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Gift tax reporting for transfers to Irrevocable Trusts

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Irrevocable trusts offer investors significant benefits, including asset protection from creditors and lawsuits, tax advantages by reducing estate and income tax liabilities, and efficient wealth transfer while avoiding probate. They also support Medicaid and government benefits planning by removing assets from personal estates, provide control over asset distribution and facilitate charitable giving with potential tax deductions. Additionally, irrevocable life insurance trusts (ILITs) help minimize estate taxes on life insurance proceeds, ensuring beneficiaries receive maximum financial benefits. These features make irrevocable trusts a powerful tool for long-term financial planning and wealth preservation.

The process of implementing an irrevocable trust as part of your estate plan can be long and arduous. First, you must settle on the best strategy that fits your overall goals and makes sense from a financial perspective (after all, you are typically planning to part permanently with assets you worked hard to acquire). The trust must then be drafted, reviewed and executed. Next, you must finalize the funding of the assets to the trust. However, the process often doesn't end there.

The federal gift tax

In many cases, you will need to report the asset transfer to the IRS. The estate tax savings that drive the purpose of such trusts requires that the transfer to the trust be considered a completed gift for gift and estate tax purposes, so it is no longer a part of your estate when you pass away.

As a result, the taxable value of the gift will count against your lifetime exemption for federal estate and gift taxes (currently $13.91 million in 2025). Once that exemption is used up, you will need to pay tax on any additional gifts. To the extent you have exemption remaining at your death, that is used to offset any estate tax liability. Taxable gifts are reported to the IRS for the calendar year in which they were made on IRS Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return, which is due on the same day as your 1040 individual return.

The good news is that federal tax law allows an exclusion for the first $19,000 (in 2025) of gifts of a "present interest" to a donee each year, which is subtracted from total gifts to arrive at the value of the taxable gift. It is the value of the taxable gift which reduces your lifetime exemption. For a gift in trust, each beneficiary who has a present right to withdraw the gift in that calendar year is treated as a separate donee for purposes of the annual exclusion. This is why irrevocable trusts often contain provisions for beneficiary "withdrawal rights" (often called Crummey withdrawal rights after the federal court case which approved their use).

Gifts to trusts that must be reported to the IRS

With few exceptions, a completed gift to an irrevocable trust which is not entirely reduced by the present interest withdrawal rights of the beneficiaries must be reported to the IRS. This naturally includes gifts to trusts for which there are no withdrawal rights. Transfers to a Grantor Retained Annuity Trust (GRAT) must be reported, since the transfer of the remainder interest following the annuity period to the remainder beneficiaries is by definition not a present interest and thus not reduced by the gift tax annual exclusion (even if the value of the remainder interest is calculated to be $0).

Similarly, transfers of real estate to a Qualified Personal Residence Trust (QPRT) are required to be reported. Gifts to Charitable Remainder Trusts (CRTs) and Charitable Lead Trusts (CLTs) need to be reported as well, with some limited exceptions, even though there will be an offsetting charitable deduction on the gift tax return for the value allocated to the charitable beneficiary.

In addition, gifts to a lifetime Qualified Terminable Interest Property (QTIP) trust, which are designed to exclusively benefit a spouse, must be reported in order to elect QTIP treatment of those assets.

Transfers to trusts that don’t have to be reported, but may be beneficial to report

A sale of an asset to an Intentionally Defective Grantor Trust (IDGT) at its fair market value, which is a common estate planning technique, is not a gift, and thus it is not required to be reported on a gift tax return. Also, a gift that is entirely reduced by the annual exclusion is not reportable to the IRS. However, it may be in the taxpayer’s interest to report them anyway.

At first you may think, why would one want to report anything to the IRS if it isn’t required? The answer is to prevent the IRS from challenging in the future the value assigned to an asset in the transaction. The value of property transferred to a trust is often not easily ascertainable. While the value of cash, stocks or other securities can be determined on any given date with certainty, other assets have to be appraised to determine an opinion of value. Like any opinion, people can differ on their assessment of an asset’s value. For instance, assume you sell a fractional interest in your business to an IDGT, and that interest is valued by an appraiser for $2 million. You therefore receive back from the trust value in the same amount (cash, promissory note, etc.). The IRS may later step in to assert that the business interest was really worth $3 million in their opinion, and therefore you made a gift to the trust worth $1 million.

The benefit of reporting a sale or gift to a trust of a hard-to-value asset is that it can limit the time in which the IRS can come back and challenge the value. Section 6501(a) of the Internal Revenue Code limits the ability of the IRS to challenge the value of an asset adequately disclosed on a gift tax return to three years from the due date of the return or when the return was actually filed (whichever is later). If you do not disclose the transaction to the IRS, even if it wasn’t required, the value can be challenged by the IRS any time – even after you die!

The importance of adequate disclosure on the gift tax return can be even greater if the appraisal includes valuation discounts for lack of control or lack of marketability, commonly used for interests in closely held business entities. The IRS has historically challenged valuation discounts, especially in the context of family investment entities.

The importance of adequate disclosure

In order to start the three-year statute of limitations, whether the gift must be reported or not, the transaction must not only be reported in a gift tax return, but also the valuation of the asset must be "adequately disclosed," the details of which are spelled out in the tax code and regulations. In essence, the taxpayer has two choices to meet adequate disclosure: (1) include a laundry list of required detail as provided in Treas. Reg. §301.6501(c)-1(f)(2), or (2) submit a Qualified Valuation Report prepared by a professional appraiser as defined in subsection (f)(3) of the Regulation. The former method has its own risks, as the requirements can be subjective. The latter method is considered by many to be a safe harbor to run the statute of limitations.

If it's important to you to ensure the IRS cannot challenge the valuation after three years, then you should consider obtaining a Qualified Valuation Report by a professional appraiser. Since these types of reports may take weeks or even months to complete (depending on the complexity of the asset), you may wish to secure a valuation expert early on in the planning process.

The federal generation-skipping transfer tax

The other purpose of the Form 709 is reporting allocation of your lifetime exemption from the federal Generation-Skipping Transfer (GST) tax, a separate tax which applies to certain gratuitous transfers during life and at death to someone two or more generations below the transferor. Since the estate and gift tax is considered a tax on the generational transfer of wealth, the GST tax sets a limit the amount one can transfer that skips a generation by adding an extra layer of tax. Currently, the GST lifetime exemption is equal to the estate and gift tax lifetime exemption ($13.91 million in 2025), although it is separately accounted for. For transfers to trusts, the GST tax is very relevant, since many trusts are designed to last over multiple generations and the allocation of GST exemption to a current transfer to a trust can exempt all the future growth in trust assets from exposure to this tax.

To further complicate matters, federal tax law and regulations provide certain rules for the automatic allocation of GST exemption to trusts. Often, these rules provide the result you want – other times, they don't.

If you want to ensure the allocation of GST exemption is made in a manner different than the automatic allocation rules, or if there is any ambiguity as to how those rules apply to your trust, you should consider filing a gift tax return to report how you want the exemption to be applied. You can even elect to have allocations of GST exemption made to a trust consistent for all future transfers, so you don't need to repeat that reporting each year a gift is made to that trust.

Conclusion

Irrevocable trusts provide a lot of value to investors however, as you can see, the gift tax reporting of transfers to trusts can be complex and may have important tax consequences.

As a part of the trust creation and funding process, you should engage tax counsel (and, if needed, a valuation professional) who is experienced with these matters along with your Mesirow Wealth Advisor to be sure the reporting to the IRS is completed accurately.

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