SHERMAN WELLS
SYLVESTER & STAMELMAN LLP

TAX AND TRUSTS & ESTATES UPDATE

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Gift Tax Reporting Reminder for Gifts Made in 2016

Gift tax returns can be an important part of your yearly tax return filing responsibilities. Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) is filed on a calendar-year basis and is due April 15th of the year following the year in which the gifts were made (unless an effective extension applies). As you determine whether or not you are required to file a gift tax return for 2016, consider the following frequently asked questions:

How much can I give without having to file a gift tax return?

An individual donor is entitled to an annual exclusion from federal gift tax on total gifts made in 2016 of up to $14,000 per donee. While some tax exemptions increase from year to year based on inflation, the gift tax exemption has remained constant since 2013 (and remains consistent in 2017). Nevertheless, there is no limit on the number of annual exclusion gifts that can be made to different donees in any year. For example, if you have three children, you (and anyone else) could have given each of them $14,000 in 2016 and not have to file a gift tax return.

What kinds of gifts would not qualify for the annual exclusion?

Total gifts to any donee in excess of $14,000 will require a 2016 gift tax return to be filed. And bear in mind that only gifts of "present interests" qualify for the annual exclusion. Outright gifts (such as cash given directly to an individual) are gifts of present interests, but gifts to trusts that do not include what are known as "Crummey" withdrawal powers for beneficiaries often are not. And even gifts to trusts that include Crummey powers should be reviewed to ensure that a return is not required – often in order to allocate federal Generation Skipping Tax ("GST") exemption to those trust gifts. The GST tax is a federal tax imposed on transfers of wealth to individuals that the IRS considers to be two more or more generations below that of the donor (for example, a gift from a donor to his grandchild) and needs to be taken into account when considering whether a gift tax return should be filed and how to report generation-skipping gifts.

My spouse and I both have annual exclusions - so we can transfer $28,000 to a donee and not have to file gift tax returns?

If each of you and your spouse makes a <u>separate</u> gift of $14,000 from his or her own separate assets, that is correct. But the IRS also allows "gift-splitting". That can occur when one spouse makes a gift of (for example) $28,000 to an individual. If the donor's spouse consents, he or she can "split" that gift, so that each is deemed to be making a gift of only $14,000. In that way, the split gift does not exceed the annual exclusion amount for either spouse. However, gift splitting will require a gift tax return to be filed to record the split <u>and</u> the spousal consent. And gift-splitting will then apply to all gifts made by either spouse in that year.

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Will I have to pay gift tax?

You will be required to pay gift tax only if your aggregate taxable gifts in prior years plus your 2016 gifts exceed the amount of the gift/estate tax exemption available to you in 2016. That exemption was $5,450,000 in 2016. If, for example, you have made $3,000,000 of taxable gifts after January 1, 1977 (and no taxable gifts before that date), you used up $3,000,000 of your exemption, but you would still be able to make taxable gifts (i.e., gifts that do not qualify for the annual exclusion or any applicable deduction) in 2016 of $2,450,000 and still not have to pay gift tax. For 2017, the exemption is increased to $5,490,000.

What deductions are available?

Regardless of amount, outright gifts to your spouse or to qualifying charities qualify for deductions from the gift tax. In fact, if you made outright gifts in 2016 only to your spouse or to qualifying charities, you will not have to file a gift tax return. The only exception would be if you transferred less than 100% of an asset to a charitable organization (e.g., half of a residence property). And if you made gifts to qualifying charities in 2016, you should talk to your accountant about whether or not such gifts are deductible on your individual income tax return.

Are there any other reasons to file a gift tax return?

Suppose you made a $14,000 gift in 2016 to a trust that included a "Crummey" withdrawal provision. Assuming notice was provided to the beneficiary of that trust, that gift would qualify for the annual exclusion, so a gift tax return would not need to be filed. But suppose that trust is intended to last for multiple generations but does <u>not</u> qualify for automatic allocation of your GST exemption. In that case, you may want to file a timely gift tax return to allocate your GST exemption to that gift. Or, if that trust is <u>not</u> intended to last for multiple generations but fits the IRS definition of a "GST Trust" so that your GST exemption is automatically allocated by statute, you will likely want to file a gift tax return to "opt out" of automatic allocation – for that gift and for future gifts to that trust – to ensure that your GST exemption is not wasted.

For example, a common trust that holds life insurance on your life and provides a trust for your spouse after your death and a further trust for children after your spouse's death <u>but</u> is expected to completely distribute the trust assets to your children during their respective lifetimes fits the IRS definition of a "GST Trust". As a result, any contribution to that trust will have GST exemption <u>automatically</u> allocated to it unless a gift tax return is filed to opt out of that allocation.

Moreover, even if automatic allocation of GST exemption is desired and useful, filing a gift tax return can help keep track of what amount of exemption was automatically allocated and when.

You must also file a gift tax return to report a gift to fund any Grantor Retained Annuity Trusts (or GRATs) that you created during 2016. A GRAT is a type of trust created which pays its grantor an annuity for a specific number of years. At the end of that "term of years", everything in the GRAT could then be distributed to the grantor's children or go into trusts for their benefit. A taxable gift occurs when the GRAT is created (there is no further taxable gift when the annuity term expires). That gift is the difference between the value of the assets contributed to the GRAT and the present actuarial value of the grantor's retained annuity interest. In most cases, this amount is actually zero – but still needs to be reported. And it may also make sense to report the beginning and end of the estate tax inclusion period (ETIP) for a GRAT which benefits a remainder trust (or, in some cases, other trusts) whose ultimate beneficiaries are individuals two or more generations below that of the donor.

