Chapter 10

Gifting Strategies

CFP® Certification Examination Principal Topics Covered in This Chapter:

Gifting Strategies

* Inter-vivos gifting
* Gift-giving techniques and strategies
* Appropriate gift property
* Gifts of present and future interests
* Applicable credit amount
* Gift, estate, and income tax implications

Basis

* Basis of property received by gift
* Basis of inherited property

Learning Objectives

To ensure that you have a solid understanding of the various gifting techniques and strategies available, the following learning objectives are addressed in this chapter:

• Recognize the tax and non-tax advantages of gifting.

• Identify the best property interests to gift, according to a client’s objectives.

• Explain the purpose and nature of the gift tax law.

• Recognize when a completed transfer has occurred.

• Define direct, indirect, present, and future-interest gifts.

• Describe the unified transfer tax system and how taxable gifts affect the estate tax.

• Understand how the unified credit shelters gift and estate taxes.

• Calculate the income tax basis of gifted property.

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Overview

When someone gives property to another person or transfers the property into an irrevocable trust, the person has made an **inter-vivos** (lifetime) **gift**. Inter-vivos gifting is a very important estate planning technique because it transfers wealth to others and reduces the value of a person’s estate, which may consequently reduce estate tax liability. Therefore, an inter-vivos gift is not a bequest, which transfers property at death according to provisions in the decedent’s will.

Financial planners need to work together with their clients to determine whether gifting strategies are warranted based on each client’s personal and financial goals, current and future liquidity needs, available assets and resources, and tax situation. Lifetime gifting should be considered as part of a client’s overall estate plan, and it should be coordinated with a client’s retirement, tax, and investment planning objectives within the framework of a comprehensive financial plan. The planner should review the client’s assets and liabilities and all sources of income—including life insurance policies—and then project the growth rate of these assets before recommending the best property interests to gift to others.

Practice Standard 300-1

Analyzing and Evaluating the Client’s Information

A financial planning practitioner shall analyze the information to gain an understanding of the client’s financial situation and then evaluate to what extent the client’s goals, needs and priorities can be met by the client’s resources and current course of action.

Gifting Strategies

Under common law, a **gift** is defined simply as a voluntary transfer without adequte consideration. To escape the **gift tax**, there must be “adequate and full consideration” equal in value to the property transferred. For example, a $100,000 building that is transferred from a mother to her daughter for $100,000 in cash clearly does not constitute a gift. If that same building was given outright to the daughter with no cash in exchange, or, if the daughter gave her mother less than $100,000, then the transfer would constitute a gift.

Parties to a Gift

A person who gifts property to another person or entity is known as a **donor**, and the recipient of a gift is the **donee**. Almost anyone can be a donee, including spouses, children, other relatives, partners, beneficiaries of a trust, and corporate shareholders. Donees can also be entities such as charities, organizations, foundations, and others. A donee does not pay any income or gift taxes when a gift is received, but the donee could pay income taxes if the property earns income or is subsequently sold. Furthermore, if the donee still owns the gifted property at the time of his death, the property could be subject to estate taxes and probate costs.

Non-tax Advantages of Gifting

Individuals give property away during their lifetimes for many different reasons. Some of the non-tax advantages of lifetime gifting may include:

* + the vicarious enjoyment of seeing the donee use and enjoy the gift;
  + to provide for the education, support, and financial well-being of the donee;
  + to provide an opportunity for the donor to see how well, or how poorly, the donee manages the business or other property;
  + to maintain privacy that would be impossible to obtain through a testamentary gift;
  + to potentially reduce probate and administrative costs and avoid delays; and
  + to protect the donor from the claims of his creditors.

Tax-oriented Advantages of Gifting

Gifting can potentially reduce a person’s estate tax liability and provide the donor with some distinct tax advantages that are available only for lifetime gifts.

* + A donor can give up to $14,000 gift tax free to an unlimited number of donees in 2015. .
  + Married couples can “gift-split” so that $28,000 can be given gift tax free to an unlimited number of individuals in 2015.
  + The value of the gifted property is removed from the donor’s estate, along with any appreciation on the property accruing between the time of the gift and the date of the donor’s death.
  + Any gift taxes paid more than three years before the donor’s death remove that money from the donor’s gross estate, which further reduces the value of the donor’s estate.

