The Basics of Gift Taxes

For many people with large estates, planning ahead and gifting to family members can save a bundle in taxes. This ultimately means your heirs may get more and Uncle Sam may get less. But before you start stuffing checks in envelopes and passing them out to your loved ones, you should know the basics of gifting. This article explains the current rules.

For federal purposes, the gift and estate taxes are unified. In other words, you can't save on estate taxes by giving your fortune away shortly before you die. Once you're above the exemption amount (discussed below), $1 of gifts reduce your estate tax exemption by $1. The 2020 exemption amount is $11.58 million (up from $11.40 in 2019 and adjusted annually for inflation) for a single individual. An individual can use his or her spouse's unused exemption amount — effectively doubling the amount for a couple to $23.16 million.

For example, Fred is single but has a favorite nephew. Fred's net worth is $15 million. In 2020, he gives $11.58 million to his nephew free of the gift tax. But two years later, he dies with a $3.60 million estate. He's used up his exemption so the estate pays tax at 40% on the $3.60 million. The tax result is the same as if he had given the entire $15 million to his nephew on his death. (We've ignored the annual gift tax exclusion and any increase in the estate tax exemption for inflation to keep it simple.)

Clearly, it can be more complicated. Even calculating the tax can be complicated for a number of reasons. There are differences between making gifts and leaving assets in your will. We'll deal with the most frequently encountered below. Keep in mind that a number of states have gift and estate taxes. Some of them are structured the same way as the federal tax, but some are not. In some cases, the exemption is lower than the federal and the rates are high enough that the tax consequences cannot be ignored.

Annual Exclusion

One frequent comment we hear is: "I know I can give away a certain amount every year without paying any gift tax but I'm not sure of the amount." For 2020, the exclusion is $15,000 (unchanged from 2019). It is indexed for inflation so it may change in future years. Tax law has contained an annual exemption amount for many years. The way it works is simple. Let's say you give $15,000 to your favorite niece in 2020. The $15,000 does not affect your $11.58 million estate tax exemption.

Exclusion Mechanics

The $15,000 exemption is available annually and applies to each donee. Thus, Sue can give $15,000 tax free to each of her 10 children and grandchildren (each year), or $150,000, without impacting her estate exemption. Over a 10-year period she could give away $1.50 million. Her husband, Fred, can do likewise, giving an additional $15,000 annually to each child and grandchild.

What if Sue controls all the money? She takes care of all the family finances and all the bank accounts are solely in her name. Sue and Fred could elect to "split" any gifts they make. In this case, Sue writes a check for $30,000, but Sue and Fred are each deemed to give $15,000 if the election is made. The election is made on IRS Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*.

As you can see from the example of Sue and her husband, if you elect to split a gift, even if you don't go over the $15,000 threshold, you'll need to file a gift tax return if one spouse controls all the money. If may be just as easy for Fred to ask Sue to deposit $15,000 in his personal checking account. Then, both could write $15,000 checks and avoid filing a gift tax return.

The exclusion applies to each donee and expires at the end of each year. Once the year is over, you've lost a chance to reduce your estate tax by $15,000. That's why year-end gifts can be important.

Considerations for Donees

Usually we think of making gifts to our children, or close relatives. But the gift tax rules aren't limited to that. Let's say you have a friend you have been close to since college. The friend has a talented son who could go on to become a professional musician but he needs funds to live on. From a gift tax standpoint, a gift to the talented musician is the same as one to your children.

The exclusion applies to an unlimited number of donees. So you can reduce your estate by giving gifts to 10, 20 or even more children, grandchildren, relatives and others. But there's a prohibition against reciprocal gifts. For example, Ken and Keith are brothers who each have two children. Ken can give $15,000 to each of his two children and $15,000 to each of Keith's two children. But if Keith reciprocates giving $15,000 to each of Ken's children, the exclusion may be denied. On the other hand, Sue and Sharon are sisters. Sue is a neurosurgeon who makes more than $800,000 a year. Sharon is a tropical medicine specialist who volunteers in Africa. Sue gives $15,000 annually to Sharon's daughter, but Sharon doesn't reciprocate. In this case, the exclusion applies.

Note: Gift taxes do not apply to gifts to political organizations.

Keep in mind that a gift is a transfer where no "consideration" is received. For example, let's say your business is short-staffed, your secretary works long hours during the year so you give her a check for $10,000 in late December. That would probably be considered a fully taxable bonus and not a gift. On the other hand, your secretary and wife have been good friends for years. Your wife becomes ill and your secretary, without being asked, takes her to doctors' appointments, stays with her after an operation, and helps out as a friend. You give her $10,000. That might be considered a gift. The facts are important.

Spousal Gifts

Gifts of cash or property to your spouse are not considered gifts for gift tax purposes. Put another way, there's an unlimited exemption. For example, let's say you inherit a small office building worth $750,000 from your parents. The attorney titles it in your name. The following year, you get married and retitle the property in both your name and your spouse's name. There are no gift tax consequences.

Exceptions and notes: If your spouse isn't a U.S. citizen and the total gifts exceed $157,000 in 2020 (up from $155,000 in 2019), you need to file a federal gift tax return.

