

# Gifts, Life Insurance and Annuities

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*An individual may accumulate a variety of properties during a lifetime: real property, as well as tangible (for example, a vehicle) and intangible (for example, stocks) personal property. One common goal of estate planning is to ensure maximum enjoyment of the property while the owners are alive. Another is to transfer it according to the owners' wishes at death. Through careful planning, these goals can be accomplished with the least possible cost to the estate. Three estate planning tools discussed here are gifts, life insurance and annuities.*

## Gifts

Some individuals believe they receive the greatest estate planning benefits when they transfer their property before their death, while they have more control. However, every lifetime gift should be examined carefully before it is made. An estate should not be depleted to the point where the donor (person making the gift) does not have enough for his or her lifetime support.

Gifts can benefit family members, charitable organizations and others that have a special place in the donor's life. Gifts can serve many purposes. For instance, they can give adult children an opportunity to learn management of a family business or help finance a college education. The gift of an interest in the farm, ranch or other business may encourage a son or daughter to remain with and advance the business. The parents' management burden thus may be lessened as they grow older.

Gifts can reduce the size of the estate that must pass through court administration, thereby reducing probate costs and, to some extent, federal and state estate taxes. Through gifts of income-producing property, income can be shifted from one family member to another who is in a lower tax bracket, and thus lead to income tax savings as well.

For a gift to be considered "bona fide," certain general rules have to be met. The donor and donee (person receiving the gift) must be legally competent. The clear intent must be to make a gift, the

donor must give up control and legal ownership of the gifted property to the donee, and the donee must accept the gift. Donors should consult with an appropriate professional if they are interested in creating a gift that may not meet all of the criteria listed above, such as retaining the right to receive some of the future income from the property or if the gifted property will be used to establish a trust.

## Types of Gifts

### Taxable gifts

Giving away property is fairly simple, but gift tax laws still apply. The federal government levies a gift tax on most transfers of real and personal property made during the donor's lifetime if the donor does not receive "adequate and full consideration." In other words, any transfer of property is subject to federal gift taxation if the person making the gift does not receive something of similar value in exchange. For example, a parent selling property valued at \$30,000 to their son or daughter for \$18,000 is making a \$12,000 gift.

With appropriate planning, donors can influence or manage the amount of gift taxes they have to pay. Tax-free gifting is discussed in the next section. For the donee's income tax purposes, a gift is NOT taxable income and not subject to income tax at the time the gift is received. However, the donor's income tax basis in the gift property transfers (carries over) to the donee. For example, the income tax basis for real estate is generally the purchase price plus the value of improvements minus any depreciation deductions taken for the property. If the gift property has a low income tax basis relative to its fair market value, the receiver (donee) could be faced with income tax liability when the gift property is later sold or redeemed.

On the other hand, property transferred at death gets a "step up" in basis equal to the value used for federal estate tax purposes (generally, fair market

value at date of death). The table on page 3 introduces the tax consequences between making a gift during the owner's (donor's) lifetime or waiting until the owner dies to transfer the property to the heir.

For the donor's gift tax purposes, the gift's value is the fair market value of the property (less the fair market value of any property received in return) on the date the gift is made. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or to sell, and both having reasonable knowledge of all relevant facts. Fair market value of a gift may not be determined as the selling price at a forced sale or the sale price of the property in a market other than that in which the property is sold most commonly to the public. Thus, in the case of property that generally is sold at retail, the fair market value is the price at which the property or a comparable property would be sold.

The assignment or transfer of a life insurance policy (where you transfer the "incidents of ownership," such as the right to cancel, borrow against or cash in the policy; or change beneficiaries) constitutes a gift for federal gift tax purposes.

- The value of a gift of life insurance that is paid up at the time of the gift is equal to the cost of replacing the policy.
- If the policy is not paid up, the amount is roughly the cash value.

