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Getting a Grip on Gifting

"I see people confused by some of the basic rules," says Mike Gray, senior vice president and CAPTRUST financial advisor in Raleigh, NC, referring to the annual gift tax exclusion and estate taxes. That's a big problem for many investors—and a good reason to get the professionals involved.

Manhattan estate planning attorney Anne-Margaret Carrozza has a cautionary tale of gifting to children gone wrong. One she says is "seared onto my brain."

A client, a retired judge who was very close to his daughter, gifted his home to her, and put it in her name. They lived together with her husband and child. But something totally unexpected happened. The daughter, who was only in her 30s, died prematurely. And because she died so young, she didn't have a will.

"Half of her assets went to her husband and half to her four-year-old son," Carrozza says. "Because she didn't have a will, the father was out of luck. The son-in-law suggested that he make other arrangements. He was to blame for putting himself in that position."

"In my practice as an estate planning attorney, I see a lot of clients ill-advisedly making gifts to adult children," says Carrozza, a frequent contributor to TV news shows on estate planning and elder law issues and a former New York state assemblywoman. "Sometimes they are trying to help a child get a mortgage or divest assets in a long-term care situation."

One of the biggest problems is that people are confused. Which is a good reason to get the professionals involved.

"I see people confused by some of the basic rules," says Mike Gray, senior vice president and CAPTRUST financial advisor in Raleigh, NC. "I don't think people are completely clear on the annual gift tax exclusion and how it works."

Michael Dalton, who has a doctorate, a law degree, and is also a certified public accountant and a principal in financial planning textbook publisher Money Education in New Orleans, agrees.

“The public doesn’t know the rules, so they don’t follow rules,” he says. “If it requires a federal gift tax return, they don’t follow the rules. Mostly, gifting is way under-reported because the public doesn’t know. They also don’t know that a gift to a person is not income.”

Any discussion of gifting to children and other relatives has to start with the basics: the annual gift exclusion and the estate tax.

The Annual Gift Tax Exclusion

Basically, Congress (and the Internal Revenue Service) does not allow people to give away assets and property with tax consequences. The *annual gift tax exclusion* is the amount that can be given away tax free to as many people as you like during the tax year. This year the annual gift tax exclusion is $14,000 per donor.

“If I’m married, I can give that much to my children or grandchildren without any tax effect.” Gray says. “My spouse can do the same.” (For a total of $28,000 per donee per couple.)

“It can be powerful if done regularly,” he says. “If you have a combination of 10 children and grandchildren, you’re talking $280,000 a year. That’s pretty powerful when you have a reasonable amount of donees and it is done with regularity.”

“If you are an individual who will have an estate subject to tax, you have removed some assets from taxation,” Gray says. “If you were going to be in the 40 percent tax bracket, you just removed $280,000 taxed at that rate. And all the growth on the gifts has escaped estate taxes as well.”

“Gifting is the doorway to estate transfers,” says Dalton. “I get wealthy enough so that I have excess money. The first thing I do is buy my 16-year-old daughter a new car. Is that a gift or is that legal support? If it is legal support, it doesn’t count. I can give her $14,000 too. If my daughter is 40 and I buy her a car, it is a gift.”

The Estate Tax

Simply put, the estate tax is a tax on property transferred to your heirs. The amount an individual can leave to heirs without estate taxes, the exemption, increased to $5.43 million this year. “You have to be north of $11 million (in assets) to be subject to estate taxes,” Gray says.

For financial planners, it seems that most people are confused by gifting and its consequences—taxes or otherwise. But, you must make sure you do it correctly. Otherwise, it can backfire.

Tips from financial planners and estate attorneys:

1. Do the math.

The first tip, says Gray, is do the calculations. Be sure that you have the money to gift before you make the donation.

"The last thing you want to do is give money away that affects your own lifetime livelihood," says Gray. "It is foolish to give money away and 10 years later say, 'I'm broke, give me some of it back.'"

"There has to be some foresight," he says. "We suggest people in retirement do forward-looking calculations, an educated guess as to how well assets and income sources meet your needs. If there is an excess, you should be thinking about things for kids and grandkids. You also have the non-financial benefit—the warm and fuzzy feeling of getting to see your money make someone happy."

2. Make sure it's appreciated.

Don't give someone an asset that you can sell for a loss, says Gray. "You'd be better off taking the loss yourself and giving them the cash from the sale. The donee will have no ability to get the loss. Conversely, it's a good idea to give an asset that has a lot of appreciation to someone who might be in a lower tax bracket, he says. "If you have a share of Coca-Cola you've had for a long time, you might give that to a grandchild and let them sell it."

3. Don't gift a house to children.

"The single biggest mistake is when parents gift their house or any real estate directly to children," Carrozza says. "Even if the children are the nicest people in America, they can't prevent their own legal liabilities from making a claim on the house."

"If I gift a house to my children, if one was divorced, it will be a new claim on the house," she adds. "I lose a tax exemption and I'm giving the kids a capital gains problem. If I bought the house for $50,000 and it's now worth $450,000, even if they are nice and let me live there, they will get banged in the head."

