Strategies to Consider Before GIFTING

By Bart A. Basi and
Marcus S. Renwick

Thinking about giving a car to someone for their birthday? Perhaps you want to buy that special person an expensive piece of electronics or jewelry. Or, if your child is buying their first home, you want to make the down payment. Well, these transactions might just be taxable to the person who is giving the gift. With effective planning, the joys of giving and receiving such gifts will not be ruined by the knock of a tax man upon the door.

Since 1976, the rules governing taxable and non-taxable gifts have not changed much. The rules on taxable gifts are covered by a special tax called the "Unified Transfer Tax," which is applied in conjunction with the regular income tax. This is the same tax that governs the taxation of estates. The sting of the Unified Transfer Tax on gifts can be avoided if a good gifting strategy is in place.

What is a Gift?

The general definition of a gift goes something like this—property transferred to another individual out of the goodness of one's heart for nothing in return. That is a very broad definition and a lot of transactions can fall within that meaning. Through much litigation, the courts have provided some guidance with a few requirements that must be satisfied for a transaction to be defined as a gift.

There are six requirements for a transaction to be classified as a gift and all of them must be satisfied in order for the transaction to be a gift.

1. The donor must own the property or the portion of interest being gifted.

2. The donor must be legally competent to give up their right to the interest in the property.

3. The donee must be able to receive the property.

4. There must be actual delivery of the property.

5. The donee must receive the property.

6. The property must be given out of the generosity of the donor.

The definition of a gift is pretty vague and the requirements are easily met, but that does not mean that any transaction that meets the definition and satisfies the requirements is a gift. There are a few transactions that are specifically excluded from being gifts. Paying some other taxpayer's medical expense or paying their college tuition are not considered gifts. Furthermore, when property is transferred because of a divorce or is part of a testamentary transfer, they are not subject to the gift rules.

What is the Value of the Gifts?

The value of the gift is the value at which it would change hands on an open market. When making gifts of any property, the value is very important in determining the correct fair market value. The fair market value determines if the gift will be a taxable gift or if it escapes taxation completely. It is advisable to have a professional appraise whatever property is going to be transferred by gifting.

It also should be noted that gifts do not include the value of any future income associated with the property gifted. That means rents from an apartment building after the date of the gift will be taxable to the donee as income. If cash is given, the value of the gift does not include any interest accrued after the date of the gift. The value of a gift is strictly the value of the property without the inclusion of any future income or interest.

A common mistake made by a donee is to think their basis (i.e., their cost equivalent) is the same amount as the fair market value of the property because the fair market value is used as the basis for the determination of taxability. Actually, the general rule is that the basis of property received by a gift is the same as the basis was in the hands of the donor. Thus, if a piece of property cost a father $7,000 but is worth $10,000, and he gives it to his son, the gift is valued for tax purposes as being worth $7,000. The only time that basis differs from the basis in the hands of the donor is when the fair market value is less than the gain basis of the donor. This creates a loss basis for the donee equal to the fair market value. It should be noted the gain basis of the donee is still the basis carried over from the donor. Getting the basis confused with the value of the gift can make for a lot of tax headaches for the receivers of gifts.

Bad Gifting Practices

The biggest gifting mistake people make is to gift away property that has a fair market value less than the donor's basis. It is really bad to do this because there is a potential to lose a huge tax benefit. Suppose a father transfers a piece of investment property to his daughter. The fair market value of the property is $20,000, but the basis of the property in the father's hands was $100,000. Well, a few years later the daughter sells the investment property for $15,000. The loss that can be recognized on the sale of the investment property is $5,000. By gifting this loss property, the father and the daughter incur a loss of $80,000 forever.

Another bad gifting practice is not paying attention to what one is gifting

continued on page 28