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2021 Year-End Estate and Gift Tax Planning

Dear Clients & Friends:

This letter discusses year-end tax planning for estate and gift tax purposes. Below, I discuss making gifts to children and grandchildren during 2021 and 2022 without incurring any gift tax. Many of these techniques also will reduce your overall income tax burden.

Use of Gift Tax Exemptions to Reduce Estate and Gift Tax

The Tax Cuts and Jobs Act of 2017 (TCJA) temporarily doubled the amount that can be excluded from estate taxes. The new amount effective 2018 through 2025 for the unified federal estate and lifetime gift tax exclusion is $11,180,000, indexed for inflation. For 2021, the indexed exclusion is $11.7 million (increasing to $12.06 million in 2022). This is the amount a taxpayer may transfer without incurring estate, gift, or generation-skipping taxes. For a married couple the amount is now $23.4 million ($24.12 million in 2022). Should a taxpayer's transfers exceed this amount, his or her estate and gift tax rate is a flat 40%. Further, through a so-called "portability" provision, if a spouse dies in 2021 without exhausting his or her estate and lifetime gift tax exclusion amount, the surviving spouse may be able to gift against that amount. This latter provision does not apply to gifts given to grandchildren, i.e., generation-skipping transfers.

Because of this, a taxpayer could, in 2021, through a well-crafted plan of giving, take advantage of what is possibly a limited opportunity to transfer over $11.7 million ($23.4 million for a married couple) in wealth without incurring either gift or generation-skipping transfer taxes. Further, these gifts could save estate taxes because they remove post-gift appreciation on and possibly income from the gifted assets from the transferor's estate. Obviously, a person whose estate exceeds $11.7 million must give serious consideration to enacting such a plan. I would be pleased to discuss not only the benefits but also the potential pitfalls of such a plan of giving.

Please remember that, aside from what we have discussed thus far, certain types of lifetime transfers are not subject to gift tax, and year's end could be a good time to make such gifts.

Annual Gift Tax Exclusion

The most commonly used method for tax-free giving is the annual gift tax exclusion, which allows a person to give each donee, up to $15,000 (increasing to $16,000 in 2022), without reducing the giver's estate and lifetime gift tax exclusion amount. A person is not limited as to the number of donees to whom he or she may make such gifts. Thus, if an individual makes $15,000 gifts to 10 donees, he or she may exclude $150,000 from tax. In addition, because spouses may combine their exemptions in a single gift from either spouse, married donors may double the amount of the exclusion to $30,000 per donee.

Because the annual exclusion is applied on a per-donee basis, a donor can leverage the exclusion by making gifts to multiple members of the same family. Thus, in 2021, a donor could give $15,000 each to his son, his son's wife and their daughter, for a total of $45,000 in tax-free gifts. He could double this tax-free amount to $90,000 if his spouse joins in the gifts.

The annual gift tax exclusion applies to gifts of any kind of property, although certain types of property may require an appraisal. Gifts of appreciated property also could result in income tax savings, because the recipient would pay the capital gains tax on any sale. Further, the threat of higher income tax rates and the possible future increase of the preferred capital gains tax rates make the gifting of such property all the more enticing.

Because a donor may not carry over his or her annual gift tax exclusion amount to the next calendar year, year-end gifting is critical so as to maximize the exclusion's benefits for each year. If a donor wishes to make a gift exceeding the exclusion amount, he or she can effectively double the exclusion by making one gift in December and the second in January. For example, a married donor could make a tax-free gift of $62,000 to any individual by making a gift of $30,000 in December 2021 and a $32,000 gift in January 2021.

The IRS has ruled that a gift will be considered complete for transfer tax purposes on the date the donee deposits the check, cashes it against his available funds, or presents the check for payment if all of the following apply:

1. The check was paid by the drawee bank when first presented to the drawee bank for payment.
2. The donor was alive when the check was paid by the drawee bank.
3. The donor intended to make a gift.
4. Delivery of the check by the donor was unconditional.
5. The check was deposited, cashed or presented in the calendar year for which completed gift tax treatment is sought and within a reasonable time of issuance.

<u>Example: Completed gift paid by check.</u>

On December 24, 2021, Martha Rich gives her daughter a check for $15,000 dated December 22 as part of an annual giving program. Her daughter deposits the check in her account on December 30 and the check cleared Martha’s account on Tuesday, January 4, 2022. Since the gift meets all the requirements noted above, it is considered complete in 2021…the year the check is deposited. Thus, Martha is entitled to use her 2021 annual exclusion.

