CHAPTER 17

GIFT TAX

INTRODUCTION — THE PURPOSE, NATURE, AND SCOPE OF GIFT TAX LAW

Purpose

If an individual could give away his entire estate during lifetime without the imposition of any tax, a rational person would arrange affairs so that at death nothing would be subject to the federal estate tax. Likewise, if a person could, freely and without tax cost, give income-producing securities or other property to members of his family, the burden of income taxes could be shifted back and forth at will to individuals in lower brackets, and income taxes would be saved.

The federal gift tax was designed to discourage taxpayers from making such inter vivos (lifetime) transfers and, to the extent that this objective was not met, to compensate the government for the loss of estate and income tax revenues.

Nature

The gift tax is an excise tax, a tax levied not directly on the subject of 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 tax is imposed only on transfers by individuals, but certain transfers involving corporations are treated as indirect transfers by corporate stockholders.)

The gift tax is based on the value of the property transferred.

The gift tax is computed on a progressive schedule based on cumulative lifetime gifts. In other words, the tax rates are applied to total lifetime taxable gifts (all gifts less the exclusions and deductions described in the section on Computing the Tax on Gifts) rather than only to taxable gifts made in the current calendar year. The unified credit is applied to offset the gift tax owing. However, once the unified credit is exhausted, all additional gifts are taxed at 40 percent rate.

Scope

The regulations summarize the comprehensive scope of the gift tax law by stating that “all transactions whereby property or interests are gratuitously passed or conferred upon another, regardless of the means or device employed; constitute gifts subject to tax.” Almost any transfer or shifting of property or an interest in property can subject the donor (the person transferring the property or shifting the interest) to potential gift tax liability to the extent that the donor does not receive adequate and full consideration in money or money’s worth in exchange for the transferred property, i.e., to the extent that the transfer is gratuitous.

Direct and indirect gifts, gifts made outright and gifts in trust (of both real and personal property), can be the subject of a taxable gift. 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 or other taxes.

The broad definition includes transfers of life insurance, partnership interests, royalty rights, and gifts of checks or notes of third parties. Even forgiveness of a note or cancellation of a debt may constitute a gift.

Almost any party can be the donee (recipient) of a gift subject to tax. The donee can be an individual, partnership, corporation, foundation, trust, or other person. (A gift to a corporation is typically considered a gift to the other shareholders in proportion to their proprietary interests. Similarly, a gift to a trust is usually considered to be a gift to the beneficiary[ies] in proportion to their interest(s).)

In fact, a gift can be subject to the tax (assuming the gift is complete) even if the identity of the donee is not known or ascertainable on the date of the transfer.

ADVANTAGES OF LIFETIME GIFTS

Nontax-Oriented Advantages

Individuals give property away during their lifetimes for many reasons. Although a detailed discussion of the nontax motivations for lifetime giving is beyond the scope of this chapter, some of the reasons include (a) privacy that would be impossible to obtain through a testamentary gift; (b) potential reduction of probate and administrative costs and delays; (c) protection from the claims of the donor's creditors; (d) the vicarious enjoyment of seeing the donee use and enjoy the gift; (e) the corresponding opportunity for the donor to see how well, or how poorly, the donee manages the business or other property and provide a person of a younger generation practice with saving and investing small amounts of money; and (f) provision for the health, education, support, and/or financial well-being of the donee.

Tax-Oriented Advantages

The unification of the estate and gift tax systems was intended to impose the same tax burden on transfers made during life as at death. The disparity of treatment between lifetime and “deathtime” transfers was minimized through the adoption of a cumulative single unified estate and gift tax rate schedule such deathtime transfers are stacked on top of lifetime gifts to effectively push up the tax rate for deathtime transfers.

The American Taxpayer Relief Act of 2012 changed the top rate for gifts to 40% for gifts made after 2012. Transfers over $500,000 up to $750,000 are taxed at 37%; transfers over $750,000 up to $1,000,000 are taxed at 39% and transfers over $1,000,000 are taxed at 40%. See the gift and estate tax tables in Appendix A.

These changes can work to the advantage of gifts that are greater than the amount protected by the gift tax unified credit in some circumstances. For example, it may make sense to make a gift and pay gift tax in one year if the tax rate would be higher if the gift is made in a later year. However, if the estate tax is reduced or eliminated by a further increased estate tax unified credit, reduced estate tax rates, or repeal of the estate tax in the year of death, then incurring gift tax could be a mistake.

Regardless, there are still some significant advantages for making gifts.

First, an individual can give up to $14,000 (in 2015) gift tax-free every year (“annual exclusion”) to each of an unlimited number of donees. This means that a person who desires to gift $14,000 to each of his four children and four grandchildren could give a total of $112,000 each year without gift tax liability. (This $14,000 gift tax annual exclusion is described in greater detail later in the chapter.)

The annual exclusion gifts of an individual’s spouse can be aggregated with the annual exclusion gifts of the other spouse. Thus, every year, a married couple can transfer gift tax free up to $28,000 (in 2015) of money or other property, multiplied by an unlimited number of donees. In the example above, the donor and spouse together could combine their annual exclusion gifts to give up to $224,000 annually on a gift tax-free basis. In fact, it the other spouse consents, one spouse can make the entire combined annual exclusion gift ($28,000) to be treated as if both spouses each made a $14,000 annual exclusion gift. This is known as gift splitting. Split-gift provisions are also covered later in the chapter in the section on Computing the Tax on Gifts.

Gift tax-free transfers can translate into significant federal estate tax savings. Consider the estate tax savings potential if the amount given to the donees over the life expectancy of the donor is invested (in life insurance, annuities, mutual funds, etc.). Figure 17.1 illustrates the potential estate or generation-skipping transfer tax savings possible if a 40-year-old donor split gifts to five donees over his life expectancy.

**Figure 17.1**

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| --- | --- |
| **ESTATE TAX OR GST TAX ADVANTAGE OF THE GIFT TAX ANNUAL EXCLUSION** | |
| Donor’s Age | 40 |
| Donees’ Annual After-Tax Return On Gifts | 4.00% |
| Amount Of Unused Annual Exclusion (with gift splitting between husband and wife) | $28,000 |
| Number Of Donees | 5 |
| Donor’s Life Expectancy (YEARS) | 43 |
| Total Amount Of Gifts ($28,000/year/donee x 5 donees x 43 years) | $6,020,000 |
| Donor’s Projected Estate Tax Bracket | 40.00% |
| Potential Estate Tax Savings | $2,408,000 |
| Projected Value Of Gifts At Life Expectancy (43 years) | $15,401,7330 |
| Potential Estate Tax Savings If Annual Gifts Invested By Donees At Compound Interest | $6,160,693 |
| \*Computations Courtesy – NumberCruncher Software: http://Leimberg.com | |

A second tax incentive for making an inter vivos as opposed to testamentary (deathtime) gift is that if a gift is made more than three years prior to a decedent’s death, the amount of any gift tax paid on the transfer is not brought back into the computation of the gross estate. In the case of a sizable gift, avoidance of the “gross up rule” can result in meaningful tax savings. Gross up rule means that all gift tax payable on taxable gifts made within three years of death are included in calculating the value of the gross estate even if the gift itself is not added back. For example, in 2011, if after exhausting the unified credit, an individual makes a $2 million taxable gift, the $780,800 gift tax payable on that transfer (40% \* $2,000,000) will not be brought back into the estate tax computation if the gift was made more than three years before the donor’s death.

Third, any appreciation accruing between the time of the gift and the date of the donor’s death escapes estate taxation. This may result in a considerable estate tax (as well as probate and inheritance tax) saving. If a father makes a taxable gift of stock to his daughter stock with a value of $100,000 and it grows to $600,000 by the date of the father’s death, only the $100,000 value of the taxable gift enters into the estate tax computation. The $500,000 of post gift appreciation does not enter into the computation of an adjusted taxable gift totally avoiding taxation with no push up of the decedent’s marginal estate tax bracket.

An excellent way of making use of this advantage is a gift by an insured beneficiary of a life insurance policy more than three years prior to his death to an adult beneficiary or to an irrevocable trust for adult or minor beneficiaries. For example, a $1,000,000 death benefit could be removed from a donor’s estate at the cost of only the gift tax on the value of the policy at the time of the transfer (in the case of a whole life policy, usually roughly equivalent to the policy cash value plus unearned premiums at the date of the gift). If the insured lives for more than three years after the transfer and the premium payments made by the insured (also considered to be gifts to the beneficiaries of the trust) qualify for the annual exclusion, there would be no additional gift tax and none of the appreciation (the difference between the death benefit payable and the adjusted taxable gift if any at the time the policy was transferred) would be included in the insured’s estate.