Best Property to Gift

The type of property to gift requires careful consideration with the client’s integrated estate plan. A number of factors must be examined when selecting the types of property that are appropriate for gifts. Be sure also to consider the age, maturity, and experience of the donee before selecting a gift.

In general, the best types of property to gift include:

* + **Property that is likely to appreciate in value.** Other things being equal, planners generally try to pick property that will appreciate substantially in value from the time of the transfer. Some examples include common stock, antiques and art, and real estate. The removal from the donor’s estate of the appreciation in the property, as well as the removal of any income from the property, could save a meaningful amount of estate and income taxes.
  + **Property that has a low gift tax value and a high estate tax value.** Life insurance, for example, is property with a low present value but a high appreciation potential. If held until the date the insured dies, its appreciation in value is guaranteed. Life insurance policies are often transferred to individuals or trusts to avoid inclusion of the death benefit in the owner-insured’s estate.
  + **Income-producing property when the donee is in a lower income tax bracket than the donor.** Income splitting between the donor and a donee aged 18 or older can be obtained by transferring high-income-producing property to a family member in a lower bracket. High-dividend participating preferred stock in a closely held business or stock in a successful S corporation is a good example of high-income-producing property. Kiddie tax rules will apply when a donee is younger than age 19, or age 19–23 and attending college.
  + **Property that has already appreciated in value** should be given away **if a sale of such property is contemplated and the donee is in a lower income tax bracket than the donor**.
  + **Appreciated property as a gift to charity**. The donor could avoid a capital gains tax and receive an income tax charitable deduction, but this deduction is subject to adjusted gross income (AGI) limitations.
  + **Property that is located in a state other than the owner’s state of domicile**. This property makes sense to gift away or to transfer into a trust to avoid facing an ancillary probate at the time of the donor’s death.

Best Property to Keep

It is extremely important to focus on the client’s circumstances before making a gift. Do not give away any asset if it will reduce the client’s standard of living or if it will financially or psychologically endanger his “comfort level.” Planners should focus particularly on the impact of the gift on the client’s income and capital needs (both present and anticipated) as well as on the client’s need for liquidity.

Some of the best types of property to keep include:

* + **Highly appreciated property that is likely to be sold after the owner’s death.** Property included in a decedent’s estate is stepped up to a new **basis** of fair market value (FMV) at death. If the property is expected to be sold immediately after the owner’s death, the person who inherits the property will not have to pay a capital gains tax on the subsequent sale. If that same property was given to the beneficiaries during lifetime, then there would be no step-up in basis, and the beneficiary would have to pay more income tax on the subsequent sale of property than if the beneficiary had taken the property as a bequest.
  + **Property that, if sold, would result in a loss.** When a donor gifts property to a donee, the donee will take the lesser of the donor’s basis or the FMV of the property as of the date of the transfer. Therefore, it is not a good idea to give away property that would result in a loss because the donee cannot use the donor’s loss to reduce his own income taxes. The donor should sell that property, take the income tax deduction for the loss himself, and then gift the proceeds of the sale to the donee.
  + **Depreciating income property.** Depreciation deductions offset an owner’s income tax liability so the property should be kept until it has been fully depreciated.

Pros and Cons of Gifting

To gift or not to gift is an estate planning issue that needs to be carefully considered, because there are several advantages and disadvantages to making inter-vivos gifts. Donors who make completed gifts remove the value of the properties from their gross estate, but they also lose control over their property and diminish their wealth. Property held until the donor’s death is included and perhaps taxed in the donor’s estate, but it will receive a step-up in basis to FMV. The heirs will inherit the property with this new basis, which is an advantage if they intend to sell the property at a later time. However, if property is gifted during the donor’s lifetime, the donee generally takes the donor’s adjusted basis in the property, which is often less than the FMV of the gift.

As you can see, there are some distinct tax—and non-tax—consequences to making gifts, and perhaps some competing family interests as well. A financial planner can expertly guide a client through the decision-making process to arrive at a course of action that is in the client’s and the family’s best interests.

Financial Planning Practice Standard 400-3

Presenting the Financial Planning Recommendation(s)

The financial planning practitioner shall communicate the recommendation(s) in a manner and to an extent reasonably necessary to assist the client in making an informed decision.

