Wealth Planning **Update**

Intergenerational planning:

How to use annual exclusion gifts effectively

Waiting to transfer your assets to family members via a will or revocable trust upon death may not be the most effective strategy. Instead, it may be advantageous to transfer some assets during your lifetime.

Proactive intergenerational planning can help transfer assets from one generation to the next while aligning with your personal goals and family values by focusing on gift and estate tax efficiency, generation skipping transfer (GST) tax efficiency and income tax efficiency.

Many parents enjoy witnessing the positive effect a significant gift can have on their children's lives. For example, asset transfer can help children buy a home, raise a family or start a business. With meaningful benefits to transferring assets during your lifetime from a gift and estate tax perspective, intergenerational planning can be a win-win for those giving and those receiving.

The basics of annual exclusion gifts

Individuals can give annual exclusion gifts to their descendants. Such gifts are defined as the value transferred in a single calendar year to another person without using the estate tax exemption. In 2022, that value is $16,000. For example, a married couple can transfer $32,000 per year to each child, each child's spouse, each grandchild, and anyone else they'd like without gift or estate tax implications.

Keep in mind, you can only transfer a limited value of assets without incurring a gift or estate tax. As a result, it's beneficial to transfer assets sooner (while the value is lower) rather than later (when the value is higher).

Individuals concerned with giving children too much access to assets too soon can use structures to determine when and for what purposes the recipients may gain access. Take trusts, for example. When designing a trust, you decide the distribution provisions and who will serve as the trustee to enforce those provisions. This makes it possible to separate the timing of the gift from when the recipient can access the gifted assets.

Note that annual exclusion gifts are a "use it or lose it" opportunity. If you don't make an annual exclusion gift during a calendar year, it's a lost opportunity. Designing a strategy to consistently use your annual exclusion gifts can make a meaningful impact on reducing a taxable estate.

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Continued

Seven annual exclusion gift strategies

The following strategies are often used for annual exclusion gifts. Each has benefits and drawbacks. Your family's unique goals will determine which is best for you.

① Uniform Transfers to Minors Act (UTMA) and Uniform Gift to Minors Act (UGMA).

UTMAs/UGMAs provide the simplest way to make annual exclusion gifts to children: You open an account for the benefit of the child and deposit a check into the account each year. The accumulated funds can be invested to maximize growth over time. Once the child turns 18 or 21 years old — depending on your state's law — the funds legally belong to the child, who can use them for any purpose. Many parents explore other options because of this provision. Note: some states allow you to convert the account to a trust. One cautionary factor to consider: A person must be at least 18 years old in order to create a valid will. Therefore, in the event a child were to pass away, the UTMA/UGMA funds would pass according to the intestacy laws of the state in which the child resides. As a general rule, this means one half of the assets will pass to the child's father and the other half of the assets to the child's mother. This would be an undesirable outcome such as divorce or separation of the mother or father from his or her family including the child.

② 529 Plans.

A 529 Plan is a tax-advantaged savings plan designed to pay for education. The account owner contributes after-tax dollars to the account, makes investment decisions and names a beneficiary. Income tax on all account earnings is deferred and withdrawals are income tax free if they are used for qualified education expenses, including college tuition, room and board, books and supplies, and elementary and secondary education expenses.

Many states allow an income tax deduction or credit for contributions to their state's 529 Plan. If the beneficiary does not use the funds for qualified education expenses, then the account owner can name a different beneficiary or withdraw the funds, but the earnings will be subject to income tax and a 10% tax penalty will apply.

③ Crummey Trusts.

A Crummey Trust is a trust created by a "grantor" for the benefit of one or more beneficiaries. The grantor decides what the distribution provisions will be and who will serve as the trustee to enforce them. Each year, the grantor makes annual exclusion gifts to the trust, which can be cash, stock or even closely held business interests.

Each time you make a gift to the trust, you must notify the beneficiary, who then has a right to withdraw that gift for a period of time (usually about 30 days). However, if the beneficiary does not exercise that right within the window of time, the assets remain in the trust. Thereafter, the trustee can distribute them according to the provisions outlined in the trust.

The benefit: the entire trust balance never becomes available to a beneficiary at any point in time, provided you don't choose to create the distribution provisions to do so.

④ ILITs (Irrevocable Life Insurance Trusts).

An ILIT is effectively a Crummey Trust, but the assets are used to purchase a life insurance policy, usually on the life of the surviving parent to help leverage larger wealth transfer via insurance upon the death of the surviving parent.

⑤ 2503(c) Trusts.

A 2503(c) Trust works much like a Crummey trust, with a couple of important distinctions.

First, the 2503(c) Trust may only have a single beneficiary, but separate trusts can be created for each child. Second, the child need not have the right to withdraw the annual gifts to the trust, rather, upon reaching age 21, the child has only one window of time (usually 30 days) to withdraw all trust assets. If the child fails to do so within that time frame, the assets are distributed by the trustee according to the trust's provisions.

⑥ 2642(c) Trusts.

A 2642(c) Trust is used when grandparents (vs parents) would like to create would like to create a trust for the benefit of a grandchild. This type of trust operates much like a 2503(c) Trust (described above). The difference is that it is designed to allow grandparents to make annual exclusion gifts to the trust for the grandchild without having to use any of the grandparent's generation skipping transfer ("GST") tax exemption. (In other words, as a general rule, gifts from grandparents to grandchildren require the use of the grandparents GST tax exemption. But gifts to a 2642(c) Trust do not require that).

⑦ Intrafamily Loans.

Families who want to give more than the annual exclusion amount to a child in a given year can establish an intrafamily loan. Each year, a portion of the loan (equal to that year's annual exclusion amount) may be forgiven.

Those who have set up trusts to use part of their annual exclusion gift each year will want to consider how much is left for other types of gifts when doing so. If your gifts to a beneficiary exceed the annual exclusion amount in a given year, you may need to file a gift tax return for annual exclusion gifting as well and use a portion of your gift tax exemption. If no gift tax exemption remains, a gift tax will apply.

In addition to annual exclusion gift strategies, there are several others that use little or none of your estate tax exemption that may also be beneficial for your family. Consult with your BMO Wealth Management expert when considering the best strategy for your family's annual exclusion gifts.

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