Billy Morton
704-335-4524

Efficient Wealth Transfers for Consideration

30,000’ Level: Taxes, Broadly

Our clients ask us a lot about how they can be tax efficient. That can mean a lot of different things, of course, because there are many forms of taxes. There are property taxes, sales taxes, income and capital gains taxes, and transfer taxes (taxes on wealth that is transferred from one person to another). And within these types of taxes, there are also levels of tax - local, state, and federal taxes to boot!

The focus of this writing is limited in its scope to federal transfer taxes. Even within that scope of the federal transfer tax regime, there are estate taxes, gift taxes, and generation skipping transfer (“GST”) taxes. The estate and gift tax regimes are essentially two halves of the same coin, and GST taxes provide an additional layer of complexity. For purposes of this article, we will ignore estate and GST taxes to focus on the gift tax implications for lifetime gifts.

20,000’ Level: Federal Gift Taxes

Even within the world of lifetime giving, there are different strata to consider. There is a lifetime exemption, which is the amount of money that can pass (during life or at death or some combination thereof) from one person to another. Currently in 2022, the gift tax exemption threshold is $12.06mm per person. In other words, a single taxpayer with a $25mm taxable estate can give away all but $12.94mm free of estate or gift tax. A married couple can double this power by using both of their exemptions, so in the same example, a married couple could theoretically give away all but $880,000 of their assets.

The exemption amount is indexed for inflation annually, but there is a built-in legislative sunset for this amount to be essentially cut in half on Jan 1, 2026. Congress could proactively change this to reduce the exemption sooner or extend the exemption, but Congress isn’t well known for its proactivity.

In addition to the lifetime exemption, there is something referred to as the annual exclusion amount (the “AEA”), which is the amount of money an individual can give away before the gift begins to eat into the $12.02mm exemption. Currently in 2022, the AEA is $16,000. This amount is per donor and per donee. So again, a married couple can double the power of this by acting in concert. Thus a fortunate adult child could receive $32,000 annually from his or her parents. The power of this gift is further increased by the "per donee" (i.e., recipient) aspect. So a grandmother and grandfather blessed with 5 grandchildren could give up to $160,000 *per year* (2 grandparents x 5 grandchildren x $16,000) without using any of their $24.12mm (2 grandparents x $12.06mm) combined gift and estate tax exemptions. Doing this several years in a row can substantially whittle down a potential estate tax liability. Typically, AEA gifts must be considered gifts of a "present interest" (meaning that the recipient has immediate access to the gifted funds) to qualify for AEA treatment. 529 plans are an exception to that rule discussed below.

Finally, there are certain gifts that are *not even considered* to be gifts under the federal gift tax laws. Those gifts include direct payments for the benefit of another individual's *qualified tuition or health care expenses* (including insurance premiums). In order to be exempt from the gift tax rules, the payments must be made directly to the educational or health care institution. This too can become a very powerful transfer tax strategy. Assume you pay private school from K through 12 to the tune of $25,000 per year, and then 4 year college expenses at $60,000 per year. That amounts to a reduction of the taxable estate of $565,000 over 22 years.

10,000' Level: Gifts to Minors for Education or Other Purposes

For those considering gifts intended to maximize wealth transferred to a minor child or grandchild without having to file a gift tax return, the remainder of this article explores some of the more common options and the pros and cons of each (specifically as it relates to control, taxation, and limitations on use).

Education-Centric Planning Options

Direct Payments to Educational Institutions:

As mentioned, making direct payments of health care or educational expenses do not "count" as gifts under the federal gift tax rules. That means there are no AEA limitations on amounts, there are no gift tax return filing requirements, and there is no need for separate accounts or trusts or any other complications. Everything from college or graduate school all the way down to kindergarten or preschool should count, as long as the institution maintains regular faculty and an educational curriculum. It does mean that you must write the check to (or send the funds to) the organization directly.

529 Savings Plans:
529 plans offer superior income tax advantages over normal taxable accounts and especially over trusts, which are subject to compressed tax rates (more on that below). A gift to a 529 plan qualifies for the annual exclusion even though the child does not have a present interest, meaning no immediate access to the dollars. 529 plans grow tax free and distributions are not subjected to taxes provided that they are used for qualified education expenses (a definition that has been expanded to include K-12 private school, repayment of student loans, expenses without triggering taxes, and can be controlled beyond the gift by you as donor. As well, you may fund the 529 plan with five years' worth of annual exclusion gifts at once. Doing so would mean that you would not be able to make AEA gifts to that recipient for the next 4 years, but frontloading the gift can offer a great jumpstart on funding education (even if it does require the filing of a gift tax return).

Note: You might consider both options in tandem (i.e., paying directly for education and health care expenses *while also* using your annual exclusion for maxing out 5 years' worth of 529 plan contributions), which would create additional estate and gift tax savings. Funding the 529 plans will allow those accounts to grow with income tax deferral/free for years. And meanwhile you could make tuition payments directly instead of out of the 529 plan. The unused 529 balance could be transferred to another beneficiary (e.g., a grandchild) or simply withdrawn (not for qualified education expenses), meaning that the owner would have to recognize the gains *and* a ten percent penalty on the gain. But this may still be an optimal result when compared to investment strategies without a tax deferral feature.

