Understanding Gift Tax and How to Minimize It

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By Kara Morin, Director of Client Services

While it may seem esoteric, understanding gift tax is very helpful if you're working on a life income gift that benefits someone in addition to, or other than, the donor. In these situations, the donor is making two gifts: one to the charity and one to the income beneficiary, and this second gift may be taxable.

It is also helpful to have a basic understanding of gift tax when you're discussing an estate gift, since gift tax and estate tax are linked together by the "Unified Credit." This credit is applied to gifts that would otherwise be taxable transfers, whether made during lifetime or at death.

Lastly, having an understanding of gift tax enables to you to do some "Monday morning quarterbacking" when gift tax is in the news, as it has been recently with reporting on gifts received by Supreme Court Justice Clarence Thomas (luxury vacations), his mother (free rent), and his grandnephew (tuition payments), from Texas billionaire Harlan Crow. Were the gifts taxable? If so, who was responsible for the tax? And if not taxable, were they reportable to the IRS? It's a conversation perfect for a tailgate at the Heckerling Institute on Estate Planning. So, grab a metaphorical hotdog from the grill, and let's dig in.

Gift Tax Basics

Gift tax evolved in direct response to a gaping loophole in estate tax law: the opportunity for an individual to avoid estate taxes by transferring or giving wealth to their heirs while still alive.

To make sure that wealth transfer was taxed, Congress instituted the gift tax and developed the Unified Gift and Estate Tax Rates in order to limit any tax advantage for gifts during lifetime.

In order to avoid reporting for small or nominal sized gifts, they put in place an Annual Gift Tax Exclusion: an amount that can be given each year to an unlimited number of recipients without the need to report a taxable gift. The Annual Exclusion for 2023 is $17,000. The amount of the

Annual Exclusion is adjusted for inflation in even $1,000 increments, so every few years it increases by a full thousand dollars.

Later, as a way to limit what had become known as the "death tax," Congress introduced a complex credit against the Unified Gift and Estate Tax. The "Unified Credit" is available to pay the tax on taxable transfers, either those made as gifts during lifetime or at death. It is often forgotten that the Unified Gift and Estate Tax begins at 18% and, like the income tax, is a progressive tax with rates increasing in brackets reaching 40% at $1 million (you can find the current Unified Gift and Estate Tax Schedule in the Help field of *PGM Anywhere*).

Commonly, we speak of a "tax free" estate. For example, in 2023 estates up to $12,920,000 ($25,840,000 for married couples) can pass "tax free." But, behind the scenes, there is a Federal Gift and Estate Tax liability which is being covered by a tax credit on taxable transfers *including gifts made during lifetime or at death*.

The Unified Credit – and therefore the "tax free" amount – is adjusted for inflation each year. Unlike the inflation adjustment for the Annual Gift Tax Exclusion, which changes only in $1,000 increments, the Unified Credit amount is adjusted each year.

So, let's sum up what this means for practical purposes. 1) Every gift is at least potentially subject to the Unified Gift and Estate Tax. 2) But, thanks to the annual gift tax exclusion, up to $17,000 can be given to an unlimited number of recipients each year without the need to report the transaction. 3) However, if the gift exceeds $17,000, then it must be reported. 4) However, the Unified Credit will cover the taxes until the cumulative total of lifetime gifts exhausts the Unified Credit which, in 2023, happens at $12,920,000.

Not Taxable But Still Reportable

If you make a gift that uses part of your Unified Gift and Estate Tax exclusion, you need to file Form 709 by the following April 15. Unlike most other tax forms, Form 709 is *cumulative,* meaning it chronicles an individual's lifetime of reportable taxable gifts (those in excess of the Annual Exclusion amount, which is $17,000 in 2023). Additional pages are added over time as new taxable gifts are made, so that each time it is submitted to the IRS the tax filer's entire history of taxable gifts is reported.

And, it is not just big gifts that need to be reported. Let's imagine I decide to give every reader of this newsletter $17,000. Because my Annual Gift Tax Exclusion of $17,000 is *per recipient*, I can do so without triggering the gift tax or filing Form 709. But, if I give each reader $17,00**1**, that extra dollar would have to be reported to the IRS on Form 709.