4. Consider a trust.

Don't give direct gifts to children, advises Carrozza. "You should consider a properly crafted trust."

"There are a lot of really mature 25-year-olds and a lot of 25-year-olds who should not have a lot of money in their hands," says Gray.

There was a lot of media coverage earlier this year about a college student who blew through the $90,000 college fund set up by her grandparents on trips to Europe and clothes. The student said she had no money left to pay tuition for her senior year of college, and called into a talk radio show to blame her parents for not teaching her better and for refusing to pay her tuition. Her parents eventually agreed to co-sign a loan—only if she got a part-time job.

The Case for Trusts

Carrozza says there are many reasons she prefers trusts. "When I have three children, the chances are better than 50 percent that one of them has problems, be it disability, divorce, or something else, a factor that can make them unable to manage money," she says. "I may want to use a trust for money management."

"But it is important that anyone setting up a trust retain certain powers," Carrozza says. "The trust should always allow the parent to remove and replace the trustee. It should also provide that the beneficiary can be changed. I want the ability to put my hand back into the trust and change the beneficiaries."

"You can't ask for it back later," says Ellen Crowley, vice president and financial advisor with CAPTRUST in Raleigh, NC. "I have seen people gifting and so upset with the way money was handled that they asked for it back. But because it was a gift, it's gone. You have no control over what the recipient does with it. That becomes a problem in some family dynamics."

"If you put your home into a trust, you must make sure you put in writing that you have all legal lifetime ownership rights," Carrozza says. "Now, no one can get mad at me and throw me out of my house."

Dalton says one of the biggest mistakes people make is to give up control over something they did not want or mean to give up control of. "With the exception of a 529 plan, there are no strings attached," he says. "You can't make a recoverable gift."

"If I give the kids the house and expect them to take care of it, and they don't, because gifts are irrevocable, there is not anything I can do but complain," he says.

"A trust can be written so that it benefits children or grandchildren, but the trustee has control over the distribution of the assets," says Gray. "Parents or grandparents make disbursements for college and beyond college, and still decide how and what is distributed. It affords the donor the ability to assess the maturity of a donee's behavior."

"When leaving money to children you never know what will happen," says Dalton. "There's always a risk. Most gifts to minors should be in a trust. That's my opinion."

High on the list of mistakes from both Crowley and Gray is one that people make often, they say. "If a grandparent, aunt, or uncle pays tuition for children, it is not considered a gift if it is paid directly to the institution," Crowley says. "If they give it to the child or parents, it is subject to the guidelines—a maximum of $14,000," she says. "A lot of people will put it into a custodial account or give it to the parent."

It's the same for medical expenses.

"If a family member has a lot of medical expenses they cannot handle, if you pay the provider, it is not considered a gift. It is a way to help out a family member and relieve them of a burden."

The Beauty of the 529 Plan

Planners generally like 529 plans. It's like an individual retirement account aimed at education needs, Gray explains. "If you create one of those for a grandchild, the money put in there is considered to be a gift, and the annual exclusion rules apply."

"I really like the 529," says Carrozza. "Unlike an informal bank account in a child's name, the money in a child's name doesn't count against the child, dollar for dollar, when figured into financial aid. Parents and grandparents can use it as a vehicle to make gifts of $14,000 per person per year. If parents or grandparents need money, they can take it out without a problem. Often, the mental negative is 'What if I need that money in the future?' With a 529 plan you can get it out freely."

There is a rule that allows someone to catch up on education funding rapidly, Gray says. In effect, you are allowed to act like that deposit was made over five years. For example, he says, take grandparents with a 13-year-old grandchild who has nothing set aside for education. The grandparents can each put in $14,000 times five—or a $140,000 deposit in one fell swoop. "The IRS lets you deem that gift as if it were made over five years."

Gifting an Interest in a Business

Dalton says the best plan for an entrepreneur who owns an interest in a business is to make the bequest after the business is up and running, but before it is poised to take off three or four years down the road.

"I can see it is likely to be successful and I own 100 percent," he says. "Since the value is low, I can give up to 49 percent to a child or grandchild. You use the annual exclusion and file a gift tax return. Three or four years later when you sell the business for millions, the child would receive it in trust and there is no transfer tax."

"Think of a person who created a tech startup," Dalton says. "If he is paying attention, there is a perfect time to make gifts. It's not when he wakes up and realizes his business is worth $10 million. The time to make gifts is when the value is very low and he can see it will be a lot more in a short period of time."

The key to gifting, all the experts say, is to get it right. Most times you can't go back and fix it. And getting it right, most of the time, involves the use of professionals. The result is fewer issues, fewer problems, and a happier family.

Family Time

One business owner, who asked not to be named, says he loves to see his children in his home on New

Year's Eve. So, every two years, on New Year's Eve, he makes a $14,000 gift to each of his children. And then, one minute after midnight, makes a second $14,000 gift.

"My kids never miss New Year's Eve every other year at my house," he says.

Author(s)

Rodney Brooks

https://www.captrust.com/people/rodney-brooks/