

# Part 5: Gifts, Life Insurance and Annuities

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*An individual may accumulate property of all kinds during a lifetime — real property, as well as tangible and intangible personal property. One common goal of estate planning is to ensure maximum enjoyment of the property while the owners are alive. Another is to transfer it according to the owners' wishes at death. Through careful planning, this can be done with the least possible cost to the estate. Three estate planning tools discussed here include gifts, life insurance and annuities.*

## Gifts

Some individuals believe they receive the greatest estate planning benefits when they transfer their property before their death, while they can still guide and affect the outcome. However, every lifetime gift should be examined carefully before it is made. An estate should not be depleted to the point where the donor (person making the gift) does not have enough for his or her lifetime support.

Gifts can benefit family members, charitable organizations and others that have a special place in the donor's life. Gifts can serve other purposes: they can give adult children an opportunity to learn management of a family business or help finance a college education. The gift of an interest in the farm, ranch or other business may encourage a son or daughter to remain with and improve it. The parents' management burden may thus be lessened as they grow older. Gifts can reduce the size of the estate that must pass through court administration, thereby reducing probate costs and, to some extent, federal estate and state estate taxes. Through gifts of income-producing property, income can be shifted from one family member to another who is in a lower tax bracket, and thus lead to income tax savings.



For a gift to be considered “bona fide”, certain general rules have to be met. The donor and donee (person receiving the gift) must be legally competent. They must have a clear intent to make a gift, and the donor must give up control of and legal title of the gift to the donee. And the donee must accept the gift. A gift may be considered complete, however, if arrangements are made such that if the person receiving the gift dies before the donor, the gift reverts back to the donor. Problems relative to incomplete gifts sometimes occur in connection with transfers to trusts.

## **Taxable gifts**

Giving away your property may sound simple at first, but gift tax laws still apply. The federal government levies a gift tax on most transfers of real and personal property made during the donor’s lifetime without “adequate and full consideration.” In other words, any transfer of value is subject to federal gift taxation if the person making the gift does not receive something of similar value in exchange. Further, there may be significant income tax consequences. Tax free gifting is discussed in the next section.

For income tax purposes, the donor’s income tax basis in the gift property is transferred to the person(s) receiving the gift. For example, the income tax basis for real estate is generally purchase price plus value of improvements minus any depreciation taken. Thus, if the gift property has a low income tax basis relative to its fair market value, the receiver could be faced with a substantial income tax liability when the gift property is later sold or redeemed. On the other hand, property transferred at death gets a “step-up” in basis, equal to the value used for federal estate tax purposes (generally, fair market value at date of death).

For gift tax purposes, the gift’s value is the fair market value of the property (less the fair market value of any property received in return) on the date the gift is made. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or to sell, and both having reasonable knowledge of all relevant facts. Fair market value may not be determined by a forced sale price, nor by the sale price of the property in a market other than that in which the property is most commonly sold to the public. Thus, in the case of property that is generally sold at retail, the fair market value is the price at which the property or a comparable property would be sold.

The assignment or transfer of a life insurance policy (where you transfer the “incidents of ownership,” such as the right to cancel, borrow against, or cash in the policy; or change beneficiaries) constitutes a gift for federal gift tax purposes. The value of a gift of life insurance that is paid up at the time of the gift is equal to the cost of replacing the policy. If the policy is not paid up, the amount is roughly the cash value. These values may be obtained from the insurer. Further, payment of a life insurance premium on a policy owned by another is generally considered a gift of the premium amount.

The person making the gift is liable for the payment of gift taxes. However, if the donor does not pay the gift tax when due, the receiver of any gift may become liable for the gift tax. The donee is not required to pay an income tax on the value of the property received, but must pay income tax on any income produced by the property after the date of the gift.

Until 1976, there were separate rate schedules for federal estate and gift taxes. Now there is a single, unified rate schedule and the same schedule is used for lifetime gifts or death transfers.

## Tax-free gifts

Not all gifts are subject to gift taxes. Donors are allowed a tax-free, annual exclusion which permits the transfer of up to \$10,000 worth of present interest in property (such as real estate, stocks, bonds, certificates of deposit, or cash—where the receiver has right to the income from the gift and possession of it) per donee (family members or other persons), without payment of gift taxes. In other words, an individual may give up to \$10,000 per calendar year to as many persons as he or she desires and the entire amount is excluded from gift taxation. The annual exclusion is not cumulative—it cannot be carried over from one year to the next.

