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Because you asked

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Lifetime gifting is one of the best ways to achieve legacy planning goals and minimize exposure to transfer taxes. However, for a gifting strategy to be successful, there are certain rules that must be adhered to and planning techniques that should be considered to optimize the tax benefits. This piece will explore general gifting rules and how they apply specifically to life insurance.

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1. What is a "gift" for gift tax purposes?

A "gift" is the transfer of property from one individual (commonly referred to as the "donor") to another (the "donee") without adequate consideration. This may include the sale or exchange of property, the assignment of life insurance policy benefits to another individual, or the transfer of property or money to a trust. Debt forgiveness, such as forgoing interest on an intra-family loan and below-market loans (i.e., loans that do not charge sufficient interest) are also characterized as gifts for the purpose of the gift tax.[1]

For gift tax purposes, a gift is considered complete when there has been a gratuitous transfer of property, the property has been accepted by the donee, and the transfer divests donor of control, dominion, and title.[2]

2. How much can be transferred without incurring a gift tax?

Each US citizen and resident can transfer a certain amount of property, during life or at death, without incurring a gift or an estate tax. This amount is commonly referred to as the "lifetime exemption." Once the lifetime exemption is exhausted (i.e., total value of all transfers made exceeds the exemption), a 40% tax is imposed on each subsequent transfer.

The current lifetime exemption is $13.61 million (for 2024), which is based off a $10 million base exemption plus inflationary adjustments. On January 1, 2026, the base exemption is scheduled to reduce to $5 million plus inflation, significantly reducing a high-net-worth individual's ability to make tax-free gifts.

Under portability rules, a surviving spouse can also inherit any unused lifetime exemption remaining at the death of their spouse so long as a portability election is made on a timely-filed federal estate tax return. For example, if Husband dies with $5 million of unused exemption, his surviving spouse can elect to add that $5 million of exemption (known as the deceased spousal unused exemption, or DSUE) to her own lifetime exemption, thus increasing the amount that the surviving spouse can transfer via gift or at death without being subjected to tax.

In addition to lifetime exemption gifts, each person can give away $18,000 (for 2024) to as many individuals as they desire each year without incurring any gift taxes. This type of gift is known as an annual exclusion gift and is neither subject to gift tax nor subtracted from a person's lifetime exemption.

3. When are gifts subject to the generation-skipping transfer (GST) tax?

The GST tax applies when a transfer is made to a "skip person," i.e., a person who is two or more generations below the donor. For example, a gift from a grandparent directly to a grandchild is considered both a gift transfer and a generation-skipping transfer. The GST tax also applies to transfers at death and transfers to, or distributions from, certain trusts benefitting skip persons.

Like the gift and estate tax rules, GST tax only applies once the GST exemption is exhausted. The current GST exemption is $13.61 million, which is based on a $10 million base exemption adjusted for inflation. Transfers exceeding this exemption are subject to a 40% tax on top of any gift/estate taxes that are due.

4. How does lifetime gifting work to minimize exposure to the estate tax?

Implementing a gifting strategy to fully utilize available exclusions and exemptions can help to significantly minimize or eliminate exposure to estate taxes. Gifting generally decreases the total estate by removing not only the asset itself, but also any appreciation on the gifted asset occurring after the gift from the estate.

5. When must a gift tax return be filed?

If a donor makes a gift that exceeds the annual exclusion amount (i.e., $18,000 for 2024) or does not qualify for an annual exclusion in a given calendar year, the donor must file a gift tax return (Form 709) on or before April 15 following the calendar year in which the gift was made. A gift tax return generally also must be filed if the donor and the donor's spouse elect to split gifts (see question 15). A gift tax return must also be filed in order to apply GST exemption, which may or may not automatically apply for annual exclusion gifts.

6. What are the income tax consequences of a gift?

When property is received as a gift, the recipient is generally required to take the donor's basis. This is commonly referred to as "carryover basis." Generally, a donor does not have to recognize income tax when gifts are made, although there are some exceptions such as when the gifted asset is subject to a loan in excess of the donor's basis, or when gifting a specific asset type triggers income (such as gifting a deferred annuity that is in a gain position). The recipient of the gift does not have to include the value of the gift (no matter the amount) into income for income tax purposes.

7. What types of property are ideal for gifting?

Certain property may be gifted for a myriad of reasons, many of which are not tax motivated. For gift and estate tax planning, however, gifting property that is likely to appreciate in value, such as real estate and life insurance, may be beneficial to remove future appreciation from the donor's estate. If the donor is in a higher income tax bracket than the recipient, gifting income-producing property may also be beneficial from an income tax standpoint.

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Additionally, property that may qualify for certain discounts (e.g., lack of marketability or lack of control discounts), such as an interest in a small business, may be ideal property to gift during life. Before gifting real estate, stock or business interests, or any asset subject to a loan or other transfer restrictions, taxpayers should consult with tax counsel to ensure that such a gift does not have unintended consequences.

