Cutting the IRS Out of Your Gifts

Article Highlights:
- Gift Tax Rule
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If you are financially well off, you may want to gift money or property to family members or others you care about. If that is the case, there are some gift tax issues you should be aware of. Oh yes, the government even taxes gifts if they are large enough, so it is best to know the rules; otherwise you may end up making a gift of taxes to the IRS.

The gift tax rules provide two exclusions from gift tax, the annual exclusion and the lifetime exclusion:

Annual Exclusion – The annual exclusion is periodically inflation adjusted and is currently $14,000 per individual. Thus you can give $14,000 a year to as many individuals as you wish without any gift tax or gift tax return filing requirements.

Lifetime Exclusion – On top of the annual exclusion, there is a lifetime exclusion that is linked to the estate tax exemption, which is also inflation adjusted, and for 2016 is $5.45 Million. Thus, in addition to the $14,000 annual per donee exclusion, there is a $5.45 Million exclusion that applies to the aggregate of all gifts in excess of the $14,000 per year per donee gifts.

There are complications to utilizing the lifetime exclusion. You must file a gift tax return to claim the lifetime exclusion, and the amounts of the lifetime exclusion used as an exclusion from gift tax will be tracked on any gift tax return(s) filed and will reduce the estate tax exemption. So for example, if in 2016 you make a gift of $3,014,000 to your child, and you haven't made gifts in the past that exceeded the annual per donee gift tax exclusion, you will pay no gift tax, but you will have reduced your remaining lifetime exclusion to $2.45 Million. If you make more large gifts in the future that use up your remaining lifetime exclusion, not only will you then be subject to gift tax on the excess gifts, but at your passing, and assuming the value of your estate is large enough to be subject to estate tax, you will have no estate tax exclusion left to offset the estate's value, so it will all be subject to estate tax.

CAUTION
The estate tax rates and the lifetime exclusion have long been a political football. They date back to 2006, when the lifetime exclusion was $2 Million. Congress can change the current $5.45 Million exclusion at any time. In fact, Democratic presidential candidate Hillary Clinton has proposed reducing the exclusion to $3 Million and raising the top estate tax rate from 40% to 45%. She would also disconnect the gift and estate tax exclusions and limit the lifetime gift exclusion to $1 Million.

exclusion, a donor may make gifts that are totally excluded from the gift tax in the following circumstances:

- Payments made **<u>directly</u>** to an educational institution for tuition. This includes college and private primary education. It does not include books or room and board.
- Payments made **<u>directly</u>** to any person or entity providing medical care for the donee.

In both cases, it is critical that the payments be made directly to the educational institution or health care provider. Reimbursement paid to the donee will not qualify. The tuition/medical exclusion is often overlooked, but these expenses can be quite significant. Parents and grandparents interested in estate reduction should strongly consider these gifts.

<u>Gift Splitting</u> **-** A husband and wife can each make annual exclusion gifts, thereby increasing the exclusion from the current $14,000 to $28,000 per year per couple. However, only one of the spouses may be in a financial position to make the gifts. Spouses may elect on the gift tax return to treat a gift made by one spouse as being made by both spouses. Gift splitting can be used for annual exclusion gifts, lifetime exclusion gifts, and gifts above the lifetime exclusions.

> ***Example - Gift Splitting -*** *John and Jane are married and have two children. In a year when the annual exclusion limit is $14,000, they would like to exclude $56,000 ($14,000 x 2 donors x 2 donees) in gifts. Jane received a large inheritance some years back; John has only a modest estate. Jane gives the children $28,000 each. Then the couple elects to gift split so that the $28,000 gift is treated as given one-half by Jane and one-half by John (or $14,000 each). The gifts all qualify for the annual exclusion. Even if both spouses have sufficient resources to make gifts, gift splitting is useful when the husband and wife have different estate planning goals.*

For residents of community property states, if community property is given, gift splitting is not necessary. Regardless of who holds the property's title, or who "makes" the gift, the property is owned one-half by each and is therefore given one-half by each.

<u>Gifts of Property</u> – Gifts of property have some of their own circumstances to consider. For instance, where gifts are made of appreciated property such as stocks or real estate, although the donor's gift is considered at the fair market value (FMV) for purposes of valuing the gift, the beneficiary of the gift assumes the donor's basis. As a result, the beneficiary of the gift is assuming any taxable gain the donor would have had if he or she had sold the property instead of gifting it and will have to include as income that gain when and if the gifted property is later sold.

Although the FMV of traded stocks is readily available, the same is not true of most other types of property, in which case a qualified appraisal will be needed to determine the value as of the date of the gift.

Finally, keep in mind that a beneficiary inherits property at its FMV at the date of the decedent's death as opposed to assuming the decedent's basis, as happens in the case of a gift.

If you are contemplating gifting money or property to an individual, it may be appropriate to consult this office in advance to minimize the impact on estate taxes and help with any gift tax filings that may be required.