A married couple can give up to \$20,000 per calendar year to as many persons as desired. Further, no gift tax is due because of the gift-splitting provision of federal law. For tax purposes, each spouse is considered to have made one-half of the gift, although the entire gift may have been owned and given by one spouse. This gift-splitting technique can be used for larger gifts. If both spouses agree, a gift from one member of the couple can be split, regardless of which spouse owned the original property. Thus, for gift tax purposes, it is as if one spouse gave one-half of the gift and the other spouse gave the other half (as long as both spouses are U.S. citizens or residents and they agree to split all gifts made during that calendar year).

Another gift generally not subject to gift taxes are those made to spouses. Married persons can make lifetime gifts of any amount to one another by taking advantage of a marital deduction provision in the federal law. Special provisions apply if the donee is not a U.S. citizen or if the donor is not a U.S. citizen or resident.

In addition, any amounts paid on behalf of a donee **directly** to a qualified educational organization (for tuition) and to a health care provider (for medical services that are not reimbursed by insurance) are excluded from federal gift taxation.

Gifts made to qualified charitable, religious, educational and governmental organizations are also gift-tax-free. There are no limits on the amount that may be given. (However, there are several limits on the types and amounts of gifts for which an income tax deduction may be claimed.) The gift must be made to an organization recognized by the Internal Revenue Service as a “qualifying organization,” and it should be made directly to the organization. In addition to giving outright gifts, there are several techniques that can be used to make charitable gifts during one’s lifetime while still retaining partial interest in the gift property.

## Gifts of farmland

Gifts of farmland with a value far in excess of the annual exclusion are sometimes difficult. There are several approaches to keeping gifts of farmland exempt.

The first approach is to give successive annual gifts of undivided fractional interests in farmland, each of which does not exceed the annual exclusion in value.

**Example:** Parents desire to deed their 400 acre farm to their two children. The fair market value (FMV) of the farm is valued at \$320,000 (\$800 per acre). The parents can gift 50 acres to the two children the first year. Each child receives an undivided one-half interest in the 50 acres. No gift taxes are due. The gift is computed as follows:

FMV of Gift (50 acres @ \$800)	\$40,000
Less: Annual Exclusion (2 @ \$20,000)	-40,000
Taxable Gift	0
Gift Tax Due	0

The same procedure could be used for the next seven years. If the value of the farmland does not change, the entire 400 acres will be given to the two children by sheltering all the gifts with the annual exclusion.

The second approach is to deed over actual acres of farmland. Each gift does not exceed the annual exclusion.

**Example:** Parents deed over to their two children 40 acres of farmland valued at \$500 per acre. No gift tax is due because the value does not exceed the annual exclusion (2 @ \$20,000).

Third, by using a corporation, partnership or limited liability company as the owner of the farmland, ownership interests (for example, stock) in the entity can be gifted to children. If the value of the interest in the entity transferred to each child doesn't exceed the annual exclusion, the transfer will not result in gift tax due.

The fourth technique is the sale-and-debt-forgiveness approach. The entire tract of farmland is transferred to the children, subject to liabilities to the parents. The value of the gift in the year of transfer is limited to the value of the property less the liabilities. In each succeeding year, the parents then forgive as much of the liabilities per child as come within the available exclusion (\$20,000). Caution must be exercised when using this method. Competent legal and tax advice is a must in using this technique.

## Unified tax credit

Even for gifts subject to federal gift taxes, a unified tax credit can be used to offset gift taxes on transfers made during life. However, when the unified credit is used on gifts, the amount of credit actually available for transfers at death is reduced.

Federal gift tax law requires the value of taxable gifts given in previous years to be accumulated into one total before computing the current year's gift tax. Thus, the accumulation of lifetime gifts results in increasing rates of taxation on later gifts. The unified tax credit is then used to reduce the tax payable on gifts (given after 1976) and death transfers.

## Gift tax returns

Generally, a donor is required to file a gift tax return to report gifts of present interest amounting to more than \$10,000 to any one donee in any one calendar year. This includes married couples who give more than \$10,000 (even though the gift may not be subject to gift taxes because of the gift-splitting provision). Gifts of future interest of any amount are also required to be listed on a gift tax return. Future interest is a legal term that includes reversions, remainders and other interests that the donee can "enjoy" at some future date.

If a gift tax return is required, it must be filed by April 15th following the close of the calendar year during which the gift was made. For example, if a single mother makes a \$30,000 gift to her daughter in November, she must file a gift tax return by April 15 of the following year. However, by utilizing the annual exclusion of \$10,000, as well as \$20,000 of her unified credit, she does not have to pay federal gift taxes at that time.

An exception is when taxable gifts are made during the calendar year in which the donor dies. In this situation, the gift tax return must be filed no later than the date when the donor's estate tax return is due, including any extensions given for the filing date.

A gift tax return need not be filed where gifts of any amount are given to spouses or where qualified transfers are made to educational institutions or to a health care provider.