Additionally, if property has already appreciated significantly in value, taxpayers should consult with their advisors to determine if the estate tax benefits of making a gift outweigh the income tax benefit of retaining the asset until death and receiving a "step up" in basis on the asset (except for certain assets such as IRAs, qualified plans and deferred annuities). Particularly in a tax environment where fewer individuals are subject to a federal estate tax but are looking to mitigate income taxation, this type of basis planning becomes especially important.

Taxpayers should also consider other non-tax aspects of making a gift, such as the recipient's personal and financial situation, whether the recipient is a minor, if the recipient may be subject to claims of creditors or divorce, etc. Trust ownership may be favorable to help manage many of these issues and achieve the donor's objectives more effectively.

8. Will there be a "clawback" of gifts made during life if the exemption amount is lower at death than at the time the gift was made?

The Tax Cuts and Jobs Act of 2017 temporarily increased the exemption amount for gift, estate, and GST tax purposes from $5 million per person to $10 million per person (adjusted for inflation). Under the provisions of the Act, this increase in exemption is scheduled to revert to a $5 million exemption on January 1, 2026, taking into account inflation from 2018–2025.

Because of the way the estate tax is calculated, there was concern that, to the extent a taxpayer made gifts during life sheltered by a larger exemption than what is available at the time of death, those gifts could be brought back (i.e., "clawed back") into their taxable estate and subject to an estate tax. On November 26, 2019, the IRS issued final regulations to clarify and confirm that gifts made during the current period of increased exemptions (between 2018–2025) do not need to be concerned about these gifts becoming taxable at their death.[3]

Example

Edward makes a lump sum gift of $9 million in 2024 (when the exemption is $13.61 million) to an irrevocable life insurance trust (ILIT) for the benefit of his children. He dies after 2025, when the exemption has returned to $5 million, adjusted for inflation. For illustrative purposes, assume the exemption at his death is $7.5 million and he has a total taxable estate equal to $10 million. To calculate the estate tax due, gifts made during life are added back, resulting in a total estate of $19 million for estate tax purposes. Without the regulations clarifying the issue of "clawback," the $19 million estate would be subject to estate tax with only a $7.5 million exemption (the exemption available at date of death) to reduce the estate tax liability. However, under the regulations, Edward's estate will now receive the higher of (1) the estate tax exemption available at death or (2) the exemption used to make gifts during life that resulted in no gift tax being due. Here, that exemption would be $9 million, which is the amount of exemption used during life to shelter the gift, for which no tax was due.

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9. What is the general rule for splitting gifts?

IRC §2513(a)(1) provides that, for gift tax purposes, if both spouses consent to split gifts made by either of them during a calendar year, then all gifts made by either spouse will be considered to be one-half from each spouse in that calendar year.

Example

Mary and Joe are married. Joe transfers $36,000 to their son, Bobby. If Mary consents to split the gift, the gift will be treated as if each of them individually transferred $18,000 to Bobby that year.

Gift splitting is only permitted if the following conditions are met:

- Both spouses consent to split the gifts
- At the time of the gift, both spouses are either US citizens or residents
- The spouses are married at the time of the gift and if they subsequently divorce (or one spouse dies), neither spouse remarries (or the widowed spouse does not remarry) prior to the end of the calendar year
- The donor spouse does not create in their spouse a power of appointment over the gifted property

Spouses cannot pick and choose which gifts to split in a particular year. If consent is provided to split gifts, all gifts made during the calendar year by either spouse must be split. If spouses do not want to split all gifts, gifts should be made in different calendar years.

10. Does the consenting spouse have to file a gift tax return?

Generally, if spouses elect to split gifts, each spouse will have to file their own gift tax return for the calendar year and each spouse will provide consent on the other's return — even if only one spouse actually makes gifts. The instructions for Form 709 (Gift Tax Return) provide, however, that only one spouse must file a gift tax return in certain circumstances, like when the only gifts made during the year qualify as annual exclusion gifts.

11. Are there estate tax implications for a spouse who consents to split gifts?

In general, consent to gift splitting should not cause estate inclusion for the consenting spouse because the spouse will not be deemed the transferor of the property for estate tax purposes.[4]

12. Can a gift to a trust in which a consenting spouse is a beneficiary be split?

Maybe. In general, gifts in which the consenting spouse has an interest may not be split, unless the spouse's interest is "ascertainable" and "severable" from the interest of third parties.[5] If the spouse's interest is severable and ascertainable, gift splitting is allowed for the amount deemed to benefit the other trust beneficiaries.

For example, if a spouse has a mandatory income interest in a trust for life with the remainder passing to the other trust beneficiaries, the spouse's interest is ascertainable and severable from the rights of the other beneficiaries and gift splitting on the value of the remainder should be allowed.

