Gifts to Family Members

Lifetime gifts to family members can be a very effective technique to remove property from an estate before death. Although federal estate tax rates are the same as the federal gift tax rates, the federal gift tax is imposed only on the value of what the donor gives; it is not imposed on the amount of federal gift tax itself. By contrast, the federal estate tax is imposed on the full value of the decedent's assets at death including the property used to pay estate taxes. Therefore, if the taxpayer makes a gift and pays a federal gift tax, and if the taxpayer lives at least three years after the date of the gift, the federal gift tax itself will not be subject to federal gift or estate tax. With the federal estate tax rate being 40%, each $1.00 of federal gift tax which the taxpayer pays (if the taxpayer lives at least three years after the date of the gift) saves $0.40 of federal estate tax which would otherwise be payable because of the taxpayer's death.

To illustrate the effect of this tax saving, a mother has $8,000,000 of extra property and she wants her children to receive the largest amount of this property possible after payment of taxes. If she uses the $8,000,000 to make a taxable gift to her children of $5,926,000, the federal gift tax would be $2,370,400. However, if she keeps the $8,000,000 until her death, the federal estate tax will be $3,200,000. Therefore, with the gift, the children receive $5,926,000 and when no gift is made and the property passes at death, the children receive only $4,800,000. The difference, as explained above, is that with a gift, no tax is imposed on the amount used to pay the federal gift tax.

Giving away property during lifetime has other advantages. By giving away property with appreciation potential, the appreciation between the time of the gift and the time of the giver's death would escape both gift and estate tax. Also, if property is given to someone in a lower income tax bracket, the income can be taxed at a lower rate.

If gifting is to be used as part of the estate plan, it would be advisable to make gifts using property with a high basis, because the recipient will receive a basis in the gifted property equal to the giver's basis. Basis, which is generally equivalent to the owner’s cost of purchasing the asset, determines the amount of taxable gain on the subsequent sale or disposition of the asset. Property kept until death will, under current law, receive a "stepped-up" basis equal to its date-of-death value.

Annual exclusion and medical or education gifts

In 2017, each person can give, without paying gift tax, up to $14,000 annually to as many different persons as he or she desires. A husband and wife can combine their gifts to give up to $28,000 annually to as many persons as they wish. In addition to the $14,000 amounts, you can pay another's medical expenses directly to the provider or pay another's tuition expense directly to educational institutions without paying any gift tax.

Personal Residence Trusts

Personal Residence Trusts are a good technique to remove the family residence or vacation home from both parents' estates at a low gift value. The parents give their residence or vacation home to an irrevocable Qualified Personal Residence Trust. They retain the right to live in the house for a term of years and give the remainder interest in the residence to their children at the end of the term of years. The value of the gift of the remainder interest is reduced by a hypothetical income interest for the retained term of years and the gift cost is reduced significantly. The gift to the children may be only 30 to 40% of the actual value of the residence. If the parents survive the term of years, the residence passes to their children without any further taxable gift. If they die before the term is up, the residence returns to their estate. Using this technique also removes the value of all the appreciation in the residence during the retained term. A potential disadvantage of the Qualified Personal Residence Trust is that the children receive the residence without a step-up in basis. Also, at the end of the term, the children own the residence and you may still want to live in it. This problem can be resolved by arranging to lease the residence after the end of the term.

Grantor Retained Income Trusts

Grantor Retained Income Trusts work like Qualified Personal Residence Trusts. A parent contributes property to an irrevocable trust. The parent retains an income interest in the property for a term of years and the remainder goes to children at the end of the term. The income interest must be a fixed income rate applied to the value of the trust assets at the time of contribution or the value of the trust assets re-determined annually. If the parent survives the term, property is removed from his or her estate at reduced gift tax cost. If the fixed income rate paid to the parent is high or the term is ten years or longer, the gift cost can be very low. This technique can work well for a closely-held business, family limited partnership, or securities that generate a predictable income stream. By using the right combination of an income payment and term of years, the value of the taxable gift for a Grantor Retained Income Trust can be reduced to zero or very close to zero.

Family Limited Partnerships (FLP) and Family Limited Liability Companies (FLLC)

A family limited partnership (FLP) or family limited liability company (FLLC) can be a very valuable part of estate planning for the owners of farms, ranches, family businesses, or income producing real estate properties.

One of the main benefits of an FLP or FLLC is that the value of an FLP or FLLC interest is generally much lower than value of assets owned by the entity. This occurs because the IRS permits valuation discounts for interests in business entities that are not freely marketable and when the interest is a minority interest. Wyoming limited partnership and limited liability company statutes are very favorable for creating family limited partnerships and limited liability companies with enhanced levels of discounts.

The goal is to reduce the older generation's interest in the FLP or FLLC to a minority interest. For Example, when Sam Walton, the founder of WalMart, began his business, he created an FLP to own the business. At the time of his death, Sam Walton only owned a very small interest in the FLP and he gave that to charity. The result was no estate taxes payable upon his death. He had given his children and other relatives ownership interests in the FLP during his lifetime and no taxable interests passed to them on his death.

Upon the creation of an FLP or FLLC, the ownership interests are divided between the parents. After the FLP or FLLC is formed, small interests may be given to the children. Each year the parents may give more interests to children as annual exclusion gifts. The value of gifts will be entitled to discounts for lack of marketability and as minority interests. The FLP or FLLC also provides flexibility and control advantages. They permit consolidation of family assets into one entity. The older generation can retain control as the general partners of the FLP or managers of the FLLC and gradually relinquish control to the children as they learn management and investment skills. The FLP and FLLC will also protect the assets of the business from the children's creditors and ex-spouses. More information about the tax and non-tax benefits of FLPs and FLLCs is available under the Practice Area, Business Planning, Planning for Family Businesses, Ranches, and Farms of this website.