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UNDERSTANDING THE GIFT TAX

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The gift tax is the most misunderstood of all taxes. Most people will never pay it, but it could cost their heirs extra estate tax. Understanding its impact, knowing how to avoid it, and when you must file a gift tax return are important.

Theory Behind Tax

The federal gift tax was enacted to prevent people from giving away their assets before they die in order to avoid estate tax. The gift tax is paid by the donor, not the recipient of the gift. There is an annual limit on how much you can give any one person before paying gift tax. There is also a lifetime exclusion of $1 million before any tax is due (the lowest rate is the same as the estate tax at 45%).

Interplay With Estate Tax

If gifts are made that exceed the annual exclusion, the excess amount counts against the lifetime $1 million limit. Any reduction in your lifetime gift tax exclusion reduces the corresponding exemption amount your estate has before paying estate taxes. The current estate tax exemption amount is $2 million. If you use $250,000 of your lifetime gift tax exclusion to make a gift to your son, then upon your death your estate tax exemption is reduced to $1,750,000. You will not pay any gift tax if the total of your lifetime gifts stays below the $1 million lifetime exemption, but your estate tax exclusion would be reduced by that number.

Annual Gift Tax Exclusion

For 2008, you can give up to $12,000 to as many different recipients as you want without any gift tax consequences. This exclusion starts over each year and is increased by inflation. You do not need to file a gift tax return for gifts under $12,000. For example, you and your spouse may give a combined $24,000 every year to each of your children and/or grandchildren without gift tax consequences. As a matter of fact, you could give $12,000 to anyone (yes, even a stranger walking down the street) without incurring gift tax.

You and your spouse can give an asset that is titled solely in your name and worth more than $12,000 (but less than $24,000) without incurring gift tax, but you must file a gift tax return to explain what you've done. If you "split" your gift in this fashion, a gift return must be filed by the first quarter of the year following the gift to utilize the spouse's exclusion.

Gifts Subject to Gift Tax

Gifts subject to gift tax do not have to be in the form of cash. Paying the debts of your adult grandchild is a gift. Loaning $10,000 or more at below market rates is a gift to the extent of the below market amount. Putting money in a custodial account for your child is a gift to the extent it is not used for legal obligations of the parents for the child. Contributions to a child's or grandchild's 529 college savings program is a gift.

Gifts not Subject to Gift Tax

Gifts to a spouse are not subject to gift tax regardless of amount. In addition to annual gifts up to $12,000, payments made (by anyone) directly to a school for tuition for the benefit of another person are not subject to gift tax. However you must make payments directly to the school. Reimbursing the person who actually paid the tuition bill will not qualify. Please note that payments for room & board, books, fees, etc. do not qualify for this favorable tax treatment.

In addition, direct payments made to hospitals and doctors for medical bills are not subject to gift tax. This also includes direct payments for medical insurance (including long term care) and transportation for medical care.

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Income Tax Effects of Gifts

If you give non-cash items like stocks or real estate, there are no income tax consequences for the recipient at the time of the gift. However he/she will generally assume your tax basis. When the asset is sold, the taxable gain will be the same as it would have been if you sold it. (although the capital gain tax rate may be lower for the recipient)

Advantages of Making Gifts

Making gifts up to the annual exclusion amount each year will reduce your taxable estate and could save estate taxes. Moreover, gifting appreciating property even if over the annual exclusion amount may also be beneficial because subsequent appreciation will likewise escape estate tax. In some cases gifting assets to loved ones in a lower income tax bracket may also reduce overall taxes (but watch out for the "kiddie tax").

Disadvantages of Making Gifts

As noted above the recipient of a gift takes a carry-over income tax basis; whereas, an heir at death takes a stepped up basis equal to its fair market value.

Filing Gift Tax Return

If you give over $12,000 to any recipient or elect to split a gift of up to $24,000 between husband and wife, you need to file a gift tax return Form 709 with the IRS by April 15th of the year following the gift.

We would be happy to answer any questions on this topic. Contact your Relationship Manager about your specific situation.

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