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GIFTING TO REDUCE FEDERAL ESTATE TAXES

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Federal estate taxes are receiving a lot of attention due to the impending potential reduction or "sunsetting" of the federal estate tax exemption in 2026. If Congress does not extend the estate tax exemption or make it permanent before the start of 2026, the exemption will reduce to $5.5 million per person plus an inflation adjustment, which will bring the total exemption to between $7 and $7.5 million in 2026. The current federal estate tax exemption for 2024 is much higher, at $13.61 million per person.

The potential lower federal estate tax exemption in 2026 and after will still be high enough for many farmers to fall under the exemption and not be subject to federal estate taxes. However, some farmers with higher estate values will see themselves move into the federal estate tax bracket in and be subject to federal estate taxes starting in 2026. Farmers in this situation should explore strategies to help reduce their federal estate tax liability.

One such strategy to consider is gifting, or giving away assets that could be subject to federal estate taxes. In some situations, gifting can help reduce federal estate taxes. In other situations, gifting may have little effect on estate taxes and instead have detrimental effects on income tax strategy. This publication discusses the implications of gifting and how gifting may or may not help with federal estate tax liability.

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TWO TYPES OF GIFTS

There are two types of gifts a person can make – the annual exclusion gift and the lifetime credit gift. The Internal Revenue Service (IRS) allows a person to make annual exclusion gifts, which are gifts of up to $18,000 per person made annually to an unlimited number of people. An annual exclusion gift is not taxable to either the person giving the gift (Giftor) or the person receiving the gift (Giftee). It is a free gift. For example, a grandparent can gift $18,000 each to 10 grandchildren for a total of $180,000, and neither the grandparent nor the grandchildren must pay a federal gift tax on the gift.

The second type of gift is the lifetime credit gift. This IRS rule allows a Giftor to make a gift larger than $18,000 and count the gift toward their federal estate tax lifetime credit. That is, a large gift will reduce the federal estate tax exemption available to the Giftor's estate. For example, if Mother gifts a farm valued at $1,018,000 to Daughter, no gift tax is owed when Mother makes the gift but Mother's federal estate tax exemption will reduce from $13,610,000 to $12,610,000 because the gift is $1,000,000 over the $18,000 annual exclusion gift amount.

For a thorough and detailed discussion of the process of gifting and implications of gifting, see the *Gifting Assets Prior to Death* bulletin, available at farmoffice.osu.edu and part of this Planning for the Future of Your Farm series.

GIFTING STRATEGIES THAT CAN HELP WITH FEDERAL ESTATE TAXES

1. Annual Exclusion Gift Strategies

One gifting strategy to help reduce federal estate taxes is to use the annual exclusion gift. As stated above, multiple gifts of up to $18,000 can be made without tax to either party. The gifts can be money, shares in a business entity, real estate or almost any other kind of asset, and can be given to any individual. The annual exclusion gift can be an effective strategy for those who have many potential recipients for the gift and/or may be close to or just over the federal estate tax exemption. Consider the following example:

> Grandma has 10 grandchildren. She calculates that she will be about $200,000 over the federal estate tax exemption in 2026. She gifts each grandchild $18,000 in both 2024 and 2025. The gifts allow Grandma to gift a total of $360,000.

These gifts allowed Grandma to move back under the estate tax exemption and avoid federal estate taxes. Neither Grandma nor the grandchildren will pay gift taxes on the gift. As the example shows, using the annual exclusion gift can be an excellent way to reduce or eliminate estate taxes.
The primary limitation to the annual exclusion gift strategy is that it may have limited effect for people who are significantly over the federal estate tax limit. While $18,000 is not a small amount of money to gift, it may be too small to make much of an impact on estate taxes of higher wealth people.

Let's continue the previous example with a change of facts:

> Grandma's net worth will be $2 million over the exemption in 2026.