Other exceptions include where gift tax returns, if required, need not be filed until later, because the transfer is not considered a gift until a later date. These include jointly owned U. S. Government savings bonds, joint bank accounts, and one type of joint brokerage account. For example, if an individual purchases U. S. Government savings bonds, but indicates joint title with another person, there is no gift until and unless the person not providing the funds redeems the bonds during the lifetime of the person who provided the funds (without any responsibility to account to the one who purchased the bonds). Similarly, if an individual deposits funds in a joint bank or street-name brokerage account, there is no gift until or unless the other co-owner(s) (not providing the funds) withdraws the funds (without any responsibility to account to the original depositor for the use of the funds). Remember, however, that if the above two situations occurred between spouses, the marital deduction would apply.

## Life Insurance

Life insurance is a popular estate planning tool, especially for people with relatively small estates. Among other things, it can be used to build an estate, provide security for survivors who depend on the insured person's income, maintain liquidity needed to preserve a business, meet living expenses for dependents while an estate is being settled and provide readily available funds to pay debts, taxes, and other estate settlement costs.

Life insurance proceeds generally go directly to the beneficiary(ies) with minimal delay and administrative costs. They generally are not subject to income taxes. However, life insurance proceeds may be subject to gift taxes (as discussed earlier) and death taxes, depending upon a number of factors.

Proceeds payable to the decedent's estate, proceeds payable from policies where the decedent retained "incidents of ownership," and gifts of life insurance within three years of death are included in the decedent's gross estate for federal estate tax purposes. However, where the proceeds are payable to a surviving spouse, the marital deduction can be used (and thus there would be no federal estate tax liability when the first spouse dies).

The insured person does not necessarily have to be the owner of the policy. In some instances, it may be beneficial to transfer ownership of a life insurance policy to another person to avoid the above situation where the proceeds are included in the decedent's gross estate. Such a transfer becomes a gift, however. In considering such a transfer, it is important to work with an insurance agent and other professional estate planning advisers to review the consequences, and if the transfer is desired, make sure the necessary changes are correctly made to the insurance policy.

## Annuities

An annuity is a contract providing for regular payments, beginning on a fixed date, and continuing for a term of years or for the lifetime of one or more individuals. The total of these payments may or may not equal the money or property contributed by the person establishing the annuity (the annuitant). Two common types of annuities are commercial and private annuities.

**Commercial annuities** are issued by insurance companies and others in the financial services industry, whereby the annuitant contributes a sum of money to the company who, in return, promises to make periodic payments to the annuitant. Fixed income annuities contract for a guaranteed amount of income beginning at a specified age and continuing for a set number of years or for life. Variable income annuities provide varying amounts of income, depending on such factors as current economic conditions and the stock market. While variable income annuities may involve more risk, they also provide some protection against inflation.

A provision to be aware of in a commercial annuity is the one governing what happens when an annuitant dies. In a straight life annuity, the annuitant typically gets payments for life or for a specified number of years, but no additional payments are made to the annuitant's estate upon death. On the other hand, refund annuities typically guarantee payments to the annuitant and also guarantee the annuitant's beneficiaries an amount at least equal to the difference (if any) between what the annuitant invested in the contract and what is received from the contract. In return for this additional responsibility, however, payments from refund annuities typically are smaller than payments from similar straight life annuities.

Another type of commercial annuity is the joint life and survivorship annuity. Payments are made to both the annuitant and a co-annuitant for as long as either lives.

Tax rules allow annuitants to recover the amount invested in the annuity (income tax-free) over the term of the payments. The other portion of the payments represents the income from the investment and is taxed income. If the annuitant lives past his or her life expectancy, payments after this date are considered totally income and not investment. If the annuitant dies sooner than his or her life expectancy, the investment that was not yet recovered tax-free can be deducted on the decedent's final income tax return.

**Private annuities** differ from commercial annuities in two major ways. Property other than cash (generally real estate) is generally used to purchase the annuity and the promise to make the payments is usually made by an individual (often a relative) rather than by an insurance company or others in the financial services industry. Those interested in exploring this type of annuity should consult with an attorney or other estate planning professional. Great care must be taken when establishing a private annuity.

## References

This publication is based on material developed by Joyce E. Jones, Extension Specialist, Adult Development and Aging, Kansas State University Cooperative Extension Service, Manhattan Kansas, 1992.

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**This publication is not intended to provide a substitute for legal advice. Nor is it intended to serve as a complete and exhaustive text on estate planning. Rather, it is designed to provide basic, general information about the fundamentals of estate planning so you will be better prepared to work with professional advisers to design and implement an effective estate plan.**

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