There are some gifts (certain terminable interests) to a spouse that also require the filing of a return.

Same-sex couples who are legally married in a state that recognizes such unions qualify for the unlimited exclusion, even if they move to a state that does not recognize such marriages.

Medical, Tuition Exclusion

Amounts you pay for qualified medical or tuition expenses are excluded from gift taxes, no matter what the amount. However, there are two requirements.

- **The expense must be qualified.** For medical expenses, they must meet the requirements for a deduction. For example, amounts paid for cosmetic surgery generally don't qualify. In the case of education expenses, the payment must be made to a qualifying domestic or foreign educational institution for tuition. College tuition qualifies, but expenses like horseback riding lessons don't.
- **The amount must be paid directly to the provider** — a doctor, hospital, etc. for medical expenses or to a college or school for education expenses. You can't cut a check to your daughter so she can pay for her tuition.

While contributions to 529 plans are subject to the $15,000 exclusion, you can make a lump-sum payment and treat it as made ratable over a five-year period. For example, you can write a check to the plan for $75,000 and treat it as you made $15,000 annually for five years.

Return Requirements

If you don't make any gifts that exceed $15,000, you generally don't have to file a return. A gift can involve cash, marketable securities or property. For marketable securities, you'll have to list how you calculated the value. For other property, you'll need a qualified appraisal. Giving your son a classic car? You need more than a handwritten note from a guy down the street who rebuilds old cars. Depending on the property, an appraisal might be costly. And the appraisal must be attached to the return. For these, and other reasons, you might want to just give cash.

Keep in mind that giving property may have implications in terms of your basis, which we'll describe below.

Failure to file a return with the IRS or to disclose all required information will keep the statute of limitations open. Gifts must be reported on the donor's estate tax return and if no gift tax return is filed, the valuation of the gift is open to challenge. If a valuation question is involved, convincing the IRS of the value you claimed could be difficult years down the road. In addition, there are penalties for willful failure to file and substantial understatement (such as undervaluing the property subject to an appraisal).

Gifts to Minors

A gift to a minor is considered a present interest and qualifies for the $15,000 exclusion if *all* of the following conditions are met:

- Both the property and its income may be expended by, or be for the benefit of, the minor before the minor reaches age 21.
- All remaining property and its income must pass to the minor on the minor's 21st birthday.
- If the minor dies before the age of 21, the property and its income is payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

Basis in Property Received

There's a big difference in the recipient's basis in the property if the transfer is a gift versus an inheritance. A donee's basis in the property is the same as the donor's basis for gain — but the lesser of the donor's adjusted basis or the fair market value of the property at the time of the gift for loss. If an individual inherits property, the basis is the fair market value at the date of death of the transferor for gain or loss.

Example 1: Fred bought a corporation at $1 a share in 1994. His total investment was $10,000. The stock is now worth $2 million. He gives his entire holdings in the corporation to his daughter, who sells the stock the next day for $2 million. She has to report a long-term capital gain of $1,990,000.

Example 2: The facts are the same as in Example 1, but Fred leaves the stock to his daughter in his will. On his death, the stock is valued at $2 million. She sells it the next day for $2 million and reports no gain.

The differences in basis will make a big difference in what assets should be gifted or left in your estate and the timing of any transfer.

For example, Fred inherited a lake house from his parents that has been in the family for years. The house is not only valuable monetarily (worth $500,000), it has sentimental value. Fred's basis is $50,000. Fred is single and will have a taxable estate. His two children, Sue and Sharon, both enjoy the property with their children. Sue and Sharon are on good terms and want to keep the property. Because of the lake's location and a low turnover of properties, prices have been climbing at more than 12% per year. Fred's in good health. It's not unreasonable to assume that the property could double in value before he dies. Gifting the property now would keep at least $500,000 (the additional increase in value) out of his estate. Moreover, the stepped-up basis on an inherited property doesn't mean much in this case because the beneficiaries have no intention of selling.

Giving property that has declined in value generally doesn't make sense because neither the donor nor the donee gets a tax benefit for the loss in value.

If you own a business or have income-producing assets such as rental properties, etc., talk with us about your options.

Income Tax Implications

You can't claim a deduction on your income tax return for gifts to your children, relatives, etc. On the other hand, the recipient is not generally liable for income taxes on the amounts received.

Other Considerations

The more complicated your assets, the more planning opportunities there may be and the more complex those opportunities become to implement. While there are steps you can take if your family assets consist only of a personal residence, vacation home, and marketable securities, your options increase if your assets consist of one or more active businesses, rental properties, farm or timber land, etc. Planning involves trade offs and an analysis of both the estate tax and income tax implications of any actions.

Other planning options may include setting up a family limited partnership, gifting property at a discount because of minority interests or other restrictions, using strategies to leverage basis in business ownership (S corporation, partnerships, LLCs, etc.), taking passive activity losses associated with business ownership, creating special trusts including charitable trusts, and implementing strategies involving the generation-skipping transfer tax. Consult with us about these and other potential avenues to explore.

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