This does not mean that the extra dollar would be immediately taxed. I would first apply part of my Unified Credit, which would cover the Unified Gift and Estate Tax on a cumulative total of $12,920,000. But if this article becomes wildly popular and is read by 13,000,000 readers, I will exhaust my lifetime gift tax exclusion, and I will have to pay a gift tax. That is, unless I can convince my husband to join me in my gift giving. Married couples can combine their Annual

Exclusions, enabling a couple to make tax-free transfers of up to $34,000 per recipient in 2023 without incurring gift tax. So, if my husband agrees to spot me that extra $1, there would be no need to report the gifts unless the total per recipient exceeds $34,000.

How to Minimize Gift Tax

There are two ways in which I could support readers without paying gift tax or using up my Unified Credit: I could make unlimited gifts to individuals by *paying directly for medical care or school tuition.*

Even if I give every reader of this article $17,000, I could also pay a tuition or hospital bill without triggering the gift tax as long as I pay the school or hospital *directly* and report my generosity on Form 709. There is no ceiling to the medical expenses or tuition. Even if a reader's tuition is $100,000 a year, provided my check goes straight to the university's bursar, I don't have a gift tax issue.

Lastly, there is an unlimited right to make gifts to a spouse, provided they are a U.S. citizen. If they are not a U.S. citizen, there's an expanded annual exclusion, indexed for inflation. This year that amount is $167,000. After exhausting that amount in a given year, the combined gift and estate exclusion can be applied.

Now or Later? How to Structure Life Income Gifts to Minimize Gift Tax Reporting

A life income gift that benefits someone other than, or in addition to, the donor, may trigger a gift tax on the beneficiary's right to life income. As with outright gifts to individuals, the donor can use their Unified Gift and Estate Tax Credit to offset the gift tax, and, under certain circumstances, can also use their Annual Gift Tax Exclusion.

To qualify for the Annual Exclusion, the gift must be of a present interest. To turn a CGA into a gift of a present interest, the right to revoke must be removed. Doing so transforms a gift of payments in the future into a gift of life interest now, thereby making it a completed gift. If the value of the beneficiary's interest is under the Annual Exclusion amount ($17,000 for 2023), then the gift is not taxable and need not be reported on Form 709.

If the beneficiary's interest in a CGA exceeds the Annual Exclusion, but the annual payments are less than the Annual Exclusion, keeping the right to revoke in the agreement is the better option. Keeping the right to revoke in the CGA allows the donor to treat each year's payment to the beneficiary as an annual gift to the annuitant. If the annual payment is below $17,000 (in 2023), then there is neither a gift tax nor a Form 709 filing requirement.

For CRTs, removing the right to revoke interest converts the future interest into a present interest, and the Annual Exclusion can be applied. However, the donor will still have to file Form 709.

Ultimately, whether to complete the gift now or later is an individual decision that the donor should make with their tax advisor.

Gift Tax Exclusion Set to Reduce in 2025

The Tax Cuts and Jobs Act of 2017 doubled the Unified Credit, therefore doubling the total amount that can be passed tax free either during lifetime or at death. However, the higher Unified Credit is time limited. Unless Congress acts, the current Unified Gift and Estate Tax exemption amount will be cut approximately in half at midnight on December 31, 2025, returning the exemption to pre-2018 levels. This means a reduction of approximately $6.2 million per individual (and $12.4 million per married couple) in the amount that can be transferred tax free beginning on the first day of January 2026.

The good news is that even if the Gift and Estate Tax exclusion drops to pre-2018 levels, any individual who chooses to take full advantage of the higher level now, maxing out their lifetime exclusion by the end of 2025, will not be adversely affected when the exclusion amount drops. There is no “claw back” of exclusions “spent” during the heyday between 2018 and 2025.

Gift Tax Tailgate

Based on the rules covered in this article, if we met in line for cheeseburgers at a gift tax tailgate, where would you come down on Mr. Crow’s gifts?

The tuition payments for Justice Thomas’s grandnephew? A softball – non-taxable but required to be reported on Form 709.

The free rent for Justice Thomas’s mother? If the value is $17,000 or less a year, then neither taxable nor reportable. If more than $17,000 a year, reportable and potentially taxable. But if the value of the free rent is below $34,000, then Mr. and Mrs. Crow could combine their annual exclusions and wipe out any gift tax.

And those luxury cruises for Justice Thomas? I’m still mulling whether they’re private transportation or a floating party. But if they are found to be taxable, time is not on Mr. Crow’s side. The clock is ticking on his ability to use the present high level of gift tax exclusion, and a conservative approach would be to report them and assign part of his lifetime gift tax exclusion while he still has $12.92 million to spend.