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Gift Tax Update (December 2016)

One of the most common questions our office gets at this time of year is "What is the maximum I can give to a relative each year and how much will be saved in taxes if I do that?"

This is based on three common misconceptions or assumptions

1) You are only allowed to give large gifts to relatives
2) There is a limit or cap on what you can give
3) That the gift is taxable to the recipient, so there must be a tax break for the giver

The reality (**with some rare exceptions**) is this: You can give gifts of **any amount** to **anyone** (relatives, friends, neighbors, enemies, even your favorite tax accountant) at any time **without limit**. In addition, the recipient neither pays tax on the gift received nor does the generous giver get a tax deduction.

Sounds easy enough, but as the saying goes: "No good deed goes unpunished". While very few are "punished" by giving gifts, with just a little knowledge and some planning, tax savings can be accomplished by gifting and some traps can be avoided. But first, what are the rules surrounding gifts and how might that affect even those of modest means when it comes to filing Tax Returns?

A quick overview. The Form 709 (Gift Tax Return) is intertwined with the Form 706 (Estate Tax Return). To understand gift taxes, we need to know about estate taxes. Each person has an Estate Tax Exclusion ($5,450,000 in 2016 and $5,490,000 in 2017). Simply put, if a person dies in 2017 and their net worth (their share of what they own less their share of what they owe) is $5.49 million or less, they pay no estate tax at all. They may have to file a Form 706 Estate Tax Return, but their estate would pay no taxes. If their estate was worth more, then there is an Estate Tax on their net worth above that amount and their Executor or Trustee must file a Form 706 on behalf of the Estate.

In addition, each person can give an amount up to the annual gift exclusion ($14,000 for 2016 and 2017) to any other individual and not have to file a Form 709 Gift Tax Return. (**Exception: Health and Education is unlimited if paid directly to the Education or Heath Provider—so college, medical expenses, etc are excluded from the gift amount if paid directly to the provider)** If you give any other person more than the annual exclusion in a calendar year, you (the giver) must file a Form 706 Gift Tax Return. The gift in excess of the annual exclusion reduces the giver's Estate Tax Exclusion when they die.

> **Example:** Snow White gives each dwarf $20,000 in 2016. Thus, she has given $6,000 over the exclusion to 7 people, or exceeded the exclusion amount by a total of $42,000. She must file a 2016 Form 709 Gift Tax Return. In addition, when Snow White dies her Estate Tax Exclusion (whatever the amount is for that year) will be reduced by $42,000. Thus, assuming she gives an excess of $42,000 a year for 10 years, when Snow White dies her Estate Tax Exclusion must be reduced by $420,000.

Many people at or near the Estate Tax Exclusion amount prefer to gift annually to reduce their potential estate taxes and to allow their heirs, friends, and family to enjoy and benefit from the money now as opposed to after they have died.

If during your lifetime, the total gifts that exceed the annual gift exclusion eventually exceeds the Estate Tax Exclusion, then a Gift Tax is due by the giver at that time. A very rare event for most taxpayers.

After explaining the above to our tax clients, a few well thought out questions arise. Some of the more frequently asked questions are ….

When are Form 709 Gift Tax Returns Due?
They are due on April 15th the year following the gifts, or the same day Income Tax Returns are due.

What are the penalties for not filing a required Form 709 Gift Tax Return?
As of now (December 2016), the penalty is based on the tax due. So, if there is no tax due there is no penalty. With the Estate Exclusion so high, very few Form 709s have tax due, thus there is no penalty. However, there is a push by some in Congress and at the IRS to make a mandatory "late filing penalty" regardless whether tax is due or not. If that happens in the future, not filing a timely Form 709 Gift Tax Return could be costly.

Does the gift have to be in cash?
No, the annual amount is a value. Thus, the gift could be comprised of cash or check, jewelry, property, or other items of value. If the total value exceeds the annual limit a Form 709 needs to be filed.

> **Example:** Grandma promised her grandson, Johnny, that if he graduates from college with a GPA of 3.0 or better, she will buy him a car. Grandma buys Johnny a brand new car worth $25,000 and puts the car in Johnny's name. Grandma has exceeded her 2016 annual exclusion by $11,000 and needs to file a Form 709 Gift Tax Return. However, if Grandma convinces Grandpa that is a good idea and they give the car to Johnny, in essence, they have each given only $12,500 and have not exceeded their annual exclusion.

If I only give the annual exclusion (currently $14,000), am I in total compliance?
Probably, but be careful. Many write checks at the end of the year for the current annual exclusion ($14,000 in 2016 and 2017) but also give small graduation gifts, anniversary gifts, etc. throughout the year and that would push the total annual gifts over the annual exclusion.

Is there any way to save taxes by gifting money to friends or relatives?
Yes, but it takes some planning. You can give property or other items that have gone up in value to a recipient and avoid the tax on the appreciation. The flip side is that the recipient gets your low tax basis in that property and if they sell it, they pay the tax on the gain at that time. So, if they are in a low or zero tax bracket, overall income taxes can be reduced or eliminated.

> **Example:** Snow White wants to sell all of her Apple stock (she dislikes apples of all types) and use the proceeds to give $14,000 to each of the Seven Dwarfs. But, her basis is $10 a share and Apple is worth around $120 a share. If Snow sold the stock she would pay tax on the gain of $110 a share. Even Prince Charming can't make that any better. So, Snow White transfers $14,000 worth of Apple Stock to the brokerage account of each Dwarf. This allows her to give gifts without having to pay tax on the appreciation of the stock. Evidently, only one of the Dwarfs sold his Apple shares and had to pay the taxes on the gain, and that made him Grumpy.

Generosity is to be commended. Your personal circumstances may make your gifts greater than the annual gift exclusion per recipient. Even if that is the case, for most Americans no tax will be due, but a Form 709 Gift Tax Return might be required. If you notice that your generosity involves giving more than the annual gift exclusion ($14,000 in 2016 and 2017) to any one person, please give us a call and we can discuss what forms and deadlines might be necessary.