Fourth, there are often strong income tax incentives for making an inter vivos gift such as shifting taxable income from a high-bracket donor to a lower-bracket donee age 24 or over. For example, shifting $10,000 of annual income generated by income-producing securities, real estate, or other property gifted by 40 percent federal and state combined income bracket would save $2,000 of income tax each year. Actually, since the property, and not just income from the property, is transferred, the income tax savings can be even greater after compounding. As illustrated by Figure 17.2, the year-in year-out income tax savings may far exceed the estate tax savings. The $5,430,000 lifetime exemption equivalent may be large enough to enable taxpayers to make multiple gifts to and from family members in order to take advantage of the income tax savings.

**Figure 17.2**

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| --- | --- | --- | --- | --- |
| **ADVANTAGE OF INCOME SHIFTING - CHILD 18 OR OLDER** | | | | |
| Investment | | | | $100,000 |
| Rate of Return | | | | 10% |
| Parent's Tax Rate | | | | 33% |
| Parent's After Tax Rate of Return | | | | 6.7% |
| Child's Tax Rate | | | | 15% |
| Child's After Tax Rate of Return | | | | 8.5% |
|  | | | | |
|  | **Accumulated Value** | | **Advantage**  **of Gift** | |
| **Years** | **Parent (6.7%)** | **Child (8.5%)** |
| 5 | $138,300 | $150,366 | $12,066 | |
| 10 | $191,269 | $226,098 | $34,829 | |
| 15 | $264,525 | $339,974 | $75,449 | |
| 20 | $365,838 | $511,205 | $145,367 | |

Fifth, gifts of the proper type of assets made more than three years prior to death may enable a decedent’s estate to meet the mathematical tests for an IRC Section 303 stock redemption, an IRC Section 6166 installment payout of taxes, and the IRC Section 2032A special-use valuation of farms and certain other business real property.

Sixth, no gift taxes have to be paid until the transferor makes *taxable* gifts in excess of the gift tax unified credit exemption equivalent or applicable exemption amount ($5,430,000 in 2015). Only taxable gifts in excess of a donor’s unused exemption equivalent will require the donor to make an out of pocket payment of gift taxes.

TECHNICAL DEFINITION OF A GIFT

Elements of a Gift

Under common law, a gift is defined simply as a voluntary transfer of property for no consideration. But for tax law purposes, neither the statutes nor the regulations specifically define the term “gift.” However, the regulations dealing with the valuation of gifts provide that

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

in cases where property is transferred for less than adequate and full consideration in money or money’s worth.

Note that this definition focuses on whether the property was transferred for adequate and full consideration in money or the equivalent of money, rather than on whether the transferor intended to make a gift. This is because Congress did not want the IRS to have to prove something as intangible and subjective as the state of mind of the transferor. This does not negate the importance of donative intent, but, instead of probing the transferor’s actual state of mind, an examination is made of the objective facts of the transfer and the circumstances in which it was made.

Certain factors are considered by courts to determine if there was the “intent” to make a gift:

(1) Was the donor competent to make a gift?

(2) Was the donee capable of accepting the gift?

(3) Was there a clear and unmistakable intention on the part of the donor to absolutely, irrevocably, and currently divest himself of dominion and control over the gift property?

Assuming that these three objective criteria are met, three other elements must be present. There must be

(1) an irrevocable transfer of the present legal title to the donee so that the donor no longer has dominion and control over the property in question;

(2) a delivery to the donee of the subject matter of the gift (or the most effective way to command dominion and control of the gift); and

(3) acceptance of the gift by the donee.

Although all these requirements must be met before a gift is subject to tax, the essence of these tests can be distilled into the following factors (with reference to state law to determine the presence or absence of these elements):

(1) There must be an intention by the donor to make a gift.

(2) The donor must deliver the subject matter of the gift.

(3) The donee must accept the gift.

Adequate And Full Consideration in Money or Money’s Worth Defined

*Sufficiency of Consideration Test*

Since the measure of a gift is the difference between the value of the property transferred and the consideration received by the transferor, a $100,000 building that is transferred from a mother to her daughter for $100,000 in cash clearly does not constitute a gift. However, the mere fact that consideration has been given does not mean there is no gift; to be exempt from the tax the consideration received by the transferor must be equal in value to the property transferred. This is known as the “sufficiency of consideration test.” If the daughter in the example above had paid $60,000, the difference between the value of the building and the consideration paid, $40,000, would be considered to be a gift.

*Effect of Moral, Past, or Nonbeneficial Consideration*

Consideration is not “in money or money’s worth” when the consideration is moral consideration, past consideration, or consideration in the form of a detriment to the transferee that does not benefit the transferor. The classic example is a man who transferred $100,000 to a widow in exchange for a promise to marry him. Upon remarriage she would forfeit a $100,000 interest in a trust established for her by her deceased husband; the $100,000 from her fiancé was to compensate her for the loss. The Supreme Court held that the widow’s promise to marry her fiancé was not sufficient consideration because it was incapable of being valued in money or money’s worth. Nor was her forfeiture of $100,000 in the trust sufficient consideration, because in spite of giving up something of value, it was of no benefit to the fiancé/transferor.

*Consideration in Marital Rights and Support Rights Situations*

Two issues often arise in connection with the consideration question: Does the relinquishment of marital rights and/or support rights constitute consideration in money or money’s worth?

The Internal Revenue Code specifically addresses the treatment of certain marital property settlements. To that point, transfers of property or property interests made under the terms of a written agreement between spouses in settlement of marital or property rights are deemed to be for an adequate and full consideration. Such transfers are therefore exempt from the gift tax, whether or not the agreement is supported by a divorce decree, if the spouses enter into a final decree of divorce within 2 years after entering the agreement. So, for example, if a husband agrees to give his wife $10,000 as a lump-sum settlement on divorce in exchange for her release of all marital rights in his estate, the $10,000 transfer is not subject to the gift tax if the stated requirements above are met. But even where the 2-year requirement was not met, a taxpayer successfully argued that the transfer was not voluntary and was therefore not a gift.

A spouse’s relinquishment of the right to support constitutes consideration that can be measured in money or money’s worth. Likewise, a transfer in satisfaction of the transferor’s minor children’s right to support is made for money’s worth. But most transfers to (or for the benefit of) adult children are generally treated as gifts unless, for some reason, state law requires the transferor to support that child.

*Transfers Pursuant to Compromises or Court Orders*

Consideration is an important factor where a transfer is made pursuant to compromises of bona fide disputes or court orders. Such transfers are not considered taxable gifts because they are deemed to be made for adequate and full consideration. For example, if a mother and daughter are in litigation, a compromise payment by the mother to the daughter is not a gift. However, if a court is not convinced that an intrafamily dispute was resolved in a bona fide arm’s length adversary proceeding was present, a gift tax will be imposed. For example, a settlement payment to a son who threatened to contest his father’s will was considered a taxable gift.

Likewise, if there is no adversary proceeding, a gift may occur with respect to a transfer made pursuant to (or approved by) a court decree. For instance, if an incompetent person’s property were transferred to his mother, the transfer would be a gift even though it was approved by court decree (assuming the incompetent had no legal duty to care for the parent).

Types of Gifts

*Direct Gifts*

Most gifts are transfers of cash or tangible personal property. Generally, delivery of the property itself consummates the gift. In the case of corporate stock, a gift occurs when endorsed certificates are delivered to the donee or his agent or the change in ownership is delivered to the corporation or its transfer agent. Real property is typically gifted by the delivery of an executed deed.

If a person purchases a U.S. savings bond registered in someone else’s name and delivered to that person, a gift has been made. If the bonds are titled jointly between the purchaser and another, no gift occurs until the other person has cashed in the bond or has the bond reissued in his name only. See, “Requirements for a Completed Gift,” later in this chapter.

Income that will be earned in the future can constitute a gift presently subject to tax. For example, an author can give his right to future royalties to his daughter. Such a gift is valued according to the present value of the future income rather than as a series of year-by-year gifts valued as the income is paid. Current valuation is made even if, for some reason, the payments are reduced substantially or even cease. No adjustment of the value of the gift is required or allowed if the actual income paid to the donee is more or less than the valuation.

