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THE FUNDAMENTALS OF GIFT TAX RETURN

This white paper addresses the basic requirements for filing a gift tax return. Specifically, this paper addresses the definition of gift tax, the taxable limits, the filing requirements and other items that apply to tax professionals when filing the gift tax return.

Background of the Gift Tax

Prior to 1976, the gift tax was lower than estate taxes. The Tax Reform Act of 1976 brought equity to the law and established a unified transfer credit that could be applied to offset the tax liability of the estate or the gift (Spaulding, 2013). The taxes were considered unified because wealthy individuals often gifted portions of their estate prior to death to reduce the value of their estate and thus lowering the estate tax.

The Tax Relief and Reconciliation Act of 2001 retained the gift tax, but lowered the rates so that the highest tax rate was equal to the "highest marginal rate on income taxes, which, in 2010, was 35%" (Spaulding, 2013). In 2010, the tax law was amended again to the exemption for estate, gift and generation-skipping transfer (GST) taxes was increased to $5 million for the 2011 and 2012 tax years and the top tax rate is 35% (Spaulding, 2013).

The lifetime maximum for any one donor to gift is $5.25 million. The IRS requires an annual filing of the amount gifted each year to track the lifetime maximum amount. The filing is required regardless of whether tax is due on the gift.

What is a Gift?

The Internal Revenue Service defines the gift tax as a "tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not." (Small Business/Self Employed: Internal Revenue Service, 2013) The tax applies to the gift of any property, including money, without expecting anything in return.

In order to be considered a gift, it must meet the following requirements.

1. The donor must be competent, meaning he/she is of sound mind as defined under state law. The donor is considered competent unless proven otherwise in a court of law.
2. The donor must have the intention of making a gift. The donor's intent is crucial. They must not be expecting any full market value return on the gift.
3. The recipient must be able to receive and possess the property. If the gift is to be made to a minor, a tax attorney or financial advisor should be consulted prior to making the gift for specific requirements.
4. The must be "actual or constructive delivery of the property" to the recipient or their representative (Spaulding, 2013).
5. The recipient must accept the gift.

The donor must give up control over the gift so they cannot later make changes to the ownership of the gift or revoke it. If the donor dies prior to giving up control of the gift, the gift becomes part of the estate and is subject to estate tax, not gift tax. The exception to this rule is if the power is limited by an "ascertainable standard" (Spaulding, 2013). This standard is invoked when the gift is used for the donor's basic living expenses, such as health and medical expenses, support or educational expenses.

The IRS deems any transfer of property between family members as a gift. To avoid this, the donor must prove that the property transfer was done just as though the property transfer was made to an unrelated third party. When looking at transfers made between family members, the gift tax will not be incurred if the following conditions are met.

- There is a promissory note signed by the borrower spelling out the terms of the transaction.
- The note includes an interest rate available on the open market, such as prime plus 2%.
- The repayment term is a fixed period.
- The borrower has the means to repay the loan and makes timely payments.

The tax is only incurred if the gift or transfer of property meets all the legal requirements for the gift and the value of said gift can be determined on the open market. The tax applies to all gifts made by legal residents of the United States and on all property located within the United States. In the event property is received by someone who is the legal resident of another country, a United States resident is responsible for paying the gift tax.

The donor is liable for the tax. In the event that the donor is unable to pay, the recipient must pay. Section 6324(b) of the Internal Revenue Code considers this the doctrine of transferee liability.

The tax is assessed on the fair market value of the gift at the time it was made. The recipient receives the gift based on the donor's tax basis of the property. This is referred to as the carryover basis and comes into play when the recipient sells the property.

Exclusions from the Gift Tax

In 1997, Congress set a dollar limit on the amount that can be gifted annually without incurring the gift tax. The first year it was $10,000 and is increased annually based on inflation in $1,000 increments. For tax years 2009-2012, the limit was $13,000. The limit was increased to $14,000 for 2013. The IRS imposed these limits to avoid incurring the tax on prime gift giving occasions such as weddings or Christmas.

Making the gift does not affect the donor's federal income tax. The amount subject to tax is done on a per recipient basis. For instance, a parent with four children could have given each child $13,000 each year from 2009-2012. Each year the amount given to each child can be excluded from the gift tax. These gifts are not tax deductible, unlike those made to charitable organizations (Small Business/Self-Employed: Internal Revenue Service, 2013).

The IRS considers any gift a taxable gift, unless it is under the annual exclusion limit. There are some exceptions in the Internal Revenue Code. The IRS does not consider the following transactions as gifts.