Tuition Payment Exclusion

In addition to the annual gift tax exclusion, a person may make tuition payments for any individual without incurring gift tax. Though the amount that may be excluded is not limited, all payments must be made directly to a qualifying educational institution for the purpose of education or training. The exclusion applies only to full tuition. Thus, payments for room and board, books, required equipment, or related expenses are not excludible. Because there is no limit on the gift amount, its timing is less important than with the annual exclusion. Nevertheless, if a person has the choice of making either a tuition payment or an annual exclusion gift for a particular beneficiary, it usually is preferable to make the tuition payment, because he or she still could make an annual exclusion gift later in the year.

Section 529 College Savings Plans

Contributions to a college savings plan established according to section 529 of the Internal Revenue Code (529 plan) do not qualify for the exclusion for tuition payments but are covered by the annual gift tax exclusion. A contribution to the plan also may entitle the contributor to a state income tax deduction. Thus, a contributor can reduce his or her own income taxes by funding 529 plans for children, grandchildren, etc., with savings that would have been used for college anyway.

Qualified distributions from a 529 plan may be used for a wide range of educational expenses, including tuition, fees, books, supplies, required equipment, and room and board, but not transportation costs. An added advantage of a gift to a 529 plan is that, generally, the income earned by plan contributions is tax-free, so long as it eventually is used for educational purposes. Also, because the contributor may be the plan's custodian, he or she can ensure that the beneficiary uses the account for educational purposes.

A special rule allows a contributor to utilize up to five annual gift tax exclusions simultaneously when funding a 529 plan. Thus, for 2021, he or she may fund the plan with up to $75,000 (5 x $15,000), then file an election with the IRS to spread this gift over five years (2021 through 2026) for gift tax purposes. By using five annual exclusions, the entire gift becomes gift-tax-free. However, the contributor must wait until 2026 to make another tax-free contribution.

Medical Payment Exclusion

Subject to limitations, a person may exclude from gift taxes all payments he or she makes directly to medical providers on behalf of another individual. The exclusion for medical payments also includes the payment of medical insurance premiums. Thus, paying a child or grandchild's insurance premiums is an efficient means of making a tax-free gift that does not consume either the annual gift tax or the estate and lifetime gift tax exclusions. Further, the payer may claim an income tax deduction for a payment made for his or her spouse or dependent.

Gifts in Trust

Despite the tax savings, a person may not wish to make outright gifts to children or grandchildren, due to the loss of control over how they use the gift. Gifts in trust allow the trust creator to determine when the beneficiaries receive the money and how it is used.

By observing special requirements, a trust creator can ensure that a gift in trust qualifies for the annual gift tax exclusion. Generally, the trust is drafted to provide the beneficiary with temporary withdrawal rights over the gift (usually for 30 days), such that the gift is considered a present interest rather than one that vests in the future. Although this arrangement presents a risk that the beneficiary could withdraw the gift from the trust, the likelihood of the trust creator terminating any further gifts to the trust is usually sufficient to prevent such withdrawals. If you are interested in making a gift in trust, we can explore this option more thoroughly.

<u>Charitable Gifts</u>

Year-end is a good time to review charitable giving to ensure it is accomplished in the most tax-efficient manner. Charitable giving is a form of estate planning because a gift to charity never will be subject to estate or gift tax and provides the giver with an immediate income tax deduction. If a person wishes to make a large gift before January 1, his or her circumstances must be reviewed to determine the gift's impact on this tax year's income tax liability and whether all or a portion of the gift should be deferred to a later tax year. If the gift is property and requires an appraisal (usually for gifts of property with a value in excess of $5,000, other than publicly traded stock), the process must be started as soon as possible so that the appraisal is available before year end.

<u>Possible Future Legislative Changes</u>

Regardless of your political affiliation or views, it's common knowledge that taxes are a political football. The party in power tends to push their agenda, sometimes successfully. Estate and gift tax laws are relatively favorable now. The exemptions are high and tax reduction techniques such as valuation discounts are still available. This may not be the case in the future for reasons including the large federal budget deficit. These are arguments for acting now.

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In conclusion, I hope you find the information in this letter useful in your gift planning for 2021 and 2022. Please feel free to call me if you have any questions or if you need any help, including crafting a complete plan designed to transfer more wealth to your heirs using the latest tax minimizing vehicles and techniques.

Sincerely,

Gregory Montagna

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