Even though Grandma can gift $180,000 each year to her grandchildren, it will take 12 years for Grandma to gift away $2 million. Additionally, her net worth will likely increase each year. In fact, the increase in net worth may outpace what she is able to gift each year. While annual gifting will always help reduce potential estate taxes, this strategy may only be moderately helpful for higher wealth people.

2. **Lifetime Credit Gift Strategies**

Another strategy is to make large gifts that are more than the $18,000 annual exclusion gift amount. As discussed above, large gifts can be made without paying gift tax. However, the estate tax exemption is reduced by the amount of the gift that exceeds the annual exclusion gift amount. So, lifetime credit gifts are offset dollar-for-dollar by a reduction in the estate tax exemption. However, this strategy can still be effective when gifting assets that are expected to appreciate in value. Gifting these assets keeps the appreciation out of the Giftor's estate. Consider the following example:

> Grandma owns the Smith Farm that sits next to town. It is currently valued at $1 million. She expects commercial development pressure to cause the value of the Smith Farm to increase to $3 million in the next few years. Grandma decides to gift the Smith Farm to her grandchildren.

Grandma can gift the Smith Farm without paying gift taxes. Her federal estate tax exemption will be reduced by $1 million. So, the gift itself does not help her estate tax situation by bringing her under the federal estate tax exemption amount. However, when the Smith Farm increases in value by $2 million, that appreciation in value will be assumed by the grandchildren. Grandma has essentially been able to gift $3 million out of her estate while only using up $1 million of her estate tax exemption.

This strategy may not be the best strategy for assets that will have no or little appreciation. For a non-appreciating asset, the gift just comes off the estate tax exemption and does not help the estate tax situation. Again, large gifts work best with appreciating assets.

Capturing the Higher Lifetime Credit

As stated previously, the current lifetime credit gifting allowance is $13.62 million and could decrease by about one-half in 2026. So, there is an opportunity to make a large gift now and capture the large gift allowance before it might be reduced in 2026. Consider the following example:

> Grandma has a net worth of $20 million. She is concerned she will be over the estate tax exemption limit by $13 million in 2026, resulting in around $5 million of estate taxes. To avoid these taxes, Grandma gifts land valued at $13.62 million to her grandchildren in 2024.

In this scenario, Grandma is able to gift her entire lifetime credit, which reduces her federal estate tax exemption to $0. But, if the estate tax exemption reduces to $7 million in 2026, there will be no "claw back" of her gift. That is, her estate tax exemption will remain at $0 because the IRS does not seek to recoup any of the 2024 gift that exceeds $7 million. So, Grandma is able to gift $13.62 million in 2024 and retains the extra $6.62 million as her exemption even if the federal exemption reduces in 2026. Grandma's net worth is reduced to $6.38 million. She will have no federal estate tax exemption left at her death, so her estate will owe estate taxes on $6.38 million. But that is much better than owing estate taxes on $13.62 million. By making the large $13.62 million gift now, Grandma saved her heirs around $2.6 million in estate taxes.

Obviously, this strategy only works for high wealth individuals. The person must have enough assets to gift more than the full exemption amount and still have adequate assets remaining to support themselves. Most people do not have enough wealth to make this strategy work, but for those who do, it can be very effective.

DISADVANTAGES OF GIFTING

Gifting is not without a few disadvantages. The impact of these disadvantages depends upon an individual's situation, so it's important to consider them before developing a gifting strategy.

1. Loss of Stepped-Up Basis

At death, the assets owned by a deceased person receives a stepped-up tax basis to the fair market value of the asset. The new owners of the assets can re-depreciate the asset or sell them for little or no tax liability. The stepped-up tax basis is a tremendous financial benefit to the new owner. A gifted asset does not receive a stepped-up tax basis at the time of gift. Therefore, gifting an asset eliminates the stepped-up tax basis opportunity. Careful consideration should be given to losing the potential of a stepped-up basis before deciding upon a gifting strategy.

For a thorough and detailed discussion of gifting and stepped-up tax basis, see the Gifting Assets Prior to Death bulletin, available at farmoffice.osu.edu and part of this Planning for the Future of Your Farm series.