Purpose and Nature of the Gift Tax Law

The federal gift tax was introduced in 1932 to prevent taxpayers from transferring their entire estates to others during their lifetime without paying a transfer tax. For tax law purposes, neither the statutes nor the regulations specifically define what is meant by the term *gift*. For gift tax purposes, a gift can be broadly defined to include a sale, exchange, or other transfer of property from one person (the donor) to another (the donee) without adequate and full consideration in money or money’s worth. The regulations dealing with the valuation of gifts provide that a gift is the difference between the value of property transferred and the consideration received.

|  |
| --- |
| Value of property transferred |
| ˗ Consideration received |
| Gift |

Some transfers do not fall within the scope of the gift tax law.

* + Services rendered for the benefit of another person
  + Compensation for professional services
  + A disclaimer, which is a written refusal to accept a gift
  + A promise to make a gift in the future
  + Bad bargains, which are sales for less-than-adequate money’s worth
  + Sham gifts, which shift the income tax burden to someone in a lower bracket
  + The assignment of income to another person
  + Payments made pursuant to a legal decree or court order
  + Contributions to political parties

The Gift Tax

The gift tax is an excise tax, a tax levied not directly on the gift itself or on the right to receive the property, but rather on the right of an individual to transfer money or other property to another. The gift tax is based on the value of the property transferred. *Value*, for gift tax purposes, is defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.” Therefore, value is usually the FMV of the property on the date of the transfer.

Elements of a Gift

Before a gift is subject to federal gift tax, certain requirements must be met, which are summarized here:

* + The donor must be competent to make a gift, and the donee must be capable of receiving the gift.
  + There must be an “intention” by the donor to make a gift.
  + The donor must deliver the gift to the donee.
  + The donee must take possession of the property.

Direct and Indirect Gifts

Taxable gifts can be both direct and indirect gifts. **Direct gifts** are gifts that are made outright to others, and they can consist of real and personal property. The gift tax is imposed on the shifting of property rights, regardless of whether the property is tangible or intangible. It can be applied even if the property transferred (such as a municipal bond) is exempt from federal income tax or other taxes. Direct gifts subject to a gift tax can also include transfers of cash, life insurance policies, stocks, bonds, partnership interests, and even gifts of royalty rights.

In addition to an outright transfer, **indirect gift**s are also subject to the gift tax. Some examples of indirect gifts include a transfer of money or property into an irrevocable trust, the payment of someone else’s expenses, the forgiveness of a debt or a note, foregone interest on an intrafamily interest-free or below-market loan, or the assignment of benefits in an insurance policy.

Present and Future Gifts

When a gift is made to an individual or transferred into a trust, the donee may have a present or a future interest in the property. A **present-interest gift** occurs when the donee has the unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property. An example is a gift of a painting to a friend. The friend can keep the painting, sell the painting, or gift it to someone else.

With a **future-interest gift**, the donee must wait before he can use, possess, or enjoy the property or obtain the income. An example of a future-interest gift is when income-producing property is transferred into a trust and the income can accumulate for a period of time before any income or corpus is distributed to the beneficiaries. The beneficiaries (donees) in this case all have a future interest in the trust property.

Completed Transfers

A **completed transfer** is necessary before the gift tax can be applied. The term *completed transfer* implies that the gift has been put beyond the donor’s recall, i.e., that he has irrevocably parted with dominion and control over the gift. Property transferred during lifetime is valued for gift tax purposes on the date the completed gift is made. No alternate valuation date is allowed.

In a number of situations it is difficult to ascertain just when a completed gift occurs because a gift can be incomplete when the transfer is initially made.

Personal Checks or Notes

No gift is made at the moment the donor gives the donee a personal check because the gift is not taxable until the check is cashed. For instance, if a check is mailed in December, received in late December, but not cashed until January of the following year, no gift is made until that year. This is because, typically, the maker of a check is under no legal obligation to honor the check until it is cashed. Likewise, a gift of a negotiable note is not complete until it is paid.

Gift Causa Mortis

An individual on his deathbed will sometimes make a **giftcausa mortis** (in anticipation of his imminent death) and then quite unexpectedly recover. Neither the original gift nor the return of the property to the donor is subject to the gift tax if the donor recovers and the donee returns the property. A gift causa mortis is therefore incomplete as long as the donor is alive; it becomes complete at the donor’s death.