These values may be obtained from the insurer. Further, payment of a life insurance premium on a policy owned by another generally is considered a gift of the premium amount.

The donor is liable for the payment of gift taxes. However, if the donor does not pay the gift tax when due, the donee of any gift may become liable for the gift tax. As stated above, the donee is not required to pay an income tax on the value of the property received but must pay income tax on any income produced by the property after the date of the gift.

Since 1976, the U.S. has had a single, unified rate schedule for federal estate and gift taxes; that is, the same tax rate is used whether the property was transferred as a lifetime gift or as an inheritance at the time of death. Since 2001, however, a

taxpayer could end up paying more in gift tax than he or she would have paid in estate tax if too many gifts are made while alive. Tax specialists should be consulted before making any large gifts.

	<b>Scenario A: ownership is transferred as a gift during the lifetime of the current owner (M)</b>	<b>Scenario B: ownership is transferred at the time of death of the current owner (M)</b>
2009 M buys land for \$200,000	From M's perspective, this land will have an income tax basis of \$200,000 to reflect the purchase price. <ul style="list-style-type: none"> <li>• M, as owner, controls the land and is entitled to its income, for example, rental income</li> </ul>	Same as in Scenario A
2012 M makes a decision	The land has appreciated to \$220,000 in value; M decides to gift the property to N <ul style="list-style-type: none"> <li>• N does not pay income tax on the gifted property</li> <li>• M may pay gift tax on the \$220,000 value (beyond the scope of this example)</li> <li>• N's income tax basis on the land will be \$200,000, that is, M's basis "carries over" to N</li> <li>• N now controls the land and is entitled to its income.</li> </ul>	M decides not to gift the land to N at this time <ul style="list-style-type: none"> <li>• M continues to control the land and continues to be entitled to the income</li> </ul>
2016 M dies	M's death has no impact on N's ownership of the land	M's will states that N should inherit the land, which now is valued at \$235,000 <ul style="list-style-type: none"> <li>• N does not pay income tax on the inherited land</li> <li>• M's estate may have to pay estate tax based on the land's \$235,000 value (beyond the scope of this example)</li> <li>• N's income tax basis on the land will be "stepped up" to \$235,000; that is, the value at the time of M's death.</li> <li>• N now controls the land and is entitled to its income</li> </ul>
2020 N sells the land for its appreciated market value of \$250,000	N will report a taxable gain (taxable income) of \$50,000; that is the difference between the selling price and the "carried over" basis (250,000 minus 200,000).	N will report a taxable gain of \$15,000; that is, the difference between the selling price and the "stepped up" basis (250,000 minus 235,000).

**Note: U.S. federal law distinguishes among the gift tax, income tax and estate tax.**

## Tax-free gifts

Not all gifts are subject to gift taxes. Donors are allowed a tax-free, annual exclusion that permits the transfer of up to \$13,000 worth of present interest in property (such as real estate, stocks, bonds, certificates of deposit or cash when the receiver has the right to possess the property and the right to receive the income from the property ) per donee, without payment of gift taxes. In other words, an individual may give as much as \$13,000 each year to as many people as he or she desires and the entire amount is excluded from gift taxation. The annual exclusion is not cumulative; it cannot be carried over from one year to the next. The annual exclusion amount is adjusted for inflation.

A married couple, for example, can gift as much as \$26,000 annually to as many people as they desire. Further, no gift tax is due because of the gift-splitting provision of federal law. For tax purposes, each spouse is considered to have made one-half of the gift, even if the entire gift had been owned and given by one spouse. This gift-splitting technique can be used for larger gifts if both spouses agree. Thus, for gift tax purposes, one spouse is considered to have given one-half and the other spouse to have given the other half of the gift (as long as both spouses are U.S. citizens or residents and they agree to split all gifts made during that calendar year).

Another gift generally not subject to gift taxes is one made to spouses. Married people can make lifetime gifts of any amount to one another by taking advantage of a marital deduction provision in the federal law. Special provisions apply if the donee is not a U.S. citizen or the donor is not a U.S. citizen or resident.