Forgiving a debt in nonbusiness situations is more likely to be a gift. For example, if a father lends his son $100,000 and later cancels the note, the forgiving the loan is the equivalent of a $100,000 gift. On the other hand, if the father lends his son $100,000 and the initial agreement is that the loan is repayable immediately upon the father’s demand (assuming an arm’s length transaction), no gift is made.

Some forgiveness of indebtedness, however, results in taxable income to the debtor. If a creditor tore up a debtor’s note in return for services rendered by the debtor, the result is equivalent to the creditor compensating the debtor in cash for those services in the amount of the discharged debt that the debtor used to satisfy the debt. In that case, the debt forgiveness results in taxable compensation to the debtor rather than a gift.

Payments in excess of one’s legal obligations may constitute a gift. Clearly paying one’s bills is not a gift. Similarly, paying bills or purchasing food for a spouse or minor children is not a gift. Courts have allowed considerable latitude with regard to these types of payments. But if a father gives his minor daughter a $50,000 ring, the IRS may claim the transfer goes beyond his obligation of support. Payments made on behalf of adult children such as paying an adult son’s living expenses or mortgage payments, or provides a monthly allowance are considered gifts.

In another situation, pursuant to an agreement incorporated in a divorce decree, the taxpayer created two trusts funded with a substantial amount of money for the support of his minor children. According to the terms of the trust, the children were to receive the trust corpus at age 21. The court determined the economic value of the father’s support obligation and held that the excess of the trust corpus over that value was a taxable gift. Only the portion of the transfer required to support the children during their minority was not considered to be a gift.

*Indirect Gifts*

Indirect gifts, such as the payment of someone else’s expenses, are gifts. For instance, making an adult son’s car payments or premium payments on a life insurance policy insuring the parent’s life owned by a daughter are gifts.

Simply shifting of property rights alone may trigger gift tax consequences. In one case, an employee who gave up his vested rights to employer contributions in a profit-sharing plan was deemed to have made a gift to the remaining participants in the plan. Similarly, an employee with a vested right to an annuity who irrevocably opts to take a lesser annuity coupled with an agreement that payments will be continued to be made to a designated beneficiary has made a gift to that beneficiary. No gift occurs until the time the employee’s selection of the survivor annuity becomes irrevocable.

A third-party transfer may also result in a taxable gift. For example, if a father gives his son $100,000 in consideration of his son’s promise to provide a lifetime income to the father’s sister, the father has made an indirect gift to his sister. Furthermore, if the cost of providing a lifetime annuity for the sister is less than $100,000, the father also has made a gift to his son.

The creation of a family partnership may involve an indirect gift. The mere creation or existence of a family partnership (which is often useful in shifting and spreading income among family members and in reducing estate taxes) does not, per se, mean a gift has been made. But if the value of the services of some family member partners is nil or minimal and earnings are primarily due to assets other than those contributed by the partners in question, the creation of the partnership (or the contribution by another partner of assets) may constitute a gift.

At the other extreme, in cases where new partners are to contribute valuable services in exchange for their share of the partnership’s earnings and where the business does not contain a significant amount of capital assets, the formation of a family partnership does not constitute a gift.

Transfers by and to corporations are often forms of indirect gifts. Technically, the gift tax is not imposed upon corporations. But transfers by or to a corporation are often considered to be made by or to corporate stockholders. The regulations state that if a corporation makes a transfer to an individual for inadequate consideration, the difference between the value of the money or other property transferred and the consideration paid is a gift to the transferee from the corporation’s other shareholders. For example, a gratuitous transfer of property by a family-owned corporation to the father of the shareholders of a corporation could be treated as a gift from the children to their father.

Generally, a transfer to a corporation for inadequate consideration is treated as a gift from the transferor to the corporation’s other shareholders. For example, a transfer of $120,000 by a father to a corporation owned equally by him and his three children is treated as a gift of $30,000 from the father to each of the three children. (The amount of such a gift is computed after subtracting the percentage of the gift equal to the percentage of the transferor’s ownership.)

A double danger lies in corporate gift situations. For example, if a family-owned corporation sold property with a fair market value of $450,000 for $350,000 to the son of its shareholders, the IRS may argue that (1) the corporation has essentially made a taxable dividend distribution to its shareholders and (2) that the shareholders in turn made a gift to the recipient of the transfer. In other words, since any distribution from a corporation to a shareholder generally constitutes a dividend to the extent of corporate earnings and profits, the IRS could claim that a transfer was first a constructive dividend to the shareholders and then a constructive gift by them to the donee. Based on this analysis, the transaction could be considered to be a $100,000 constructive dividend to the shareholder-parents (the amount the son “underpaid” the corporation for the property), followed by a $100,000 constructive gift of that dividend to their son.

Life insurance or life insurance premiums can constitute n indirect gift in three types of situations: (1) the purchase of a policy for another person’s benefit, (2) the assignment of an existing policy, and (3) payment of premiums. (The first two of these three situations are discussed directly below. Premium payments are discussed in the property valuation section later in the chapter.)

If an insured purchases a policy on his life and

(1) names a beneficiary(ies) other than his estate, and

(2) does not retain the right to regain the policy or the proceeds or revests the economic benefits of the policy (i.e., retains no reversionary interest in himself or his estate); and

(3) does not retain the power to change the beneficiaries or their proportionate interests (i.e., makes the beneficiary designation irrevocable),

the insured has made a gift measurable by the cost of the policy (provided all three requirements have been met).

If an insured makes an absolute assignment of a policy or in some other way relinquishes all his rights and powers in a previously issued policy, there is a gift measured by the replacement cost (in the case of a whole life policy generally equal to the interpolated terminal reserve plus unearned premium at the date of the gift).

This scenario may lead to an insidious tax trap. Assume a wife owns a policy on the life of her husband that names her children as revocable beneficiaries. At the death of the husband, the IRS may argue that the wife has made a constructive gift to the children. In this example, the gift is equal to the entire amount of the death proceeds as if she received the proceeds she was entitled to and then gave the funds to her children.

An extension of this reasoning, which was actually (and successfully) applied by the IRS, involves an owner of insurance policies on the life of her husband who placed the policies in trust for the benefit of her children. Because she reserved the right to revoke the trust at any time before her husband’s death, there was no completed gift until his death at which time she relinquished all her powers over the policy. Upon the husband’s death, the trust became irrevocable, and therefore the gift became complete. Because the gift did not become complete until the husband’s death, the value of the gift was the full amount of the death proceeds paid to her children, rather than the replacement value of the policy when it was placed in trust.

Does the right to use property (such as money) at no charge constitute a gift of property? Yes, interest-free and below market rate loans between family members and friends are treated as taxable gifts. A gift tax is imposed on the value of the right to use the borrowed money, the so-called “foregone interest” (see Chapter 37), generally a statutory minimum rate of interest the money could earn in the given situation. (By this reasoning, a gift of the use of real estate or other property, such as a vacation home or car, at little or no rent would seem to be a gift, but the IRS has been focusing on property interest transfers rather than permitted-use cases.)

GRATUITOUS ARRANGEMENTS THAT ARE NOT TAXABLE GIFTS

A number of common gratuitous arrangements are not considered gifts in the tax sense. These arrangements fall into three basic categories: (A) where property or an interest in property has not been transferred, (B) certain transfers in the ordinary course of business, and (C) sham gifts.

The Requirement That Property or an Interest in Property Be Transferred

*(1) Gratuitous Services Rendered*

The gift tax is imposed only on the transfer of property or an interest in property. Although the term property is given the broadest possible meaning, it does not include services that are rendered gratuitously. Regardless of how valuable the services one person renders for the benefit of another person, those services do not constitute the transfer of property rights and do not, therefore, fall within the scope of the gift tax.

Difficult questions often arise in this area. For example, if an executor performs the multiplicity of services required in the course of the administration of a large and complex estate, the services are clearly of economic benefit to the estate’s beneficiaries. Yet, since services are just that, they do not constitute a transfer of property rights. If the executor formally waives the fee (within 6 months of appointment as executor) or fails to claim the fees or commissions by the time of filing and indicates through action (or inaction) that he intends to serve without charge, no property has been transferred.

