Estate Planning Insights

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TAXABLE GIFTS: COMMONLY MISUNDERSTOOD

Newsletter Delay. We apologize for the delay in sending this newsletter. For nearly ten (10) years, we have sent quarterly newsletters "like clock work" (to review those prior newsletters, go to the "Reference Center" on the firm's website, www.gerstnerlaw.com). The law firm has been "short-handed" since September 2013, so that is the primary reason for our delay in getting out this newsletter. (We are still short-handed, and continue to interview candidates to fill vacant slots. So, if you know any experienced legal assistants, paralegals or attorneys who are smart, careful, professional and personable, please send them our way.)

Expert Witness Cases. Karen Gerstner was recently involved in two litigation matters as an "expert witness." Expert witnesses are allowed to testify in certain cases to help the jury understand complicated issues. One of the pending cases involved the failure of a now deceased person to file a federal gift tax return to report a "taxable gift." In this particular case, a special election called the "QTIP election" was also involved. As a result of that failure to file a gift tax return, the decedent's estate owed unpaid federal gift taxes, interest and penalties dating back to 1985. As you can imagine, the total amount was sizeable.

The Federal Gift Tax. Over the years, we have discovered that many of our clients simply do not understand the federal gift tax rules and, especially, what constitutes a "taxable gift." First, note that Texas does not have a state gift tax. Only two states in the United States impose a state gift tax: Connecticut and Minnesota. Thus, most people who make gifts only have to understand and comply with the federal gift tax rules. NOTE: The federal gift tax is imposed on the gift-giver, not the recipient.

Let's start with some basic definitions:

Donor: a person who makes a gift–i.e., the gift-giver

Donee: the recipient of a gift–i.e., the beneficiary

Gift: a transfer of *anything of value* from the donor to the donee that isn't a sale at fair market value

Taxable Gift: a gift that must be *reported* on a federal gift tax return by the donor (regardless of whether gift taxes are payable or not), that uses up some or all of the donor's lifetime gift tax exclusion

Lifetime Gift Tax Exclusion Amount: the total amount of taxable gifts that a donor can make during life, in the aggregate, before federal gift taxes have to be paid (currently, $5,340,000)

Annual Gift Tax Exclusion Amount: the total amount that the donor can give to *each* donee in a particular year (a "tax-free gift"), without having to use any of the donor's lifetime gift tax exclusion amount to avoid paying gift taxes on that gift

Medical and Tuition Exclusion Gifts: "tax-free" gifts that the donor makes on behalf of the donee by paying medical and/or tuition amounts *directly* to the provider (e.g., to the hospital or university)

Value of a Gift: the value of a gift is the *fair market value* of the gifted asset on the date when the gift is made

Carryover Basis: if the gift is a gift other than cash, the donee who receives the gifted asset will have an income tax basis in that asset equal to the donor's income tax basis (or, cost basis) prior to the transfer

Taxable Gifts. All "taxable gifts" made by a donor in a particular year must be *reported* by the donor in a timely filed federal gift tax return: Form 709, US Estate (and Generation-Skipping Transfer) Tax Return (sometimes referred as a "Form 709" or as a "federal gift tax return"). The federal gift tax return is due by April 15 of the year following the year when the gift is made, although the due date can be extended by extending the due date of the donor's federal income tax return. Note that the same form–Form 709–is used to report *both* taxable gifts and generation-skipping transfers (and to make affirmative allocations of GST exemption).

In general, a *taxable gift* is a gift that does not qualify for the medical and/or tuition exclusions and that has a total value exceeding the annual gift tax exclusion amount for that year. The gift tax annual exclusion amount for 2014 is $14,000. Thus, if a widow makes a gift of $20,000 to her only child in 2014, she has made a taxable gift of $6,000. The widow must report that taxable gift to the IRS in a federal gift tax return. If she has not previously used the full amount of her lifetime gift tax exclusion, then she likely has sufficient exemption to avoid owing any gift taxes on that taxable gift. She will, however, use up $6,000 ($20,000 - $14,000) of her lifetime gift tax exclusion amount on that gift.