- Tuition or medical expenses paid for another person, such as those made by parents on behalf of their college aged children.
- Gifts given to the spouse of the donor.
- Any gift given to a political organization for its use up to the amount limited by law.
- Payments that fulfill the spousal or child support requirements, based on state law.
- Gifts made to a 529 Educational Plan can be made in amounts of up to five times the annual exclusion rate. However, the donor cannot give any additional gifts to the recipient within 5 years of the deposit. Additionally, the donor must live at least 5 years after making the gift.

The gift tax and estate tax apply to different property. Therefore any property that is subject to the gift tax is not subject to the estate tax and vice versa.

Gifting Together

Spouses are permitted to combine the annual gift limit together. In 2013, spouses may gift a total of $28,000. This “gift-splitting” applies even if only one spouse gives the gift. The non-gifting spouse must agree to split the gift and IRS Form 709 (United States Gift (and Generation –Skipping Transfer) Tax Return) must be filed. Form 709 must be filed even if the amount gifted is less than the annual exemption amount. If the gift is from the couple, rather than one spouse, gift-splitting is not applicable.

Spouses can share the $5.25 million lifetime exclusion, provided they consent to the gift-splitting and file Form 709. This has the effect of reducing the amount available to each spouse to make tax-free transfers at death to heirs other than the surviving spouse. When the first spouse dies, there is “less unused exclusion left for the survivor to carry over through portability.” (Jacobs, 2013)

Spaulding provides an example of gift-splitting in his article for thismatter.com. A couple decides to split their 2013 gifts with the husband gifting his nephew $24,000 and the wife giving her niece $20,000. Despite each individual amount being in excess of the 2013 annual exclusion, gift-splitting eliminates the tax liability. The gift to the nephew is treated as being half from his uncle and half from his aunt, amounting to $12,000 from each spouse. The gift to the niece is split similarly, with $10,000 being attributed to the uncle and $10,000 being attributed to the aunt. Each gift is less than the annual exclusion, so the gifts do not create any tax liability. However, Form 709 must be filed to notify the IRS of the gift-splitting.

It is important to note that if the husband had actually gifted the nephew $12,000 and the niece $10,000 and his wife had done likewise; no gift-splitting is required since each gift is within the annual exclusion limit. Thus Form 709 is not required.

Lifetime Exemptions

As previously stated, donor has a lifetime tax credit that allows amounts under $5.25 million, as indexed. This lifetime exemption also applies to gifts from the donor's estate and can be used to offset the GST tax. This unified credit applies to both gift taxes and estate taxes. Taxpayers may only offset $5.25 million from their gift tax or estate tax, but not both (Miller & Maine, 2011).

Valuing Gifts

When a gift of property is made, the value is determined as of the date of the gift. For tax purposes, the value of the gift is similar to the value of property in real estate transactions (Miller & Maine, 2011). The IRS terms this Fair Market Value. Fair Market Value is defined as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts." (Small Business/Self-Employed: Internal Revenue Service , 2013). The Fair Market Value of the property is included in the decedent's estate is not determined by a forced sale price, nor is it determined by a sale in a market other than one commonly used by the public, given the parameters of the location of the property (Small Business/Self-Employed: Internal Revenue Service , 2013).

If the recipient sells the property that has been gifted, the basis used is that same as the one used for the donor. For instance, if the recipient is gifted stock valued at $50 per share at the time of the gift, this is the basis for the gift. If the recipient sells the stock at $75 per share, the recipient pays tax on the gain of $25 per share (Small Business/Self-Employed: Internal Revenue Service , 2013).

Marital Rules

Gifts made to spouses who are US citizens are not subject to the gift tax. However, if the spouse is not a US citizen, there is an annual limit on the amount that can be gifted. This amount is also adjusted annually for inflation. In 2012, the maximum amount that could be gifted to a non-citizen spouse was $138,000. For 2013, the amount is $143,000.

Transfers in marital property made during divorce proceedings can be subject to gift tax. If the transfers of property are made pursuant to a written agreement between the parties to settle property rights or to provide support for minor or dependent children, Section 2516 of the Code states transfers are "adequate for consideration" provided the divorce occurs within two years of the written agreement. The agreement need not be part of the divorce decree (Spaulding, 2013).

The Code also has a marital deduction. This allows one spouse to give an unrestricted number of gifts without regard to their value to their husband or wife. These gifts can be either testamentary or inter vivos. These gifts are not subject to either the gift or estate tax. The IRS has this provision since they assume that the value of property in a spouse's estate will pass to the surviving spouse. When the surviving spouse passes, then the value of the estate will be subject to tax. However, if the surviving spouse is not a US citizen, only $60,000 qualifies for the marital deduction.

