POLARIS
WEALTH ADVISORY GROUP

The Polaris Perspective

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It's May, spring is in the air. The frost is thawing, and the flowers are blooming. Love is all around us with the wedding season blossoming. Seniors in High School and College are so close to graduation they can almost taste it! But, what does all of this mean for you?

It means it is the time of the year you should review the federal gift tax!

Let's face it, weddings and graduations can be expensive, and they can become even pricier due to gift tax laws, if done improperly. For example, did you know that you may be subject to gift taxes if you give your daughter money for her wedding if it costs more than $56,000? What about if you buy your son a $30,000 car for graduating top of his class?

These situations show why it's important to have an idea of gift tax rules before giving a gift.

What is the gift tax?

People often have a goal of leaving a financial legacy, and there are only two ways that an individual can transfer assets to their heirs: inter vivos (during life) and testamentary (at death). When you die, the IRS allows you to pass up to $5.49 million (for 2017) to your heirs tax free. Beyond $5.49 million all assets are taxed at the rates in the table below.

For Taxable Estates in This Range	You'll Pay This Base Amount of Tax	Plus This Rate on the Excess Above the Lower End of the Range
$0 to $10,000	$0	18%
$10,000 to $20,000	$1,800	20%
$20,000 to $40,000	$3,800	22%
$40,000 to $60,000	$8,200	24%
$60,000 to $80,000	$13,000	26%
$80,000 to $100,000	$18,200	28%
$100,000 to $150,000	$23,800	30%
$150,000 to $250,000	$38,800	32%
$250,000 to $500,000	$70,800	34%
$500,000 to $750,000	$155,800	37%
$750,000 to $1 million	$248,300	39%
$1 million and up	$345,800	40%

Source: Dan Kaplinger, 2016 https://www.fool.com/retirement/2016/11/11/2017-estate-tax-rates.aspx

You may be thinking, "If I have more than $5.49 million and I have terminal cancer, why wouldn't I just pass my assets to my heirs before I die to avoid this tax?" Well, unfortunately, Uncle Sam is way ahead of you, and he wants his cut. Among other things, this is the primary reason that the IRS created the gift tax. The IRS wants to constrain the amount of money that you can pass to your heirs without tax implication. As a result, the IRS combined transfers during life and at death into a single unified transfer tax system, which provides the same tax liability on assets transferred during life and at death. That $5.49 million is your magic number. That is your "lifetime exclusion" which can be passed without tax implications at any time throughout your life or at your death. The unified tax system is cumulative, so if you haven't been careful with how you've passed on money and made a $3 million gift that was applied to your exclusion during your life, then you can only transfer $2.49 million at death tax free.

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What can be considered a gift?

Any time you transfer assets (or value) to another individual it can be considered a gift in the eyes of the IRS. Common mistakes people make include giving children money directly for the cost of a wedding, buying cars, titling accounts in joint names, forgiving family loans, selling property to a family member at a discount to market rate, giving money directly to your children to pay for school instead of directly to the institution... All of these can be considered gifts in the eyes of the IRS.

Tools of the trade

As I mentioned above, the Unified Transfer Tax system grants us a $5.49 million lifetime exclusion, but did you know there are ways to gift without dinging your exclusion? If you are planning a wedding or giving a generous graduation gift, luckily the IRS provides you with some tools that you can use to lower or extinguish your gift tax burden. The most commonly used tools are the annual exclusion, gift splitting, intra-family loans, and the unlimited marital deduction.

1. Annual Exclusion

Every year you can gift up to $14,000 ($1,000 indexed for inflation, currently its $14,000) per recipient. You can gift $14,000 to as many people as you want, but when you gift more than $14,000 to any one person in a year, it takes away from your lifetime exclusion (the $5.49 million).

2. Gift Splitting

If you are married, then you can gift split. Gift splitting is when a married couple agrees to split a gift to one individual. This doubles the amount you can gift to that individual each year. For example, you and your spouse could gift $14,000 each for a total of $28,000 to as many individuals as you want within a year.

