Like the federal estate tax, the federal gift tax is an excise tax on the transfer of property. The federal gift tax is a tax on a donor's privilege of being able to transfer property by gift during a calendar year. IRC § 2501(a)(1); Treas. Reg. § 25.2511-2(a).

The gift tax applies to all gifts made by U.S. citizens or residents and to gifts made by nonresident aliens of property situated in the U.S. Subject to certain exceptions, it does not apply to gifts made by nonresident aliens of intangible property. Shares of stock issued by a domestic corporation and debt obligations of any U.S. citizen or any federal or state government, however, are deemed to be property situated in the U.S. IRC §§ 2501(a)(2), 2511(a), and 2511(b); Treas. Reg. § 25.2511-3.

Generally, a gift is subject to gift tax based on its fair market value on the date of transfer (the date the gift becomes complete). IRC § 2512(a). "Fair market value" is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. Treas. Reg. § 25.2512-1. Certain valuation discounts can be applied to reduce the value of a gift. For example, common discounts include (i) discounts for lack of marketability, (ii) discounts for minority interests and (iii) discounts for fractional interests.

The gift tax annual exclusion under IRC § 2503(b) permits an individual to give an amount equal to the annual exclusion ($17,000 in 2023) per donee without incurring gift tax liability, provided that the gift is of a present interest. A married donor can annually give up to $34,000 per donee if the donor's spouse agrees to apply his or her annual exclusion amount by gift-splitting. IRC § 2513. Gift-splitting allows one spouse to treat his or her gifts to any person other than his or her spouse as made one-half by each spouse.

IRC § 2503(e)(1) excludes from gift tax certain "qualified transfers," which include amounts paid by a donor directly to a qualifying education institution or a medical provider on behalf of an individual for tuition expenses or medical care. IRC § 2503(e)(2).

IRC § 2523 allows an unlimited gift tax marital deduction for qualified interests that a donor gives to the donor's spouse.

## Calculation

IRC § 2502(a) and Treas. Reg. § 25.2502-1 describe the computation of a donor's gift tax liability. A donor's gift tax liability for gifts made in the previous calendar year is calculated on an annual basis. IRC §§ 2501(a)(1) and 2502(a).

**<u>Computation</u>**. In general, a donor's gift tax liability is the amount equal to the excess of: (1) the tentative gift tax on the aggregate sum of the donor's taxable gifts for the current year and the donor's taxable gifts for all prior years; over (2) the tentative gift tax on the aggregate sum of the donor's taxable gifts for all prior years.

**(1)** **<u>Total Gifts</u>**. The first step is to determine the donor's total gifts during the calendar year in question.

(2) **Allowable Exclusions and Deductions**. The second step is to determine the donor's total allowable exclusions and deductions.

(3) **Total Taxable Gifts**. The donor's "total taxable gifts" is determined by adding the donor's taxable gifts for the calendar year in question to all of the donor's taxable gifts for prior calendar years.

(a) **Taxable Gifts for Calendar Year in Question**. The donor's taxable gifts for the current year is determined by subtracting from the value of the donor's total gifts the donor's total allowable exclusions and deductions. IRC § 2503.

(b) **Taxable Gifts for All Prior Years**. The donor's taxable gifts for a prior year is based on the donor's total gifts and exclusions, deductions and exemptions as were allowed under the gift tax laws applicable to that year. IRC § 2504.

(4) **Tentative Tax**. The donor's total tentative tax is determined by subtracting the tentative tax on taxable gifts for prior years from the donor's tentative tax on his total taxable gifts. IRC § 2502(a).

(a) **Tentative Tax on Total Taxable Gifts**. A tentative tax on the donor's total taxable gifts is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's total taxable gifts. IRC § 2502(a)(1).

(b) **Tentative Tax on Prior Taxable Gifts**. A tentative tax on the donor's taxable gifts from all prior years (excluding the current year) is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's taxable gifts from all such years. IRC § 2502(a)(2).

(5) **Reduction by Unified Credit**. The donor's total tentative tax is then reduced by the unused portion of the donor's unified credit. IRC § 2505.

## Gift Tax Return

**Who Must File**. Generally, any individual donor who in any calendar year makes a gift must file a gift tax return (Internal Revenue Service ("IRS") Form 709). No return is required, however, if all of the donor's gifts fall into one or more of the following categories of gifts: (1) annual exclusion gifts (without gift-splitting) under IRC § 2503(b); (2) gifts to an educational institution or health care provider under IRC § 2503(e); (3) gifts that qualify for the marital deduction under IRC § 2523; and (4) certain outright gifts that qualify for the charitable deduction under IRC § 2522(d). IRC § 6019.

