

“Net” gifts

Dear Reader:

You recently asked how you can make a gift and have the recipient (“donee”) cover the gift tax liability that will arise. The gift tax liability on a taxable gift falls on the donor under the gift tax rules. However, there is nothing to prevent the donor from making the gift conditional on the donee's paying the tax.

This type of gift is called a “net” gift. The gift tax liability is based on the value of the taxable portion of the gift, just as with any gift. However, the gift is deemed to be smaller, i.e., reduced by the tax bill covered by the donee, which in turn lowers the tax liability. Following is an illustration of how net gifts work. (Recall that the gift tax annual exclusion makes a certain amount given to each donee each year nontaxable. The amount of the exclusion is \$13,000 in 2009. In addition, the amount covered by the gift tax credit for gift tax purposes is \$1 million in 2009.)

Assume that the donor made \$1 million in lifetime taxable gifts earlier in 2009, so any additional taxable gifts in 2009 (i.e., gifts above the \$13,000 annual exclusion) result in a gift tax liability. He wishes to give \$63,000 to his nephew (which would be a taxable gift of \$50,000), but he wants his nephew to pay the gift tax.

Under the gift tax rates, the gift falls in the 41% gift tax bracket, so the gift tax bill would be \$20,500. However, if the nephew must pay the tax, then the gift is not \$50,000, but is only \$29,500 (\$50,000 – \$20,500). So the gift tax is only 41% of \$29,500 (\$12,095) and not \$20,500. But if the gift tax is less than \$20,500, then the gift is higher than \$29,500, which would mean the gift tax liability is higher, the gift lower, and so on and so on.

To escape the above circular calculation, the IRS permits the following formula to be used to arrive at the tax:

tentative tax/(1 + tax rate)

The tentative tax is the tax liability on the unreduced amount of the gift, or \$20,500 in the above example. Thus, here, the tax would be $\$20,500/1.41 = \$14,539$. This makes the gift \$35,461, which is \$50,000 minus \$14,539. And this result is consistent, because 41% of \$35,461 equals \$14,539.

Note that the net gift calculations grow more complex if the gift falls into more than one gift tax bracket or if a state gift tax also applies.

Keep in mind as well that the above describes a situation in which the donee is *obligated* to pay the gift tax under the terms of the gift. If the donee *voluntarily* covers the tax, the treatment is different. The entire amount of the transfer (\$50,000 in the above example) is treated as the gift and the payment of the tax (\$20,500 in this case) would be a separate transaction with no effect on the gift amount.

I should also note that under federal tax legislation enacted in 2001, the estate tax is scheduled to be repealed, effective 2010. However, the gift tax was not repealed, presumably to discourage taxpayers from making transfers to related taxpayers in lower income brackets. Therefore, the gift tax promises to remain a powerful consideration in the structuring of lifetime dispositions and in estate planning.

Please call if you wish to discuss net gifts further or gift-giving in general.

