Forbes

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TAXES 11/24/22

Gifts Can Be Taxed, Even On Holidays

At the holidays, many people give gifts or donations, but telling them apart can be important for tax purposes. The holiday season starts with Thanksgiving. The classic O. Henry story Two Thanksgiving Gentlemen illustrates the giving spirit. Each year, a homeless man receives a grand dinner hosted by a successful businessman. Ironically, the businessman is down on his luck and has to go pinch pennies to afford the meal, while the homeless man has already had *other* dinners that day and attends because he knows how important it is each year to the businessman.

Despite the charity on both sides, the charity the two Thanksgiving gentlemen exchange isn't tax deductible. The IRS says business gifts you make in the course of your trade or business are deductible up to $25 per person. Is that dollar amount reasonable today? Hardly, but the limit just hasn't kept pace and is not keyed to inflation.

Donations to recognized charities are different, but even if you are giving to a charity, you can't deduct the value of your time or your services. This is so even if you usually bill by the hour and donate many hours of otherwise billable time to charity. You also can't deduct gifts made directly to the needy even if you're trying to get your money where it will do some good. You can read the IRS's take on charitable contributions here.

Even if you've checked the credentials and IRS tax exemption of an organization, how do you know how much goes to overhead and what your money really supports? Public charities and churches are supposed to benefit the general public, not private individuals. Some charities pay executive salaries and other perks that can make you squirm. Many types funnel money to charities of the full 501(c)(3) variety, making contributions to those charities tax deductible by donors. The stakes are large, and nonprofits often face scrutiny from the IRS.

Lavish spending and private inurement are classic problems with some non-profits. When the IRS finds this, penalties can be assessed, and in extreme cases, the government can threaten to actually revoke the charity's tax exemption. Big payments for goods or services don't necessarily violate the law, but there is IRS scrutiny to be sure there's no private inurement. The usual key to such arrangements is whether the terms and conditions are at arm's length—the kind of deal unrelated parties strike.

If a tax exempt church or charity pays a founder or someone else more money than is fair for goods or services, it can jeopardize the tax-exempt status of the organization. There's a particularly big risk if it looks like the charity is the founder's own private fiefdom. How does the IRS find out? Although tax-exempt, these charities must file tax returns on IRS Form 990.

What about gift tax? Gifts are not taxed as income to the recipient, so if any gift tax is payable, the giver pays it. But there is a $16,000 annual exclusion from gift tax for as many people as you want, regardless of whether they are family. If you go over the $16,000 per person—and that includes birthdays and Christmas—it eats into your lifetime exclusion from gift and estate tax, currently about $12.06 million.

The moral? When it comes to giving don't be controlled solely by taxes, like the two Thanksgiving gentlemen. Alternatively, get some tax advice before you act. Incidentally, make sure your donee can use what you give. In O. Henry's "The Gift of the Magi," a struggling young couple wants to exchange something special for Christmas. Della cuts off her flowing hair and sells it to a wig maker to buy a platinum chain for her husband Jim's heirloom pocket watch. Jim sells his prized watch to buy combs for Della's hair. It is a lovely story about the spirit of giving, but each ends up with something they can no longer use. Sometimes, tax deductions are like that too.

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