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Clearing Up Common Misconceptions About the Tax Implications of Gifting

As estate planners, we often come across questions about the tax consequences of making lifetime gifts. This article is intended to shed some light on how gifting fits into the overall tax system and to clear up common misconceptions about the tax implications of gifting.

By **Amy Neifeld Shkedy and Rebecca Rosenberger Smolen** | September 27, 2018

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Although often misunderstood, it is important to understand that when a person makes a gift (other than a charitable gift), it does not affect the federal income tax of the donor or the donee of the gift. That means that the donor making the gift cannot deduct the value of the gift (other than charitable contributions) on his federal income tax return, and, likewise, the donee receiving the gift is not subject to federal income tax on the funds received. The federal gift tax regime, not the federal income tax regime, is what's at play.

When making a gift, it is generally the giver or donor of the gift who would be subject to the federal gift tax and not the receiver or donee of the gift. The federal gift tax is imposed at the rate of 40 percent, however, gifts are only taxed to the extent that their value (on a cumulative basis for each taxpayer/donor) exceeds the donor's lifetime exemption amount (which is currently $11.18 million per individual in 2018 or twice that amount for a married couple, indexed for inflation for future years) and to the extent that the gift does not fall within certain exclusions from the gift tax, as more particularly discussed below.

The following gifts are not considered taxable gifts and, thus, will not use up a donor's lifetime exemption amount. In general, gifts that fall within these exceptions do not need to be reported on a gift tax return to the extent that there are no other gifts for that calendar year:

- Gifts which are not more than the annual exclusion amount for the calendar year. In 2018, the annual exclusion is $15,000 per donor (this is an increase from 2017, and this figure is indexed for inflation).
- Tuition or medical expenses paid directly to the service provider for a donee's benefit.
- Gifts to a U.S. citizen spouse (gifts to noncitizen spouses are limited to up to $152,000 per year in 2018).
- Gifts to political organizations.
- Gifts to qualifying charities.

For any other gifts, the donor of the gift would need to report the gift on a federal gift tax return (Form 709). Although there may be a reporting obligation for such gifts, there may not be any gift tax liability to the extent that the gift falls within the donor's lifetime exemption amount. This lifetime exemption amount is tied to the federal estate tax exemption amount, so that any exemption that is used during an individual's lifetime would reduce, dollar for dollar, that individual's exemption at death from the federal estate tax (it is a unified transfer tax system). It is possible that an individual who is a widow or widower may have more than the $11.18 million exemption available if he inherited any of his or her predeceased spouse's unused exemption amount through the portability election. A portability election allows a surviving spouse to acquire a predeceased spouse's unused exemption amount if a portability election is timely made on the federal estate tax return of the first deceased spouse.

As noted above, a donor does not need to use any of his or her lifetime exemption to the extent that the gift falls within his or her annual gift tax exclusion of $15,000 or falls within another exception as described above and, for such gifts, a federal gift tax return is generally not required. A married person can give up to twice the amount of the annual gift tax exclusion (i.e., $30,000) gift tax free; however, the donor's spouse would need to consent to split this gift on a gift tax return (unless each spouse separately makes the gift or they make a gift together using joint assets). In addition to making direct outright gifts to beneficiaries, annual exclusion gifts can also be made through Section 529 plans (education savings accounts). For 529 plans, there is a special rule that enables a donor to front-load annual exclusion gifts over a five-year period, so that a donor can give up to $75,000 to a 529 plan (or a couple can donate twice that amount, or $150,000) in one year, provided that a gift tax return is required to be filed in order to make a special election to "front-load" the gift over a five-year period. The donor should keep in mind that if this 5 year election is chosen, the donor cannot make other annual exclusion gifts to the beneficiary of the 529 plan over the five-year period which could cause the donor to exceed his or her use of annual exclusions during such time period.

