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The Real Story Behind Gift Tax

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February 2014

Federal gift tax can be a mystery to some people. Many people wonder why a tax is owed on money or assets that a person has already paid income tax on. (Incidentally, Pennsylvania has no gift tax.) As an elder law attorney, I see numerous clients with questions as to how this system works: Who has the gift tax liability? Is there any gift tax liability if the gift exceeds the annual gift tax exclusion? How does gift tax affect Medicaid transfer rules?

Federal gift tax can be imposed on a person when he or she transfers something of value to a third party or certain irrevocable trusts without receiving compensation in return. However, there are two layers of gift tax exemptions: a lifetime exclusion and an annual exclusion.

- **Lifetime Federal Gift Tax Exclusion:** The current lifetime federal gift tax exclusion is $5,340,000 as of January 1, 2014. This exclusion encompasses the amount of gifts that an individual can give away to anyone (or certain irrevocable trusts) over the course of his lifetime without incurring any gift tax liability. These gifts must be reported to the IRS on a Gift Tax Return (Form 709) by April 15th of the year following the year that the gift was completed, even if the gift does not exceed the lifetime exclusion amount. This allows the IRS to keep a "tally" of all reportable gifts to determine whether or not an individual has exceeded the exclusion amount during his lifetime as well as remaining exclusion for the federal "death tax".

- **Annual Gift Tax Exclusion:** The current annual gift tax exclusion is $14,000 in 2014. This exclusion allows an individual to transfer up to $14,000 per recipient within each calendar year. This annual exclusion is essentially a "giveaway" or a "freebie" allowed by the federal government which is not included as a part of a person's lifetime federal gift tax exclusion amount referenced above. As a result, if the total gifts made by a taxpayer during a calendar year do not exceed this amount per donee, the gifts do not have to be reported to the IRS on a Gift Tax Return. However, if even one gift per donee is in excess of $14,000, technically a Gift Tax Return must be filed.

The following is an example of how these two exclusions work together: In 2014, Rick transferred $114,000 to his son, Carl. By April 15th of 2015, he must file a Form 709 Gift Tax Return. Because of the annual exclusion amount of $14,000 in 2014, Rick only has to use $100,000 of his lifetime exclusion on the Gift Tax Return. However, there is still no tax liability to Rick because he has a remaining lifetime federal gift tax exclusion amount of $5,240,000. ($5,340,000 lifetime exclusion - $100,000 reportable gift = $5,240,000 remaining).

If we recommend gifting as part of a client's estate plan, the children, as the recipients (or ultimate beneficiaries if a trust is utilized) of the gift, are sometimes concerned that they will incur gift tax liability. Rest assured that the recipient of the gift typically has no tax liability either from a gift tax perspective or an income tax perspective as the gift is not considered income.

In addition to gifts that fall under the annual exclusion, there are other uncompensated transfers that are not subject to gift tax, such as gifts to charities, gifts to a political organization, gifts to one's spouse that is a U.S. citizen, and payments made directly to an institution for a third party's education or medical expenses.

Please note that the lifetime federal gift tax exclusion is tied into the federal estate tax exclusion. Under the American Taxpayer Relief Act of 2013, the federal gift tax exclusion remains equal to the federal estate tax exclusion. Any amounts that an individual transfers during his lifetime and that are reportable for federal gift tax purposes are subtracted from and reduce that individual's federal estate tax exclusion upon his death. As a result, when engaging in estate planning, an individual in a federal estate tax bracket needs to be cognizant of the impact that lifetime gifts will have upon his estate at death.

How does all of this factor into Medicaid planning? Many people are under the assumption that the annual gift tax exclusion carries over to Medicaid transfer rules. This is a false and sometimes dangerous misconception. For Medicaid eligibility purposes in the state of Pennsylvania, any gifts that exceed $500 in each calendar month over the course of five years prior to the date of application will be subject to transfer penalties. So, while the $14,000 transferred to a child in a calendar year does not have to be reported on a gift tax return and is not subject to gift tax liability, if made within five years from the date that a Medicaid application is filed, it will indeed trigger a penalty for Medicaid eligibility purposes. At that point, the Medicaid applicant will have to figure out how to pay for his expensive nursing care for the duration of the incurred period of ineligibility (approximately 1.6 months for a $14,000 transfer). When these types of gifts are made by an elderly individual or someone that may have disability issues, he should consult an eldercare attorney prior to making such gifts to determine the impact on future Medicaid and other government benefits.

As you can see, it is important to have a clear understanding as to how the gift tax system works, whether one is in a federal gift and estate tax bracket or not. It is this type of knowledge that an estate and eldercare attorney utilizes when structuring an individual's estate and long term care plan.