Stock

A gift of stock is completed on the date the stock was transferred or the date endorsed certificates are delivered to the donee (or his agent) or to the corporation (or its transfer agent).

U.S. Government Bonds

A transfer is not a completed gift until the registration is changed in accordance with federal regulations. For example, if a grandmother purchases a U.S. savings bond that is registered as payable to her and to her two children as co-owners, no gift is made to the grandchildren until one of them surrenders the bond for cash.

Totten Trust

This is a bank savings account where the donor makes a deposit for the donee (Joanne Q. Donor in trust for James P. Donee) and retains possession of the savings book. Because the donor can recover the entire amount deposited, it is a revocable transfer, and no gift occurs until the donee makes a withdrawal of funds.

Joint Bank Accounts

Typically with a joint checking or savings account, the person making a deposit can withdraw all of the funds or any portion of them. Therefore, the donor has retained a power to revoke the gift, so it is incomplete. Similar to a Totten trust, when the donee makes a withdrawal of funds from the account (and thereby eliminates the donor’s dominion and control), a gift of the funds occurs. For example, if a father deposited $100,000 into a bank account in November of last year, and his son withdraws $8,000 this March, the father has made a gift to his son of $8,000 this year.

Joint Brokerage Account

The creation and contribution to a joint brokerage account held in “street name” is not a gift until the joint owner makes a withdrawal for his personal benefit. At that time, the donee acquires indefeasible rights and the donor parts irrevocably with the funds. Conversely, if a person calls her broker and says, “Buy 100 shares of Texas Oil and Gas and title them in joint names, mine and my husband’s, with right of survivorship,” the purchase constitutes a non-taxable gift to her husband. The husband has acquired rights to a portion of the stock on the date of the purchase that he did not have before.

Real Estate

Real estate is transferred by executing a deed in favor of the donee. But if the donor retains the deed, does not record it, makes no attempt to inform the donee of the transfer, and continues to treat the property as his own, no transfer occurs.

Forgiveness of a Note

When property is transferred in exchange for an installment note, the transaction is treated as a sale for income tax purposes, but forgiveness of the note is a gift. The gift occurs when the donor marks the note “cancelled by gift.”

Split-interest Gifts

When the owner of a property keeps a lifetime interest in the property for himself and gifts the remainder interest in the property away, the owner has made a gift of the present value of the remainder interest. Although the donee has to wait to own the property outright, the gift is made at the time the donor transfers the property interest into a trust or changes the title of the deed.

Incomplete Gifts in Trust

An **incomplete gift** in trust does not trigger a gift tax. Donors sometimes transfer property to a trust, but they retain the right to revoke the transfer. Property transferred into a revocable trust is not a completed gift. A completed gift occurs only when a donor relinquishes all control over the transferred property, i.e., when the trust becomes irrevocable. However, distributions from the trust will be treated as a completed gift.

Client Situation

Emily created a revocable trust in 2013 for the benefit of her disabled brother, Peter. She transferred $90,000 into the trust and gave a corporate trustee the discretion to make disbursements of income and corpus for her brother’s health, education, maintenance, and support. Last year the trust distributed $15,000 to Peter. Only $15,000 is a completed gift subject to the gift tax, not the $90,000 that Emily initially transferred into the trust. If Emily chooses to make the trust irrevocable this year, then a completed gift will occur, and the trust corpus will be subject to a gift tax.

When property is transferred into an irrevocable trust, it is treated as a completed gift if the donor has parted with total control over the property. However, there are several instances where transfers into irrevocable trusts are treated as *incomplete* gifts and are not taxed, when the grantor retains certain powers:

* + The power to alter the interest of the trust beneficiaries
  + The power to name new beneficiaries of the trust
  + A testamentary general power of appointment over the remainder of the trust, to dispose of the trust assets at death

Client Situation

Alan transferred stock to an irrevocable trust for his two children and three grandchildren. The income from the trust is payable to Alan’s children for as long as they live. Then, the remainder is payable to his grandchildren or their estates. If Alan retains the power to vary the amount of income his children will receive, or to reach into the corpus to enhance their security, the gift is incomplete. But the gift becomes complete if Alan relinquishes control. If that happens when the stock has substantially increased in value, the taxable gift—and possibly the gift tax payable by Alan—may also increase substantially.