Also, if you made a gift of assets that are difficult to value or for which you took a valuation discount, you may want to file a gift tax return to begin the running of the statute of limitations period. If no return is filed, the IRS has an unlimited amount of time to challenge the value of that gift. If a return is filed and the gift (and its valuation) is adequately disclosed, the IRS has only three years (in most cases) to challenge the value of that gift. Even a sale transaction (e.g., a sale of assets to an intentionally defective grantor trust) might be appropriate to report on a gift tax return, so that – after the statute of limitations has run – the IRS cannot revalue the assets sold and assert that part of the transaction was a gift. Please note that since the proposed Section 2704 regulations have been published, there are additional disclosures that may be required to meet the adequate disclosure test.

Estates of New Jersey Residents Who Do Not Survive Until 2018 Could Confront Costly and Unnecessary New Jersey Estate Taxes

As you may know, the New Jersey estate tax has recently undergone drastic changes. For New Jersey residents dying in 2017, the amount exempt from that tax has increased from $675,000 to $2,000,000. As of January 1, 2018, that tax will be repealed entirely. (The separate New Jersey inheritance tax has not been repealed.)

Many wills and revocable trusts currently create a trust for the benefit of spouse and children that would be funded by formula (a “credit shelter”, “bypass” trust or “exemption” trust) geared to the amount exempt from either federal estate tax (which provides a larger funding amount but would incur New Jersey estate tax) or federal and state estate tax (which provides a smaller funding amount and is intended to incur neither tax).

If your documents include a funding formula for such a trust that provides that it will receive the maximum amount exempt from federal estate tax, you may end up paying **as much as $350,000 in completely unnecessary New Jersey estate taxes** in the event of a death in 2017. Before the recent changes in the New Jersey estate tax, it often made sense to pay some of that tax at the first spouse’s passing in order to provide maximum funding for the credit shelter trust. But with the complete repeal of the New Jersey estate tax coming in 2018 and the increased exemption applicable in 2017, paying New Jersey estate tax to get that maximum funding may no longer be worth the cost.

If your documents include a funding formula that provides the maximum amount that would not incur federal or state estate tax is to go into a credit shelter/bypass/exemption trust, the increase in the New Jersey estate tax exemption could dramatically increase the funding amount in the event of death in 2017 and later years, which – tax considerations aside – may not be your intent. Your formula might unexpectedly be putting too much in trust when an outright disposition to your surviving spouse might be preferable.

Since 2001, and the “de-coupling” of the federal estate tax from the prior state death tax credit, we have suggested in numerous client newsletters that you re-examine your will or revocable trust to see if the funding formulas still make sense. If you have not done so previously, you should especially do so now, since the formula could not only accelerate New Jersey estate taxes, but might cause your estate to incur that tax completely unnecessarily, if you were not to survive through this year.

If your will or revocable trust includes either kind of formula funding language, you should revisit your estate plan in the very near future to see if it still works as originally intended. If not, a short codicil or amendment might be in order.

...And New York Residents Should Similarly Review Their Estate Planning Documents Given The Moving Target of the "Cliff" Past Which New York Estate Tax Will Apply

Similarly, estate plans of New York residents may mandate full use of the federal exemption, which is greater than the New York exemption (presently $4,187,500, and increasing to $5,250,000 as of April 1st). If you have such a plan in place, and the first spouse dies prior to the full phase-in of the New York estate tax to match the federal exemption on January 1, 2019, unnecessary New York estate taxes will also be incurred. As we have previously advised, New York residents' estate plans should be reviewed and revised as necessary to avoid the possibility of unnecessary estate tax at the first spouse's death.

The Nonprofit Forum

This is another in a series of articles on nonprofit organizations and issues that we feature in our regular Updates. We have found this area to be one of ever-increasing interest to our clients and colleagues, and we hope you will find these articles helpful and insightful.

Warning: Even Donations to Your Private Foundation Need a Written Acknowledgment

Most taxpayers who make charitable donations in any meaningful amount are now aware that contributions of $250 or more must be acknowledged in writing prior to the earlier of the filing of your tax return for the year of the donation or the due date (with extensions) of that return. Without that acknowledgment, you can't take an income tax deduction for the contribution. There are no exceptions to this rule.

And this rule applies to all contributions of $250 or more to a charity, even if that charity is your personal private foundation.

The form of acknowledgment is very simple. It just needs to describe the gift (including the amount, if cash), the date of the gift, and whether or not you received any goods or services in exchange for any part of the gift (in the case of a donation to your own foundation, you should not be getting any goods or services in exchange). And it needs to be delivered on behalf of the foundation. For example:

> The __________ Foundation acknowledges your gift of 100 shares of the common stock of Publicly-Held Corp. on ______, 20__. No goods or services were provided to you in exchange for any part of this contribution.
>
> Dated:_______
> By:________________, [trustee/officer, etc.]

Email works, too, as long as the sender can be properly identified as a foundation representative.

Multiple gifts throughout the year can be acknowledged in the same acknowledgment. And the acknowledgment requirement only applies to single gifts of $250 or more. For example, if all you give during the year is four separate gifts of $200 each, no acknowledgment is required.

Finally, be sure to keep a copy of the acknowledgment with your tax records for the particular year.

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