Conversely, once fees are taken (or if the fees are deducted on an estate, inheritance, or income tax return), the executor has received taxable income. If he then chooses not to (or neglects to) actually receive that money and it goes to the estate’s beneficiaries, he is making an indirect (and possibly taxable) gift to those individuals.

*(2) Disclaimers (Renunciations)*

In some cases an intended donee may decide (for whatever reason) that he or she does not want or does not need a gift another person intends to make. For example, a trust may provide him or her with a remainder interest in trust corpus. On the other hand, if the intended donor disclaims the right to the gift (refuses to take it), it will usually go to someone else as the result of that renunciation.

By disclaiming, the intended transferee is in effect making a gift transfer of the intended property interest to the new recipient subject to the gift tax unless the disclaimer is a “qualified disclaimer.” By making a qualified disclaimer, the property interest is treated as being transferred directly from the original transferor to the person who actually receives it. In other words, the person who makes a qualified disclaimer is not treated as the donor of a taxable gift to the person to whom the property interest passes.. This makes the qualified disclaimer an important estate-planning tool.

There are a number of requirements for a qualified disclaimer of gifted property:

(1) The refusal must be in writing.

(2) The writing must be received by the transferor, his legal representative, or the holder of the legal title to the property no later than nine months after the later of (a) the date on which the transfer creating the interest is made or (b) the date the person disclaiming reaches age 21.

(3) The person disclaiming must not have accepted the interest or any of its benefits.

1. Because of the refusal, someone other than the person disclaiming receives the property interest. The person making the disclaimer cannot in any way influence who is to be the recipient of the disclaimer.

Disclaimers are discussed in detail in Chapter 11.

*(3) Promise to Make a Gift*

Although income that will be earned in the future can be the subject of a gift, the promise to make a gift in the future is not considered a taxable gift if the promise is unenforceable. This is because a mere promise to make a transfer in the future is not itself a transfer. On the other hand, if the promise is legally enforceable under state law, the IRS will not consider it to be a taxable gift as long as it cannot be valued. When it does becomes capable of valuation, the IRS may take the position that the promising party has made a taxable gift.

At the end of calendar year 2012, there was a lot of interest in this technique as a way to utilize the estate tax exemption in the event the exemption was to be later reduced. Arguably, if the promise is enforceable under local law, and is made for less than full and adequate consideration in money or money’s worth, it should be treated as a taxable gift. There is significant disagreement between commentators with regard to the success of this technique or whether it would receive the blessing of the IRS.[[1]](#endnote-1) However, it did provide a way for less wealthy people to utilize the larger exemption.

Transfers in the Ordinary Course of Business

*(1) Compensation for Personal Services*

Situations often arise in business settings that purport to be gifts from corporate employers to individuals. The IRS often claims that such transfers are, in fact, taxable compensation for personal services rather than gifts. As a result, the employee would receive taxable income and the corporate employer would not be deemed to have made a taxable gift.

To this point, the applicable regulations state that “the gift tax is *not* applicable to…ordinary business transactions.”[[2]](#endnote-2) An ordinary business transaction, defined as a sale, exchange, or other transfer of property (a transaction which is bona fide, at arm’s length, and free from donative intent) made in the ordinary course of business, will be considered as if made for an adequate and full consideration in money or money’s worth.

A transfer “free from donative intent” will be considered an ordinary business transaction and classified as a tax-free gift to the recipient. This means that donative intent becomes quite important as the taxpayer-recipient would prefer the treatment of the transfer as an income tax-free gift. On the hand, the IRS would prefer the transfer to be treated as taxable compensation.

When will a payment be considered an income tax-free gift to the recipient (potentially subject to gift tax owning by the donor) rather than taxable income? In the ordinary course of business, the transferor has made a gift if the dominant reason for making the transfer was detached and disinterested generosity. For example, flood relief payments made by an employer to his employees because of a feeling of affection, charity, or similar impulses has made a gift to those employees rather than consideration for past, present, or future services.

Conversely a transfer by an employer to an employee is not a gift if the primary impetus for the payment is (a) the constraining force of any legal or moral duty, or (b) anticipated benefit of an economic nature.

Among the factors typically studied in examining the donor’s intent are:

(1) the duration and value of the employee’s services;

(2) the manner in which the employer determined the amount of the reputed gift; and

(3) the way the employer treated the payments in corporate books and on tax returns, i.e., was the payment deducted as a business expense? (The corporation’s characterization of payment is often persuasive where the corporation makes a payment or series of payments to the widow of a deceased employee. The employer generally prefers to have such payments treated as taxable compensation (for the employee’s past services) so that the corporation can take a corresponding deduction.

In one case, a business friend gave the taxpayer who furnished him

the names of potential customers a car. The impetus for the transfer was payment for past services as well as an inducement for the taxpayer to supply additional names in the future. For that reason, the transfer of the car was not a gift.[[3]](#endnote-3) In another case, an employer had made a $20,000 payment to a retiring executive. After examining the employer’s esteem and kindliness, and the appreciation of the retiring officer, the court found the transfer to be a gift rather than taxable income to the officer. In a similar case, the Supreme Court came to the same conclusion when it found payments were made “from generosity or charity rather than from the incentive of anticipated economic benefit.”[[4]](#endnote-4)

Whether a transfer is a gift or compensation is settled on a case-by-case basis after an analysis of the circumstances evidencing motive or intent. Generally, an intrafamily transfer will be considered a gift, even if the recipient rendered past services. On the other hands, transfers to persons outside the family will usually be considered compensation.

*(2) Bad Bargains*

A bad bargain is another ordinary course of business transaction, i.e., a sale, exchange, or other property transfer made in the ordinary course of business that is treated as being made in return for adequate and full consideration in money or money’s worth. This assumes the transaction is (a) bona fide, (b) at arm’s length, and (c) not donative in intent.

There are a number of cases in which a bad bargain was not treated as a gift from the taxpayer who was on the short side of the bargain. In one case,[[5]](#endnote-5) certain senior executive shareholders sold stock to junior executives at less than fair market value pursuant to a plan arranged to give the younger executives a larger stake in business profits. Although the transfers were for less than adequate consideration, the Tax Court stated that “the pertinent inquiry for gift tax purposes is whether the transaction is a genuine business transaction, as distinguished, for example, from the marital or family type of transaction.” Bad bargains, sales for less than adequate money’s worth occur every day in the business world for one reason or another; but no one would think for a minute that any gift is involved, even in the broadest sense of the term gift.[[6]](#endnote-6).

But the ordinary course of business exception does not apply where the transferor’s motive was to pass on the family fortune to the following generation. In one case, a father transferred property to his children at a price below the fair market value. In return, he received noninterest-bearing notes, rather than cash, and he continued to make certain payments with respect to the property on the children’s behalf. Based on these facts, the court concluded that the father was not dealing with his children at arm’s length. It is possible that the same result could occur if the father employed the son at a wage of $50,000 a year, but the son rendered services worth only $20,000 a year. The IRS could claim that the $30,000 difference constituted a gift.

Sham Gifts

If the taxpayer’s goal is to shift the burden of income taxes from a high- to a relatively lower-bracket relative age 18 or older, it would be advantageous to characterize the transfer of the property necessary to generate such income as a gift. But if the transfer has no real economic significance other than the hoped-for tax savings, the courts and the IRS will recognize that fact and will therefore not allow the shift of the burden of income taxation contemplated by the parties. For example, a well-known golfer contracted with a motion picture company to make a series of pictures depicting his form and golf style. In return, the golfer was to receive a lump sum of $120,000 plus a 50 percent royalty on the earnings of the picture. But before any pictures were made, he sold his father the right to his services for $1. The father, in turn, transferred the rights to the contract to a trust for his son’s three children. The court held that the entire series of transactions lacked any tax effect and that the income was completely taxable to the golfer.

These types of transactions may be subject to the “step transaction” doctrine. Under this doctrine, the IRS can combine a series of actions which – individually - may technically comply with the tax code, but when viewed together serve no economic purpose other than to obtain tax savings. When the doctrine applies, the IRS will view the purely tax-motivated series of steps as a single integrated event and tax it accordingly..

*Assignments of Income*

Assignment of income questions are among the most common, and also confusing, in the tax law, because the property, gift, and income tax results are often inconsistent. For example, a person enter an agreement to give his son one-half of every dollar he earned in the following year. Although the agreement may be legally enforceable and effective for property law purposes, it would like be treated as a gift from the father to his son in the amount of the present value of a father’s future income. Yet, for income tax purposes, the father would remain taxable on the earnings because a taxpayer who earns income cannot relieve himself of his obligation to pay the corresponding tax by assigning the right to that income to another person.