Relationship of the Gift Tax System to the Estate Tax System

The gift tax and the estate tax are both transfer taxes that are unified and interrelated under a federal transfer tax system. Under the Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010,[[1]](#endnote-1) lifetime gifts and testamentary transfers became subject to the same unified gift and estate tax rate schedule as they had been in the past. This act imposes the same tax burden on transfers made during life as at death. In 2012, these provisions were made permanent under "The American Taxpayer Relief Act of 2012" (ATRA).[[2]](#endnote-2)

Cumulative and Progressive

Gift and estate taxes have commonalities because both are **cumulative** and **progressive** in nature. The gift and estate tax rates are progressive and range from 18% to a maximum of 40%. The gift tax is cumulative, because all previous taxable gifts from 1932 are added to the current year’s taxable gifts before a gift tax is applied. This pushes the tax into a higher rate bracket up to the maximum bracket of 40%. The estate tax is also cumulative. All taxable gifts made since 1976 are added back into the estate tax calculation to bump up the estate tax rate to a higher bracket.

Client Situation

Gary and Renee made their first gift to their daughter Kenna last year. The taxable gift for each spouse was $15,000 and the tax on the gift was $2,800. This year Gary and Renee made another taxable gift of $15,000 to their daughter Rory. The tax on this year’s gift is $3,200, not $2,800. Even though Gary and Renee have made the same amount of taxable gifts each year, the gift tax is higher this year than last year, because the gift tax is cumulative and progressive.

Unified Credit

Each person can make taxable gifts up to $5,430,000 through lifetime inter-vivos gifts, or transfer $5,430,000 through bequests at death, and avoid taxation. The $5,430,000 is the **exemption equivalent** amount that escapes taxation. Each taxpayer has a **unified credit**, also called an ***applicable credit***, which offsets the tax on a dollar-for-dollar basis. Based on the current year’s unified gift and estate tax table, the tax on $5,430,000 is $2,117,800, but the unified credit(of $2,117,800 ) will offset the entire gift or estate tax liability.

The unified credit must be used to offset tax each time a taxable gift is made. As a result, the remaining unified credit is reduced with each new taxable gift, so less of the credit is available to offset future taxable gifts. The unified credit is fully depleted once taxable gifts or estates exceed $5,430,000 in 2015; at that point, a tax must be paid. The excess amount is taxed at 40%.

**Client Situation**

Beth gave her brother Sean a taxable gift of $430,000 this year. Last year Beth made taxable gifts totaling $5 million. Beth did not have to pay a tax on the gift she made to Sean, because she used the remaining portion of her unified credit to offset the tax. Two months later, Beth made another taxable gift worth $300,000 to her sister Irene. Because Beth had exhausted her unified credit on the gift she made to Sean, no further credit is available to reduce the tax on the additional $300,000. Therefore, Beth will have to pay a gift tax this year when she files her gift tax return.

**Practitioner Tip:** So far, Beth has reduced the value of her gross estate by $5,730,000 and the amount of gift tax she has to pay this year. However, the $5,730,000 will be added back into Beth’s estate tax calculation as an adjusted taxable gift, which will increase her estate tax rate because of the progressive nature of the tax. Any gift taxes Beth pays will be entered as a credit on her estate tax return, which will reduce her estate tax liability. This example demonstrates how the federal unified gift and estate tax transfer systems are interrelated.

Marital and Charitable Deductions

Both the gift and estate taxes permit deductions for property transferred to spouses and qualified charities through marital and charitable deductions. The marital deduction can be claimed on the donor spouse’s gift tax returns or on the decedent spouse’s estate tax return. A gift made to a qualified charity or a tax-exempt organization during life can result in both an income tax and a gift tax charitable deduction, whereas a bequest to a charity will receive only an estate tax charitable deduction.

Gift and Estate Tax Differences

Some unique aspects of the federal gift tax system do not pertain to estate taxes. For example, the value of a gift can be reduced by an annual exclusion. A donor can make tax-free gifts of $14,000 to an unlimited number of donees in 2015 without reducing any portion of the donor’s unified credit. Gift splitting is another gift tax reduction technique available to married couples; it reduces the value of a gift by one-half for each spouse. If a spouse consents to gift split, then a couple can gift $28,000 gift-tax-free to an unlimited number of donees in 2015.