2. Loss of Control and Income

A gift is a gift. This means that the person gifting the asset cannot retain any control or ownership. It can be difficult to give up control of assets that took a lifetime to accumulate. Also, retaining any income rights from the gifted property will cause the property to remain in the estate. Gifting should only be done if the income from that property is not required for living needs and the Giftor is willing to relinquish all ownership and control of the asset.

3. Risk of Losing the Property

A nightmare scenario for the Giftor is to see the gifted assets lost due to financial mismanagement or misfortune by the Giftee. Consider the following example:

> Grandma gifts the Smith Farm to granddaughter Julie. Unbeknownst to Grandma, Julie is heavily in debt due to overspending and poor financial management. After Julie receives the Smith Farm, her creditors file suit against her and force her to sell the Smith Farm to pay her debts.

Once Grandma gifts the Smith Farm, she can no longer control it. She cannot protect it from Julie's creditors and the farm may be lost unless Grandma can buy it back. Before making large gifts, it is good practice to have an idea of the financial stability of the person to whom the gift is being made.

One way to overcome this issue is to use an irrevocable trust. The trust holds the assets and distributes income to the beneficiaries. Because the beneficiaries do not legally own the assets in the trust, their personal financial misfortunes cannot affect the assets. Consider the following example:

> Grandma wants to gift the Smith Farm to Julie but knows Julie is not the best at managing money or assets. Grandma establishes an irrevocable trust for Julie. The trust will provide income to Julie for the remainder of Julie's life, and then at her death, the farm will go to Julie's children. Grandma transfers the Smith Farm to the trust and names, Jeff, her son, to be trustee of Julie's trust.

In this scenario, the Smith Farm is not at risk if Julie has financial difficulties. Julie does not own the Smith Farm so her creditors cannot get access to it. The income from the trust may be required to be paid to creditors but the farm itself is safe. Irrevocable trusts can be a good way to make gifts and help protect them from financial problems of the Giftee.

PAYING MEDICAL AND EDUCATION EXPENSES RATHER THAN GIFTING

The IRS does not consider the payment of certain educational and medical expenses to be a gift. Therefore, an unlimited amount of educational and medical expenses can be paid on behalf of someone else without triggering a gift tax or reduction of the estate tax exemption. Paying educational and medical expenses for someone else will help reduce federal estate tax liability.

1. Educational Expenses

There are two important points to remember regarding education expenses. First, the exclusion applies only to tuition payments. Other school-related expenses like books, supplies, and room and board costs are not eligible for this exclusion. Second, the tuition must be paid directly to the institution and cannot go directly to the student.

2. Medical Expenses

Payments that qualify for the medical exclusion are those made directly to a healthcare provider, medical institution, or medical insurance company for another person's benefit. Transportation and lodging costs related to the person's medical care can also be covered, but there are specific rules so it is best to consult with a tax professional. The payments must go directly to the care provider or insurance company, not to the individual receiving care, to avoid being considered a taxable gift.

SEEK LEGAL AND TAX ADVICE

Making gifts, particularly large gifts, have significant legal and tax consequences. Before implementing a gifting plan, be sure to consult with legal and tax advisors to explore all options and understand the implications of different strategies. While gifting may seem like a simple solution to federal estate tax liability, gifting is often complicated and has complex legal and tax consequences that should be carefully considered.

CONCLUSION

Many farmers may be facing estate tax liability in 2026. While there are no easy solutions to avoiding federal estate taxes, there are some gifting strategies that can help reduce or minimize them. But the implications of gifting, both positive and negative, must be carefully analyzed before acting. In many situations, the negative aspects of gifting may be greater than the benefits. Before implementing a gifting strategy, be sure to consult with an attorney and accountant.

Find all our **Planning for the Future of Your Farm** resources at https://go.osu.edu/farmplanning

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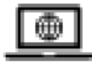
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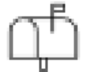
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