Similarly, a general agent for a life insurance company assigned renewal commissions to his wife who then had a property law right to the commissions. The present value of the assigned renewals was treated as a gift. Yet, under assignment of income principles, the general agent was taxable on the commissions as they were paid. In a similar case, a doctor transferred the right to accounts receivable from his practice to a trust for his daughter. Again, the court held that as the trustee received payments from the doctor’s patients, those sums were taxable income to the doctor even though he had made an irrevocable and taxable gift to his daughter through the trust.

Gifts of income from property meet a similar fate. For example, if a person assigns the right to next year’s rent from a building to her daughter or next year’s dividends from specified stock to her grandson, the transfers will be effective for property law purposes and be treated as a taxable gift potentially subject to gift tax. On the other hand, all income will be taxable to the donor.

Gifts of property, however, produce a more satisfactory result to the donors; by analogy, if the tree (property) is given away, the fruit (income) it bears will be taxable to the tree’s new owner. Thus, if instead of giving the donee the right to the income from the building or the stock (the fruit), the donor had given away the actual building and the stock (the tree), there would have been a taxable gift equal to the value of those properties. Subsequently, post-transfer, because the daughter and grandson now own the property (the tree), they are taxed on the income produced by those assets (the fruit). The tax moral of this example is that in order to shift the burden of taxation with regard to the fruit, the donor must gift away the tree.

EXEMPT GIFTS

A few types of gratuitous transfers are specifically exempted in the Code from the gift tax. Examples include property transferred to an alternative beneficiary through a qualified disclaimer as well as certain transfers of property between spouses in divorce and separation agreements.

Tuition paid directly to an educational institution for the education or training of an individual is exempt from the gift tax regardless of the amount paid or the relationship of the parties. This means parents, grandparents, or even friends can pay private school or college tuition directly to the educational institution for an individual without fear of incurring a gift tax.

Still another exempt transfer is the direct payment of medical care. Any donor can pay for another’s medical care without making a taxable gift potentially subject to gift tax. This allows children or other relatives or friends to pay the medical expenses of needy individuals (or anyone else) without worrying about incurring a gift tax. The amount of this exclusion is unlimited.

REQUIREMENTS FOR A COMPLETED GIFT

A transfer subject to potential gift tax must be complete. The phrase “completed transfer” implies that the subject of the gift is now beyond the donor’s reach, i.e., that he has irrevocably parted with dominion and control over the gift. Thus, there is no completed gift if the donor retains the power to change the disposition of the gift and thus alter the identity of the donee(s) or amount of the gift. More technically stated, if the donor can (alone or in conjunction with a party who does not have a substantial amount to lose by the revocation) revoke the gift, it is not complete.

Parting with dominion and control is a good test of completeness, but in a number of cases it is difficult to ascertain just when that event occurs. Some of the more common problem areas are (a) incomplete delivery, (b) cancellation of notes, and (c) incomplete transfers to trusts.

When Delivery is Complete

Incomplete delivery involve transfers where certain technical details have been omitted or a stage in the process has been completed. For example, a transfer of personal check or note is not a completed gift until it is paid (or certified or accepted) by the drawee or it is negotiated for value to a third person. 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 later year. This is because, typically, the maker of a check is under no legal obligation to honor the check until it is cashed (presented for payment or negotiated to a third person for value). Likewise, a gift of a negotiable note is not complete until it is paid.

An individual on his deathbed will sometimes make a gift *causa mortis* (in anticipation of his imminent death) and then quite unexpectedly recover. Assuming that the facts indicate (1) the transfer was made in anticipation of death from a specific illness and that (2) the gift was contingent on the occurrence of the donor’s death, neither the original conveyance nor the return of the property to the donor is subject to the gift tax if the transferor recovers and the transferee returns the property. A gift *causa mortis* is therefore incomplete as long as the donor is alive, but becomes complete at the donor’s death.

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).

Transfer of U.S. government bonds is governed by federal law, rather than by state law. Even if state law requirements for a valid gift are met, for tax purposes no completed gift has been made 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.

The creation of a joint bank account (checking or savings) constitutes a common example of an incomplete transfer. Typically, 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 and it is not complete. 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.

A similar situation occurs in the case of a 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 rights of survivorship,” the purchase constitutes a gift to her husband. He has acquired rights that he did not have before to a portion of the stock. (No gift tax would be due in this case, due to the unlimited gift tax marital deduction described below.)

Totten trusts (bank savings accounts 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) are, typically, revocable transfers. Here again, because the donor can recover the entire amount deposited, no gift occurs until the donee makes a withdrawal of funds.

Some property cannot conveniently be delivered to the intended donee; farm property is a good example. Where it would be difficult or impossible to make physical delivery of the gift, a gift will usually be considered completed where the delivery is as complete as possible. In one case, a father owned cattle he wished to give his minor children. The court held that the gift was complete when he branded the livestock with each child’s initials, even though he kept the cattle with others he owned. The court held that the father was acting as the natural guardian of the children and had done everything necessary to make a completed gift.

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.

Cancellation of Notes

In many cases, property is transferred pursuant to an installment sale in which the transferee executes notes payable to the transferor. Although the transaction will be treated as a sale for income tax purposes, if the transferor forgives the notes, the discharge could result in a taxable gift subject to potential gift tax.

Cancellation of notes is a frequently used as a gifting technique for two reasons. First, it provides a simple means of giving gifts to a number of donees of property that is not readily divisible. Second, by forgiving the notes over a period of years, the donor could maximize the use of the $14,000 (in 2015) annual exclusion and unified credit discussed below in Computing the Tax on Gifts. A good example is a situation where the donor deeds real estate to her sons and takes back notes payable serially on an annual basis. Each son is required to pay his mother $14,000 per year. But when the notes become due, the donor marks the note “cancelled by gift.” The gift would occur in the year each note was cancelled, provided there is no preestablished and predetermined plan for the donor to forgive notes on a systematic basis in future years.

Although, in the example above, the annual exclusion would eliminate the gift tax consequences, each note cancellation would trigger taxable income to the donor since she is actually selling the real estate to her sons. Under the installment reporting rules, in spite of the fact that the donor forgives each note, the amount of gain the donor would recognize with respect to each note must nonetheless be included in her gross income for income tax purposes.[[7]](#endnote-7) Stated differently, it is as if each of her sons paid her the $14,000 as each note became due (with respect to which she would have income) and, in turn, she gifted the $14,000 back to them.

Incomplete Gifts in Trust

Donors will sometimes transfer property to a trust, but retain the right to revoke the transfer. For that reason, property transferred to a revocable trust is not a completed gift. Only when the donor relinquishes all his retained control over the transferred property (i.e., when the trust becomes irrevocable) is a completed gift made.

The amount of the gift tax is based on the value of the property or property interest at the moment the gift becomes complete, rather than the time of the transfer. For example, if the donor retains the power to alter the interests of the trust beneficiaries, even if he cannot exercise any powers for his own benefit, the transfer is not complete. This can have harsh gift tax consequences particularly if the value of the transferred property substantially appreciates subsequent transfer.

For example, assume a donor transfers stock to a trust for his two children and three grandchildren. Income is payable to the donor’s children for life, with the remainder to be distributed to his grandchildren or their estates. If the donor retains the power to vary the amount of income his children will receive or to reach into corpus to enhance their security, the gift is incomplete. However, if and when the donor relinquishes this control, the gift will be complete. If this occurs when the stock has substantially increased in value, as is often the case, the gift tax payable by the donor would potentially be much greater than it would have been had the gift been completed when it had been initially transferred into the trust.

Grantor Retained Annuity Trusts (GRATs) and Grantor Retained Unitrusts (GRUTs) are attractive gifting vehicles because the amount of the gift is determined by the value of property interest at the time the gift is complete. By making a gift to an irrevocable nonreversionary trust, but reserving an annuity or unitrust interest for a specified period of years, the grantor/donor reduces the taxable value of the gift (this is because the value of the property retained by the grantor is not considered part of the gift). The gift is difference between the value of the transferred asset and the actuarial value of the interest retained by the grantor. (See Chapter 26 regarding GRATs and GRUTs.)

