 78% of the net income of the non receivers, but if you added in their gifts their net incomes were 98% of those who did not receive gifts, yet they only had 57% of the net worth of the non-receivers. This trend was true in eight of the ten occupations. It was not true of professors and teachers. Professors and teachers who received gifts had a higher net worth than those who did not receive gifts.

What do we learn from this survey? In general, regular annual gifts are not a productive way to transfer wealth to the next generation in terms of the impact on the recipients if your objective is to facilitate wealth accumulation in your children. Please note two aspects of this statement. First, I said “in general.” You know your children. You know the impact. You may not have stopped to

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think of it, but when you do, you know. And you know if the impact which is occurring is one you want. Even in the above survey, the impact of regular annual gifts on professors and teachers was positive in terms of wealth accumulation. Second, I stated “if your objective is to facilitate wealth accumulation.” Your objective may not be to facilitate wealth accumulation. You may want them to have a higher standard of living than you did or than they would if they did not receive the gifts. You may

plan on supplementing their retirement accumulation with additional gifts and/or their inheritance. Whether regular annual gifts accomplishes your objectives depends both on your objectives and your children.

Let's assume that your objective is to facilitate wealth accumulation. I have asked all these questions and given you sobering survey results. So with all these questions and caveats, are gifts counterproductive? Let me say - it ain't necessarily so. Gifts can be a wonderful learning device.

What are some productive uses of money transfers to the next generation? The two main ones are:

< Education.

< Seed money to start a business.

You are giving your children the tools and/or the opportunity to build their own estate, to give them self esteem - the type of legacy that you want to give them. What if the education does not lead to a high paying job and/or the business is a failure? Was it a mistake to fund the education and the business? In my opinion, absolutely not. Let me hasten to add, I am not supporting marginally passing extended schooling or whimsical business ideas. I am supporting all sincere efforts by our children regardless of the outcome. I care about the process; I do not care (too much) about the results.

Other than these gifts, are there any gifts which could or should be made? Go back to your objectives. If your objective is to increase their standard of living, let that be your guide. Let's assume that regular annual outright gifts do not serve your objectives. Some other types of gifts which many individuals choose to make are:

< Funds to make a down payment on a home.

< Funds to provide additional household help while their grandchildren are young.

< Funds to educate their grandchildren.

If regular annual outright gifts do not accomplish your purposes, that does not necessarily mean you do not make the gifts; it may mean that you do not make them to your children outright. If annual exclusion gifts suit your estate plan in other ways, for example, if you need to reduce the size of your taxable estate and have more than sufficient resources for your lifetime, then make the gifts but make the gifts through trusts or partnerships in a form which ensures the retention of the funds for a period of time.

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For what period of time? There is a time when the impact of making gifts does not affect your children's self esteem or productivity. As you might guess, my answer is that you know or will know. I will say that an age which fairly regularly is mentioned by my clients in my practice is age 40. By age 40 most children have learned what they are going to learn or will never learn it. I'm not sure I could say that applies to me. Some time shortly

after age 40 I realized what I wanted to do when I grew up, so perhaps an age between 40 and 50 is a little more prudent.

Gifts to Minors - UGMA/UTMA/2503(c)/trusts

Frequently, gifts are made to minors from grandparents. Parents also will frequently make gifts to their children to provide a college fund for their children. How should these gifts be made?

Making gifts to minors presents a couple of issues. The minor cannot legally enter into a contract, so that an account in the name of a minor alone cannot be changed without going to court and opening up a legal guardianship. For this reason, gifts are generally made in custodianships or in trust. The custodian or the trustee can then invest the funds held in trust and may make distributions to or for the benefit of the minor. Another issue which must be addressed is whether the gift to the minor qualifies for the $11,000 annual exclusion from gift tax. As I mentioned above, in order to qualify for the exclusion, the recipient of the gift, the donee, must have the present right to the funds. This right is referred to as the "present interest" requirement. The purpose of a gift to a minor is to provide for the minor, but not to literally give the minor the full use of the funds. The Internal Revenue Code has a special provision, Section 2503(c), which provides that if a trust is created for a minor that may be spent for the minor's benefit during the term of the trust, is distributed to the minor at age 21, and is included in the minor's estate if he dies prior to age 21, then a gift to that trust qualifies as a gift of a "present interest" and is eligible for the annual exclusion from gift tax. Case law has allowed the trusts to continue past 21 so long as the child is given the right to withdraw the funds at age 21 for a period of 60 days.

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Custodianships under the Uniform Gift to Minors are a form of trust. State law provides the terms of the trust. The custodianship accounts are structured to qualify as a gift to the minor under Section 2503(c). When the legal age in Texas was changed to 18, the age at which the custodianship terminated was also changed to 18. This change created significant problems with custodianships, since the custodianships terminated at the time when the child was to enter college - a most inopportune time for the parent. In 1995, Texas passed the Texas Uniform Transfer to Minors Act (TUTMA). TUTMAs are essentially the same as TUGMAs, except that the age at which the custodianship terminates is 21.