Annual exclusion gifts can also be made to certain qualifying trusts. In order for gifts to trusts to qualify for the annual gift tax exclusion, the beneficiary of the trust must have a "present interest" in the trust. There are different types of trusts that qualify for the annual exclusion. One type of annual exclusion trust is a "Section 2503(c) trust," which is a trust that can be set up for a beneficiary under the age of 21 to receive annual exclusion gifts each year. Although this is an irrevocable trust, once the beneficiary reaches age 21, he will have the legal right to withdraw the assets of the trust (although this right is generally limited to a short window of time). Another type of irrevocable trust that can receive annual exclusion gifts is called a "Crummey trust." This type of trust gets its name from the taxpayer friendly 1968 U.S. Court of Appeals for the Ninth Circuit case, *Crummey v. Commissioner*. Crummey trusts provide the beneficiary, or his guardian in the case of a minor beneficiary, the right to withdraw the gift to the trust each year for a certain window of time after the gift is made (often 60 days). To the extent that the beneficiary doesn't exercise his right to withdraw the funds within that time period, the right of withdrawal lapses and the gifted property remains in the trust. In addition to using Crummey powers in basic gift trusts, Crummey powers are also used in life insurance trusts in order to qualify trust contributions (generally annual cash contributions by the insured to provide funding for insurance premiums) for the annual exclusion from the federal gift tax. Without the Crummey withdrawal power, gifts to a trust would not constitute "present" interests as is necessary for a gift to a donee to qualify for the annual exclusion, and thus would, instead, use part of the donor's $11.18 million exemption from the federal gift and estate tax.

When making lifetime gifts, in addition to considering potential gift tax implications, there is another burdensome transfer tax of which to be mindful at the federal level—the Generation-Skipping Transfer (GST) tax, which is imposed at the same 40 percent rate as the other transfer taxes, in addition to those taxes. The GST tax applies to gifts (during lifetime or at death), either directly or via trust, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor, such as a grandchild, or more remote descendant). The simplest example of a transfer subject to GST tax is when a grandparent leaves a bequest to his or her grandchild, which bypasses or “skips” a living child. However, the GST tax can also be triggered when gifts are made to trusts, either at the time of the initial gift (if all of the beneficiaries are “skip persons”) or at a point in the future, such as when a distribution is made from the trust to a grandchild or other skip person, at the death of a child or at the termination of the trust in favor of grandchildren. Fortunately, just as is the case with the federal gift and estate taxes, there is an $11.18 million exemption available for the GST tax. Thus, only GST taxable transfers above that amount (on a cumulative basis for each taxpayer/donor) would be taxed at the 40 percent rate.

A donor’s GST exemption can be allocated to a trust that the donor funds in order to make the trust assets and future growth in the trust exempt from GST tax. This allocation is done by making a special election on a gift tax return. Whenever making gifts to trusts, care should be taken in order to determine whether or not an allocation of GST tax is beneficial. If there is a reason that a taxpayer does not want GST exemption allocated to a trust so that it can otherwise be preserved for other assets, it may be necessary for a gift tax return to be filed in order to “opt out” of the GST exemption with respect to certain trusts where the GST exemption is otherwise automatic under the Internal Revenue Code. Likewise, a gift tax return may be required in order to “opt in” to the allocation of GST exemption for certain trusts where the allocation of GST exemption is not automatic under the Internal Revenue Code.

Another way to avoid the GST tax, and perhaps one of the most basic, involves making carefully structured gifts on behalf of a grandchild for his or her education or medical expenses (paid directly to the service provider), which can pass completely free of GST tax and gift tax, regardless of the amount. Similarly, the GST tax does not apply to outright gifts and gifts to carefully structured trusts that are excluded from gift tax due to the annual exclusion (up to $15,000 per donee or $30,000 per donee if the donors are married); however, in order to qualify for the GST annual exclusion for those trusts, the following provisions should be included in the trust during the life of the beneficiary no portion of the income or principal may be distributed to any person other than the beneficiary and the trust must either terminate during the life of the beneficiary or, if not, be included in the beneficiary’s estate at his death.

There are numerous ways in which individuals can make gifts and many different trust structures that can be implemented for gifting. Whenever gifts are made, whether outright, in trust or by some other arrangement, a determination must be made as to whether that gift has any federal gift or GST tax implications and whether a federal gift tax return should be filed to properly document the gift. It is advisable to consult with your estate planning attorney in order to determine whether or not a federal gift tax return is required or, even if not required, whether it is otherwise advisable to file a federal gift tax return for reasons such as the allocation of the GST tax exemption, the valuation of a gift (perhaps, at a discounted value) or for a host of other reasons.

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