Jeffrey Frye - Sat, 12/18/2021 - 11:16

It’s that most wonderful time of year again – lots of good cheer, too much fruitcake, not enough eggnog – and gifts – so many gifts! We see lots of gifts this time of year, and many different types of gifts – those between persons, certainly, but also gifts by employers, exchanges within groups, and of course, donations to charity. And in *certain* cases, the gifts fall into more than just one of those categories. In our world of planned giving, we frequently work with gifts that benefit both individual persons and charitable organizations. All of that is good, of course, but some gifts involve *potential costs for the person doing the giving*. It may seem counter intuitive, but in some cases, there are *potential costs of giving*.

To make sense of this apparent contradiction, let’s take a step back. If we leave out the charitable piece for a moment, we can focus on just the gifts that are made between persons. Most people would agree that one can never have too much money, but there are consequences of having great wealth under our tax structure. Since the early twentieth century, the United States has had a tax on the transfer of significant amounts of wealth between individuals. When we talk about “transfer taxes,” we are typically speaking about the taxes on transfers of wealth between living persons – “gift tax” – or taxes on the transfers of wealth from a deceased person to living persons – “estate tax.”

Although there have been transfer taxes for over 100 years, they have generally affected only the very wealthy. As part of the tax structure, there are generous exemption amounts, below which transfers of wealth are not taxed. Currently the exemption amount for all types of transfer taxes – gift tax, estate tax, and generation-skipping transfer tax (GST) – are set at the same amount. In 2022, the “lifetime exemption” is $12,060,000. That means each American citizen who dies in 2022 can transfer up to $12,060,000 in total to any other persons without any transfer tax. That total exemption amount includes both the gifts made during lifetime and at death. Upon a person’s death, the estate tax return combines the total of all potentially taxable lifetime gifts and all potentially taxable testamentary gifts. Any amount over the $12,060,000 is taxed at the 40% federal transfer tax bracket. [Certain states and other jurisdictions also impose gift and/or estate taxes, but we’ll just focus on the federal taxes for simplicity.]

Now let's see how certain planned gifts can be affected by these transfer tax considerations. Life income gift arrangements make up a substantial portion of all planned gifts, and as split-interest vehicles, a portion of each such gift includes a charitable benefit. That's why the charitable deduction is for a *portion* of the total amount transferred. But what about the other portion of a life income gift? The other portion of the initial funding amount is considered a personal financial benefit. A simple example would be a charitable gift annuity (CGA) being funded with $10,000 in cash; if the charitable income tax deduction is $6,000, then the non-charitable interest is $4,000. When the donor and the annuitant are the same person, the donor is giving herself a benefit – a gift – of $4,000. That is the value of the annuity itself; this benefit is also called the "Investment in Contract."

When the donor is not the annuitant, however, the value of the personal benefit inherent in the gift arrangement is a *potentially taxable transfer* and could be subject to gift or estate tax. This aspect is not widely understood, and a review is always helpful. When the donor sets up a $10,000 gift annuity for her brother, the donor is getting a charitable tax deduction of $6,000 for herself, but she is giving her brother a $4,000 gift. That non-charitable benefit is a potentially taxable transfer under the gift tax rules.

But in the example above, the donor probably doesn't owe any actual gift tax. In addition to the significant lifetime exemption for all transfer taxes, there is a certain amount each year that the federal tax code permanently excludes from any gift tax liability. For 2022, the annual gift tax exclusion amount is $16,000. The donor in the above example can use a portion of her annual gift tax exclusion to shield the $4,000 benefit to her brother from any transfer tax liability. She could establish a gift annuity for even a much larger amount and use the same strategy. As long as the value of the benefit to her brother does not exceed the $16,000 threshold – and as long as she doesn't make any other potentially taxable transfers to her brother – she can apply the annual gift tax exclusion to avoid owing any gift tax. She could also do the same for another sibling, or for a friend; the $16,000 annual gift tax exclusion may be applied to any number of gifts each year. In fact, she could establish 100 different CGAs, in theory, for 100 different people, and if the value of the Investment in Contract did not exceed $16,000 in any of those arrangements, there would be no federal gift tax.

While that scenario may be titillating, let's bring the conversation back to the reality that gift planners most likely would face. When we're dealing with a donor who wants to establish a gift annuity for another person, we should feel comfortable pointing out that the arrangement *might be subject to gift tax*. It's perfectly fine to point out that the CGA, where the donor is not the annuitant, "may involve potential gift tax considerations." Please keep in mind, however, it is *not* a gift planner's responsibility to estimate the *amount* of gift tax that a donor might owe. Transfer taxes are all about the donor's lifetime of potentially taxable transfers, and they are also about all the potentially taxable transfers that will be made upon the donor's death. A gift planning professional can *never* begin to know all the details of the donor's lifetime of gifts to other persons or their ultimate gifts upon their passing. Estimating transfer taxes is in the realm of professional financial and estate planners, and it is somewhat inappropriate (and potentially dangerous) for gift planners to take on that role.

Charitable gift annuities established by one person to benefit another are not the only situations with potential gift tax considerations; a charitable remainder trust (CRT) established along the same pattern would also involve potential gift tax exposure. In fact, because donors fund CRTs with considerably more money than CGAs, there is a greater likelihood that a CRT could involve significant transfer tax liability. If the donor established a $500,000 CRUT for the benefit of her brother, the value of the potentially taxable transfer can be calculated easily using PG Calc's *PGM Anywhere* or *Planned Giving Manager*. **The Non-charitable Interest Actuarials chart** is the specific calculation of the non-charitable portion of the gift arrangement. Generally speaking, if the charitable deduction is $200,000 for the above-mentioned CRUT, the value of the non-charitable benefit – i.e., the value of the future stream of payments for the brother – will be $300,000.

With the larger gift amounts involved in charitable remainder trusts, the donor likely won't be able to eliminate gift tax liability by using the annual gift tax exclusion. That is where the lifetime transfer tax exclusion comes in. As long as the donor has not used her lifetime exclusion – or at least, as long as the donor still has at least $300,000 remaining of her lifetime exclusion – she may be able to use it to obviate any potential gift tax resulting from the CRT. Although generally we should try to avoid estimating actual gift taxes, it's worth noting that in this case – absent any available exclusion for the donor to use – the gift tax liability could be in excess of $100,000.

One way donors can mitigate the potential impact of gift taxes is through the unlimited marital deduction. If the donor were married to the person who is his significant other, the value of the benefit being established for the other person would be excluded from gift tax, because all transfers of wealth between spouses are exempt from any transfer taxes. And now that same-sex marriages are recognized under federal law, the unlimited marital exclusion would be available *regardless of the gender of the other spouse.* [Note that the unlimited marital deduction is only available if the spouse is a U.S. citizen.]

Another strategy to defer triggering potential gift taxes associated with life income gifts is to retain the right to revoke a beneficiary's income interest. If the donor retains the right to revoke the right to receive CGA or CRT payments, the gift to the annuitant or beneficiary is the amount of the payments received on a yearly basis. So long as the annual payments are less than the applicable annual exclusion or the remaining available lifetime exclusion, generally speaking, no gift tax would be due.

We shouldn't discourage a donor from establishing a gift annuity or CRT that benefits another individual because of potential transfer tax issues. However, be prepared to spot the issue if there is a possible transfer tax issue in such a gift arrangement. While the computation of gift tax is for the donor's advisor, the gift officer can easily compute the value of the income interest being established for the other person using planned giving software, such as *PGM Anywhere*. These actions by the gift officer will be enormously helpful to the donor and will likely generate greater goodwill in the process. And especially at this time of year, the more goodwill, the better!

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