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Since 2503(c) trusts and TUTMAs are very similar, is there any reason to use a TUTMA rather than a 2503(c) trust, since you can have an extension of the trust after age 21 in the 2503(c) trusts? Yes. Income taxes. The property held in a trust is taxed to the trust unless the income is distributed to the beneficiary. If the income is distributed to the beneficiary, then it is taxed to the beneficiary. The income tax rates for trusts are horrendous. The top income tax bracket is reached at under $10,000 ($9,250 in 2003 and adjusted upward annually for inflation). In a custodianship, the income is treated as income of the minor. While the child is under age 14, the income will be taxed at the parents' rates. After the child reaches age 14, the income is taxed to the child at the child's rates. Much more favorable.

Because of the difference in income tax treatment, I have rarely used 2503(c) trusts since the Texas Uniform Transfer to Minors Act raised the age at which the custodianships terminate to age 21. However, I do still use one type of trust - the "Crummey trust."

Crummey Trusts

Many of you have heard of "Crummey trusts". For those of you who have not, the title is not an indication of the quality of the trust or the drafter. The trust is named after a taxpayer who used this type of trust and was successful in a challenge by the IRS. Let me begin with a little background.

In creating a trust, one of the characteristics we would frequently like in the trust is for a gift to the trust to qualify for the $11,000 annual exclusion from gift tax. As mentioned earlier, in order for a gift to qualify for the annual exclusion from gift tax, the person receiving the gift (the donee) must have the right to use the property currently, he/she must have a "present interest" in the property. Generally a gift to a trust is not a gift of a present interest since the purpose of the trust is to provide some management of the money or some control over the receipt or use of the funds. However, if

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you give the beneficiary of the trust the right to withdraw the gift to the trust for a period of time, usually 30 days, then the gift to the trust is a gift of a "present interest" in the property and does qualify for the $11,000 annual exclusion from gift tax, even though the donee/beneficiary cannot take the property out of the trust thereafter. Using this method to create a present interest in property given to a trust has been used for years. In the 1970's, Mr. Crummey created a trust for his minor children and gave them the right to withdraw the property he contributed to the trust. The IRS challenged the gift as not being one of a present interest, since his minor children did not have the legal capacity to withdraw the money (and in all likelihood would not have understood the whole concept of withdrawing money from the trust). Mr. Crummey won, and later the IRS acquiesced in the decision.

The beauty of the Crummey trust is that you can provide for any terms you want in the trust, as long as you include the

withdrawal power in the trust and give the beneficiaries notice of their right to withdraw when a contribution is made to the trust. The trust does not need to terminate at 21 or any age. The trust can include numerous beneficiaries and can provide that the income may be used for the beneficiaries who need the income (or principal) and need not be distributed equally.

Non-effective Methods

Some methods are not effective to actually transfer property to your children. The most common "transfer," which is not actually a transfer to your child, is to open an account in your name as Trustee for your child with no written trust agreement. If you do not have a trust agreement, then the account is considered to be a "revocable" trust. You have transferred the property to a trust which you can cancel at any time. Since you can cancel the trust at any time, the transfer is not a completed gift and does not qualify for the $11,000 annual exclusion from gift tax. In addition, the trust is included in your taxable estate, since you have the power to cancel it at any time. The only effect this type of account has is to transfer the property to your child upon your death. If your child is a minor, a guardian may have to be appointed after your death in order to have access to and/or to reinvest the funds.

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Other transfers may be effective to qualify as a gift to your child, but the property may still be included in your estate. So long as your estate is non-taxable this result is not a problem. However, if your estate is taxable and one of your purposes was to remove the property from taxation in your estate, you have not accomplished that purpose. In general, if you transfer property to yourself as custodian or as Trustee for your child, the property will continue to be included in your estate. It is possible to draft a trust of which your child is the sole beneficiary and of which you are Trustee but which is not included in your estate, but most trusts are not drafted in this manner.

If the trust is created by another person and you are the Trustee for your child, generally the trust is not included in your estate. If you have the power to use the property to discharge your legal obligation, then the property is included in your estate.

Permissible Uses of the Trust Assets

The purposes for which the trust may be used are governed by the trust instrument. Usually a 2503(c) trust (or a custodianship) permits the property to be used in its entirety for the benefit of the minor. Most other trusts permit the Trustee to use the property for the health, education, support and maintenance of the beneficiary. In addition, the trust usually provides that the trust assets cannot be used to discharge any person's legal obligation, such as your legal

obligation to support your child. What type of expenses can you pay and what can't you pay? Food, clothing and shelter are generally support obligations. Private school tuition, sports, music lessons and cars are not part of your legal obligation to support your child. You are also not required to support your children after they are 18, so all of your children's expenses after they reach age 18 are not your legal obligation. If you are not legally obligated to pay those expenses, the expenses may be paid by the trust. And the trust cannot pay expenses of your child which you are contractually obligated to pay. For example, you sign a contract for your child's tuition in private

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school. The trust then pays the tuition bill. The payment of the tuition bill is discharging your contractual obligation to pay the tuition. The payment of the tuition may be permissible under the terms of the trust; however, if the trust pays a bill which you are legally obligated to pay, the payment of the bill is considered to be income taxable to you.