Season 1 – Episode 14 - Tax Blueprints: Demystifying the Annual Gift Tax Exclusion: Strategies and Implications

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Host: Daniel J. Rohr, CPA/PFS, EA, M.S. Tax

Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today we're diving deep into the workings of the annual exclusion for gift tax. At its core, the annual exclusion allows an individual to gift a certain amount to another person each year without triggering the gift tax. And for 2023, this amount is $17,000 per recipient. This means you can give up to $17,000 to as many individuals as you want in a single year without incurring any gift tax or using any of your estate tax exemption. However, if you gift an amount exceeding the 17,000 annual exclusion to a single individual in one year, the excess reduces your lifetime estate exemption. So, for instance, if you gift someone $27,000, the $10,000 over the annual exclusion will count against your lifetime estate exemption. That said, it's essential to understand that this doesn't imply you owe a tax right now. Instead, it's a cumulative calculation, meaning it reduces the total amount you can leave tax free upon your death.

With the current estate exemption being really quite high at $12,920,000 for 2023 for a single individual and it's double for married couples, many individuals might never actually reach the point where their gifts and estates combined exceed that threshold. Therefore, even if you use some of your lifetime exemption due to large gifts, you may never actually incur a tax. And provided the estate exemption remains significantly high, this underscores the power of gifting as a tax saving strategy. By transferring assets out of your estate while you're alive, you can effectively reduce the potential size of your estate that might be exposed to estate tax upon your passing, especially if you anticipate your estate growing significantly in the future. For married couples, you can elect to split gifts to an individual, and gift splitting is a technique that can effectively double the annual exclusion amount. Here's how it works.

So say you want to gift your child $34,000 this year, and normally this would exceed the $17,000 limit. But if you're married, you and your spouse can each gift $17,000, totaling the $34,000 without any tax implications. Now, gift splitting isn't automatic, and even if only one spouse provides the gift, both spouses must agree to split the gift. And when you choose to split, it mandates that you file a gift tax return on form 709, even if no tax is owed. This is because the IRS needs a record of the agreement between the spouses to split the gift. Another powerful use of the annual exclusion can be utilized with a 529 college savings plan. These plans are designed to allow for tax free growth and withdrawals for qualified education expenses. Now, the unique advantage of the 529 plan from a gifting perspective is the ability to front load your contributions.

This means that you can make a lump sum contribution equal to five years worth of the annual gift tax exclusion. So that's $85,000 in 2023 and that would not trigger a gift tax. So for couples who gift split the amount doubles to $170,000. The five year election effectively spreads the gift over a five year period allowing for a substantial contribution in one year without consuming your lifetime exemption. If you do make such an election, you can't make any additional tax free gifts to the same beneficiary within that five year window without reducing your exemption. Now, the strategy can be particularly powerful for grandparents or parents wanting to fund child's or grandchild's future education. It allows for a significant amount of money to grow tax free while simultaneously reducing the size of their taxable estate. And it's important to note that on any 709s that are filed to report a gift tax anytime that you file that throughout your life that return needs to be considered a permanent document.

And it's useful for when you pass away in case there is a potential estate tax. And what about the person receiving the gift? A common misconception is that the recipient of a gift has to pay tax on it. It actually isn't the case. The person receiving the gift isn't taxed on the gift itself. However, the type of gift can have future tax implications. When someone receives a gift they generally receive a carryover basis in the property. They essentially step into the shoes of the person gifting the property. So for example, if a parent bought a stock for $5,000 which is their original basis, and then gifts it to their child when it's worth $7,000, the child's basis is also the $5,000. And so if the child later sells the stock they would calculate their capital gain or loss using the $5,000 basis. Now, like most things in tax there are exceptions to the general rule and there's a dual basis rule regarding gifted stock as an example.

Now, the dual basis rule comes into play when the fair market value of the gift at the time of the gift is less than the donor's original basis. And here's where it can get more intricate. So let's use an example. Suppose a parent purchased a stock years ago for $10,000. Over time, the value of the stock decreased and when they decided to gift it to their child, it was only worth $7,000. In this situation, the child has a dual basis. And which basis they use depends on whether they eventually sell the stock at a gain or a loss if the child sells the stock for more than the parent's original basis. So more than $10,000, let's say $12,000, they would use the parent's original basis of $10,000 to determine their gain. So it'd only be a $2000 gain. Now, if the child sells the stock for less than its fair market value when they received it.

So less than $7,000, let's say $6,000, they'd use the fair market value at the time of the gift to determine their loss. So the loss would be $1,000, $7,000 minus the six if the child sells the stock for an amount between the donor's original basis and the fair market value at the time of the gift. So between seven and $10,000, there would be no taxable gain or loss. The dual basis rule ensures that the donee the child doesn't get a double tax benefit from a depreciated gift. They can't use the donor's higher original basis to calculate a capital loss and they also use the lower fair market value to calculate a capital gain. So what about gifting real estate? By gifting a home with equity to children, families might just not just pass down a roof and walls. But as mentioned earlier, they can also strategically move a valuable asset out of the estate, potentially paving the way for tax savings and consider a hypothetical situation.

So parents own a home worth one and a half million and intend to pass it to their children through their estate. But what if the house's value climbs over the years, potentially hitting a $3 million mark? This growth might push their estate value past the estate tax exclusion, opening the door to having an estate tax liability. And with that said, transferring the property to the kids now can expose the kids to tax liabilities. As I stated earlier, the children will step into the shoes of the parents in terms of the base of the property. So if the children sell the home, they will have a gain based on the difference from the selling price and the parents original cost basis. If the parents were to keep the home in their estate and the kids inherited the property, however, the children would have a stepped-up basis to the value at the date of death of the second parent.

This essentially eliminates any gain if the property is sold soon after the parent's passing. So it's a balancing act between the choices that you make depending on specific family situations. If we continue on with the gifting of real estate and its potential complications, I want everyone to keep in mind so what if the property has a mortgage? If the kids take over the mortgage, it's viewed as if the parents are accepting partial payment for the property. So a house worth $1.2 million with a $500,000 mortgage, if that's gifted to the kids and the kids take over the mortgage, it's perceived as a $700,000 gift and a $500,000 sale. And depending on how the property was used by the parents, this deemed sale can result in taxes owed. It's important to note that kids looking to assume the mortgage must of course be approved by the lender, which can be tricky if their credit worthiness is in question.

An estate planning Technique it is actually available if the parents are anticipating an estate tax and therefore want to remove the home from their estate, but they want to remain in the home. This can be accomplished with a qualified personal residence trust or QPRT. This arrangement allows parents to reside in the gifted home for a specified period, and if the house's value increases substantially during this term, the beneficiaries could be shielded from hefty estate taxes, making it a smart maneuver for some. In summary, the intricacies of gifting whether it's liquid assets, stocks or real estate, come with a wide array of tax implications. The annual gift exclusion offers a powerful tool for estate planning, allowing individuals to transfer wealth the next generation while minimizing potential tax burdens. Leveraging tools like the 529 College Savings Plan can further optimize this process, especially for those keen on funding educational pursuits.

In additionally, the nuances of gifting assets like stocks and real estate, especially with considerations like basis and mortgages, require a keen understanding and often personalized strategy. For families with substantial estates, these considerations can have multigenerational impacts. And as with any complex financial decision, it's imperative to consult with the tax professionals and estate planners to navigate these waters effectively. Ultimately, gifting can be a profound way to pass on legacies, support loved ones, and ensure that the wealth you've worked hard to accumulate is distributed in the most efficient and impactful manner possible.

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