The Spirit of Gifting

One of the greatest feelings in life is the ability to give to others. What makes it even better is when you can receive a tax break by doing so. Distributing one's wealth in the most tax advantageous way during life and at one's death is a key financial planning consideration. Let's examine the advantages and guideposts for gifting effectively.

Defining Annual Gift Exclusion

The annual gift exclusion is the amount of money that a person may transfer to another as a gift without incurring a gift tax or affecting the unified credit. Gift tax is a federal tax on any gifts you give during the year that are worth more than the annual gift tax exclusion, which is $17,000 for gifts given in 2023. This is up from $16,000 in 2022. There are no state gift taxes. This annual gift exclusion can be transferred in the form of cash or other assets.

How Does the Annual Exclusion Work?

The annual exclusion applies to each gift made. For gift tax purposes, a gift is any money, property, or other asset that you give someone else without the expectation that they will pay you back. This includes giving money in any form, interest-free loans, real estate, personal possessions, and intangible assets like stock options.

If you sell something for less than its fair market value, then what you sell also qualifies as a gift. Fair market value (FMV), is the amount you can reasonably expect someone to pay if you sold something on the open market. The difference between the sales prices and the FMV is the amount that counts as a gift. For example, if your antique car is reasonably worth $50,000 but you sell it to your son for $10,000, then you have given a gift of $40,000 ($50,000 - $10,000) and will need to file a gift tax return for that $40,000.

Here's another example: If you gift to each of your children, each amount will be considered for an annual gift exclusion separately. Generally, gifts are a taxable event, with some exceptions. The following gift exceptions are not taxable:

- Gifts that are less than the year's annual exclusion
- Spousal gifts
- Medical expenses (must pay the medical facility directly)
- Tuition expenses (must pay the educational institution directly)
- Political gifts

Qualifying charitable gifts are also deductible from the value of the gift made. Otherwise, taxpayers cannot deduct the value of gifts they make. For more information, please refer to IRS Publication 559, Survivors, Executors, and Administrators.

To qualify for an annual exclusion, taxpayers must submit copies of appraisals, copies of relevant documents regarding the transfer, and any documentation of unusual items shown on the return.

Giving away more than $17,000 requires you to complete a federal gift tax return, though you don't actually have to pay any tax until your combined lifetime gifts (in excess of the annual exclusion) exceed the lifetime gift tax exclusion, which is $12.92 million in 2023.

If your goal is to transfer assets to your heirs while minimizing taxes, a revocable trust is something to consider.

Lifetime Gift Tax & Estate Tax Exemption

Your lifetime gift tax exemption is also the same as your estate tax exemption and they are often referred to together as part of the unified tax credit. Estate tax applies when your estate, which is the sum of all the money, property, and assets owned, is transferred after your death. It should be noted that very few people pay estate tax because you only need to pay on the value of your estate tax that exceeds the exemption amount.

For 2023, the lifetime gift tax exemption is $12.92 million. This means that if you are married, you and your spouse can give away a total of $25.84 million before paying the gift tax. These new exemption thresholds were established by the Tax Cuts and Jobs Act (TCJA), which expires in 2025. The federal estate and gift tax exemption more than doubled by the TCJA. Prior to the TCJA, this amount was around $5 million. It is reasonable to think that this estate tax exemption will change again, either up or down, in the future.

The $17,000 annual exclusion means you can give $17,000 to as many people as you like. This means you can give each of your three grandchildren $17,000 per grandchild in any given year, for a total of $51,000. Any gift you make to a single person in excess of $17,000 counts toward your combined estate and gift tax exclusion. This is the amount you are allowed to leave in your estate or give as gifts during your life, tax-free.

Digging deeper, let's assume you gift a grandchild $317,000 in 2023. You will exceed the annual exclusion by $300,000 and your lifetime estate exemption will also decrease by $300,000. If that was the only gift you ever gave, your new exemption is $12.62 million. At the time of your death, assuming the estate tax exemption rate remains unchanged, then your estate will only have to pay estate tax on its value exceeding $12.62 million.

What's Next?

It is nearly impossible to know when estate tax exemptions will change, particularly in light of the current pandemic and economic crisis. It is likely is that estate tax exemptions will change. What is critical is to discuss the potential impacts of estate tax exemption changes with your advisor every 12-18 months if you haven't done so already.

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