In addition, any amounts paid on behalf of a donee **directly** to a qualified educational organization (for tuition) and to a health-care provider (for medical services that are not reimbursed by insurance) are excluded from federal gift taxation.

Gifts made to qualified charitable, religious, educational and governmental organizations also are gift-tax-free. No limits are set on the amount that may be given to such organization. (However, several limits are imposed on the types and amounts of gifts for which an income tax deduction may be claimed.) The gift must be made to an organization recognized by the Internal Revenue Service as a "qualifying organization," and it should be made directly to the organization. In addition to giving outright gifts, several techniques can be used to make charitable gifts during one's lifetime while still retaining partial interest in the gift property.

## Gifts of farmland

Gifts of farmland with a value far in excess of the annual exclusion are sometimes difficult. Several approaches can be used to keep gifts of farmland exempt from gift taxes.

The first approach is to give successive annual gifts of undivided fractional interests in farmland, each of which does not exceed the annual exclusion in value.

**Example:** Parents desire to deed their 400 acre farm to their two children. The fair market value (FMV) of the farm is \$440,000 (\$1,100 per acre). Because they are a married couple, the parents can give as much as \$26,000 to each child annually. This annual exclusion represents 5.9 percent of the current value of the land (26,000 divided by 440,000). Accordingly, the parents could deed an undivided interest of 5.9 percent to each child the first year. The land now would be a tenancy in common, with each child owning 5.9 percent and the parents co-owning the remaining 88.2 percent (see table below). However, the parents must allow the children to function as co-owners; otherwise, the five criteria for a gift (described in a previous section) would not be met and the gift will fail.

Year	Value Per Acre	Value of Tract	Annual Gift Tax Exclusion	Percent Gifted Tax-free Per Donee	Cumulative Ownership for Donee A	Cumulative Ownership for Donee B	Remaining Ownership by Parents
2012	1,100	440,000	13,000	5.9%	5.9%	5.9%	88.2%
2013	1,100	440,000	13,000	5.9%	11.8%	11.8%	76.4%
2014	1,100	440,000	13,000	5.9%	17.7%	17.7%	64.5%
2015	1,100	440,000	13,000	5.9%	23.6%	23.6%	52.7%
2016	1,100	440,000	13,000	5.9%	29.5%	29.5%	40.9%
2017	1,100	440,000	13,000	5.9%	35.5%	35.5%	29.1%

A second challenge with this arrangement is the percent that can be transferred each year will vary as the value of land changes and as the annual exclusion is varied by Congress. The table below illustrates how the percent that can be gifted varies as the value of the land changes.

A second approach to gift farmland is to deed actual acres each year to each donee. The annual gifts would be arranged so their value would not exceed the annual exclusion, which means a different number of acres might be given each year.

**Example:** Parents deed approximately 23.6 acres (26,000 divided by 1,100) to each of their children. Again, the family must assure that all criteria for a gift are met, but perhaps more frustrating may be the complex title of ownership because transfer requires defining another parcel of land in the record of title.

Third, by using a corporation, partnership or limited liability company as the owner of the farm-

land, ownership interests (for example, stock) in the entity can be gifted to children. If the value of the interest in the entity transferred to each child does not exceed the annual exclusion, the transfer will not result in a gift tax. In deciding whether to employ a business structure, the family will want to consider possible income tax and farm program consequences. Appropriate professional consultation is critical at this point in the planning process.

The fourth technique is the sale-and-debt-forgiveness approach. The entire tract of farmland is transferred to the children, subject to liabilities to the parents. The value of the gift in the year of transfer is limited to the value of the property less the liabilities. In each succeeding year, the parents then forgive as much of the liabilities per child as come within the available exclusion (\$26,000). Caution must be exercised when using this method. Competent legal and tax advice is a must in using this technique.