When many years after the grantor created the trust, the property is ultimately distributed from the trust to the intended beneficiaries, it may have appreciated significantly. Because appreciation occurring after the gift is completed is not considered part of the gift, none of it is subject to gift tax. So when the gift was initially completed any gift payable was offset by the unified credit and that was the end of it. In essence, this “leverages” the unified credit, because a much smaller amount of the credit was used to offset the gift when its value was significantly less.

VALUATION OF PROPERTY FOR GIFT TAX PURPOSES

Valuation is the first step in the gift tax computation process. Only after the property is valued can the annual exclusion and various deductions be applied in arriving at the amount of the taxable gift and the ultimate gift tax. (See Chapter 59 regarding “Valuation Planning.”)

The value of the property on the date the gift becomes complete is the amount of the gift. 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.”[[8]](#endnote-8)

Although the valuation of gifts is similar to the valuation of estate property valuations, gifts are valued on the date of the gift with no alternate valuation date.

The following variables make certain gift valuations problematic: (1) indebtedness with respect to transferred property, (2) restrictions on the use or disposition of property, (3) transfers of large blocks of stock, (4) valuation of mutual fund shares, and (5) valuation of life insurance and annuity contracts.

Indebtedness with Respect to Transferred Property

Generally, when gifted property is encumbered or otherwise subject to an obligation, only the net value of the gift, the value of the property less the amount of the obligation, is subject to the gift tax. This result assumes the donor is *not* personally liable for the debt so the amount of the gift is the donor’s equity in the property.

However, if the donor is personally liable for the secured indebtedness on the gift property, a different result occurs. Assuming the donor remains personally liable with respect to the debt, the amount of the gift may be the entire value of the property, unreduced by the debt. The reason for the difference is that where a solvent donor makes a gift subject to a debt and the creditor proceeds against the pledged property, the donee is, in effect, paying the donor’s personal debt. In some cases, this makes the donee a creditor of the donor. If the donee can then collect from the donor the amount he has paid to the donor’s creditor, the donee has received the entire value of the gift, rather than merely the equity.

*Example:* Assume the donor transfers a $100,000 building subject to a $40,000 mortgage on which he is personally liable. If the donor’s creditors collect the $40,000 by proceeding against the pledged building and the donee is subrogated to that creditor’s rights against the donor-debtor (i.e., the donee now stands in the shoes of the creditor), the donee can collect an additional $40,000 from the donor. As a result, the gift would be the entire value of the building (unreduced by the debt).

A third possibility is that the donor-debtor is personally liable for the indebtedness secured by a mortgage on the gifted property, but the donee has no right to step into the creditor’s shoes and recover the debt from the donor. In this case, the amount of the gift is merely the amount of the donor’s equity in the property. In the example above, that amount would be $60,000 ($100,000 fair market value minus $40,000 of indebtedness).

Where the donee has no right to proceed against the donor and recover the debt, actual facts must determine the result. If the donor, in fact, pays off the liability after transferring the mortgaged property to the donee, he is making an additional gift. But if the donee pays off the liability (or if the mortgagee forecloses), the gift was only the donor’s equity.

Among the obligations that could be imposed upon a donee is a requirement that the donee pay the gift tax. This is called a “net gift.” Although the donor has primary liability to pay the gift tax, and the donee is secondarily liable. The donor could expressly, or by implication, require the donee to pay the donor’s gift tax liability. If the donee is required to pay the gift tax imposed on the transfer (or if the tax is payable out of the transferred property), the value of the donated property must be reduced by the amount of the gift tax. But the gift tax computation is based on the value of the property transferred. Obviously, the two figures, the net amount transferred and the tax payable on the transfer, are interdependent. Fortunately, there is a revenue ruling formula for making the computation.

An example of the net gift calculation[[9]](#endnote-9) follows.

|  |  |
| --- | --- |
| **TRUE TAX ON NET GIFT** | |
|  |  |
| Year | 2015 |
| Tentative Taxable Gift | $6,000,000 |
| Gift Tax on $6,000,000 | $2,345,800 |
| Unified Credit | $2,117,800 |
| Tentative Tax [$2,345,800-2,117,800] | $228.000 |
| Tax Rate | 40% |
| True Tax [$228,000 ÷ (1 + .40)] | $162,857 |
| Net Gift [$6,000,000- 162,157] | $5,837,843 |

It is important to note that, for income tax purposes, the Supreme Court has held that if the done pays the gift tax or where the payment is made from gifted property, the donor must recognize income taxable gain. The amount of gain recognized is the difference between the gift tax paid and the donor’s basis for the property.[[10]](#endnote-10) It is as if the donor sold the property for an amount equal to the gift tax, realized a gain, and then gave the remaining value of the gift property to the donee.

Restrictions on the Use or Disposition of Property

The value of property received by gift is affected by restrictions placed on the donee’s use of, or ability to dispose of such property. Although as a general rule, the most restrictive agreements do not fix the value of such property, they often have a persuasive effect on price. For example, a donor gives stock to his daughter subject to an agreement between the corporation and its shareholders. Under that agreement, the corporation is entitled to purchase those shares at their book value, $30 per share, upon the retirement or death of the shareholder.

As set forth in the above example, does a restrictive agreement fix the value of the shares at book value? Obviously, no buyer would pay more than $30 a share as long as that restriction was in effect. But if there is value to the stock other than sale values (for example, if the stock paid dividends of $10 a year) it may have a fair market value in excess of $30. On one hand, the corporation’s option right to purchase the stock at $30 a share limits the fair market value, but on the other hand the right to receive dividends increases the fair market value. How much the dividend flow increases the fair market value of the stock is largely dependent on how much time may pass before the corporation is able exercise its option and on the probability that the corporation would in fact exercise it.

In the example above, a court would probably hold that the existence of a restrictive agreement would not fix the purchase price, since at the time of the transfer the donor was alive and not yet retired. But the existence of the agreement itself is likely to have a depressing effect on the market value of the stock and should result in a discounted gift tax value. (However, see discussion of IRC Section 2703 in Chapter 40 and IRC Section 2704 in Chapter 59 regarding restrictions that may be disregarded when valuing property.)

Transfers of Large Blocks of Stock

Another principle that applies, to some degree, to both lifetime and deathtime gifts is the so-called blockage rule. The blockage rule is not based on forced sale value. Instead, it attempts to value gifts of large blocks of stock based on the price the property would bring if the stock were liquidated in a reasonable time in some way outside the usual marketing channels. The marketability (and therefore the value) of a massive number of shares of stock may have a lower value than the current per share market value of the same stock, because of the depressive effect a block of stock would have on the market if sold all at one time. The utility of blockage evaluation is diminished, and may be inapplicable, when a large block is divided among a number of donees or when gifts are spread over a number of tax years.

Valuation of Mutual Fund Shares

Mutual fund shares are valued at their net asset value, the price of the fund net of any load charge.

Valuation of Life Insurance and Annuity Contracts

When a life insurance policy is gifted to an individual or a trust, the value is the policy’s replacement value: the cost of similar or comparable policies issued by the same company. If the policy is transferred immediately (within the first year) after its purchase, the gift is equal in value to the gross premium paid to the insurer.

If the policy is paid up at the time it is assigned (or is a single-premium policy), the amount of the gift is the amount of premium the issuing company would charge for the same type of single-premium policy of equal face amount on the insured’s life, based on the insured’s age at the transfer date. Although impaired health of the insured is not considered by the regulations, it is possible that the IRS would argue that the adverse health of the insured at the time of the gift may affect valuation.

If the policy is in a premium-paying stage at the time it is transferred, the value of the gift is generally equal to the sum of (a) the interpolated terminal reserve, plus (b) unearned premiums on the date of the gift.

Except in the early years of most contracts, the interpolated terminal reserve is roughly equivalent to the policy’s cash value. In special conditions, such as where the interpolated terminal reserve does not approximate the policy’s true value (for example, if the insured donor was terminally ill and had only 1 or 2 months to live), the value of a premium-paying policy may be more than the sum of the interpolated terminal reserve plus unearned premiums as of the date of the gift. (Unearned premiums are defined as the proportionate part of the last premium paid that is attributable to the remainder of the period for which the premium was paid.)

