Gift Taxes

An overlooked law

By Patricia J. Villano, CPA, MBA, AEP and Joseph L. LiPari, CPA, MBA

Gift taxes are too often an overlooked area of tax law. Most clients aren't aware the tax exists and are often not advised of the reporting requirements, even when executing significant gift transactions. It's up to tax professionals to educate clients in this regard. While there is a strong possibility that estate taxes may soon be no more, it is highly unlikely that gift taxes will disappear anytime soon.

The gift tax system, as it currently operates, assures that full asset appreciation is taxed when assets are sold. Without this tax, individuals would give away assets to lower tax bracket individuals to reduce or even eliminate the income taxes on the asset sale (assuming there is no kiddie tax). Afterwards, the cash from that sale can then be transferred back into the hands of the original owner. Shifting income in this way can result in a tax savings. While uncertainty remains as the tax landscape prepares for a shift, it's imperative that taxpayers comply with the laws as they now stand. In order for accountants to advise clients, there are many aspects to be considered.

Mechanics of the Tax

For 2017, every individual is entitled to an overall transfer of $5,490,000 of assets during life and after death without incurring any gift or estate tax. This is called the basic exclusion amount, and it's indexed for inflation each year. When the taxpayer's combined total transfers exceed this amount, then taxes are due either as gift taxes if the threshold is exceeded during life, or as estate taxes, if not exceeded until after death.

What is a "Gift"?

A lifetime completed transfer of property from donor (gift giver) to donee (gift recipient) for less than full and adequate consideration in money or money's worth is considered a gift. The parties do not have to be related. Joy and love do not constitute money's worth. Payment of legal obligations is not considered a gift. So you may provide clothing and shelter to a minor for his or her well-being without triggering a gift. However, cars, iPhones or other non-essentials would qualify as gifts. Gifts may be made outright to a donee or put in a trust. Providing services without receiving adequate consideration in money or money's worth in exchange is not counted as a gift.

Why Make Gifts?

Individuals make gifts for many reasons—some tax driven. Often the objective is to reduce the value of the individual's estate by moving the asset, the potential asset appreciation and potential earnings from the asset out of the estate. Others may merely be looking to avoid the probate process and associated probate costs. Many deathbed transfers occur with this goal in mind. Perhaps the taxpayer is looking to protect assets from potential future creditors. Relinquishing title of assets serves as a safeguard. There may be business owners looking to transition the business to others during their lifetime. Maybe the donor seeks to discreetly transfer different amounts to different parties without being judged for being partial. Information on assets that pass through a will after death is available to the public. With lifetime gifting, however, the donor may retain privacy. Some seek personal recognition for granting gifts during life. Others just want to experience the joy of giving and seeing the donee's pleasure of receiving and using the gift.

Statute of Limitations

The filing of Form 709, *United States Gift (and Generation Skipping Transfer Tax) Return*, not only affords peace of mind for being in compliance with the law, but the filing also starts the clock running on a three-year statute of limitations. This becomes critical, for example, when there are assets that are troublesome to value, when transfers have occurred within a family or when valuation discounts have been applied to the transfer. The statute will run as long as the gifts are adequately disclosed on the gift tax return. The guidelines include:

- Providing a description of the gift;
- The relationship between donor and donee;
- How the asset was valued;
- Any valuation discounts applied;
- Any identifying numbers associated with the asset;
- Copies of appraisals/valuations; and
- A copy of the trust document if a gift is made in trust.

If the return is not filed and/or disclosure requirements are not met, then the IRS may challenge the value of gifts or discounts taken anytime, and often when the estate tax return, Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, is filed. IRS Form 4506-T, *Request for Transcript of Tax Return*, should be filed in order to obtain transcripts of previously filed gift tax returns. Form 4506, *Request for Copy of Tax Return*, can be used to obtain actual copies of the gift tax returns with attachments filed during the taxpayer's lifetime. Accountants should not depend on clients to produce a complete set of these returns, as the total of cumulative lifetime gifts must be reported each year.

Requirements

Gift tax laws apply to citizens and residents of the U.S., even if they are gifting property outside the U.S. The tax also applies to nonresident aliens (those who live outside the U.S. and are not U.S. citizens) who gift tangible property located in the United States. Gift tax returns report taxable gifts for the calendar year and are due on April 15 of the year following the gift. The only exception is for a calendar year during which the donor dies. In that case, the gift tax return will be due at the same time as an estate tax return, including extensions. Filing an automatic six-month personal extension request with Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*, will also extend the time to file the gift tax return. If any gift tax is due, Form 8892, *Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax*, is required along with full payment. There are no jointly filed gift tax returns. A tax return must be filed by each donor. Any gift tax liability is the responsibility of the donor. The value of the gift tax paid does not itself constitute another gift. This is an added benefit when seeking to reduce the value of the estate. Any gift tax paid within three years of the donor's death, however, will get added back as an asset to his/her taxable estate.

Taxable Gifts vs. Exempt Gifts

For tax year 2017, the tax code permits an annual exclusion for gifts of up to $14,000 per donee for the year. The stipulation is that the gift be of a present interest, meaning that the title has passed completely to the donee, who now has the immediate unrestricted right to use, possess and enjoy the property. This annual exclusion is not cumulative, so if the exclusion has not been fully used for the year, it will be lost. Annual exclusion gifts are not considered taxable gifts and, therefore, do not impact gift taxes. A husband and wife (including same-sex married couples) who are each citizens or residents of the U.S. may elect to "split gifts," whereby each party consents to having gifted half of the value of the total gift. This allows the married couple to transfer a combined $28,000 worth of assets to any one individual during calendar year 2017 without gift tax consequences. If the married couple elects to split any one gift during the calendar year, then all gifts during that year must also be split. Gifts of community property are deemed to be split gifts, so no formal election is required in that case.

