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When Generosity Bumps Into Gift Tax

By DEBORAH L. JACOBS

THESE days, many prosperous baby boomers are subsidizing parents, and sometimes siblings, who are less fortunate. Innocuous as this may seem, being generous can also subject you to gift tax. While helping a family member often occurs under the radar, if the gift exceeds a certain value and the I.R.S. catches it, you could be forced to pay the tax as well as interest.

Nancy G. Henderson, a trusts and estates lawyer with Henderson & Caverly in Rancho Santa Fe, Calif., has advised clients on these issues and dealt with them in her personal life. After her mother developed health problems in 2002, Ms. Henderson suggested she move west from Dallas and live closer to family. Trouble was, her mother, Anita Gundermann, 80, couldn't afford the higher rent. So Ms. Henderson bought a house for her in Carlsbad, Calif., about 15 minutes away.

Ms. Henderson's gift to her mother, rent-free living worth about \$21,600 annually, fits well within what's called the annual exclusion. This is the \$12,000 in cash or other assets (\$24,000 if, like Ms. Henderson, you're married) that you can give each year to as many people as you want without having to worry about gift tax. There is also a lifetime exemption of \$1 million (\$2 million for married couples) before a 45 percent gift tax applies.

Here are strategies for subsidizing relatives without having to pay gift tax.

¶Capitalize on the annual exclusion. Although simply writing a check is the easiest approach, you can also put money or income-producing assets (like bonds or shares in a closely held company) into trusts that will benefit various family members. You can add \$12,000 a year for each trust beneficiary, so the more beneficiaries the more you can give away without paying tax.

Another way to use the annual exclusion is to put money in Section 529 education savings plans. That can help siblings who might be burdened by saving for their own children's college education, said Randi Grant, a financial planner with Berkowitz, Dick Pollack & Brant in Fort Lauderdale, Fla.

¶Pay medical and educational expenses. Without using your annual exclusion, you can pay for education, dental and medical expenses (including health insurance premiums) of anyone you want. But you must make the payments directly to the providers of those services.

Especially with elderly parents, the chance to pay for medical expenses is an "overlooked opportunity," said M. Read Moore, a lawyer with McDermott Will & Emery in Chicago. You can cover anything that the person would be allowed to deduct on a tax return as an unreimbursed expense. This includes big-ticket items like medically necessary home improvements or home-care attendants. You can also pay part of another person's long-term-care insurance — up to \$3,080 for someone 61 to 70 years old, and up to \$3,850 if they

are over 70.

¶Employ family members. Whether they provide child care, manage real estate or keep the books, the compensation must be reasonable — not more than you would pay a stranger for the same work. Business owners who hire family members can also deduct at least part of the cost of health insurance and long-term-care insurance as a fringe benefit, said Bernard A. Krooks, a lawyer with Littman Krooks in New York.

¶Lend and borrow money. Credit between family members requires the formalities of a bank loan, but the rate can be more favorable.

If you lend money to family members — say, to buy a house or a car, start a business or pay off an unfavorable bank loan — you must charge a minimum rate of interest set each month by the Treasury, called the applicable federal rate. In April, the rate for long-term loans (those lasting more than nine years) and requiring monthly payments is an extremely attractive 4.31 percent.

Alternatively, you can benefit parents or siblings by borrowing money from them and paying more interest than they could get from money markets or bank C.D.'s. There's no maximum government-set rate, but Mr. Moore suggests you "mimic the market" by paying what a bank in your area would charge for a comparable personal loan.

¶Make a family member your dependent. To do that, you must pay at least 50 percent of the person's support, said Jerome M. Hesch, a tax lawyer with Greenberg Traurig in Miami. The law defines dependents very broadly — it can include most of your relatives and their spouses, for example.

The only catch is that you can't claim someone as a dependent if his or her gross income is more than \$3,400. Social Security doesn't count, but required withdrawals from retirement plans, like I.R.A.'s and 401(k)'s, do.

There are ways around the income limits, though. In one case, Mr. Hesch recommended that a parent reduce his income by giving \$300,000 worth of investment assets to his children so they could claim him as a dependent. He advised another couple to sell \$500,000 of corporate bonds and instead buy tax-exempt municipals because income from those would not count toward the limit.

Those who claim a relative as a dependent can reap a huge tax benefit themselves, Mr. Hesch said, by deducting the dependent's unreimbursed medical expenses when the total is more than 7.5 percent of their own adjusted gross income.

Finally, if a family member is relying on your largess, make sure you provide a safety net, like life insurance or an inheritance, in case something happens to you, Mr. Moore said.

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