admin - Wed, 12/4/2013 - 12:09

You are working with a donor who decides that they really don’t need income themselves, but they would like to make a gift that provides income for someone else. The income beneficiary may be a child, parent, friend or employee, and the gift may be a remainder trust, gift annuity or pooled fund. Alarm bells should go off, as there are some tax issues that may come as a surprise.

The Potential Taxes

Life income gifts to benefit someone other than the donor give rise to potential transfer tax and capital gain tax issues. Transferring assets to another can trigger transfer taxes in the form of gift taxes, if it is a lifetime transfer; and estate taxes, if it is a transfer at death. A gift annuity for the benefit of someone other than the donor, which is funded with appreciated property, can trigger capital gain tax in the year of the gift.

Regardless of whoever is the income beneficiary, the donor is entitled to the income tax charitable deduction generated as a result of the gift. The income beneficiary, not the donor, is liable for any ordinary income or capital gain income taxes paid from the life income plan.

Transfer Taxes

A gift tax or estate tax issue comes up when a donor wants to set up a life income plan for the benefit of someone other than themselves. It comes as a surprise to many donors to learn that there is not an unlimited right to give away assets free of taxes, as unlike with income tax returns, many donors never will have filed a gift or estate tax return before. Why have most of us never paid any transfer taxes? There are generous exemptions to offset transfer taxes that make gifts between all but the most wealthy free from these taxes. For example, each taxpayer has an annual exclusion amount to offset taxable transfers to others.

The federal annual gift tax exclusion in 2013 allows every person to transfer up to $14,000 per year to each of any number of other people (the $14,000 is indexed for inflation and may change). Transfers above this amount are taxable gifts. The annual exclusion is only available for gifts of a “present interest,” which means that the person receiving the gift has an unrestricted right to use or enjoy the gift

immediately. Therefore, if the beneficiary must wait for the donor’s income interest to lapse, or if the gift is income from a deferred annuity, the annual exclusion is not available.

If a donor establishes a remainder trust, gift annuity or pooled income fund making current payments to an income beneficiary, the income interest represents a gift of a present interest, entitling the donor to exclude the first $14,000 from the value of the income interest from the taxable gift as an annual exclusion gift. If the income interest starts payments immediately, then the present value of the income stream qualifies for the annual gift exclusion.

In addition to the annual exclusion amount, each taxpayer is entitled to a gift tax exemption that currently allows lifetime transfers up to $5,250,000 free of gift tax.

Calculating the Taxable Gift

If an income recipient of a life income plan is not the donor or the donor's spouse, the donor has made a taxable gift to the income recipient equal to the value of the recipient's income interest. Therefore, a gift of $100,000 to fund a gift annuity for an income beneficiary other than the donor will not result in a taxable gift equal to $100,000. It is the present value of the income to be paid from the annuity that is subject to gift taxation.

The value of the gift taxable income interest is equal to the face amount of the funding principal of the life income gift minus the charitable deduction, which is the charitable interest in the gift. Therefore you can compute the value of the income interest, the amount subject to gift tax, by subtracting the charitable income tax deduction from the gift principal.

Example

Tim Johnson wants to establish an immediate payment gift annuity that will pay income to his mother for life. Mrs. Johnson is 84, so she would be entitled to a gift annuity rate of 7.6%. Suppose Tim funds a gift annuity with $100,000 for his mother. Tim is entitled to an income tax charitable deduction of $55.221. The value of Mrs. Johnson’s income interest is $44,779, that’s the $100,000 principal minus the deduction of $55,221. Mrs. Johnson will receive annual income of $7,600, a portion of which she will have to report as ordinary income.

What are the gift tax consequences of such a gift? Tim Johnson is making a taxable gift of $44,779 to his mother. Tim will file a gift tax return reporting this amount as a gift. He can offset the gift with his $14,000 annual exclusion. If this is a joint gift with Tim's wife, they can use two annual exclusions and offset $28,000 of taxable gifts. Assuming two annual exclusions, there will still be a taxable gift of $16,779. If Tim has not used his $5,250,000 gift tax exemption amount, he can offset the rest of the taxable gift with his exemption amount. Tim is not then liable for any gift tax.