Foreign Gifts

Any US citizen who receives a gift from a foreigner must report the gift and pay the tax provided the value of all gifts received in a calendar year is more than $13,258 as indexed. The exception is foreign gifts of tuition or medical expenses which are paid on behalf of a US citizen are exempt. Payments must be made directly to the institution.

Death Rule

Gifts made within three years of the donor's death plus any gift taxes paid are added to the estate which prevents donors from avoiding taxes on their estate. An example of this would be a life insurance policy which is issued when death is imminent. The value of a policy while the insured is alive is much less than when the death benefit is paid to the beneficiaries. The beneficiaries receive the death benefit tax free assuming the premiums were paid with after-tax dollars.

Both the gift of the policy and the gift taxes paid reduce the donor's estate. The IRS includes any gift and the associated taxes paid within three years of the donor's death are considered to be part of the estate and are subject to estate taxes. Credit is given for any gift taxes paid and the credit is applied to the estate tax due.

Gifts in Trust

Whether a trust is subject to gift tax depends on how the interest is paid on the trust. If the property is held in trust and the interest paid on the trust is mandatory, there is no gift so no taxes are due. If interest payments are discretionary, the determination of gift status depends on if the discretion is governed by an "express ascertainable standard" (Spaulding, 2013). If the trustee is governed by an express ascertainable standard, then no gift is made for purposes of the tax. The law says the gift must be gratis.

Events not Subject to Gift Tax

As previously states, gifts made to cover educational or medical expenses for another individual are not subject to the gift tax. Payments must be made directly to the institution, rather than the recipient of the services. Additional information can be found in Section 2503(e) of the Code.

Any property transaction between unrelated parties is generally not considered to be a gift since the donor generally receives adequate consideration during the transaction. Transactions between related individuals are, however, generally scrutinized by the IRS.

Gift tax and estate tax are applied differently given the ownership of the property. The IRS does not apply the estate tax to property that has been gifted or the gift tax to property held by the estate. There are exceptions which have been addressed in this paper previously.

IRS Form 709

The IRS has issued Publication 950 to assist preparers in filing Form 709. The form is filed, even when no tax is due to track the lifetime exclusion limit. When filing the Form, there are three items that must be included (Small Business/Self-Employed: Internal Revenue Service , 2013):

- Copies of any appraisals of the gift property. This establishes Fair Market Value at the time of the gift in the event the recipient chooses to later sell the property or gift it to another family member.
- Copies of any relevant documents regarding the transfer. This can include deeds, special caveats or any other document that supports the value and intention of the gift.
- Documents showing any unusual items appearing on Form 709 such as partially-gifted assets or any items that are pertinent to the gift that can later affect the tax liability for either the donor or recipient.

When the IRS decides to audit an estate return, it will generally audit the gift return as well. Even if no tax is due, the IRS requires the form to be filed. If there is not adequate proof that the property transferred was a gift, the IRS can disallow the gift and include it as part of the estate (Jacobs, 2013).

The $5.25 million lifetime exclusion is cumulative so any returns containing Form 709 must be kept indefinitely. While not the only documentation the IRS will accept, it is certainly the easiest one for heirs to produce to prove the estate tax was documented correctly.

In the event Form 709 has not been filed in the past, it can be filed later. Provided there is no gift tax involved, there is no penalty for late filing. The filing deadline is the same as Form 1040; April 15 unless an extension has been filed. If gift tax is due, it must be paid with the extension form to avoid penalties and interest being assessed on the tax.

Tax Saving Strategies

Aside from the obvious goal of reducing the size of the estate, gifts remove future appreciation on the gift from the estate. A gift of stock valued at $25,000 at the time of transfer may appreciate to $75,000 at the time of death. The $50,000 appreciation is excluded from the estate (Gift Tax Fundamentals, 2007).

Any property that quickly appreciates should be gifted at the beginning of the year. This prevents the appreciation from being included in the gift. The earlier in the tax year the gift is made, the lower its value (Spaulding, 2013). The exception to this is when property is gifted to charity. This allows the donor to receive income from the property throughout the year, but still receive consideration for the gift (Spaulding, 2013).

Conclusion

While gifts are common, there is a relatively low percentage of people who will reach the $5.25 million lifetime exclusion. Generally most gifts are non-taxable since they fall below the threshold for tax purposes. Married couples can double the amount they gift and are required to file Form 709 only if gift-splitting occurs. There are specific appreciation rules and depending on when the gift is made, it can be tricky to determine whether the tax should be paid as a gift tax or by the estate.

It is vital that individuals who make large gifts seek skilled assistance when making gifts and filing the appropriate returns. Individuals should seek out the assistance of a CPA, Enrolled Agent or estate attorney when planning gifts.