The Case for the Continuing Relevance of the Gift Tax

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With the passage of the Tax Cuts and Jobs Act of 2017 (the 2017 Tax Act) the lifetime exemptions from estate, gift and generation skipping transfer tax (GST) more than doubled from an already steep $5,490,000 to a cliff-hanging $11,180,000 as of January 1, 2018. As in the past, these exemption amounts continue to be adjusted for inflation leaving us with a gift tax exemption of $11,400,000 as of January 1, 2019. New York State repealed its gift tax back at the turn of the millennia, so the gift tax is strictly a federal phenomenon for New Yorkers.

In general, a federal gift tax is imposed on the transfer of property by gift in each calendar year (per IRC Section 2501). The gift tax is computed as set forth in IRC Section 2502, but the applicable rate of tax on gifts is the same as that for the rate of tax on estates and is set forth in IRC Section 2001. The maximum gift tax rate for gifts made in 2019 is 40%.

There is currently an exclusion from gift tax of up to $15,000 per donee on gifts of a present interest made by an individual taxpayer in 2019 (IRC section 2503). However, couples may exclude gifts of either $15,000 each or up to $30,000 for gifts made by either, if a gift-splitting election is made (IRC Section 2513). Gift tax returns are due on the same day as your personal income tax return, on or before April 15 of the calendar year following the year in which the gift is made.

With the exemption from gift tax set at $11,400,000 in 2019. that means a couple may exclude up to $22,800,000 under current law and this figure is expected to climb each year, as it is adjusted for inflation, until at least December of 2025, after which the relevant portions of the 2017 Tax Act are scheduled to sunset unless Congress takes action to the contrary.

With exemptions as high as those allowed under current law, why would anyone be concerned with planning for the gift tax and for that matter what motivation if any is there to file gift tax returns to report gifts in excess of the annual exclusion amount? Below I will outline five reasons why the filing of gift tax returns is still quite relevant and even critical in some cases.

1. Gift Tax Filings Are Required by Law

For starters, the filing of a federal gift tax return is required by law for persons making gifts of a present interest in excess of the annual exclusion amount in any calendar year. No annual exclusion is allowed for gifts of future interests. A gift of a present interest is a gift of something in which the donee will receive an immediate interest such as the outright transfer of cash or publicly traded securities, as opposed to the gift of a future interest such as the right to receive the remainder of a trust after a term of years or the death of another. In fact, the failure to file a gift tax return could result in the penalty of up to 25% of the tax shown to be due on a gift tax return (5% per month for up to 5 months). There is also a penalty for failing to pay, of up to 5% of the tax determined to be due, but the failure to file penalty will be offset to the extent of any failure to pay penalty. In fact, if the IRS determines your failure to file to be fraudulent the maximum penalty increases to as much as 75% (15% per month for up to 5 months). That being said, no failure to pay or failure to file penalty is imposed if no tax is due.

2. The Gift Tax Exemption Could Fall after 2025 or Sooner

The increase in the estate, gift and GST exemptions, like so many other facets of the 2017 Tax Act is set to sunset after 2025. If the 2017 Act is allowed to sunset, then the exemption will return to 2017 levels adjusted for inflation. As noted above the 2017 exemption amount was a mere $5,490,000, less than half of the current exemption. The fate of those colossal sun setting exemption amounts will depend largely on how the political winds are blowing in 2024. In fact, there is nothing to prevent a reduction in the estate, gift and GST exemptions below 2017 levels if future occupants of Congress and the White House deem it prudent to do so. As a case in point, democratic presidential candidate Elizabeth Warren recently proposed bringing the estate tax exemptions back down to 2009 levels which would be $3,500,000.

3. For Those with an Estate in Excess of the Exemption Amount Planning Is Critical

The gift tax exemption has always been used as a tool to garner substantial estate tax savings by astute planners and their clients.

The Estate Freeze is a technique by which rapidly appreciating assets are gifted now at today's values allowing all future appreciation in the gifted assets to escape estate taxation. Today's top marginal estate tax rate of 40% is twice that of the top capital gains rate of 20% so substantial savings can be achieved through the proper use of this technique. In fact, a properly drafted grantor trust will even provide the grantor with the ability to mitigate capital gains, to some degree, through asset swaps which makes the loss of the basis step-up on death less critical.