Year	Value Per Acre	Value of Tract	Annual Gift Tax Exclusion	Percent Gifted Tax-free Per Donee	Cumulative Ownership for Donee A	Cumulative Ownership for Donee B	Remaining Ownership by Parents
2012	1,100	440,000	13,000	5.9%	5.9%	5.9%	88.2%
2013	1,150	460,000	13,000	5.7%	11.6%	11.6%	76.9%
2014	1,200	480,000	13,000	5.4%	17.0%	17.0%	66.0%
2015	1,200	480,000	13,000	5.4%	22.4%	22.4%	55.2%
2016	1,250	500,000	13,000	5.2%	27.6%	27.6%	44.8%
2017	1,350	540,000	13,000	4.8%	32.4%	32.4%	35.2%

Of course, other personal goals are to be considered. For example, would child A want child B to receive ownership interest in the land if A is involved in operating the farm and likely to operate it in the future, whereas B is not likely to be involved in the farm business? But even in such a situation, the children must realize that the parents are the current owners and they can gift their property as they desire, even if their gifts do not fully align with the hopes of each son or daughter.

## Life Insurance

Life insurance is a popular estate planning tool, especially for people with relatively small estates. Among other things, it can be used to build an estate, provide security for survivors who depend on the insured person's income, maintain liquidity needed to preserve a business, meet living expenses for dependents while an estate is being settled and provide readily available funds to pay debts, taxes and other estate settlement costs.

Life insurance proceeds generally are paid directly to the beneficiary(ies) with minimal delay and administrative costs. They generally are not subject to income taxes. However, life insurance proceeds may be subject to estate taxes depending upon a number of factors. Gifts of life insurance policies may be subject to gift taxes (as discussed earlier) depending on the value of the policy.

When proceeds are payable to the decedent's estate, proceeds are payable from policies in which the decedent retained any "incidents of ownership," and when gifts of life insurance are completed within three years of the death of the donor, insurance proceeds can be included in the decedent's gross estate for federal estate tax purposes. However, where the proceeds are payable to a surviving spouse, the marital deduction can be used (and thus there would be no federal estate tax liability when the first spouse dies).

The insured person does not necessarily have to be the owner of the policy. In some instances, transferring ownership of a life insurance policy to another person may be beneficial to avoid the situation in which the proceeds are included in the decedent's gross estate. However, such a transfer becomes a gift and is subject to gift taxes.

Another option could be to create a trust for the proceeds of life insurance. This option is discussed further in the "Trusts" section of this publication. In considering such a transfer, working with an insurance agent and other professional estate planning advisers is important to review the consequences, and if the transfer is desired, make sure the necessary changes to the insurance policy are made correctly.

## Annuities

An annuity is a contract providing for regular payments, beginning on a fixed date and continuing for a term of years or for the lifetime of one or more individuals. The total of these payments may or may not equal the money or property contributed by the person establishing the annuity (the annuitant). Two common types of annuities are commercial and private annuities.

**Commercial annuities** are issued by insurance companies and others in the financial services industry, and the annuitant contributes a sum of money to the company, which, in return, promises to make periodic payments to the annuitant. Fixed-income annuities contract for a guaranteed amount of income beginning at a specified age and continuing for a set number of years or for life. Variable-income annuities provide varying amounts of income, depending on such factors as current economic conditions and the stock market. While variable-income annuities may involve more risk, they also provide some protection against inflation.

A provision to be aware of in a commercial annuity is the one governing what happens when an

annuitant dies. In a straight-life annuity, the annuitant typically gets payments for life or for a specified number of years, but no additional payments are made to the annuitant's estate upon death. On the other hand, refund annuities typically guarantee payments to the annuitant and also guarantee the annuitant's beneficiaries an amount at least equal to the difference (if any) between what the annuitant invested in the contract and what is received from the contract. In return for this additional responsibility, however, payments from refund annuities typically are smaller than payments from similar straight-life annuities.

