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Abstract: As the combined gift and estate tax exemption continues to increase, fewer families will be subject to federal gift taxes. If a person's wealth is well within the exemption amount, does that mean he or she doesn't need to file a gift tax return? This article examines situations in which it's necessary (and desirable) to file a return. A sidebar explains the benefits of making direct payments of medical and education expenses.

Do you need to file gift tax returns?

Avoid these common mistakes

For 2019, the lifetime gift and estate tax exemption has reached a whopping $11.40 million ($22.80 million for married couples). As a result, few people will be subject to federal gift taxes. If your wealth is well within the exemption amount, does that mean there's no need to file gift tax returns? Not necessarily. There are many situations in which it's necessary (or desirable) to file Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return" — even if you're not liable for any gift taxes.

All gifts are taxable, except . . .

The federal gift tax regime begins with the assumption that all transfers of property by gift (including below-market sales or loans) are taxable, and then sets forth several exceptions. Nontaxable transfers that need not be reported on Form 709 include:

- Gifts of present interests (as opposed to future interests; see below) within the gift tax annual exclusion amount ($15,000 per recipient in 2019),
- Direct payments of qualifying medical or educational expenses on behalf of an individual (see "Medical and educational expenses: Direct payments only"),
- Gifts to political organizations and certain tax-exempt organizations,
- Deductible charitable gifts, and
- Gifts to your U.S.-citizen spouse, either outright or to a trust that meets certain requirements, or gifts to your noncitizen spouse within a special annual exclusion amount ($155,000 for 2019).

If all your gifts for the year fall into these categories, no gift tax return is required. But gifts that don't meet these requirements are generally considered taxable — and must be reported on Form 709 — even if they're shielded from tax by the lifetime exemption.

Traps to avoid

If you make gifts during the year, consider whether you're required to file Form 709. And watch out for these common traps:

Future interests. Gifts of future interests, such as transfers to a trust, aren't covered by the gift tax annual exclusion, so you're required to report them on Form 709 even if they're less than $15,000. Be aware, however, that it's possible to have gifts in trust meet the present interest requirement by giving beneficiaries Crummey withdrawal powers (the right to withdraw a contribution for a limited time after it's made).

Spousal gifts. If you make a gift to a trust for your spouse's benefit and want the gift to qualify as a nontaxable transfer, the trust must 1) provide that your spouse is entitled to all the trust's income for life, payable at least annually, 2) give your spouse a general power of appointment over its assets and 3) not be subject to any other person's power of appointment. Otherwise, the gift must be reported. And be careful with gifts to a noncitizen spouse: If they exceed the $155,000 annual exclusion, they must be reported regardless of whether they're outright gifts or gifts in trust.

Gift splitting. Spouses may elect to split a gift to a child or other donee, so that each spouse is deemed to have made one-half of the gift, even if one spouse wrote the check. This allows married couples to combine their annual exclusions and give up to $30,000 to each recipient in 2019. To make the election, the donor spouse must file Form 709, and the other spouse must sign a consent or, in some cases, file a separate gift tax return. Keep in mind that, once you make this election, you and your spouse must split *all* gifts to third parties during the year.

529 plans. If you make gifts to a 529 college savings plan, you have the option of bunching five years' worth of annual exclusions into the first year. So, for example, you can contribute $75,000 to the plan ($150,000 if you and your spouse split the gift) and treat the gift as if it were made over the next five years for annual exclusion purposes. To take advantage of this benefit, you must file an election on Form 709.

Consider filing voluntarily

It may be a good idea to file a gift tax return even if it's not required. For example, if you make annual exclusion gifts of difficult-to-value assets, such as interests in a closely held business, a gift tax return that meets "adequate disclosure" requirements will trigger the three-year limitations period for audits.

Suppose you transfer business interests valued at $10 million over a period of years, through a combination of tax-free gifts to your spouse and annual exclusion gifts to your children. If the IRS finds that the interests were worth $15 million, which exceeds the lifetime exemption amount, it can assess gift taxes plus penalties and interest. If you don't file regular gift tax returns, the IRS has unlimited time to challenge the values of your gifts.

Stay on the right side of the IRS

A smart gifting strategy continues to offer significant benefits for you and your loved ones. However, to keep from running afoul of the IRS, it's critical to know when you need to file a gift tax return. We can help you in that determination.

Sidebar: Medical and educational expenses: Direct payments only

Paying tuition or unreimbursed medical expenses on behalf of a child or other loved one is a great strategy for making *unlimited* tax-free gifts without using up any of your $15,000 annual exclusion or $11.40 million lifetime exemption. But it works only if you make the payments *directly* to a qualifying educational institution or medical provider.

A common mistake is for a parent or grandparent to advance the child the funds he or she needs to pay the expenses or to reimburse him or her for expenses that have already been paid. These payments are treated as gifts to the child, which must be reported on Form 709 if they exceed the annual exclusion amount.

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