**Due Date**. The donor must file his or her federal gift tax return on or before April 15 of the year following the calendar year in which the gifts were made. IRC § 6075(b)(1). An extension to file the donor's individual income tax return is deemed an automatic extension of time to file the donor's gift tax return. IRC § 6075(b)(2). A donor can also request an extension of time to file. IRC § 6081. With respect to a donor who dies, the gift tax return must be filed no later than the time for filing the donor's estate tax return. IRC § 6075(b)(3).

## Practical Effects of Lifetime Gifts

### 1. Transferred Property (Including Appreciation and Income) Removed From Estate

Property that a donor transfers by gift during lifetime is not included in the donor's estate. The donor's transfer tax liability for such a gift is calculated at the date of gift. Therefore, any post-gift income or appreciation generated by the transferred property will not be subject to gift tax or estate tax.

➔ **Planning Point:** Making lifetime gifts of property likely to appreciate or generate a significant amount of income can effectively reduce the donor's transfer tax liability at death.

> **EXAMPLE:** D gave a vacation home worth $100,000 to D's son, B. At D's death 20 years later, the vacation home had appreciated in value to $2,000,000. The vacation home was not included in D's estate. If D had retained the vacation home until death, the home would have been included in D's estate at a value of $2,000,000, and D's estate tax liability (assuming a 50% estate tax rate) would have increased by approximately $1,000,000.

### 2. Gift Tax Out of Donor's Estate if Donor Survives at Least Three Years

Assuming the donor survives at least three years after the date of gift, any gift tax paid on the gift is also removed from the donor's estate, even if the gift itself is included in the donor's estate. IRC § 2035(b).

### 3. Tax Exclusive Gift Tax v. Tax Inclusive Estate Tax

The gift tax is "tax exclusive" while the estate tax is "tax inclusive." That is, the tax used to pay gift tax is not itself subject to gift tax. The tax used to pay estate tax is itself, however, subject to estate tax. The tax exclusive nature of the gift tax makes the gift tax rate effectively lower than the estate tax rate. This is true even though the same tax rate schedule applies to both the gift tax and the estate tax.

### 4. Taking Advantage of Gift Tax Exclusions Can Significantly Reduce Taxes

As discussed earlier in this Chapter, an individual can give $13,000 each year to an unlimited number of donees, and may pay medical expenses and tuition expenses for another person free of gift tax and GST tax. All such property given away is also removed from the donor's estate. Therefore, such gifts are not subject to any transfer tax.

➔ **<u>Planning Point</u>:** A planned giving program that takes advantage of these exclusions can significantly reduce an individual's total transfer tax liability.

### 5. Income on Transferred Property Generally Taxed At a Lower Rate

Income on property transferred by gift is generally taxed to the donee. If the donee is in a lower income tax bracket than the donor, then less income tax will be paid on the same property. The "kiddie tax," however, subjects children under age 19 to the same marginal income tax rate as their parents, limiting this benefit. IRC § 1(g).

### 6. Basis Not Increased Except Portion of Gift Tax Paid On Appreciated Gift

Under current law, in general, property transferred by gift retains the donor's basis, but property transferred at death, assuming the executor is able to allocate sufficient basis to the property, gets a step up in basis to the property's fair market value at death. IRC §§ 1015 and 1022. If the donor pays gift tax on appreciated property, however, the donee's basis increases by the portion of the gift tax attributable to the appreciation in the property. Treas. Reg. § 1.1015- 1(a)(2). To calculate the increase, the gift tax paid is multiplied by a fraction, of which the numerator is the appreciation, and the denominator is the fair market value of the gift.

➔ **<u>Planning Point</u>:** For property transferred by gift, all of the appreciation in excess of the donor's basis (plus any adjustment for gift taxes paid on appreciated property) will be subject to income tax on the sale of the property. For property transferred at death, assuming that the executor is able to allocate sufficient basis to the property under IRC § 1022, only the appreciation after the decedent's death will be subject to income tax on the sale of the property. In determining whether to make lifetime gifts of appreciated property versus retaining such property until death, practitioners should consider the amount of appreciation in the property, the likelihood of a sale in the near future and the likelihood the client will survive until 2010 when the basis step-up becomes limited.