**Client Situation**

John transferred $6,014,000 to an irrevocable trust for his daughter Gabrielle this year. Gabrielle can receive all of the income from this trust for life, and she can access the trust corpus without restriction. John can use an annual exclusion of $14,000 to reduce the taxable gift to $6 million. The gift tax on $6 million is $2,345,800, but John can apply his unified credit of $2,117,800 to reduce his gift tax liability to $228,000. John must pay the gift tax when he files his gift tax return, and the $228,000 tax will be paid from his personal bank account. It is not paid from the $6,014,000 million transferred to the trust because the gift tax is tax exclusive. To date, John’s gross estate has been reduced by $6,242,000 (the sum of the gift and the gift tax paid).

Assets included in a decedent’s gross estate are “stepped-up” in basis, which means that basis is increased to the property’s fair market value at the date of death. The recipient of inherited property can avoid paying a capital gains tax if the property is sold before it appreciates in value. Therefore, if the estate is not subject to estate tax, there are clear income tax advantages for heirs if property remains in the owner’s estate and transfers at death. In contrast, property that is gifted during lifetime retains the owner’s carry-over basis in the property, and may be subject to a capital gains tax once the property is sold.

Gift Tax Relationship to Income Taxes

When the gift tax law was written, one of its principal purposes was to discourage taxpayers from making gifts to family members in a lower tax bracket to reduce their taxable incomes. Income-producing property transferred into trusts or acquired by a trust may be taxed to the donor, the trust, or the beneficiaries, and if it is taxable to the beneficiary, it may be taxed at the parent’s rate (for minors) or at the beneficiary’s tax bracket. Donees who receive a direct gift of property acquire a carry-over basis in the property that is used to calculate a potential income tax gain on a future sale. Property transferred to a trust also retains the grantor’s basis in the property. Financial planners must understand the relationship and impact of income taxes on property transfers to individuals and trusts, and they should know the basis rules for gifted property.

Determining the Basis of Gifted Property

Basis is the starting point in any computation used to determine how much gain (or loss) is incurred upon a sale of property. Gain, for example, is found by the formula:

Amount realized – Adjusted basis = Gain

Therefore, the higher the basis, the lower the reportable gain on the sale of an asset. For an asset acquired by a purchase, basis is usually the cost of the property.

When property is transferred from a donor to a donee and the donee later disposes of the property by sale or other taxable disposition, the gain depends on the donee’s basis. To calculate the tax on the property sold, the donee must first determine his carry-over basis.

The Fair Market Value of a Gift Exceeds the Donor's Adjusted Basis

If the FMV of an asset on the date a gift is made is *greater* than the donor’s basis, then the donee will take over the donor’s basis and the donor’s holding period.

Client Situation

A mother's adjusted basis in stock is $12,000, and she gifts this stock to her daughter when the stock is worth $15,000. The daughter then sells the stock for $15,000 and realizes a capital gain of $3,000.

Holding Period at Death

The holding period for inherited property that is subsequently sold is a long-term capital gain, regardless of the actual holding period.

Client Situation

A son inherited stock from his father with a stepped-up basis of $100,000. The son sold the stock five months later for $120,000; therefore, the son will have a $20,000 long-term capital gain.

The FMV of a Gift Is Less than the Donor's Adjusted Basis

In this situation, the donee’s new cost basis and holding period depend on the price the donee eventually sells the property for.

1. If the FMV on the date of the gift is *less* than the donor’s basis, and the donee sells the property at that price (FMV) or lower, then the donee’s new basis will be the FMV of the gift at the date of transfer. Furthermore, the donee’s holding period begins on the date the gift is made.

**Example 1:** Ron’s basis in stock is $12,000, and he gifts the stock to his son Jim when it is worth $10,000. Jim then sells the stock four months later for $8,000. Jim’s carry-over basis is $10,000, and his short-term capital loss is $2,000.

2. If the donee subsequently sells the property at any price *greater* than the FMV at the time of the gift but for *less*than the donor’s basis, no gain or loss is recognized on the sale.

**Example 2:** Jane’s basis in stock is $20,000, and she gifts the stock to her daughter, Laurie, when it is worth $16,000. If Laurie sells the stock for $18,000, her carry-over basis is $16,000, and she recognizes no capital gain or loss on the sale.

