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The Gift Tax: What you need to know

The Gift Tax is a federal tax on assets transferred to a recipient when full payment is not received in return. Contrary to popular belief, donors are responsible for paying gift taxes, not the recipient. The following are examples of gifts that will be taxable if you exceed the annual and lifetime exclusions:

- Checks
- Loans greater than $10,000 (if interest is less than the market rate)
- Cancelled Debts
- Paying someone else's debts
- Gifts made to a corporation
- Adding a joint tenant to real estate you own
- Real estate (foreign & domestic)

The good news is that gift tax exclusions are quite generous and with strategic planning, gifts can actually be made in a way that reduces income and estate taxes.

In this article, we'll explain gift taxes, how to avoid them, and how you can make gifts in the most advantageous way. Let's start by clarifying what constitutes a taxable gift.

What is considered a Gift for Tax Purposes?

Put simply, a gift is a transfer of property for less than its full value. If you give something away and aren't paid back in full, you've made a gift. Fortunately, not all gifts are considered "taxable gifts."

The following types of gifts are not taxable:

- Charitable gifts of any amount made to a valid charity.
- Gifts to your U.S. citizen spouse are not taxable, in any amount. Gifts to a foreign spouse are subject to an annual limit of $155,000.
- Gifts for tuition are unlimited as long as you pay the educational institution directly.
- Medical expenses qualify for unlimited exclusion as long as you pay the care provider directly.
- Legally required child support payments are not considered gifts.

How to Avoid Paying Taxes on Gifts

In addition to the gifts which bypass gift taxes, the federal government offers substantial exclusion limits. You can gift amounts up to the annual and lifetime exclusion limit as defined below.

Annual Exclusion

The annual exclusion amount is currently $15,000 per individual recipient. For instance, you could give your son a gift of $15,000 and your daughter a gift of $15,000 (as well as any other individuals) per year without having to pay federal gift taxes on the gifts. And, of course, your children would not have to pay income taxes on the financial gifts either. If you are married, you and your spouse can make joint gifts up to $30,000 per person, per year to any number of individuals. Together, you could potentially gift an unlimited number of different family members and friends $30,000 each, without having to worry about federal gift taxes.

To illustrate just how generous the annual exclusion limits are, here's an example:

Let's say you are married, with a large family, and a substantial estate. You have 500 family & friends and you and your wife would like to give each of them an annual gift of $30,000 (which falls within your joint annual exclusion limit). You could give away $15 million dollars per year without ever worrying about federal gift taxes.

If you exceed the per person annual exclusion amount, however, your lifetime exclusion amount will kick in.

Lifetime Exclusion

The current lifetime exclusion amount is $11.4 million, in addition to the annual exclusion amount. Let's say you're single and gift your son $18,000 and your daughter $18,000 in the same year. You've exceeded the annual exclusion amount for your son by $3,000 and your daughter by $3,000. Now, your lifetime exclusion will be reduced by $6,000 - the total amount not covered by the annual exclusion. While you will have to report the $6,000 to the IRS (so they can track how much of your lifetime exclusion you've used) you will not have to pay taxes until you exceed your annual and lifetime limits.

Tax Advantages of Gifts

If you are certain you have more than enough assets to care for yourself in the event of an extended retirement or illness, you might be able to take advantage of the gift tax rules.

Using Gifts to Reduce Income Taxes: You may be able to reduce your income taxes by shifting assets to family members in lower tax brackets. Gifting assets that generate a lot of taxable income (like a rental property) can reduce your taxable income.

Using Gifts to Reduce or Avoid Estate Taxes: If you have a sizeable estate that could be subject to federal estate tax (estates over $11.58 million in 2020) gifting can reduce or avoid estate taxes altogether. Essentially, you can move money out of your estate by making gifts during your lifetime.

Let's flashback to the annual exclusion example given earlier. Using the annual exclusion limit, you were able to gift an unlimited number of people up to $15,000 per year. In our example, you gifted $15 million to friends and family in one year, tax-free. If you did not gift the $15 million and instead opted to give $15 million in bequests through your will, that money would be part of your taxable estate for federal (and state) purposes. Federal estate taxes are as high as 40% for estates valued over $11.58 million. You wouldn't have to pay taxes on the first $11.58 million of your estate but would be taxed on the amounts beyond that. For the sake of our example, you would be taxed at least $1,368,00 (40% of the taxable $3.42 million). That's nearly $1.4 million in taxes that could have been avoided entirely with advanced gift planning.

Another, subtler way to save on estate taxes with gifts is by removing future appreciation on the assets from your estate. For instance, let's say you give your son real estate that's worth $11,415,000 million on the date the gift is made. This uses up your $15,000 annual exclusion and your entire $11.4 million lifetime exclusion. Then you live for another 15 years and the value of that real estate jumps to $20 million at the time of your death. Fortunately, your son won't have to worry about paying estate taxes on that $20 million piece of property because it is no longer part of your estate. In this case, that would mean there's $8.42 million less to be taxed in your estate (worth millions in savings)!

How to Report and Pay Taxes on Gifts

If you make taxable gifts in excess of the annual exclusion amount, you must file Form 709: U.S. Gift Tax Return. On your gift tax return, you'll report the fair market value of the gift on the date of transfer and the identity of the recipient. Even if you have not reached the $11.4 million, you must file this form if you exceed the $15,000 annual gift tax exclusion so the IRS can keep track of your usage of your lifetime exclusion.

Conclusion

If you'd like to learn more about using gifts to your advantage, contact the professionals at our office for more information. We can assist with advanced gift planning, tax avoidance, and estate planning.

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