On a smaller scale, you could pay the tuition expense directly and use the 529 plan for other qualified expenses like room and board, books, etc.

<u>AEA Options *Apart* from Education Funding</u>

While these next options could be used for educational purposes, direct payments and/or 529 plan funding are far more efficient than the below techniques. Some donors prefer a "belt AND suspenders" approach for their gifting, to provide some dedicated funding for education and also to provide some funding that is not limited in its utility to education only.

Basic gifts to a minor's custodial (UTMA) account:
A simple but powerful method of using your AEA for general use by recipients who are minors is simply to contribute annually to an UTMA account. Some grandparents will

give $32,000 per year (this figure will increase over time as the inflation rider on the AEA ticks up) starting in the year of their grandchild's birth, investing and piling up well over $1,000,000 by the time the child is a young adult. As a side note, the power of compounding has a lot to do with this result…

One important feature of an UTMA is that at the age of majority (in North Carolina, that is 21 and other states are between 18-21) the minor will become the sole owner of the account. There are two limiting factors to an UTMA that should be considered:

- First, the assets in a custodial account are included in the estate of the donor IF the donor is also the account custodian and dies while the beneficiary is still a minor. So a grandparent should consider naming the minor's child as the custodial owner. Some grandparents don't like the result of this as it relates to control.
- Second, not all 21 year olds are ready to have unfettered access to $1mm. I surely wasn't. The solution with a *willing* child who has reached the age of majority is to encourage them to transfer the assets to a self-settled irrevocable trust until a later date. The trust assets would, of course, still be available to him per the trustee's discretion.

Gifts to Trusts Instead of Outright/UTMA:
To address the so called Knucklehead Risk (i.e., the risk that the gift recipient had my level of maturity at age 21), donors may consider making the gift to a trust instead of outright or to an UTMA. However, in order for such a gifting trust to qualify for the gift tax annual exclusion (to avoid using part of your lifetime exemption) requires the beneficiary have a *present interest* in the gifted property or qualify for an exception to that rule.

<u>Crummey Trusts</u>: Named for the taxpayer who won a lawsuit with the IRS defending the technique (and not a commentary on its worth or appearance), a Crummey trust is a trust designed to work around the "present interest" requirement. The strategy works by providing written notice (via a "Crummey letter") that a gift is made to the trust and that the beneficiary has the right to withdraw the funds in the next 30 days. With minor beneficiaries, the letter may delivered to their parent or legal guardian. Regardless, upon the lapse of the withdrawal right, the gift remains in trust, subject to the trust's dispositive scheme.

<u>2503(c) Trusts</u>: The exception to the present interest requirement is granted by Section 2503(c) of the Internal Revenue Code and is unique to trusts created for minors. During

the period that the beneficiary is a minor, no withdrawal right is required and therefore no "Crummey notice" must be made for gifts during the period. Instead of notice given at each AEA gift, a notice window must open when the child reaches age 21. Unlike the UTMA account, this is a discrete window (30 days) rather than a permanent change. During that window, the beneficiary must have unfettered access to ALL the assets of the trust during that window, but after the window closes then the trust may continue according to its dispositive scheme. The practical result of how this mitigates the knucklehead risk better than an UTMA is the impermanency of the window. As well, there are administrative benefits: no new trust to draft, explain, and execute; only a letter acknowledging the withdrawal right.

Practical Considerations

Belt & Suspenders: Where AEA gifts are concerned, some donors don't want to put all their chips on any one strategy. So, they may split their AEA gifts between education funding through 529 plan contributions and other more general gifting through UTMAs or trusts. That split can be done in a couple of ways. It could literally split by giving one half of the AEA to a 529 plan and the other half to a trust/UTMA. Or it could be a temporal split. For example, you could frontload 5 years' worth into a 529 plan and then begin gifting to an UTMA or trust in year 6.

Going Bigger: All of the methods detailed herein have assumed you wish to transfer wealth without being required to file a gift tax return (other than possibly a return acknowledging split gifts for married donors). There is certainly no rule that says you can't implement multiple wealth transfer strategies that *do* require a gift tax return or the use of your gift and estate tax exemption. At the time of this writing, the historically high exemption amount coupled with a struggling stock market present a unique window of opportunity to increase the potential longterm impact of generational gifting. It might not feel like it in the moment, but this combination of circumstances will not last forever.

Regardless of the size or type of gifts you're contemplating, the strategies described herein warrant a deeper conversation prior to implementing. As always, we welcome a conversation about how some of these ideas might be suitable for you, your family, and your legacy goals.

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services. If tax, legal, or actuarial advice is required, you should consult your accountant, attorney, or actuary. MBL Advisors Inc., does not replace those advisors.

Before investing, the investor should consider whether the investor's or beneficiary's home state offers any state tax or other benefits available only from that state's 529 Plan.

The use of trusts involves a complex web of tax rules and regulations. You should consider the counsel of an experienced estate planning professional before implementing such strategies.

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