3. If a donor gifted property with an FMV of *less* than his adjusted basis and the donee subsequently sells the property for a *gain***,** then the donee’s basis is the donor's adjusted basis, and the donee will assume the donor’s full holding period.

**Example 3:** Ted’s uncle purchased some very volatile stock several years ago for $50,000. He gifted this stock to Ted when the FMV was $30,000. When Ted sold the stock six months later for $60,000, his carry-over basis was his uncle’s adjusted basis of $50,000. Ted’s long-term capital gain was $10,000.

Gift Tax Paid

A donor who gifts more than $5,430,000 in his lifetime must pay gift taxes on any subsequent taxable gifts in 2015. If the donor must pay a gift tax when a gift is made and the FMV of the gift is *greater*than the donor’s basis, then the gift tax is included when calculating the donee’s new basis in the gifted property. However, if gift taxes were paid when the FMV of the gift was *less* than the donor’s basis, then no gift tax adjustment is made to the donee’s basis.

**Client Situation**

Suppose Ellie has stock with a basis of $24,000, which she gifts to her niece Mary Ann when the stock’s FMV is $64,000. Ellie has to pay a gift tax on this gift because she used up her unified credit of $2,117,800 when making previous gifts totaling over $5,430,000. Ellie can use an annual exclusion of $14,000 to reduce the gift tax because she made no other gifts to Mary Ann this year. Therefore, her taxable gift is $50,000, for which the gift tax is calculated to be $20,000. The gift tax is tax exclusive because it will be paid from a source other than the gift.

Ellie’s adjusted basis is used to determine Mary Ann’s new basis in the stock. First, the appreciation of the stock is divided by the taxable gift multiplied by the gift tax paid. In this case, the appreciation of the gift is $40,000 ($64,000 - $24,000) divided by the taxable gift of $50,000, or .80, multiplied by the gift tax paid ($20,000), or $16,000. This $16,000 is added to Ellie’s adjusted basis of $24,000 to determine Mary Ann’s new basis in the property, which is $40,000. Because the FMV of the gift is greater than the donor’s basis, the donee will assume the donor’s full holding period.

If Ellie made a $14,000 gift to Mary Ann before giving her this stock, then the appreciation of $40,000 would be divided by the taxable gift of $64,000 or .625 multiplied by the gift tax paid, ($25,600) or $16,000. Mary Ann’s new basis in the property would be $40,000 ($24,000 + $16,000 ).

Bargain Sale to Family Member—Donee’s New Basis

A **bargain sale** is part sale and part gift. If the sale price is below FMV, the difference between the sale price and FMV is the gift. Bargain sales can be made to charities, so the donor receives cash from the sale (gains must be reported) and a partial income tax deduction for the gift. A bargain sale to family members could result in a taxable gift.

Client Situation

Lucy sold her vacation home, worth $600,000, to her son Billy for $400,000. Lucy had paid $100,000 for the home many years ago, which is her basis in the property. Lucy’s taxable gain is $300,000 (the $400,000 sale price minus her basis). Billy’s basis in the home is his purchase price of $400,000. Lucy has also made a taxable gift of $200,000 (the difference between the sale price and FMV) minus the annual exclusion.

Reverse Gift

A donor with low-basis property may gift the property to a donee who is seriously ill to receive the property back with a full step-up in basis at the donee’s death. This technique, called a **reverse gift**, will not work if the donee receives the property within one year of his death. In that case, the donor’s basis would be the adjusted basis in the property that the donee held before death, including any gift taxes the donor paid upon transfer. The property may be included in both the donee’s gross estate and the donor’s gross estate at the date-of-death FMV. It should be noted, however, that the transfer will receive a step-up in basis to FMV at the date of death if the following conditions apply:

* + The donee lives for more than one year after receiving the gift.
  + The property is bequeathed to someone other than the donor or the donor’s spouse.

Client Situation

Jerry gifted stock worth $80,000, which has a basis of $20,000, to his dying wife Connie. If Connie dies 10 months later, the stock will not receive a step-up in basis to FMV unless she bequeaths it to someone other than Jerry. If Connie dies 15 months after receiving the stock from Jerry, and she bequeaths it to Jerry, the stock will receive a step-up in basis to FMV at Connie’s death.