Why must taxable gifts be reported even if no gift taxes are currently payable? First, because it's the law and, therefore, failure to file a federal gift tax return to report taxable gifts is gift tax fraud. Second, because filing a Form 709 each time the donor makes a taxable gift keeps track of the total of all taxable gifts made by that donor through the end of the last reporting year. This aggregate amount is important and relevant. Taxable gifts attract (i.e., use up) some of the donor's lifetime gift tax exclusion amount and, at the same time, decrease the amount of the donor's estate tax exclusion available for transfers made by the donor at death. So, filing gift tax returns keeps track of how much exemption has been used and how much exemption remains.

Another way to think about taxable gifts is to imagine that the government gives everyone a pre-loaded gift card, and each time a person makes and reports a taxable gift, his card is being swiped to deduct the amount of that taxable gift. The remaining amount on the card will be the remaining amount of the donor's transfer tax exclusion amount at death, more or less (ignoring annual inflation adjustments to the exclusion amount and gifts made in the year of death).

In essence then, the term, *taxable gift*, basically means a *reportable* gift and does not necessarily mean that the donor has made a gift that will require the donor to pay gift taxes at that time.

CAVEAT: Present Interest. In order for a gift to qualify for the annual exclusion from the federal gift tax, it must constitute a "present interest." Basically, a present interest means that the donee has full and immediate access to the gifted asset. In most cases, that requirement is easily satisfied. Outright gifts from the donor to the donee clearly qualify. However, gifts made to most trusts do not constitute present interest gifts. That is why trusts that do not themselves qualify for present interest treatment (such as "2503(c) trusts") must give the beneficiary of the trust the right to withdraw the amount given to the trust (or a defined portion of the amount given to the trust) in order for the amount over which the beneficiary possesses the withdrawal right to be treated as a present interest gift. This withdrawal right is commonly referred to as a *Crumme*y withdrawal power (based on the name of the taxpayer in a federal tax case who used this technique and received the court's blessing). Trusts that give beneficiaries this type of withdrawal right are sometimes referred to as *Crummey trusts*.

Fair Market Value. As noted, the value of a gift for federal gift tax purposes is the fair market value of the gifted asset on the date of the transfer. In general, *fair market value* is defined as the price at which an asset would sell on the open market (i.e., to an independent person). It assumes that there is a willing buyer and a willing seller, that both parties have knowledge of all relevant facts, and that neither party is under a compulsion to act (i.e., to buy or sell). Some assets, such as cash and publicly traded securities, have a clear fair market value. For example, per IRS regulations, the fair market value of publicly traded stock is the mean (average) of the Hi and Lo reported prices on the date of the gift (and *not* the Closing price on that date).

Some assets do not have a readily ascertainable fair market value. Examples include real property, business interests, art, etc. Thus, in those cases, a qualified appraiser will need to evaluate the asset based on applicable valuation principles and prepare a written opinion (an appraisal) of the fair market value of the gifted asset on the date of the gift. That written appraisal report would then be included with the federal gift tax return filed by the donor.

There are some gifts that people may not even realize are gifts. For example, if you lend a relative $50,000 and later decide to forgive the amount owed to you (and it exceeds $14,000), you have made a taxable gift. Or, if you guarantee a loan for another person, that guarantee has a value and that value could be large enough to constitute a taxable gift. Remember that taxable gifts are *reportable* gifts that use up some or all of your lifetime gift tax exclusion amount. You may not have to pay any gift taxes on a taxable gift–it depends on how many taxable gifts, in the aggregate, you have made and how much gift tax exclusion amount you still have left.

No Statute of Limitations on Unreported Taxable Gifts. Note that there is no statute of limitations on unreported taxable gifts. When the donor dies, the IRS can assess gift taxes, interest and penalties for unreported gifts made during life, going all the way back to the date when the gift was made. Thus, if a person made a taxable gift during life and never reported it on a federal gift tax return, the Executor of that person's estate must file (and should file) a *late* gift tax return to report that taxable gift. Remember that Executors have personal liability for all taxes owed by the decedent. Also, in most situations, if gift taxes should have been paid when the unreported taxable gift was made, then interest and penalties on the unpaid gift tax amount will accrue until paid, making the total amount due much higher than it otherwise would have been.