For example, Mr. Martin owned an ordinary life policy on his partner’s life to fund a cross-purchase agreement. The policy was 9 years and 4 months old at the time of Mr. Martin’s death. The gross annual premium was $2,800, and Mr. Martin died four months after the most recent “premium due” date. Assuming no accrued dividends or policy loans, the policy would be valued as follows:

|  |  |
| --- | --- |
| Terminal reserve at end of 10th year | $14,601 |
| Terminal reserve at end of 9th year | 12,965 |
| Increase (10th year) | $ 1,636 |
| Portion of year between death of Mr. Martin and last preceding premium due date is 4/12 (1/3) of a year. 1/3 of increase in reserve (1/3 of $1,636) | $ 545 |
| + |  |
| Terminal reserve – end of 9th year | 12,965 |
| = |  |
| Interpolated terminal reserve at date of Martin’s death | 13,510 |
| + |  |
| 2/3 of gross premium | 1,867 |
| Total value of insurance policy | $15,377 |

The interpolated reserve method will be allowed as long as the contract is not an unusual contract and this method does not develop an amount that varies greatly from the true value of the contract.

Premiums paid by (or on behalf of) the donor after the transfers are also gifts. Therefore, when an owner of a life insurance policy irrevocably assigns that policy to another person or a trust, each premium he pays subsequent to the transfer is considered a gift to the new policy owner (or the beneficial owner[s] of the trust’s assets).

Usually, the premium payor and the donor are the same. However, the IRS has stated that if an employee assigns his group life insurance policy to an irrevocable trust he had established for his family, a cash premium paid by the employer is deemed to be a gift of the amount of the premium. The deemed gift is from the employee to the beneficiaries of the trust. But (in a rather poorly considered and not widely accepted ruling) the assignment of the group term coverage itself was held not to be a taxable gift because the coverage had no ascertainable value.

In a split-dollar arrangement, an interest in a life insurance policy is often assigned to a trust. See Chapter 30, on life insurance, regarding the valuation of such interests.

COMPUTING THE TAX ON GIFTS

Gift tax rates are applied to a net figure, taxable gifts. Before the tax on a transfer is computed, certain reductions are allowed. These reductions may include

(1) annual exclusion (including gift splitting)

(2) a marital deduction

(3) a charitable deduction

The Annual Exclusion

*Purpose of and Effect of the Annual Exclusion*

Generally, the annual exclusion allows the donor to make, tax free, up to $14,000 (in 2015) worth of gifts (other than “future-interest gifts” as they are defined below) to any number of persons each year. In one respect, it is a *de minimis* rule for gift giving. The purpose of *de minimis* rule is to avoid the necessity of administrative record keeping for relatively small items. The gift tax annual exclusion is a classic example as it was instituted to eliminate the need for a taxpayer to keep an account of or report numerous small gifts. Congress intended that the amount of the annual exclusion be set large enough so that no reporting would be required in the case of wedding gifts or other occasional gifts of relatively small amounts.

Significantly, annual exclusion gift do not count against the unified credit. Thus, a donor can make as many gifts as he or she desires without using any of the applicable exclusion amount so long as none of the gifts exceed the annual exclusion amount. For example, in a single calendar year, Asher makes $14,000 gifts to each of his 5 children and 4 grandchildren, or a total amount of $126,000. To date, Asher has not used any of his applicable exclusion amount ($5,430,000 in 2015) to offset any taxable gifts. In this instance, since none of Asher’s gifts exceed the annual exclusion amount, none of them need to be offset by the applicable exclusion amount. As a result, Asher’s entire exclusion amount remains intact. Conversely, if Asher had gifted $20,000 to each of his children and grandchildren, each gift would have been $6,000 over the exclusion. Thus, to that extent ($54,000 or 9 donees \* $6,000), Asher’s applicable exclusion amount would be reduced ($5,430,000 minus $54,000).

*Effect of Gift Splitting Coupled with Exclusion*

Gift splitting, which applies only to gifts by a married donor to a third party and only with respect to non-community property, was introduced into the tax law to equate the tax treatment of common-law taxpayers with that of community-property residents. When one spouse earns a dollar in a community-property state, fifty cents is deemed to be owned by the other spouse automatically and immediately. Therefore, if the couple gave that dollar to their daughter, each spouse would be treated as having given only fifty cents.

If an individual is married and his or her spouse consents to splitting a gift, each spouse is deemed to have made one-half of the gift. This means that both spouses can combine their individual annual exclusions to make larger gifts without using any of the applicable exclusion amount ($5,340,000 in 2015). In fact, it does not matter how much each spouse contributes to the gift or whether one spouse makes the entire gift. The privilege of gift splitting is available only with regard to gifts made while the couple is married. Therefore, gifts the couple makes before they are married may not be split, even if they are later married during the same calendar year. Likewise, gifts made after the spouses are legally divorced or one spouse dies may not be split. But gifts made before one spouse dies may be split; even if that spouse dies before signing the appropriate consent or election, the deceased spouse’s executor can make the appropriate election or consent. If the spouses elect to split gifts to third parties, all gifts made by either spouse during that reporting period must be split.

For example, assume in 2015, Asher made the following gifts: $20,000 to his brother, $28,000 to his father and $18,000 to his son, or a total of $66,000. Asher is married to Ashley and she consents to splitting the gifts. As illustrated in Figure 17.3, even though each gift exceeds Asher $14,000 annual exclusion by some amount, when combined with Ashley’s $14,000 annual exclusion, there are no taxable gifts as well as no reduction of either or their applicable exclusion amounts.

**Figure 17.3**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Donee** | **Amount**  **of Gift**  **to**  **Donee** | **Treated**  **as if**  **Donor Asher**  **Gave** | **Exclusion** | **Subject**  **to Tax** | **Treated**  **as if**  **Nondonor**  **Ashley**  **Gave** | **Exclusion** | **Subject**  **to Tax** |
| Brother | $ 20,000 | $ 10,000 | $ 10,000 | – | $ 10,000 | $ 10,000 | – |
| Father | $ 28,000 | $ 14,000 | $ 14,000 | – | $ 14,000 | $ 14,000 | – |
| Son | $ 18,000 | $ 9,000 | $ 9,000 | – \_ | $ 9,000 | $ 9,000 | – \_ |
| Totals | $ 66,000 | $ 33,000 | $ 33,000 | – \_ | $ 33,000 | $ 33,000 | – \_ |

*Present versus Future Interest*

As significant as the annual exclusion is, it only applies to “present-interest gifts.” This means any “future-interest gift” regardless of the amount is a taxable gift and must be offset by the donor’s applicable exclusion amount. A present interest is one in which the donee’s possession or enjoyment begins at the time the gift is made. Conversely, with respect to a future interest, the donee’s possession or enjoyment will not commence, if at all, until sometime in the future. Examples of a “future interest” and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.

An easy way to distinguish between a present interest (which qualifies for the gift tax annual exclusion) and a future interest (which does not qualify for the gift tax exclusion) is to ascertain:

At the moment of the gift, did the donee have an immediate, unfettered, and actuarially ascertainable legal right to use, possess, or enjoy the property in question?

If the answer is “Yes,” the gift is a present interest. If the answer is “No,” the gift is a future interest gift.

Clearly, the outright and unrestricted gift of property to a donee (even a minor) that passes legal and equitable title is a present-interest gift.

A single gift can be split into two parts: one a present interest that qualifies for the annual exclusion and the other a future interest that does not. For example, in 2015, a widowed donor transfers income-producing property in a newly created trust. The income is payable annually to the donor’s son for life. At the son’s death, the remainder is to be distributed to the donor’s grandson. The gift of an annual income interest to the son is a present-interest gift, since he has unrestricted right to its immediate use, possession, or enjoyment (the right to annual income commencing immediately). Arbitrarily assuming a 5.0% Section 7520 rate, if the son is 30 years old at the time of the gift and $100,000 is placed into the trust, the present value of that gift would be worth $87,677 ($100,000 times .87677, the present value of the stream of income produced by $100,000 of capital and payable annually over the life expectancy of a 30-year-old, according to tables in government regulations – see single life valuation tables in Appendix B). Of the gifted $87,677, $14,000 would be sheltered by the annual exclusion. The balance, $73,677 would be a taxable gift offset by an equivalent amount of the donor’s applicable exclusion amount.

On the other hand, the gift of the remainder interest to the grandson is a future interest gift because his enjoyment of the gift will not occur until the death of his father. For that reason, none of it would be subject to the annual exclusion. So regardless of its value, the full amount of the future interest gift would be a taxable gift to be offset by an equivalent amount of the donor’s annual exclusion.