Gift Subject to a Mortgage

A gift of property subject to indebtedness that is greater than its cost to the donor may result in a taxable gain. A gift of such property causes the donor to realize a capital gain on the excess of the debt over the basis.

Client Situation

Vince purchased a building many years ago for $100,000, which has appreciated to $1 million this year. Last month he gifted the building, which was mortgaged to $700,000, to his wife Audrey. This resulted in an income tax gain to Vince on the difference between the debt outstanding at the time of the transfer and his basis, or $600,000. The gain would be realized when the gift is complete.

Chapter Highlights

* Gifting is an important estate planning technique that affords a donor many tax and non-tax benefits.
* Financial planners should work with their clients to identify the best property interests to gift and the most advantageous gifting strategies to pursue.
* Planners should calculate a wealthy client’s current estate tax liability to show how inter-vivos gifting will reduce the value of his estate and possibly the resulting estate tax.
* Financial planners must be aware of the ramifications of how the federal gift tax affects the estate tax, and how gifting affects the income tax basis of the property the donee receives, before making any gift and estate tax planning recommendations.

Key Terms

applicable credit

bargain sale

basis

completed transfer

cumulative

direct gift

donee

donor

exemption equivalent

future-interest gift

gift

gift causa mortis

gift tax

incomplete gift

indirect gift

inter-vivos gift

present-interest gift

progressive

reverse gift

stepped-up basis

tax exclusive

tax inclusive

unified credit

Review Questions

**10-1**. Tony has a gross estate of $5.5 million. He wants to gift some property to his daughter Paula to reduce the value of his gross estate at death. Which property should Tony gift?

A. A vacation home worth $600,000 that Tony inherited from his father at a basis of $100,000. Paula and her family vacation there every year and would never sell the home.

B. Four lakefront cottages that Tony bought for $150,000, which he owns and manages. The cottages were recently appraised at $600,000. Paula and her husband do not want to manage the cottages after Tony dies, and they plan to sell them soon after his death.

C. An investment in undeveloped land valued at $600,000 that Tony purchased for $700,000.

**10-2.** From the following options, identify which gifts are subject to the gift tax law.

A. A father established a revocable trust five years ago and last month changed the beneficiary of the trust to his daughter.

B. A mother changed the deed to her home to give her son a remainder interest in the property.

C. An author gave his right to future royalties to his daughter.

D. A father added his son as a joint owner on his brokerage account.

**10-3.** Grandmother (GM) is a widow. She has a bank account with $400,000 in her name. She adds granddaughter (GD) as a joint owner of this account with right of survivorship. Which of the following statements best describes the estate planning consequences associated with GM’s action?

A. At GM’s death, $200,000 will be included in her estate.

B. At GM’s death, this account will not be subject to probate.

C. GM has made a gift of $200,000 to GD.

D. All of the above.

**10-4.** Which of the following statements is/are incorrect?

A. A direct gift is an outright transfer of real or personal property.

B. A transfer of $1 million into an irrevocable trust is an indirect gift made to the trust beneficiaries.

C. Transferred property is valued for gift tax purposes on the date the completed gift is made, or on the alternate valuation date.

D. When someone receives the remainder interest in an irrevocable trust, he has received a future interest gift.

**10-5.** A donor makes a gift to a donee. Which of the following statements is/are correct with respect to the basis of the property?

A. The donor’s basis is always carried over to the donee.

B. The donor’s basis is always carried over if the property is transferred at a loss.

C. The donee acquires the donor’s basis as long as the property is transferred at a gain.

D. The donee’s basis is equal to the FMV of the property on the date of the transfer.

**10-6**. Which of the following statements does/do not correctly pertain to the unified credit?

A. The credit is available to offset both inter-vivos gifts and testamentary transfers.

B. Use of the unified credit is mandatory for all taxable inter-vivos gifts.

C. The unified credit offsets the gift tax and the estate tax to reduce tax liability.

D. The unified credit is also known as the *exemption equivalent amount*.

Notes

1. . Pub. L. 111-312, 124 Stat. 3296, H.R. 4853. [↑](#endnote-ref-1)
2. . Pub. L. 112-240—JAN. 2, 2013  126 STAT. 2313 . [↑](#endnote-ref-2)