3. Intra-family Loans

The IRS allows for low interest loans amongst family members at the Applicable Federal Rates (AFR). The applicable federal rate is currently (April 2017) 0.86% for a loan less than 3 years, 1.52% for loans between 3 and 10 years, or 2.04% for a loan 10 years or greater. You can apply your annual $14,000 ($28,000) exclusion to forgiving the debt each year. Intra-family loans are a binding legal contract. If an intra-family loan makes sense for you, make sure you consult with your attorney, CPA, and financial advisor to avoid any legal or tax issues.

4. Unlimited Marital Deduction

When you are married you also get the benefit of the unlimited marital deduction. You can transfer an unlimited amount to your spouse without any immediate tax ramifications. ***Intrigued yet?***

How can you use these tools?

Let's use the examples from the beginning. Say you are throwing and paying for a lavish wedding for your daughter. You believe it is going to cost $100,000. The wedding is next year. What can you do? If you are married, by gift splitting with your spouse you could gift $28,000 to both your daughter and her fiancé this year for a total of $56,000. Then you could do the same next year before the wedding. You have successfully gifted $112,000 and paid for the wedding without incurring any gift tax liability. If you, as an individual, had gifted that all to your daughter in one year without gift splitting, you could have incurred an $86,000 taxable gift. This mistake would have either lowered your lifetime exemption by $86,000, or cost you over $25,000 in gift taxes.

You could do something similar with the car you bought for your son's graduation. You could gift split with your spouse and buy a $28,000-dollar car. If the car was more than $28,000, you could loan your son the difference and have him pay off the loan with future gifts you made. The loan would be subject to the applicable federal rate (AFR), meaning that you'd have to charge your child interest on the loan. The rate, however, is significantly lower than going rates at the bank. And by lending your child the money, you'd avoid gift taxes or losing some of your lifetime exclusion.

These are also great scenarios for using an intra-family loan. You can loan your child money for a car or wedding all at once at the applicable federal rate, and then forgive the principal portion of the debt by applying your annual gift exclusions to forgive a portion of the loan each year.

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Why is it important to consider the gift tax now?

Now, you may be asking yourself, "If the lifetime exclusion is $5.49 million, and I am below that, why should I worry about that now?" There are several reasons why you should consider it. For one, the lifetime exclusion has changed drastically over the past several decades. You can never guarantee the exclusion amount will stay the same. The estate and gift taxes are some of the most commonly altered taxes as the political party in power changes. For example, in 2010 there was no estate tax, in 2009 the lifetime exclusion was $3.5 million, and in 2008 the exclusion was $2 million.

Secondly, compounding interest can be a very powerful tool. Even if you only have 3 million now, a market return of 10% would put you above the exclusion in less than 8 years. If one of your financial goals is to leave a financial legacy for your heirs, then it is a good idea to utilize the annual exclusion now.

Are there other ways to maximize gifting?

Absolutely! There are tons of ways to maximize gifting. For example, if grandparents want to pay for their grandchildren's education then they can avoid gift taxes by paying the institution directly instead of giving the money to the parents or grandkids. Also, you can get more out of your gift by gifting highly appreciable stock to a charity or to a child in a bottom income tax bracket with no capital gains implications. If you have a stock with a current capital loss and good long term prospects, you can gift that stock with a lower tax burden for your heirs. If you own a business property, you can gift the property, and then the business can lease the property from the recipient. By doing this you accomplish three things: you get the property out of your estate, provide your heir cash flow, and get a tax deduction for your business, all at the same time. There are dozens of more ways that you can maximize your gifting. These items are just the tip of the iceberg.

As you can see, there are many considerations to make when transferring your assets to another individual, so before you start writing those wedding or graduation checks, speak with your financial advisor to ensure you are going about it in the best way!

Sincerely,

Joshua Bennett, CFP®
Director

Source: CCH, a Wolters Kluwer business, 2010 - https://www.cch.com/press/news/historicalestategifttaxrates.pdf
Source: Index of Applicable Federal Rates (AFR) Rulings - https://apps.irs.gov/app/picklist/list/federalRates.html

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