

Giving from the Heart:

It's More than the Thought that Counts

Whether it's the season for giving, or your heart-felt and ongoing commitment to sharing your blessings with those you love, there's a time, method and reason for giving.

For growing numbers of individuals and families, sharing the wealth now . . . while they can see the smiles it generates . . . is gaining in popularity. But when it comes to giving away our assets to loved ones, the matter can quickly become complex. In fact, two serious pitfalls can derail your generosity and cost you and your loved ones dearly. First, when you give away your wealth, you also give up control, and in some circumstances, that can be a blueprint for disaster. Secondly, unless you exercise great care in your giving, you may inadvertently create a taxable event for yourself or your loved ones. Let's look at both these gifting pitfalls and see how you can avoid them.

Giving Away Your Money Without Losing Control

It may sound uncharitable to suggest that you keep control over your assets, even as you give them away to loved ones. But sometimes doing just that is the best way to ensure that your loved ones truly benefit from your legacy. Here's why.

The minute your gift leaves your estate and becomes part of a loved one's, it is subject to a host of threats. It can be lost to creditors if the loved one has bad debts or liens, for example. Or if your legacy is co-mingled with a loved one's spouse, some or all of it may be lost in a future divorce action. Of equal concern is the fact that not everyone has the wisdom, maturity or financial savvy to make the most of your gift. Even loved ones with the best of intentions may squander your legacy through errors of judgment or other costly mistakes. Fortunately, you can give away your wealth while still retaining control with a number of strategies.

Custodial Accounts

When loved ones are minors with expensive acquisitions -- such as college education -- in their future, a custodial account established under the Unified Gift to Minors Act may be just the ticket. You create a custodial account (naming someone other than yourself as the child's custodian), and make irrevocable gifts to the child's account. The money can only be used for specific purposes, such as college expenses, and any funds remaining in the account when the child turns 21 become the child's. Beware the so-called "kiddie tax," however. To keep parents, grandparents and others from shifting large blocks of wealth to minors, the IRS now imposes the parents' effective tax rate on any interest or dividends a child under 14 earns over a \$1,000 annual exemption. At age 14, children are taxed at a much kinder rate: anything over an exemption of \$500 in interest and dividends is taxed at the child's own rate.

Minor's Trusts

Similar to this custodial account in many ways is the Minor's Trust (also known as a 2503(c) trust), with a few significant differences. First, the Minor's Trust requires annual trust tax returns. On the plus side, however, the first \$5,000 in income earned by the trust is taxed at only 15 percent, with income over that amount taxed at 28 percent, so it is ideal for large gifts. Finally, the Minor's Trust allows you, as Trustee, a much greater degree of control while the child is a minor. Then, after the child reaches the age of majority, he or

she has just 30 to 60 days to withdraw the funds from the trust. Failing to do so will allow you to retain control of trust funds until the date you've specified.

Irrevocable Life Insurance Trust

A surprising fact to many is that the life insurance you own can actually increase your estate tax bill. Here's a solution that lets you avoid estate taxes on your life insurance policy while seeing to it that your loved ones benefit fully from the policy's proceeds. The Irrevocable Life Insurance Trust (ILIT for short) owns a policy on your life, which names your loved ones as beneficiaries. Any policy premiums under \$10,000 that you may pay are tax-free, as long as you follow the tax guidelines for ILITs. As part of the ILIT's design, you create instructions as to when, how and why your loved ones may use the policy's proceeds after you're gone, and you designate who you want to manage the funds on your loved ones' behalf. For instance, you can have a professional money manager oversee funds on behalf of a beneficiary who is still a child or who may have little financial experience. You can designate how much money should be paid out and how often. You can even determine under what circumstances loved ones should receive disbursements: for example, money for college, a down payment on a new home, etc. With the ILIT, you can ensure that your loved ones -- and no unintended creditors, ex-spouses or others -- put this money to best use.

In addition, you may even be able to provide loved ones with a source of emergency funds before you pass away. Some policies have generous no-cost or very low-cost policy loan provisions. You can include directions in your ILIT's trust documents about those circumstances in which you'll permit loved ones to make policy loans while you live.

The Family Limited Partnership

Finally, in some circumstances, a Family Limited Partnership (FLP) may be the best bet for removing assets from your estate and into the estates of your loved ones, all while retaining complete control over the asset.

