

Gift Tax

“Never look a gift horse in the mouth” is a famous adage that warns us not to ask questions when given a gift—just be grateful! However, gift *giving* should be executed strategically to make the most of a contribution. While there are numerous gifting techniques that alleviate taxes, there are also numerous contingencies regarding the size, frequency, and purpose of the gift. Be gracious when receiving, but be cautious when gifting.

The gift tax applies to the transfer by gift of any property. You make a gift if you give property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If you sell something at less than its full value or if you make an interest-free or reduced interest loan, you may be making a gift.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule.

Generally, the following gifts are not taxable gifts:

- Gifts that are not more than the annual exclusion for the calendar year,
- Tuition or medical expenses you pay directly to a medical or educational institution for someone,
- Gifts to your spouse,
- Gifts to a political organization for its use, and
- Gifts to charities.

Annual exclusion. A separate annual exclusion applies to each person to whom you make a gift. For 2004, the annual exclusion is \$11,000. Therefore, you generally can give up to \$11,000 each to any number of people in 2004 and none of the gifts will be taxable.

If you are married, both you and your spouse can separately give up to \$11,000 to the same person in 2004 without making a taxable gift. If one of you gives more than \$11,000 to a person in 2004.

Inflation adjustment. After 2004, the \$11,000 annual exclusion may be increased due to a cost-of-living adjustment.

Example 1. In 2004, you give your niece a cash gift of \$8,000. It is your only gift to her this year. The gift is not a taxable gift because it is not more than the \$11,000 annual exclusion.

Example 2. You pay the \$15,000 college tuition of your friend. Because the payment qualifies for the educational exclusion, the gift is not a taxable gift.

Example 3. In 2004, you give \$25,000 to your 25-year-old daughter. The first \$11,000 of your gift is not subject to the gift tax because of the annual exclusion. The remaining \$14,000 is a taxable gift. You may not have to pay the gift tax on the remaining \$14,000. However, you do have to file a gift tax return.

Gift Splitting

If you or your spouse make a gift to a third party, the gift can be considered as made one-half by you and one-half by your spouse. This is known as gift splitting. Both of you must consent (agree) to split the gift. If you do, you each can take the annual exclusion for your part of the gift.

In 2004, gift splitting allows married couples to give up to \$22,000 to a person without making a taxable gift.

If you split a gift you made, you must file a gift tax return to show that you and your spouse agree to use gift splitting. You must file a Form 709 even if half of the split gift is less than the annual exclusion.

Example. Harold and his wife, Helen, agree to split the gifts that they made during 2004. Harold gives his nephew, George, \$21,000, and Helen gives her niece, Gina, \$18,000. Although each gift is more than the annual exclusion (\$11,000), by gift splitting they can make these gifts without making a taxable gift.

Harold's gift to George is treated as one-half (\$10,500) from Harold and one-half (\$10,500) from Helen. Helen's gift to Gina is also treated as one-half (\$9,000) from Helen and one-half (\$9,000) from Harold. In each case, because one-half of the split gift is not more than the annual exclusion, it is not a taxable gift. However, each of them must file a gift tax return.

Applying the Unified Credit to Gift Tax

After you determine which of your gifts are taxable, you figure the amount of gift tax on the total taxable gifts and apply your unified credit for the year.

Example. In 2004, you give your niece, Mary, a cash gift of \$8,000. It is your only gift to her this year. You pay the \$15,000 college tuition of your friend, David. You give your 25-year-old daughter, Lisa, \$25,000. You also give your 27-year-old son, Ken, \$25,000. Before 2004, you had never given a taxable gift. You apply the exceptions to the gift tax and the unified credit as follows:

1. Apply the educational exclusion. Payment of tuition expenses is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.
2. Apply the annual exclusion. The first \$11,000 you give someone during 2004 is not a taxable gift. Therefore, your \$8,000 gift to Mary, the first \$11,000 of your gift to Lisa, and the first \$11,000 of your gift to Ken are not taxable gifts.

3. Apply the unified credit. The gift tax on \$28,000 (\$14,000 remaining from your gift to Lisa plus \$14,000 remaining from your gift to Ken) is \$5,560. You subtract the \$5,560 from your unified credit of \$345,800 for 2004. The unified credit that you can use against the gift tax in a later year is \$340,240.

You do not have to pay any gift tax for 2004. However, you do have to file Form 709.