Typically, the value of the spouse's interest in the trust will be determined using the same principles applied in the valuation of annuities, life estates, terms of years, remainders, and reversions.[6]

13. Can Crummey gifts be split?

Yes, but the spouse's interest in the trust may need to be ascertainable and severable from the interest of the third-party beneficiaries. In the past, Crummey gifts typically had been treated as gifts made directly to the Crummey beneficiary who had the right to withdrawal. Consequently, when Crummey gifts were made to beneficiaries other than the spouse, the spouse-beneficiary's interest in the trust was irrelevant for purposes of determining whether the gift qualified for split-gift treatment.[7] However, in two recent Private Letter Rulings, the IRS looked beyond the third-party withdrawal powers to see if the spouse had an interest in the trust that was ascertainable and severable from the interest of the other beneficiaries before permitting the gift splitting (see question 18).[8] It is unclear whether the IRS's failure to follow its prior position in these most recent PLRs was inadvertent or whether these rulings signal a change in its analysis for the ability to elect gift splitting for Crummey gifts to third-party beneficiaries.

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14. When is a spouse's interest in a trust ascertainable and severable?

If actuarial principles can be used to determine the value of the interest of the consenting spouse, the spouse's interest is likely ascertainable and severable.[9] For example, if the spouse had a mandatory income interest in a trust for life or a term of years, the spouse's interest in the trust is ascertainable based on general valuation methods set forth in the Regulations.

Even if the spouse only has a discretionary interest in a trust, the courts have indicated that gift splitting is available if the trustee's discretion to distribute to the consenting spouse is limited by an ascertainable standard, such as health, education, maintenance, and support.[10] However, it is unclear exactly how to value this "ascertainable" discretionary interest apart from the interest of the third-party beneficiaries, so it may be difficult to determine the amount of the gift that can be split.

15. Can spouses elect to split gifts in community property states?

Yes, if the gifted property is considered "separate property" of the donor spouse. If a gift is made from community property, the gift will automatically be considered made one-half by each spouse and each spouse will need to file a gift return.

16. How is the GST exemption used for split gifts?

If spouses elect to gift split for a particular calendar year, each spouse will be treated as the transferor for GST tax purposes of one-half of the gift eligible for gift splitting.[11] The deemed allocation rules under IRC §2632 will apply automatically to each spouse's one-half gift and any voluntary allocation of the GST tax exemption must be made by each spouse on his or her own gift tax return.

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17. How do gifts to ILITs qualify for the annual exclusion?

For a gift to qualify as an annual exclusion gift, the individual receiving the gift (or trust beneficiary) must receive a "present interest" in the property. A transfer is considered a "present interest" if there is an unrestricted right to the immediate use, possession, and enjoyment of property, or the income from the property.[12]

Contributions to an ILIT typically can qualify as an annual exclusion gift if the beneficiaries possess a power to withdraw the contributions for a limited period of time. These withdrawal powers, called "Crummey Powers," cause the contributions to be treated as present interest gifts and thus qualify for the annual exclusion from gift tax.[13] ILITs almost always include "Crummey Powers" for some or all of the trust beneficiaries, which may include the grantor's spouse, children and/or grandchildren, whether or not their interests in the trust are vested.[14]

Once the trustee receives the gift from the insured/grantor, in most cases, the trustee will need to notify the beneficiaries who hold the "Crummey Powers" that the contribution is available for withdrawal in the trust account for a specified period of time (usually 15–30 days) before the premium will be paid. The trustee should review the trust document to determine how and when the notice should be provided to the Crummey beneficiaries. Typically, the trustee must provide written notice to the beneficiaries who have Crummey withdrawal rights and either the beneficiaries or their guardians (if they are minors) must sign the Crummey notice to acknowledge receipt.[15]

In addition to Crummey powers, many trusts will also have "hanging Crummey powers" that apply when a beneficiary's withdrawal right is not exercised. A failure to exercise a withdrawal right under a Crummey power is considered a release of a power of appointment and any amount released that exceeds the greater of $5,000 or 5% of trust assets (5x5 rule) may be treated as a gift from the Crummey beneficiary to future beneficiaries. To avoid the lapse of a withdrawal right being treated as a gift, hanging powers allow the withdrawal right in excess of the 5x5 rule to "hang" or roll over into the next taxable year, when additional amounts can lapse without a taxable transfer. These hanging powers will continue to rollover for the lifetime of the Crummey beneficiary.