Ideally suited to a family business but also used occasionally for other types of assets, the FLP lets you transfer ownership to a special kind of limited partnership. You and your loved ones own "interests" in the partnership, rather than owning the assets themselves. By naming yourself the general partner of your limited partnership, you retain complete control over how the asset is managed, even earning income for your management duties. One of the biggest advantages to the FLP is the so-called valuation adjustment, which means that the ownership interests are valued lower for tax purposes than the actual value of the underlying asset. As a result, you can give away more of your wealth to loved ones, and you can do so much faster, than you could otherwise. Further, ownership of an asset that can't be readily split into pieces -- such as real estate or a family farm or business -- can be easily distributed fairly and equally among loved ones, while keeping the asset intact.

Giving with No Strings Attached

Your loved ones may be mature, financially experienced and immune from the threats of creditors, lawsuits or divorce. So, you want to give away your wealth to them now, while you can live to see them enjoy the fruits of your hard work.

You can give away assets to your loved ones tax-free if you follow a few simple guidelines. Each year you can give away up \$10,000 per recipient gift-tax and estate tax free. You can give away \$10,000 to as many individuals as you like, and still do so without a tax penalty.

If you're married, you and your spouse can give a combined gift of up to \$20,000 to an individual, and still avoid the tax man's reach.

What if you want to give away more than \$10,000 per person? You can do so without a tax penalty, if you apply the difference to your lifetime estate tax exemption. Starting last year, the exemption has slowly begun to increase in value. In 1999, each person can give away as much as \$650,000 estate tax free. By the year 2006, the exemption will reach a maximum of \$1 million per person, or \$2 million per married couple if they plan properly.

There's no reason you can't give away more than your exemption. But just remember that you'll expose anything over that amount to gift or estate taxes. These taxes can add a costly penalty to your largess. Federal estate taxes, for example, begin at 37 percent and rise to a maximum of 55 percent on every dollar over your individual estate tax exemption.

Even if you follow the guidelines and keep your gifts within your exemption amounts, you may still create a tax liability for your loved ones. For instance, if you give away a highly appreciated asset -- such as a stock portfolio, real estate or work of fine art -- you may also be passing along to loved ones a large capital gains tax bill, should they ever sell your gift. Gifts made while you live retain your original "cost basis," or your investment in the asset. When loved ones sell the asset, they will have to pay capital gains taxes on the difference between the asset's selling price and your original purchase price. That can add quite an unexpected sting to your act of generosity. On the other hand, assets passed on to loved ones at your death receive a "step-up in basis," meaning that their current market value becomes your loved ones' cost basis, allowing them to save on capital gains taxes. For that reason, you're better off giving cash or assets which have not appreciated significantly to loved ones while you live, and waiting until after death or use strategies like the Charitable Remainder Trust to dispose of highly appreciated assets.

When to Give with Caution

As much as I hate to curb any generous impulses you may have, there are occasions when you should give carefully, or perhaps not at all. I urge you to proceed with caution and seek the advice of a professional if you encounter any of these warning signs:

You May Need Medicaid Benefits in the Future

To discourage Medicaid abuse and fraud, the government has enacted harsh penalties for those who apply for Medicaid assistance if they know they are ineligible. And it's easier than you might think to be ineligible for Medicaid benefits. The government enforces a "look back" period of three to five years on Medicaid applicants. If the government finds that during the "look back" period, you gave away assets that might now be used to pay your medical expenses, it may declare you knowingly ineligible. The alternative, if you have given away assets to loved ones and your health or finances take a serious turn for the worse, is to wait for up to three to five years before you can legally apply for benefits. So, if you think you or your spouse may need the government support of Medicaid, be very careful about when, why and how you give your assets away.

You Plan to Use Joint Tenancy to Give an Asset Away

In past columns, we've talked about the trouble with joint tenancy, but because it is used so pervasively, I'll take yet another opportunity to encourage you to think twice about this common ownership strategy.

Many consumers own assets with loved ones as joint tenants with rights of survivorship. Joint tenancy means that all the joint tenants own 100 percent of the asset. If one of the joint tenants die, the others immediately inherit his or her ownership interests, avoiding death probate. But it has significant drawbacks. If the joint tenants are married and have a taxable estate, they will lose one of their two estate tax exemptions -- a mistake that will cost heirs over \$200,000. If you should add someone other than your spouse to an asset, you may incur costly gift or estate taxes. Finally, whether joint tenants are married or single, they expose the entire asset to risk if one of the joint tenants is sued, has bad debts or unpaid taxes. If you're looking for ways to give your wealth away to your loved ones while you live, there are much better options than joint tenancy.