2002 Changes

Increased Estate Tax Applicable Exclusion Amount

The applicable exclusion amount is the amount on which the unified credit (applicable credit amount) is based. An estate tax return for a U.S. citizen or resident needs to be filed only if the gross estate exceeds this amount.

| <u>Year</u> | <u>Exclusion</u> | <u>Amount</u> |
|----------------------|------------------|---------------|
| 2002 and 2003 | | \$1,000,000 |
| 2004 and 2005 | | 1,500,000 |
| 2006, 2007, and 2008 | | 2,000,000 |
| 2009 | | 3,500,000 |

Increased Gift Tax Applicable Exclusion Amount

Beginning with gifts made in 2002, the applicable exclusion amount for lifetime gifts will be fixed at \$1 million.

Increased Annual Exclusion for Gifts

The annual exclusion for gifts of present interests made to a donee during the calendar year is increased to \$11,000.

The annual exclusion for gifts made to spouses who are not U.S. citizens is increased to \$110,000.

Reduction of Maximum Estate and Gift Tax Rate

For estates of decedents dying, and gifts made, after 2001, the maximum rate for the estate tax and the gift tax will be reduced as follows.

Maximum

| <u>Year</u> | <u>Tax Rate</u> |
|----------------------|-----------------|
| 2002 | 50% |
| 2003 | 49% |
| 2004 | 48% |
| 2005 | 47% |
| 2006 | 46% |
| 2007, 2008, and 2009 | 45% |

Use Form 709 to report the following:

- Transfers subject to the federal gift and certain generation-skipping transfer (GST) taxes and to figure the tax, if any, due on those transfers, and
- Allocation of the lifetime GST exemption to property transferred during the transferor's lifetime.

All gift and GST taxes must be computed and filed on a calendar year basis. List all reportable gifts made during the calendar year on one Form 709. Do not file more than one Form 709 for any one calendar year.

How To Complete Form 709

1. Determine whether you are required to file Form 709.
2. Determine what gifts you must report.
3. Decide whether you and your spouse, if any, will elect to split gifts for the year.
4. Complete lines 1–18 of Part 1, page 1.
5. List each gift on Part 1, 2, or 3, of Schedule A, as appropriate.
6. Complete Schedule B, if applicable.
7. If the gift was listed on Part 2 or 3 of Schedule A, complete the necessary portions of Schedule C.
8. Complete Schedule A, Part 4.
9. Complete Part 2 on page 1.
10. Sign and date the return.



Remember, if you are splitting gifts, your spouse must sign line 18, in Part 1, page 1.

Who Must File

In general. If you are a citizen or resident of the United States, you must file a gift tax return (whether or not any tax is ultimately due) in the following situations.

- If you gave gifts to someone in 2004 totalling more than \$11,000 (other than to your spouse) you probably must file Form 709.
- Certain gifts, called future interests, are not subject to the \$11,000 annual exclusion and you must file Form 709 even if the gift was under \$11,000.
- A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709.
- You must file a gift tax return to split gifts with your spouse (regardless of their amount) as described in *Part 1 — General Information* on page 5.
- If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of \$100,000 of community property is considered a gift of \$50,000 made by each spouse, and each spouse must file a gift tax return.
- Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.
- Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
- The donor is responsible for paying the gift tax. However, if the donor does not pay the tax, the person receiving the gift may have to pay the tax.
- If a donor dies before filing a return, the donor's executor must file the return.

Who does not need to file. If you meet all of the following requirements, you are not required to file Form 709:

- You made no gifts during the year to your spouse,
- You did not give more than \$11,000 to any one donee, and
- All the gifts you made were of present interests.

Gifts to charities. If the only gifts you made during the year are deductible as gifts to charities, you do not need to file a return as long as you transferred your entire interest in the property to qualifying charities. If you transferred only a partial interest, or transferred part of your interest to someone other than a charity, you must still file a return and report all of your gifts to charities.

If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return.

Transfers Subject to the Gift Tax

Generally, the federal gift tax applies to any transfer by gift of real or personal property, whether tangible or intangible, that you made directly or indirectly, in trust, or by any other means to a donee.

The gift tax applies not only to the gratuitous transfer of any kind of property, but also to sales or exchanges, not made in the ordinary course of business, where money or money's worth is exchanged but the value of the money (or property) or money's worth received is less than the value of what is sold or exchanged. The gift tax is in addition to any other tax, such as federal income tax, paid or due on the transfer.