18. Can an ILIT beneficiary make gifts to a trust?

It is typically inadvisable for an ILIT beneficiary to make a gift to the trust for several key reasons: (1) the gift may not be considered a completed gift for annual exclusion purposes; (2) gifts to a trust in which the transferor is a beneficiary may cause inadvertent estate tax inclusion and/or result in the beneficiary becoming a transferor for GST tax purposes; and (3) the beneficiary may potentially lose creditor protection of trust assets. Moreover, there may be inadvertent income tax consequences if the transferor is treated as the grantor of the trust for income tax purposes.

One notable exception is when a spouse is a beneficiary of the ILIT. In this case, it may be possible to gift-split, although there are several rules that must be followed. **See question 17** for more information.

19. What is the impact of a gift or transfer of a life insurance policy made within three years of death?

Life insurance policies that are gifted within three years of death are includible in the transferor's taxable estate under §2035. An exception to this rule exists for a bona fide sale for "adequate and full consideration." Consequently, the sale of a policy by the insured to the insured's grantor trust for full and adequate consideration will avoid the three-year look back.1[6]

Our BYA on Valuation of life insurance policies has more information on what constitutes "adequate and full consideration."

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20. What is the "Goodman Triangle" and how does it cause gift taxation?

Life insurance contracts are unique in that there are three distinct parties that may be associated with a policy: the policy owner, the insured, and the beneficiary. When these parties are all different, unexpected gift tax liability may result. This three-party scenario is commonly referred to as a "Goodman Triangle" after the 1946 case, *Goodman v. Commissioner.*[17]

Where a life insurance policy is owned by one person on another's life and names a third party (who is not the owner's spouse) as the policy beneficiary, the death benefit will be treated as a taxable gift from the policy owner to the beneficiary at the insured's death.

Example

Mom wants to insure her life for $3 million. Her son, Nathan, is named the owner of the policy on Mom's life. The beneficiaries are Nathan, and his two sisters, Jane and Michelle. When Mom, as the insured, dies, the $3 million death benefit will be paid in equal shares to Nathan, Jane, and Michelle. To Nathan's surprise, as the owner of the life insurance policy, when the death benefit is paid, he will be deemed to have made a taxable gift of $1 million to each of his sisters.

To avoid the Goodman Triangle tax trap, most clients will use an ILIT to own the policy. The use of an ILIT in the above example would have helped keep the death benefit out of Mom's estate and avoided the gift tax issues when the proceeds were paid out. The ILIT structure also helps to provide creditor protection and gives the grantor more control over how the proceeds are distributed to beneficiaries.

21. Can a "Goodman Triangle" situation arise in the business context?

A three-party scenario can also be problematic in an employer/business scenario where a business owns a policy on the life of an employee/shareholder and names an outside entity or individual as beneficiary. Although not technically a Goodman Triangle because it is not related to gift taxes, this type of arrangement can cause income taxation of the death benefit received by the third-party beneficiary. To avoid potential income taxes on the death benefit, typically the employee or shareholder must pay or recognize an economic benefit each year associated with the death benefit receivable.[18]

Note also, for employer-owned policies, Internal Revenue Code (IRC) §101(j) causes the death benefit to be subject to income taxation unless certain exceptions apply and notice and consent is obtained. See our **BYA on Requirements for employer-owned life insurance**.

1. See Treas. Reg. §25.2511-1(a).
2. Treas. Reg. §25.2511-2.
3. Treas. Reg. §20.2010-1.
4. Rev. Rul. 54-246. See also, PLR 200213013.
5. See Treas. Reg. §25.2513-1(b)(4).
6. Id.
7. PLR 2002130030, PLR 81381092 and PLR 8112087.
8. PLR 200422051 and PLR 200616022.
9. Id.
10. See Wang, TC Memo 1972-143 and Falk, TC Memo 1965-22; see also PLR 200345038.
11. IRC §2652(a)(2).
12. Treas. Reg. §25.2503-3(b).
13. Crummey Powers get their name after the taxpayer in the seminal case Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968) and IRC §2503(b).
14. See Cristofani v. Commissioner, 97 T.C. 74 (1991) and Kohlsaat v. Commissioner, T.C. Memo 1997-212. In Cristofani, the court stated that the Crummey beneficiaries did not have to have a vested present interest or vested remainder interest in the trust, in order to qualify for the annual exclusion.
15. It is customary for the Crummey withdrawal period to last 30 days. There should never be an explicit understanding among family members that a withdrawal power will not be exercised, otherwise the IRS may disallow the use of the annual exclusion.
16. See IRC §2035(d); Rev. Rul. 85-13; Rev. Rul. 2007-13.
17. Goodman v. Commissioner, 156 F.2d 218 (2nd Cir., 1946).
18. See split dollar regulations at Treas. Reg. §1.61-22.

Life insurance death benefit proceeds are generally excludable from the beneficiary's gross income for income tax purposes. There are few exceptions such as when a life insurance policy has been transferred for valuable consideration. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. No legal, tax, or accounting advice can be given by John Hancock, its agents, employees, or registered representatives.

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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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