While they may seem to be of a future interest, certain transfers for the benefit of minors and transfers to trusts with *Crummey* powers (present right of withdrawal) may qualify as present interest gifts.

Any present interest gifts in excess of the $14,000 annual exclusion amount and any future interest gifts of any dollar amount, must be reported as taxable gifts on Form 709. Remember that most taxpayers will never get to the point of owing a gift tax, but filing of the tax return, nonetheless, is mandatory.

There are several categories of transfers that will not be counted as "taxable gifts." Many are not even required to be reported on Form 709. For example, gifts to political organizations are nontaxable and not reportable. Gifts made directly to a medical provider for medical expenses that would otherwise qualify as itemized deductions, may be excluded. Payments made directly to an educational institution for tuition (not for books, supplies, room or board) are excluded gifts. The funds must go directly to the provider of medical and/or educational institutions for these exclusions to be valid. (Note: Payments to a qualified §529 Education Savings Account do not qualify for this exclusion.) Other transfers that are not classified as "taxable gifts" include donations to charities, and any transfers between spouses that are not terminable interests [unless qualified terminable interest property (QTIP)]. Gifts to noncitizen spouses are not unlimited, but instead are subject to a $149,000 maximum annual exclusion in 2017.

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Valuing Gifts

The gift tax return will report the total of current year and all prior year taxable gifts. Gift tax rates are progressive, with 40% being the current maximum gift tax rate.

Gifts are valued based on the fair market value (FMV) on the date the transfer is completed. This is the dollar amount that would change hands between a willing buyer and willing seller, each being informed of all relevant facts. Unlike estate tax rules, there is no alternate valuation date for gifts. Valuing transfers of business interests, especially when utilizing discounts (e.g., minority interest, lack of marketability) is perhaps the most highly abused area, and most scrutinized, within current gift tax reporting.

Tax professionals must clearly educate clients on the difference between what is reported as gift value on the gift tax return, as opposed to the donee's basis in the gift. This basis must be reported on Form 709. The donee gets a carryover basis from the donor for appreciated assets, which means their basis is the same as the basis that was in the hands of the donor. If that amount is low, based on current market value, then this could trigger a large capital gains tax to the donee when the asset is sold. On the other hand, if that asset did not pass to the recipient until after death, then that beneficiary would receive a basis amount equal to the FMV of the asset at the date of death. This is referred to as "step-up basis." The potential to reduce capital gains taxes in this case could be substantial. If the carryover basis for gifts and step-up basis for estates remain federal law, then perhaps restricting gifts to those with high basis or otherwise postponing transfers until after death would be best.

Special Situations

Some other examples of special situations when a gift tax return must be filed would be when reporting split gifts (husband and wife each file to show consent to the gift splitting), any charity split interest gifts (e.g., gifts to a charitable lead trust or charitable remainder trust) where the charity and another party/parties share the gift and any gift to a spouse when making a QTIP election.

Unintended Consequences

Too often, an event occurs without a taxpayer realizing he or she has made a gift. For example, the forgiveness of a debt, as long as it's not a legal obligation of support, constitutes a taxable gift. The transfer of an asset for an amount less than adequate and full consideration in money or money's worth triggers a gift of the dollar difference. Below market loans, interest free loans and use of property for less than full value consideration produce taxable gifts. Creating a joint tenancy, adding someone else's name to an investment account or a piece of real estate or making any other irrevocable transfers also create gift situations. Funding an irrevocable trust becomes a gift to the beneficiary. The intent of the donor is not essential, based on federal law.

Gift Tax Planning

While transfer tax laws should be a part of lifetime planning for clients, often it may be best to advise clients to forgo gifting. Perhaps the client cannot afford to gift or may anticipate needing the assets for his or her own care. Once a gift is made, it is an irrevocable transfer. Maybe the donor makes an outright transfer of a valuable gift to a donee, who soon thereafter dies leaving the asset in the possession of an unintended in-law or other party. This could have been avoided if the asset distribution after the donor's death had been carefully planned for or even set up via transfer in trust.

Planning is not complete without also taking into account transfer tax laws of the taxpayer's state of domicile (note that Connecticut imposes a gift tax), and rules regarding federal generation skipping transfer (GST) taxes. Be sure to determine if a surviving taxpayer has any DSUE (deceased spousal unused exclusion) amount available to utilize.

Conclusion

While nothing is truly permanent when it comes to tax law, it is unlikely that lawmakers will repeal the gift tax, thus granting taxpayers the ability to legally shift income. Tax professionals can best serve clients by asking them each and every year whether they made gifts during said year. When required, adequate preparation and filing of Form 709 with full disclosures will provide peace of mind and avoid any potential repercussions in the future. In addition to penalties for late filing and/or late payment on balance due gift tax returns, significant penalties are assessed for undervalued assets included on a tax return. Therefore, it is advisable not to take shortcuts, to utilize questionable valuations or to apply inappropriate discounts. Avoiding adequate disclosure is unacceptable to the IRS and will not start the clock on the statute of limitations. In addition, there is no statute of limitations for failure to file gift tax returns, so it's better to file complete and accurate returns late than not at all. ■

About the Authors

Patricia J. Villano, CPA, MBA, AEP, is an Instructional Specialist at Montclair State University, Montclair, NJ in the Department of Accounting and Finance. She maintains an accounting practice in Closter, NJ.

Joseph L. LiPari, CPA, MBA, is an associate professor at Montclair State University, Montclair, NJ in the Department of Accounting and Finance.