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Enhancing understanding of sophisticated planning strategies and their applications.

Gifting

Whether it's the grandchildren's education gifts or urgent year-end alma mater donations, the act of gifting usually involves enthusiastic participation; however, the effectiveness of gifts and how they might be optimized in the broader context of an organized tax and financial program can easily be lost on the individual. This overview on Gifting focuses solely on the world of family gifts (non-charitable) as a tax-effective method of long-term financial planning, to enhanced family security, and for wealth transfer leveraging.

Introduction

According to the IRS, any direct or indirect transfer to an individual where full consideration (measured in money or money's worth) is not received in return, constitutes a gift. The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- Gifts that are not more than the annual exclusion for the calendar year.
- Tuition or medical expenses you pay for someone (educational and medical exclusions).
- Gifts to your spouse.
- Gifts to a political organization for its use.

Additionally, gifts to qualifying charities are deductible from the value of the gift(s) made for **income** tax purposes.

Gift Tax Background

Purpose of the Tax

The federal gift tax, when applicable, is levied upon the **giver** of the gift or donor (not the recipient, referred to as the donee). Its purpose is to create a **lifetime** transfer tax on inter-generational gifts in order to back up the existing estate tax levied upon transfers **at death**. However, using applicable offsets described below, it is possible to employ efficient lifetime transfer techniques to mitigate the potential effects of the gift tax.

Gift Types

- **Outright without restrictions:** The outright gifts qualifying as "present interest" for an annual gift tax exclusion or deduction (currently $14,000 per recipient each year).
- **Deferred as to the recipient's use (generally in trust):** The deferred "future interest" gifts in trust, which have no deduction and must use the lifetime exemption in order to avoid a **payable** gift tax (currently $5.45 million per donor).

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Gift and Estate Tax Unification

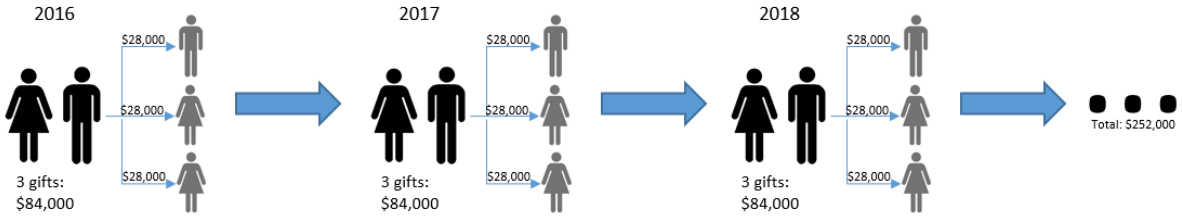
Until 1976, lifetime gift and estate taxes were two separate transfer taxes. Since then, both comprise a single monolithic wealth transfer tax system that is cumulative through one's lifetime. This makes lifetime taxable gifts collectively taxable on top of any prior years' lifetime gifts (within the graduated gift/estate tax table). The taxable estate transferred at death will also stack on top of those lifetime taxable gifts within the same (gift and estate) transfer tax table.

The bottom line is—except for annual exclusion gifts ($14,000), which are fully deductible and do not create a **taxable** gift requiring use of the lifetime exemption—all other lifetime property transfers cannot exclude the gifted **value** from the taxable estate; one cannot remove the asset value itself from the taxable estate, only the property's post-gift subsequent **growth**. This concept is essential to bear in mind when selecting the family assets to receive this favorable lifetime gifting technique.

Family Gifting

Annual Exclusion Gifting

Despite the seemingly minor gift amount allowed to be excluded annually, the power of a regular intra-family annual gifting program should not be underestimated. Two parents, **each** armed with the ability to gift up to $14,000 **each** year to **each** family recipient (children and grandchildren), have the ability to shift a significant amount of wealth, including its ongoing asset growth, to the next generation, free of all gift and estate taxes.



Intra-family gifting and inter-generational asset transfers offer several tax, financial, and psychological benefits:

- The ability to provide 'seed money' to children for purchasing their own home or starting their own business, thereby successfully distributing the family wealth to the next generation(s).
- The opportunity to shift capital on an incremental trial basis. This allows the chance to observe management results during lifetime instead of waiting to bequest everything at death, leaving effective succession to chance.
- By gifting high-earning assets to younger family members in a lower income tax bracket, family wealth already destined for the next generation can grow more effectively on an after-tax basis.
- This same high-growth property, if gifted or partially gifted, can shift otherwise estate taxable value to the next generation, or those beyond, through trust planning.
- Family businesses can utilize the advantages of a structured gifting program by earmarking ownership for "active" heirs while setting aside other non-business assets (or equalizing life insurance) for the "inactives."