Carryover Basis vs. Step Up In Basis. In our April 30, 2012 newsletter, we discussed the difference in the tax basis for the donee of receiving an appreciated asset as a gift during the donor's life versus inheriting that same asset on the donor's death. From an income tax standpoint, it is better to inherit an appreciated asset on the death of the donor than to receive that same asset as a gift while the donor is living because assets that have appreciated in value get a "step up" in income tax basis on the donor's death. In view of the fact that the current estate tax exclusion amount is $5,340,000, very few estates will be subject to federal estate taxes on the donor's death. Thus, this adjustment in tax basis on the donor's death will be a "tax-free step up in basis," something very valuable under the tax code. So, it may not make sense for most donors to give away appreciated assets during life, at least from the standpoint of the donee's basis in the asset received.

Possible Changes to Gift Tax Annual Exclusion. The Treasury Department has released its revenue proposals (often called the "Greenbook") for fiscal year 2015. One of the Greenbook proposals is to change the rules regarding the gift tax annual exclusion. The $14,000 per donee annual gift tax exclusion would still be available for an unlimited number of outright gifts and gifts to certain "vested interest" trusts, such as 2503(c) trusts. However, with respect to gifts made to *Crummey trusts* (and other non-outright gifts), each donor would have a $50,000 annual limit, in the aggregate. The good news is that this amount would be available regardless of whether the gift qualifies as a present interest (or not). The bad news is that this is a per donor limit, not a per donee limit. Of course, this proposal may not make it into law.

Executor Liability. Over the years, we have pointed out that an Executor has personal liability for all taxes owed by the decedent. That is one reason why it is foolish for an Executor to distribute all estate assets prior to ascertaining whether the decedent owes any taxes of any type (income taxes, "nanny" taxes, estate taxes, gift taxes, employment taxes, corporate taxes, etc.). In a recent case, the administrators of a decedent's estate were held personally liable for all of the decedent's unpaid income taxes. *See US v Robert Shriner*. The administrators had made large distributions from the decedent's estate to the beneficiaries prior to determining whether the decedent owed any taxes of any type. Once they discovered the decedent's unpaid income taxes, it was too late to get any of the distributed money back from the beneficiaries. So, the Executors ended up being personally liable for paying those taxes.

Related to this liability exposure is the Executor's duty to file gift tax returns to report all previously unreported taxable gifts made by the decedent during life. Therefore, make sure that you timely report all taxable gifts you make during life so that you don't cause a problem for the Executor of your estate.

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Karen S. Gerstner & Associates, P.C. **April 30, 2014**

Continuing with our final theme of "Executor liability," we want to urge our clients, once more, to avoid titling *all* their "after-tax accounts" in a manner that causes the funds or assets in those accounts to be distributed directly to named beneficiaries upon death. By saying "after-tax accounts," we are *excluding* assets that pass solely by beneficiary designation form on death, such as employee benefit plans, retirement accounts, IRAs, life insurance and annuities. Instead, we are referring to "regular" accounts, such as checking, money market and savings accounts, CDs, and brokerage and investment accounts holding stocks and bonds. You are not required to place a beneficiary on these types of accounts. If there is no named beneficiary (and if these accounts are not titled in the name of your Living Trust before death), then these accounts will be distributed pursuant to your Will when you die. Thus, your Executor will have possession of these accounts after your death. This is important because your Executor needs funds to pay your funeral expenses, debts, including final medical expenses and final income taxes (and all other taxes you may owe), property taxes and other real property expenses, support and maintenance amounts to your spouse and children during the post-death administration period, and post-death estate administration expenses, such as legal fees and accounting fees. Thus, if you put beneficiaries on ALL of your accounts, you may be placing your Executor in a precarious position (i.e., without any funds to pay your post-death expenses and taxes, triggering personal liability for your Executor). So, we urge you not to use JTWROS, POD and TOD on all of your accounts, despite your banker and broker urging you to do that to "avoid probate." There are better ways to avoid probate than using these account arrangements, such as creating a Living Trust and fully funding it before you die.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above. You can also reach us by email addressed to:

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