The exercise or release of a general power of appointment may be a gift by the individual possessing the power. General powers of appointment are those in which the holders of the power can appoint the property subject to the power to themselves, their creditors, their estates, or the creditors of their estates. To qualify as a power of appointment, it must be created by someone other than the holder of the power.

The gift tax may also apply to the forgiveness of a debt, to interest-free or below market interest rate loans, to the assignment of the benefits of an insurance policy, to certain property settlements in divorce cases, and to the giving up of some amount of annuity in exchange for the creation of a survivor annuity.

Bonds that are exempt from federal income taxes are not exempt from federal gift taxes. Code sections 2701 and 2702 provide rules for determining whether certain transfers to a family member of interests in corporations, partnerships, and trusts are gifts. The rules of section 2704 determine whether the lapse of any voting or liquidation right is a gift.

Gifts to your spouse. You must file a gift tax return if you made any gift to your spouse of a terminable interest that does not meet the exception described in *Life estate with power of appointment* on page 10 or if your spouse is not a U.S. citizen and the total gifts you made to your spouse during the year exceed \$114,000.

You must also file a gift tax return to make the Qualified Terminable Interest Property (QTIP) election described under *Line 13—QTIP election for annuities* on page 10.

Except as described above, you do not have to file a gift tax return to report gifts to your spouse regardless of the amount of these gifts and regardless of whether the gifts are present or future interests.

Transfers Not Subject to the Gift Tax

Three types of transfers are not subject to the gift tax. These are transfers to political organizations and payments that qualify for the educational and medical exclusions. These transfers are not “gifts” as that term is used on Form 709 and its instructions. You need not file a Form 709 to report these transfers and should not list them on Schedule A of Form 709 if you do file Form 709.

Political organizations. The gift tax does not apply to a transfer to a political organization (defined in section 527(e)(1)) for the use of the organization.

Educational exclusion. The gift tax does not apply to an amount you paid on behalf of an individual to a qualifying domestic or foreign educational organization as tuition for the education or training of the individual. A qualifying educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

The payment must be made directly to the qualifying educational organization and it must be for tuition. No educational exclusion is allowed for amounts paid for books, supplies, room and board, or other similar expenses that do not constitute direct tuition costs. To the extent that the payment to the educational institution was for something other than tuition, it is a gift to the individual for whose benefit it was made, and may be offset by the annual exclusion if it is otherwise available.

Contributions to a qualified tuition program on behalf of a designated beneficiary do not qualify for the educational exclusion.

Medical exclusion. The gift tax does not apply to an amount you paid on behalf of an individual to a person or institution that provided medical care for the individual. The payment must be to the care provider. The medical care must meet the requirements of section 213(d) (definition of medical care for income tax deduction purposes). Medical care includes expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or for transportation primarily for and essential to medical care. Medical care also includes amounts paid for medical insurance on behalf of any individual.

The medical exclusion does not apply to amounts paid for medical care that are reimbursed by the donee's insurance. If payment for a medical expense is reimbursed by the donee's insurance company, your payment for that expense, to the extent of the reimbursed amount, is not eligible for the medical exclusion and you have made a gift to the donee.

To the extent that the payment was for something other than medical care, it is a gift to the individual on whose behalf the payment was made and may be offset by the annual exclusion if it is otherwise available.

The medical and educational exclusions are allowed without regard to the relationship between you and the donee.

Qualified disclaimers. A donee's refusal to accept a gift is called a disclaimer. If a person makes a qualified disclaimer with respect to any interest in property, the property will be treated as if it had never been transferred to that person. Accordingly, the disclaimant is not regarded as making a gift to the person who receives the property because of the qualified disclaimer.

Requirements. To be a qualified disclaimer, a refusal to accept an interest in property must meet the following conditions.

1. The refusal must be in writing.
2. The refusal must be received by the donor, the legal representative of the donor, the holder of the legal title to the property to which the interest relates, or the person in possession of the property within 9 months after the later of:
 - a. the day on which the transfer creating the interest is made, or
 - b. the day on which the disclaimant reaches age 21.
3. The disclaimant must not have accepted the interest or any of its benefits.
4. As a result of the refusal, the interest must pass without any direction from the disclaimant to either:
 - a. the spouse of the decedent, or
 - b. a person other than the disclaimant, and
5. The refusal must be irrevocable and unqualified.

