2319 N Andrews Avenue Ft. Lauderdale, FL 33311 (800) 382-1040 franchiseaccounting.com

Gifts And Their Tax Consequences

There is always a great deal of confusion about making gifts. Some people think it is a tax deduction for them on their individual tax return. Others think it will cost them income tax if they give money. Most wonder if they have to record this gift with the government in some form or another. Here's a quick overview of the 2000 IRS rules and regulations of making gifts.

Income Tax Vs Estate Tax

First, understand that there are two major forms of federal taxes people face: Income taxes, and Estate taxes. Income taxes refer to the moneys owed the government based on how much taxable income you make each year. Estate taxes refer to taxes your estate may owe upon your death based on the net assets you have. In effect, it is a tax on your net worth, not your income.

How does a gift come into play? In a nutshell, gifts do not directly impact your income tax liability. Thus, you will not save any income taxes, nor can you deduct a gift on your income tax return if you make one to an individual. Nor will you owe any income taxes if you make a gift.

However, making gifts may affect your estate tax situation, either positively or negatively, depending on the type of gift, and the size of your estate. This is because of the way gifts over a certain size are handled by the laws. In effect, it "lumps" them together over a cumulative period so that making a gift may affect your overall estate tax filings and liability.

How Big A Gift Can You Make?

A taxpayer gets a break on making annual gifts. Under current federal 2000 rules, a person can give up to $10,000 per year(adjusted annually for inflation), per person without any consequences, and without generally being required to file any gift tax return. A married couple can jointly give $20,000 per person without it creating a taxable event.

Beyond this amount however, complications arise. If you give more than $10,000 per person per year, you are then required to file a Gift tax return which is due by April 15 of the year following the gift date. This gift amount may then be subject to a tax, depending on the cumulative value of all prior taxable gifts. In effect, you are running a balance with the government until you reach certain limits. How much are these limits? You have a "Unified Credit" with Uncle Sam which allows you to leave a cumulative total of $675,000 to beneficiaries through either your estate and/or cumulative gifts exceeding the previously mentioned $10,000 per year per person.

As an example, if you give someone $25,000 in one year, the rough calculation works like this. The first $10,000 is not subject to tax. The remaining $15,000 must be recorded as a reduction in your allowable $675,000 exemption equivalent. You pay no tax now, but it may be subject to a tax in later years if you exceed the remaining balance of the $675,000 exemption.

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What tax rate will you pay on this gift in excess of $10,000 per year? It depends on the amount by which you eventually exceed the $675,000 exemption. When your combined taxable gifts and net estate value(at death) exceed this exemption, the tax rate can rise rapidly. It starts at 37% and can reach 55% at the upper levels quite rapidly, so it is a potentially stiff tax.

There is an exception to this $10,000 per year figure, however, if you are directly paying for educational costs on a secondary level, or medical expenses for a person.

Using Gifts For Estate Planning

Making gifts can therefore be used to save on estate taxes. If you know your overall net worth will exceed $675,000 at death, you can make use of the $10,000 annual exclusion to reduce your estate, and therefore save taxes down the road. If you have a large estate, the savings can amount to upwards of 55 cents on every dollar given away. As you can see, it can be a very important tax-saving tool, as well as being a very nice thing to do!

Non-Cash Gifts

A common misconception occurs when it comes to making non-cash gifts, and it is important to set the record straight. This issue frequently involves giving stocks or property. When a gift of this nature is made, the value of the gift for reporting purposes, and for gift/estate purposes is usually the fair market value at the date of the gift(there are exceptions if the gift has depreciated in value since its acquisition). So, if you give your daughter a house currently worth $200,000, that's the gift figure you must use when you file the gift tax return.

However, when your daughter then sells the property, her basis for tax purposes may be different. In most situations, the basis she must use for determining whether or not she has a capital gain is your original basis(plus any capital improvement costs), not the fair market value at the gift date. Thus, if the house you give her only cost you $25,000, your daughter must use this figure and pay taxes on the difference.

Thus, gifting assets that have appreciated in value requires proper planning. You must coordinate this activity with your overall estate planning, and with the tax bracket of the recipient if they anticipate selling the property.

The moral of the story? Consult your financial and/or legal advisors before making any gifts exceeding $10,000 per year per person, and especially if the gift consists of appreciated property, like real estate or stocks. Small fortunes in taxes can be lost with improper planning in this area.

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