

THE FAMILY GIFT TRUST

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Many of our firm's estate planning strategies focus on the use of long term planning techniques designed to maximize protection of family wealth and the potential for tax free transfers of wealth to successive generations. Strategic gifting of assets has, for many years, been an integral part of these plans. Most of this gifting has been outright gifts to family members. However, as the amounts being transferred by gift have increased and the concern over long term asset protection planning has grown, we have developed new planning techniques to reflect these developments. This article explores the significant issues surrounding the use of these trusts. Should you have any questions after reviewing this article, please feel free to contact us.

WHAT IS A FAMILY GIFT TRUST?

It is a separate legal entity that is designed to receive and hold gifts of property. The beneficiaries are usually family members of the donor, but can be other persons if desired. The terms of the trust are set forth in a document that describes how the trust property is to be invested and distributed. The gifts are primarily made to achieve the estate planning goals of the donor. The donor is the person who creates the trust and makes gifts to the trust. The trustee is the person who agrees to run the trust for the benefit of the trust's beneficiaries and is named in the trust document. This type of trust is an irrevocable trust.

WHY ARE GIFTS MADE?

The primary tax reason for making gifts is to reduce the taxable estate of the donor. The gift and any future appreciation in the value of the gift are removed from the donor's taxable estate.

WHY ARE THE GIFTS MADE TO A TRUST?

Gifts are made to a Family Gift Trust (FGT) to obtain estate planning benefits not available if the property is given outright to a person. This is important for achieving goals such as asset protection planning, tax savings and equalization among family members. These benefits are discussed in more detail later in this article.

HOW MUCH CAN BE GIFTED EACH YEAR?

Each person can give up to \$11,000 each year to any individual they want. This means that *each* parent can each give *each* of their children and grandchildren \$11,000 (two parents permits a total gift per recipient of \$22,000). These gifts are called **annual exclusion gifts** and they are totally excluded from the gift tax system.

Also, during a person's lifetime or at death, each person can give an amount that is equal to the applicable exclusion amount. In 2003 and 2003, this amount is \$1,000,000. This is the total amount that can be given away without the payment of any gift or estate taxes, in addition to annual exclusion gifts.

In some cases, the donor will use up all of this exclusion amount during his lifetime with a large gift to a FGT (instead of waiting until the donor's death). The purpose of this lifetime gift is to leverage the use of the exclusion amount by removing all of the growth of the gifted property from the date of the gift to the donor's death from the donor's taxable estate. This, however, is only done in certain situations after careful discussion and analysis.

Gifts that are in excess of the available annual exclusions and lifetime applicable exclusion are subject to gift tax. There may even be instances where the payment of a gift tax is desired to take advantage of the different way that the gift tax and the estate tax is calculated on property owned by a donor! Again, this is undertaken only after counseled deliberation.

WHO CAN BE THE TRUST BENEFICIARIES?

Usually, the beneficiaries are the members of the donor's family. However, there is no requirement that they be family members and the donor can include as beneficiaries anyone he wants.

CAN A SPOUSE OF THE DONOR BE A BENEFICIARY OF THE TRUST?

Yes, and there are potential distinct advantages to this such as the ability to continue to remove assets from both the donor's estate and from the surviving spouse's estate. Several things need to be kept in mind, however. The gift to

the trust must be from a separate account in the name of the donor only. If the gift is made from a joint account it will not be effective because it will be treated as being made by the spouse as well. Further, while there is an unlimited marital deduction for gifts to spouse (any amount can be given to a spouse gift tax free), for tax reasons, we need to separately analyze how much should be gifted to the trust for a spouse.

WHAT ARE THE MECHANICS OF SETTING UP AND OPERATING THE TRUST?

These are the important steps that need to be performed after the trust is signed:

- A separate share is set up for each trust beneficiary and this share will have its own federal tax identification number. The trustee will sign a separate application for a tax number for each beneficiary's trust share. This form is filed with the IRS, who assigns the tax id number.
- The trustee will set up an investment account for each beneficiary and allocate to that account a portion of the property given to the trust (in accordance with instructions contained in the trust). This property needs to be invested in a prudent manner by the trustee. Investment related issues are discussed later in this memorandum.
- Upon receiving the gift, the trustee sends a letter to each beneficiary advising them of the gift and their right to withdraw it for a limited time. In order to qualify each gift as annual exclusion gifts, the beneficiaries must be aware of the gift to the trust and must have a right to withdraw the gift. This is the reason for the notification letter to the beneficiaries (sometimes called a "Crummey" letter after the man who presented the idea to the IRS for approval). A sample letter for gifts to adults and to minors is attached to the end of this memorandum. If a beneficiary is a minor, the letter is addressed to his parent. If the parent is also the trustee, a gift letter is not required.
- The trustee is to keep a copy of each letter that is sent. This is to prove the beneficiaries were notified if there were an audit by the IRS.
- The trustee may make distributions of the trust share of each beneficiary to such beneficiary in accordance with the instructions contained in the trust. Generally, distributions can be made for the beneficiary's support, health care and/or educational needs.

WHAT IS THE NAME OF THE TRUST FOR EACH BENEFICIARY?

This is the format for the name of each separate trust:

**Name of person acting as trustee, Trustee of Name of donor
Family Special Trust dated Date trust signed fbo Name of
child, grandchild or other beneficiary**

“Special” means that the trust is irrevocable. “Fbo” means “for the benefit of.”