The 9-month period for making the disclaimer generally is determined separately for each taxable transfer. For gifts, the period begins on the date the transfer is a completed transfer for gift tax purposes.

Annual Exclusion

The first \$11,000 of gifts of present interests to each donee during the calendar year is subtracted from total gifts in figuring the amount of taxable gifts. For a gift in trust, each beneficiary of the trust is treated as a separate donee for purposes of the annual exclusion. All of the gifts made during the calendar year to a donee are fully excluded under the annual exclusion if they are all gifts of present interests and they total \$11,000 or less.

Note. For gifts made to spouses who are not U.S. citizens, the annual exclusion has been increased to \$114,000, provided the additional (above the \$11,000 annual exclusion) \$103,000 gift would otherwise qualify for the gift tax marital deduction (as described in the line 4 instructions on page 9).

A gift of a future interest cannot be excluded under the annual exclusion.

A gift is considered a present interest if the donee has all immediate rights to the use, possession, and enjoyment of the property or income from the property.

A gift is considered a future interest if the donee's rights to the use, possession, and enjoyment of the property or income from the property will not begin until some future date.

Future interests include reversions, remainders, and other similar interests or estates.

A contribution to a qualified tuition plan on behalf of a designated beneficiary is considered a gift of a present interest.

A gift to a minor is considered a present interest if all of the following conditions are met:

1. Both the property and its income may be expended by, or for the benefit of, the minor before the minor reaches age 21;
2. All remaining property and its income must pass to the minor on the minor's 21st birthday; and
3. If the minor dies before the age of 21, the property and its income will be payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

The gift of a present interest to more than one donee as joint tenants qualifies for the annual exclusion for each donee.

Transfers Subject to the Generation-Skipping Transfer Tax

You must report on Form 709 the GST tax imposed on *inter vivos* direct skips. An *inter vivos* direct skip is a transfer made during the donor's lifetime that is:

- Subject to the gift tax,
- Of an interest in property, and
- Made to a skip person.
- A transfer is subject to the gift tax if it is required to be reported on Schedule A of Form 709 under the rules contained in the gift tax portions of these instructions, including the split gift rules. Therefore, transfers made to political organizations, transfers that qualify for the medical or educational exclusions, transfers that are fully excluded under the annual exclusion, and most transfers made to your spouse are not subject to the GST tax.

Transfers subject to the GST tax are described in further detail in the instructions beginning on page 6.



Certain transfers, particularly transfers to a trust, that are not subject to gift tax and are therefore not subject to the GST tax on Form 709 may be subject to the GST tax at a later date. This is true even if the transfer is less than the \$11,000 annual exclusion. In this instance, you may want to apply a GST exemption amount to the transfer on this return or on a Notice of Allocation.

Transfers Subject to an Estate Tax Inclusion Period

Certain transfers that are direct skips receive special treatment. If the transferred property would have been includible in the donor's estate if the donor had died immediately after the transfer (for a reason other than the donor having died within 3 years of making the

gift), the direct skip will be treated as having been made at the end of the estate tax inclusion period (ETIP) rather than at the time of the actual transfer.

For example, if A transferred her house to her granddaughter, B, but retained the right to live in the house until her death (a retained life estate), the value of the house would be includible in A's estate if she died while still holding the life estate. In this case, the transfer to B is a completed gift (it is a transfer of a future interest) and must be reported on Part 1 of Schedule A. The GST portion of the transfer would not be reported until A died or otherwise gave up her life estate in the house.

Report the gift portion of such a transfer in Schedule A, Part 1, at the time of the actual transfer. Report the GST portion in Schedule A, Part 2, but only at the close of the ETIP. Use Form 709 only to report those transfers where the ETIP closed due to something other than the donor's death. (If the ETIP closed as the result of the donor's death, report the transfer on Form 706.)

If you are filing this Form 709 solely to report the GST portion of transfers subject to an ETIP, complete the form as you normally would with the following exceptions:

1. Write "ETIP" at the top of page 1;
2. Complete only lines 1–6, 8, and 9 of Part 1, General Information;
3. Complete Schedule A, Part 2, as explained in the instructions for that schedule on page 9;
4. Complete Schedule C. Complete Column B of Schedule C, Part 1, as explained in the instructions for that schedule on page 11;
5. Complete only lines 10 and 11 of Schedule A, Part 4; and
6. Complete Part 2 — Tax Computation.