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Selective Lump Sum Gifts

A disciplined annual exclusion gifting program can be incredibly effective for many estate planning clients, especially those with large high-growth assets such as family businesses. But even then one may need to consider a single large gift transfer well beyond the available annual exclusions. When a gift is in excess of the annual exclusion, you must either pay the tax or elect to use your unified credit. The unified credit enables you to give away $5.45 million (plus the annual inflation adjustments) during your lifetime without having to pay gift tax. This amount doubles for married couples ($10.9 million). By using the unified credit during your lifetime, you'll reduce the amount available to offset the estate tax upon your death.

By using that transfer tax exemption during lifetime to shelter gift taxes, the property owner can assure that all subsequent valuation growth will pass outside his or her own estate with transfer taxes deferred and shifted to the next generation(s).

Additional Valuation Reduction Techniques

Many estate planning situations involve properties exceeding $5.45/$10.9 million value, or involve owners who may have already utilized some or all of their exemptions. In these cases, planning tools are available for high-value property owners to "shrink" the transfer-taxable value of their subject asset in order to bring its amount into the range where it can be covered by their remaining available exemptions.

- **Family Limited Partnerships** or limited liability companies can fractionalize ownership interests, rendering minority or non-controlling interests into a discounted value that is manageable for gift tax purposes.
- **Grantor Retained Annuity Trusts** (GRATs), by paying an up-front income stream to the donor with the remainder interest specified to junior generation members, you can create a time-value-of-money discount making the gift taxable value fall within available exemptions; in some cases, even of no value in "zeroed-out" GRATs.
- **Combination "Cyborg" Techniques** in the right circumstances can integrate both the above-described techniques by gifting a fractionalized ownership interest to a GRAT and thereby leveraging the best of both transfer tools.

The Role of Life Insurance

When properly arranged to pass the estate tax-free, whether single life on the primary estate owner or survivorship life on both spouses' lives, life insurance can be especially valuable in generating substantial liquidity to execute the estate plan. Consider these perspectives:

- Providing cash in a timely manner to pay estate taxes without resorting to distress sales of illiquid assets.
- Keeping family wealth intact by offsetting any estate tax value erosion that still occurs, even after all lifetime tax-reduction gifting techniques have been employed.
- Utilizing the income and estate tax-free policy proceeds in family business scenarios to create meaningful non-business inheritances for "inactive" heirs.

Summary

Lifetime family gifting programs can be the foundation of a proactive, long-term estate plan, focused on a two-pronged asset management and tax minimization

outlook. Transferring some property to the next generation during the senior's lifetime creates opportunities for trial succession planning on an incremental basis. In addition, it has the effect of reducing or holding estate taxes at the lowest possible level, before calculating and arranging for the appropriate life insurance liquidity—all part of a manageable "freeze and fund" wealth transfer plan.

Possible Case Example Situations

Case #1—Annual Exclusion Gifts

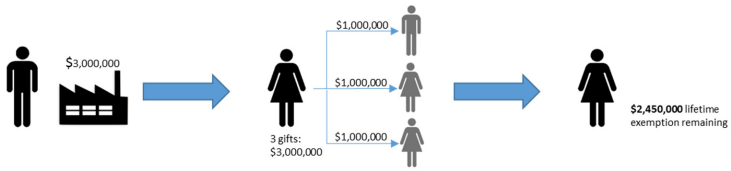
A husband and wife age 55 with two adult children, each with two children (four grandchildren). Assume that together they gift $28,000 to their six descendants (grandchildren in trust) for an annual total of $168,000 over the next 15 years, growing at 5% net to a final amount of $3,625,199, fully removed from their estate without paying any gift taxes or using any of their lifetime exemptions.