Another type of commercial annuity is the joint life and survivorship annuity. Payments are made to both the annuitant and a co-annuitant for as long as either lives.

Tax rules allow annuitants to recover the amount invested in the annuity (income tax-free) during the term of the payments. The other portion of the payments represents the income from the investment and is taxed income. If the annuitant lives past his or her life expectancy, payments after this date are considered totally income and not investment. If the annuitant dies sooner than his or her life expectancy, the investment that was not yet recovered tax-free can be deducted on the decedent's final income tax return.

**Private annuities** differ from commercial annuities in two major ways. Property other than cash (generally real estate) generally is used to purchase the annuity, and the promise to make the payments usually is made by an individual (often a relative) rather than by an insurance company or others in the financial services industry. Those interested in exploring this type of annuity should consult with an attorney or other estate planning professional. Take great care when establishing a private annuity.

## Potential Gift and Estate Tax Consequences

### Unified Tax Credit

Even for gifts subject to federal gift taxes, a gift tax credit can be used to offset gift taxes on transfers made during life. However, when the gift tax credit is used on gifts, the amount of credit available for transfers at death is reduced.

Federal gift tax law requires the value of taxable gifts given in previous years to be accumulated into one total before computing the current year's gift tax. Thus, the accumulation of lifetime gifts results in increasing rates of taxation on later gifts. The gift tax credit then is used to reduce the tax payable on gifts.

### Gift Tax Returns

Generally, a donor is required to file a gift tax return to report gifts amounting to more than \$13,000 to any one donee in any one calendar year. This includes married couples who give more than \$13,000 (even though the gift may not be subject to gift taxes because of the gift-splitting provision). This includes gifts of both present and future interest. A future interest is a legal term that includes reversions, remainders and other interests that the donee can "enjoy" at some future date. Future interest gifts do not qualify for the annual exclusion. So a \$13,000 gift of property to be enjoyed two years from now still would be a gift, but the entire value of the gift would be subject to the gift tax.

If a gift tax return is required, it must be filed by April 15 following the close of the calendar year during which the gift was made. For example, if a single mother makes a \$30,000 gift to her daughter in November, she must file a gift tax return by April 15 of the following year. However by utilizing the annual exclusion of \$13,000, as well as some of her unified credit to cover the other \$17,000, the donor does not have to pay federal gift taxes at that time.

An exception is when taxable gifts are made during the calendar year in which the donor dies. In this situation, the gift tax return must be filed no later than the date when the donor's estate tax return is due, including any extensions given for the filing date.

A gift tax return need not be filed where gifts of any amount are given to spouses or where qualified transfers are made to educational institutions or to a health-care provider.

Other exceptions include instances in which gift tax returns, if required, need not be filed until later because the transfer is not considered a gift until a later date. These include jointly owned U. S. government savings bonds, joint bank accounts and one type of joint brokerage account.

For example, if an individual purchases U. S. government savings bonds but indicates joint title with another person, is the bonds are not a gift until and unless the person not providing the funds redeems the bonds during the lifetime of the person who provided the funds (without any responsibility to account to the one who purchased the bonds).

Similarly, if an individual deposits funds in a joint bank or street-name brokerage account, the funds are not a gift until or unless the other co-owner(s) (not providing the funds) withdraws the funds (without any responsibility to account to the original depositor for the use of the funds). Remember, however, that if the above two situations occurred between spouses, the marital deduction would apply.

## Closing Thought

Properly planned gifts can help a property owner achieve his or her individual goals of transferring ownership to benefit donees while minimizing taxes and other consequences.

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**This publication is not intended to provide a substitute for legal advice. Nor is it intended to serve as a complete and exhaustive text on estate planning. Rather, it is designed to provide basic, general information about the fundamentals of estate planning so you will be better prepared to work with professional advisers to design and implement an effective estate plan.**

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