Frequently, a child of the donor will be the trustee of his own share and also will be the trustee for any separate shares established for such child’s children. This does not always occur and someone else may be named as trustee for various reasons.

WILL THERE BE GIFTS EACH YEAR?

The frequency of gifts will be determined by the donor. There is no requirement that there be any gifts. Further, a donor can make gifts to one beneficiary and not to any others. The donor may elect to make gifts one year, and then not make gifts the succeeding year.

CAN PEOPLE OTHER THAN THE DONORS MAKE GIFTS?

Yes, but this must be discussed with us before this is done. A beneficiary cannot make a gift to a trust held for his benefit nor to a trust of which he is trustee.

WHAT ARE THE BENEFITS OF RECEIVING GIFTS THROUGH A TRUST?

These are the most important reasons:

- The trust property will be protected from the claims of creditors of the beneficiary. If the beneficiary runs into financial problems, causes an accident or is otherwise liable, the creditors will be unable to reach the trust assets.
- If a beneficiary gets divorced, the gift to the trust is not subject to division in a divorce proceeding. This is because the gift is not marital property.
- If a beneficiary becomes incapacitated, the trust property will be controlled by the trust and expensive, time consuming guardianship proceedings will be avoided as to the property in the trust.
- There is an opportunity to manage distributions to minimize income taxes. Examples are in select circumstances using the initial lower tax brackets of the trust versus those of the beneficiary and avoiding the “kiddie tax” on distributions to beneficiaries who are fourteen or less.
- There will be no probate administration of trust property. The trust contains instructions directing who the next beneficiaries are in the event of a beneficiary’s death and the terms under which they receive distributions.
- Quite likely, all or a significant portion of the trust assets will not be in the estate of the deceased beneficiary for estate tax purposes.
- There can be a cohesive, professional investment program put into place by the trustee and the trust investment advisor.

WHEN AND HOW ARE DISTRIBUTIONS MADE FROM THE TRUST?

The trust document contains specific instructions as to when distributions to the beneficiaries can be made. The trustee has the discretion to determine when trust property is to be distributed. The primary reasons are to provide for the beneficiary's health, support, maintenance and education. The trust may have other provisions reflecting special issues for particular beneficiaries.

The trustee may consult with the donor before making distributions from the trust (but this is not required). For planning considerations, generally it is not anticipated that any distributions will be made from the trust during the donor's life.

HOW IS THE INCOME OF THE TRUST TAXED?

Each trust held for a beneficiary is a separate taxable entity. All income, gains and losses are taxed to the trust unless the trust makes distributions. To the extent that the trust distributes property, it is first (a) income to the extent the trust has income, then (b) capital gains to the extent the trust has capital gains, next (c) non-taxable income to the extent the trust has non-taxable income and finally (d) any remaining portion of the distribution is a non-taxable distribution of principal.

If a beneficiary receives the distribution, the beneficiary treats the distribution in the same manner as the trust: income, then capital gains, etc.

Because trust marginal income tax rates get to the higher brackets much quicker than the individual income tax rates, it is common for trustees to make distributions to the beneficiaries to save on income taxes. However, this is a question that should be reviewed periodically either with us or the tax accountant. There are other considerations that may play into the decision-making.

IS IT RECOMMENDED THAT THE TRUSTEE USE AN INVESTMENT ADVISOR?

Yes. The person used should be familiar with the tax issues and opportunities that are presented when investing assets in a FGT and with the fact that the FGT is only one component of a sophisticated estate plan. This is because investment strategy is impacted by the fact that the investments are held in a trust which is subject to the highest income tax rates at a much lower threshold than the threshold for individual taxpayers. It is also affected by estate planning factors.

We recommend consulting with an investment advisor who is familiar with these issues. It is particularly helpful to use the donor's investment advisor as he has

been involved in the overall estate plan and can integrate the investment planning for the FGT into his overall investment strategy.

The trust agreement explicitly allows the trustee to use the services of an investment expert. If a recommendation is needed for a financial advisor who is familiar with investing assets in FGTs, we can provide the trustee with names of skilled advisors he can interview.

SHOULD AN ACCOUNTANT BE INVOLVED?

Engaging a qualified accountant familiar with tax planning matters and fiduciary returns is advisable. This person can help insure that the greatest income tax advantages are being accomplished. If you need the name of a qualified person, please discuss this with us. We also suggest that you give this person a copy of this memorandum and advise him that he should contact us if he has any questions.

The tax accountant can prepare the income tax return for each trust. This is not a complex return for a skilled professional and it is important that this be done each year and correctly.

DOES THE TRUSTEE NEED TO SPEAK WITH SMITH AND CONDENI?

We understand that reading this memorandum is, in many cases, not enough. It is advisable that we have at least a telephone conversation with the trustee after he has reviewed this memorandum. If the trustee wants to meet with us in person, he should call to set up an appointment. This service is part of the agreement that we have with the donor and is covered in our fees.

We expect that there will be periodic reviews of the estate plan by the donor at which time we will also review the operation and performance of any FGTs and make suggestions and recommendations.

At any time, trustees of FGTs may contact us with questions or concerns that they may have.

SOME FINAL THOUGHTS

This memorandum focuses on the important questions and considerations concerning FGTs. Our development of this planning technique is part of our continuing efforts to bring to our clients and their families advanced planning strategies designed to maximize and protect family wealth.