What if Tim does not want to file a current gift tax return or use any of his gift tax exemption? A gift tax is only triggered if there is a completed gift. One strategy would be for Tim to add a provision to the gift annuity agreement that allows him revoke his mother's income interest. Obviously, he isn't actually going to revoke Mom's income interest, or he can forget about getting a birthday card next year! The idea of the revocation clause is to make the gift to Mom incomplete, and the gift tax is not triggered.

Each year Mom is going to receive $7,600 income from the gift annuity, so these are completed gifts each year. Tim can easily offset these gifts using his annual exclusion. In fact, Tim can retain the right to revoke his mother's income interest and increase the gift principal so that his Mom receives up to $28,000 (assuming Tim's wife joins him in the gift) a year without any current gift tax! However, if Tim predeceases his mother, her life interest in the gift annuity must be revalued as of his death and included in his estate for estate tax purposes. So there are some tradeoffs to be considered in using a revocation clause, if Tim expects to pay estate tax.

Capital Gains Tax
An additional element to consider is whether a life income gift for another is being funded with cash or an appreciated asset. If the donor is using appreciated property, there are potential capital gains tax consequences that will vary, depending on the type of life income gift the donor establishes.

A charitable remainder trust or pooled income fund gift funded with appreciated property does not trigger capital gains tax liability to the donor. Income from a pooled income fund is generally taxable to the beneficiary as ordinary income. Income from a charitable remainder trust may be taxed as capital gain, to the extent the trust has current capital gain income and past undistributed capital gain

income. Therefore, the income beneficiary, not the donor, may have to report capital gain income from a CRT.

A gift annuity can create a current capital gain tax liability for the donor if the annuity for another is funded with appreciated property. If a donor makes a gift of appreciated property in order to purchase a gift annuity, a portion of the capital gain must be realized. For most gift annuities, the donor is able to recognize any gain ratably over his life expectancy, rather than in the year the gift is made. To receive this treatment, the donor must be the primary annuitant. If the annuity is for the benefit of someone other than the donor, this prorata capital gain treatment is not available.

Let's look at our example of Tim Johnson establishing a gift annuity for his mother. If the $100,000 funding principal is an appreciated asset with a cost basis of $25,000, a portion of that gain will be due in the year he funds the annuity. Tim will report $33,584.25 in realized capital gain in the year he funds the annuity for his mother. The potential capital gain tax liability associated with gift annuities can discourage donors from funding annuities for someone else using appreciated property. Keep in mind that if Tim sold the same property he used to fund his mother's annuity, he would have realized $75,000 in capital gains. Arguably the gift annuity saved Tim capital gain taxes.

The pro-rata capital gain treatment is lost even if the primary annuitant is the donor's spouse. In that case, one strategy is to re-title the property in the spouse's name prior to making the gift. Re-titling the property in both names may also be a good idea if appreciated property owned by only one of the spouses is being used to fund a two-life gift annuity; where both spouses are concurrent annuitants.

Adding Others as Successor Beneficiaries

Gift and estate tax issues also come up if the donor wants income for life, but in addition wants to name others as successor beneficiaries. Often a revocation clause works well in these situations. However, naming the donor's spouse along with other beneficiaries may spoil the unlimited marital deduction for gift and estate tax purposes that would otherwise apply for gifts to spouses. A revocation clause can help but may just defer the transfer tax to the donor's estate.

Conclusion

A gift of life income can be an efficient and effective way to benefit a loved one as well as charity. Take care not to act as the donor’s tax advisor, but gift planners should be aware of the potential gift, estate, income and capital gain tax consequences of the gift plans they illustrate.

Print
Categories
Taxation