To illustrate the power of this technique assume the following:

- With compound growth of 5%, a $10,000,000 investment could grow to nearly $18,000,000 in just 12 years.
- At 40% the estate tax rate on growth of $8,000,000 would be $3,200,000.
- On the other hand, the capital gains tax of $1.6M ($8M @ 20%), which would result on sale from this appreciation, would be half of the estate tax and an easier pill to swallow.
- However, as mentioned above, with a properly drafted intentionally defective grantor trust commonly referred to as an "IDGT," a grantor retaining the power to substitute trust assets for fair value could swap high basis cash for the low basis appreciated capital assets held by the Trust thereby achieving a step-up and further increasing the tax savings to as much as $3,200,000 under ideal circumstances.
- Further, the low interest environment that has prevailed for the past decade may even justify having the grantor borrow money in order to make the swap.

Other reasons why gift tax planning and reporting is still critical include the following:

- The gift tax statute of limitations does not begin to run until the later of three years after the due date of a gift tax return or the date of filing. If a gift tax return is not filed, the statute of limitations does not begin to run. For taxpayers who fail to file gift tax returns, there is a risk that years later, perhaps even after the death of the taxpayer, the IRS may claim gifted property had a far higher value than that claimed by the taxpayer which could result in substantially higher gift and or estate taxes as may be applicable. The IRS may not make this argument once the gift tax statute of limitations has expired, provided that all disclosure requirements are met on the return.
- The New York Estate Tax kicks in, as of 2019, at an exemption level of $5,740,000, which is just over half of the current federal exemption of $11,400,000. Further, the benefit of the New York Estate Tax Exemption is completely phased out for estates that exceed the exemption level by just 5%. This phenomenon is known as the New York Estate Tax Cliff and can result in dramatically different tax outcomes for decedents with estates just a few thousand dollars

apart. For example, a New York decedent with a taxable estate of $5,739,000 would pay no New York State Estate Taxes, while a decedent with a taxable estate of just $6,050,000 would pay a New York Estate Tax of $516,800. Since New York State does not have a gift tax and does not include adjusted taxable gifts in its calculation of the New York State Estate Tax, substantial savings can be had by making gifts. For example, if the taxpayer noted above had made just $310,000 of gifts prior to death reducing their estate from $6,050,000 to $5,739,000, they would not incur any of the $516,800 of estate tax that would otherwise have been incurred. During the phase-in period of New York's increased estate tax exemption there was a clawback rule in place that brought gifts made within three years of death back into the estate for estate tax purposes. This rule was in place for gifts made between January 1, 2014 and December 31, 2018, but does not apply to gifts made after December 31, 2018.

- Even when relatively modest gifts are made, gift tax reporting is very important for taxpayers with potentially taxable estates in order to keep track of any Decedents Unused Estate Tax Exemption (DSUE), a surviving spouse may have.
- Even when the only gifts made are annual exclusion gifts, taxpayers with potentially taxable estates will need to file in order to keep track of their remaining Generation Skipping Transfer Tax Exemption to which the annual exclusion may not apply for gifts to GST Trusts with more than a single beneficiary.

4. Gift Tax Returns Are a Good Way to Keep Track of Basis.

Taxpayers are supposed to report their basis of gifted property on their gift tax returns. Gift tax reporting allows both the IRS and the taxpayer to keep track of basis. A taxpayer is far more likely to be able to go through his or her records at the time of gift to come up with the carryover basis that the recipient of the gift will be receiving than the recipient of the gift years, in some cases decades, later when the stock is sold.

5. Proof of Donative Intent

Over the years, I have found that a good non-tax reason for filing a gift tax return is to establish proof of donative intent, in the event that donor's intention to make a gift is called into question during litigation after the death of the taxpayer years later.

Conclusion

As noted above, there are a number of tax and non-tax related reasons why gifting and gift reporting can still be useful and, in some cases, critical. Yes, it is true that the exemption from estate and gift tax more than doubled from $5,490,000 on December 31, 2017 to $11,180,000 on January 1, 2018 guaranteeing that fewer people will be subject to estate and gift taxation over the next few years. However it is equally true that, if Congress fails to take action to the contrary, those same exemptions will be cut back to 2017 levels when many of the nonpermanent provisions of the 2017 Tax Act are slated to sunset on January 1, 2026, with adjustments for inflation. In the meantime, for high net worth clients across the country, the estate-freezing benefits of gifting are still very relevant. Finally, gifting and gift tax reporting continues to be particularly relevant for New York residents who are close to the State's more modest exemption, currently $5,740,000, and would like to avoid the cost of falling off the steep cliff of taxation that awaits those who exceed 5% of the New York State exemption amount.

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- Eighteen Billionaires Call for a Wealth Tax (/news/publications/the-trusted-professional/article/eighteen-billionaires-call-for-a-wealth-tax-062419)
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