Husband	$ 14,000
Wife	$ 14,000
Joint Exclusion	$ 28,000
Children	2
Grandchildren	4
Total Annual Gift	**$ 168,000**

Year	Tax Free Gift	Growth Rate	Growth Potential
1	$ 168,000	5%	$ 168,000
2	$ 168,000		$ 344,400
3	$ 168,000		$ 529,620
4	$ 168,000		$ 724,101
5	$ 168,000		$ 928,306
6	$ 168,000		$ 1,142,721
7	$ 168,000		$ 1,367,857
8	$ 168,000		$ 1,604,250
9	$ 168,000		$ 1,852,463
10	$ 168,000		$ 2,113,086
11	$ 168,000		$ 2,386,740
12	$ 168,000		$ 2,674,077
13	$ 168,000		$ 2,975,781
14	$ 168,000		$ 3,292,570
15	$ 168,000	**Year 15:**	**$ 3,625,199**

Case #2—Lump Sum Gift

A 60-year old widow who owns a $3 million family business left by her husband, with three children actively running the business. Instead of continuing ownership with resulting high growth estate-taxed at her death, she uses $3 million of her $5.45 million lifetime exemption to gift her interest equally among the children. At an assumed continued 10% growth rate, the business interest will grow to $47,589,279 over the next 30 years of her life expectancy. Making the gift will have removed the $44.6 million of subsequent post-gift appreciation from the reach of estate taxes at her death.

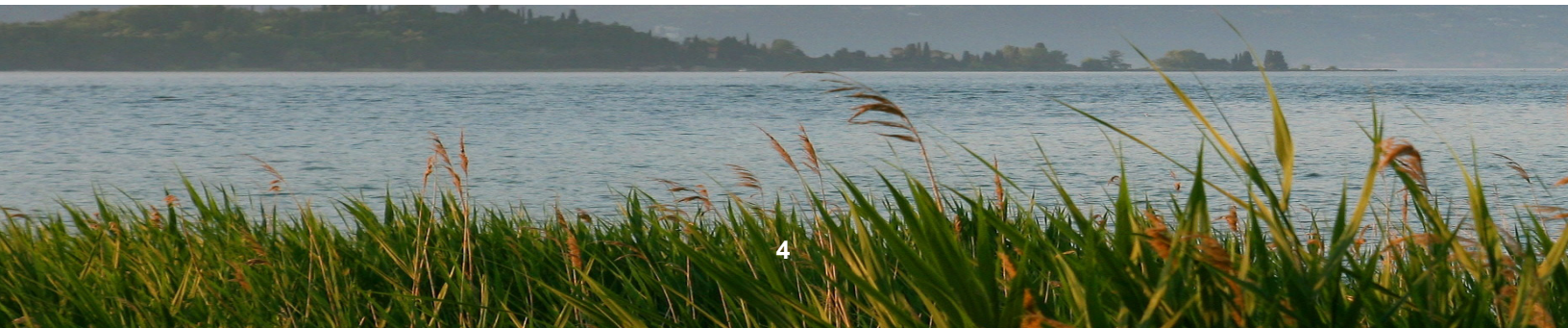


Business Interest Growth Rate 10%

Year	Widow's Age	Estate Tax Liability
1	60	$ 3,000,000
2	61	$ 3,300,000
3	62	$ 3,630,000
4	63	$ 3,993,000
5	64	$ 4,392,300
6	65	$ 4,831,530
7	66	$ 5,314,683
8	67	$ 5,846,151
9	68	$ 6,430,766
10	69	$ 7,073,843
11	70	$ 7,781,227
12	71	$ 8,559,350
13	72	$ 9,415,285
14	73	$ 10,356,814
15	74	$ 11,392,495

Year	Widow's Age	Estate Tax Liability	
16	75	$ 12,531,745	
17	76	$ 13,784,919	
18	77	$ 15,163,411	
19	78	$ 16,679,752	
20	79	$ 18,347,727	
21	80	$ 20,182,500	
22	81	$ 22,200,750	
23	82	$ 24,420,825	
24	83	$ 26,862,907	
25	84	$ 29,549,198	
26	85	$ 32,504,118	
27	86	$ 35,754,530	
28	87	$ 39,329,983	
29	88	$ 43,262,981	
30	**89**	**$ 47,589,279**	**Life Expectancy**

Removed from Estate
$ 47,589,279
$ (3,000,000)
$ 44,589,279



July 2016

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Gifting

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Contact Information

Patrick J. McNamara, MSFS
Firm Managing Principal
pmcnamara@finconcepts.com

Kathleen M. Garber, CLU, CLTC
Vice President, Case Design
kgarber@finconcepts.com

Kathy H. Barnett, CLU, CHFC
Vice President, Underwriting
& Client Services
kbarnett@finconcepts.com

Colleen M. Coon, CPA, CFP
Chief Financial Officer
ccoon@finconcepts.com

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FINANCIAL CONCEPTS INC
24 Frank Lloyd Wright Drive, Suite 3050 H, Ann Arbor, MI 48105

734.214.9770

www.finconcepts.com