In another example, the donor and his spouse create a trust that provides their son income for 10 years after which the principal to be distributed to their grandson. Arbitrarily assuming a 5.0% Section 7520 rate, if the donor had placed only $1,000 in the trust, the exclusion for the gift of the income interest would be $386 ($1,000 times .386087, the term certain income interest valuation factor in Appendix B). Due to the relatively small amount of the present interest gift as compared to a much larger annual exclusion, gift splitting would probably not be necessary unless they intended to make additional gifts to the same done.

As to the gift of the future interest (remainder) that passes to the grandson at the end of 10 years, the annual exclusion is not available even though he has an interest that cannot be forfeited. For that reason, regardless of its value, all of it will count against the donor’s applicable exclusion amounts (one-half to each spouse).

Importantly, if instead of an income interest for life or a term of years, the trustee had been given the power or discretion to accumulate the income, rather than distribute it, it would not be a present interest gift for the lack of the unfettered and immediate use of the income. For that reason, no annual exclusion would be allowed. Similarly, if a trustee is required by the trust agreement to accumulate income for a time (or until the occurrence of a specified event), the income interest is a future interest.

*Summary of Rules for Ascertaining the Amount and Availability of the Gift Tax Annual Exclusion*

These rules regarding the annual exclusion can be summarized as follows:

(1) In determining the number of annual exclusions to which a donor is entitled, a gift in trust is a gift to a trust’s beneficiaries, and not to the trust.

(2) If the trustee is required to distribute trust income at least annually, the value of an income interest in a trust qualifies for the exclusion even if the value of the remainder interest does not.

(3) The gift of an interest that is contingent upon survivorship is a gift of a future interest. (For example, if a trust provides income to the grantor’s son for life, then income to the grantor’s daughter for life, the son’s gift is a present interest gift, but the daughter’s gift is a future interest gift)

(4) A gift is a future interest if enjoyment depends on the exercise of a trustee’s discretion. (The nature of the interest must be present as of the date of the gift, not determined by what the trustee may subsequently do, or not do, in the exercise of a discretionary power.)

(5) A gift must have an ascertainable value to qualify for the exclusion. (The exclusion will be denied if the donor or anyone else can divert the income from the beneficiary.)

*Identity of Donees*

A gift made to a trust is considered a gift to the beneficiaries of the trust (not the trust itself). For instance, if there are three life income beneficiaries, there are three potential annual exclusions. Conversely, if a donor created five trusts for the same beneficiary, only one exclusion is allowed. Technically, the actuarial value of each gift in the five trusts to that beneficiary would be totaled. That total would be added to any direct gifts the donor made to that beneficiary for purposes of computing to what extent the $14,000 exclusion would be available to shelter those gifts.

A transfer to a corporation is treated as a gift to its shareholders. However, the gift is one of a future interest.

Transfers to two or more persons as joint tenants with right of survivorship, tenants by the entireties, or tenants in common are considered multiple gifts. Each tenant is deemed to receive an amount equal to the actuarial value of his interest in the tenancy. If, for example, one person has a one-half interest in a tenancy in common, a cash gift of $6,000 to the tenancy would be treated as a $3,000 gift to that person. This would be added to other gifts made directly by the same donor to determine how much of the exclusion is available. Similarly, gifts to partnerships should follow the same rules: a gift to a partnership should be treated as if made to each partner in proportion to his partnership interest.

Note that a joint gift, in which neither party can sever his or her interest without the other’s consent, will be considered a future interest gift and will not qualify for the annual exclusion. For instance, if Herb gives Diana and Laura joint ownership in a policy on his life, and if the insurer will not allow either Diana or Laura to sever her interest without the other’s consent, Herb has made a future interest gift to each daughter.

*Gifts to Minors*

Outright gifts to minors pose no particular qualification problem. In Rev. Rul. 54-400,[[11]](#endnote-11)the IRS ruled that “an unqualified and unrestricted gift to a minor, with or without the appointment of a guardian, is a gift of a present interest.” But there are, of course, practical problems involved, especially with larger gifts. Although minors can buy, sell, and deal with some limited types of property, such as U.S. savings bonds, gifts of other types of property create difficulties. For example, some states do not give minors the legal capacity to purchase their own property, care for it, or sell or transfer it. Some states forbid the registration of securities in a minor’s name, and a broker may be reluctant to deal in securities titled in a minor’s name. In many states, a minor has the legal ability to disaffirm a sale of stock sold at a low price that later rises in value. Furthermore, a buyer receives no assurance of permanent title when a minor signs a real estate deed.

Legal guardianship of the minor is not a viable answer in many situations. Since guardianship laws are rigid, a guardian must generally post bond, and periodic and expensive court accounting is often required. Most importantly, a parent may not want to give a legal minor control over a large amount of cash or other property.

To minimize these and other practical problems involved with most large gifts to minors, such transfers are generally made in trust or under some type of guardianship or custodian arrangement. An incredible amount of litigation developed over whether such gifts qualified for the annual exclusion. IRC Section 2503 provides clear and precise methods of qualifying gifts to minors for the exclusion. There are three basic means of qualifying “cared-for gifts” to minors under Section 2503: (1) a Section 2503(b) trust, (2) a Section 2503(c) trust, or (3) the Uniform Gifts to Minors Act (or the Uniform Transfers to Minors Act).

*Section 2503(b) Trust.* To obtain an annual exclusion for gifts to a trust, an individual can establish a trust that requires that income *must* be distributed at least annually to or for use of the minor beneficiary. The trust agreement would state how income is to be used, and would give the trustee no discretion as to its use. The minor would receive possession of the trust principal whenever the trust agreement specifies. A distribution does not have to be made by age 21; corpus may be held for as long as the beneficiary lives, or for any shorter period of time. In fact, the principal can actually bypass the income beneficiary and go directly to the individuals whom the grantor, or even the named beneficiary, has specified. The trust agreement can also control the dispositive scheme if the minor dies before receiving trust corpus. Trust assets do not have to be paid to the minor’s estate or appointees.

Mandatory payment of income to (or on behalf of) beneficiaries seems onerous, especially while the beneficiary is a minor. But such income could be deposited in a custodial account and used for the minor’s benefit, or left to accumulate in a custodial account until the minor reaches majority (at which time the unexpended amount would be turned over to the beneficiary).

Although the entire amount of property placed in a 2503(b) trust would be considered a gift, for exclusion purposes it would be split into two parts: income and principal. The value of the income, measured by multiplying the amount of the gift by a factor that considers both the duration over which the income interest will be paid and the discounted worth of $1 payable over the appropriate number of years, would be eligible for the annual exclusion. The balance of the gift would not qualify for the annual exclusion.

*Example:* Assume a donor places $10,000 into a Section 2503(b) trust that is required to pay his 10-year-old daughter all income until she reaches age 25. Assume a 5.0% Section 7520 rate. The present value of the income the daughter would receive over those 15 years is $5,190 ($10,000 x .518983, see term certain valuation tables in Appendix B). If the income were payable for her entire life, the present value would jump to $9,417 ($10,000 x .94171, see single life valuation tables in Appendix B).

It is important to note that, according to at least one revenue ruling, the annual exclusion would be denied for a 2503(b) trust that permits principal to be invested in non-income-producing securities, non-income-producing real estate, or life insurance policies (since they do not produce taxable income).

*Section 2503(c) Trust.* The Section 2503(b) trust described above has the advantage of not requiring distribution of principal at the minor’s reaching age 21, but it does require a current (annual) distribution of income. The Section 2503(c) trust requires the distribution of income and principal when the minor reaches age 21. But it does not require the trustee to distribute income currently.

Certain requirements make it possible for a donor to obtain the exclusion by a gift to a minor under Section 2503(c): the trust must provide: (1) the income and principal may be expended by or on behalf of the beneficiary; and (2) to the extent not so expended income and principal will pass to the beneficiary at age 21; or (3) if the beneficiary dies prior to that time, income and principal will go to the beneficiary’s estate or appointees under a general power of appointment. (The annual exclusion will not be lost merely because local law prevents a minor from exercising a general power of appointment.)

A substantial amount of flexibility can be built into the 2503(c) trust. Income that has been accumulated in the trust, as well as any principal, can be paid over to the donee when he reaches age 21. This may be indicated if the sums involved are not substantial. But the donor may want the trust to continue to age 25 or some other age. It is possible to provide continued management of the trust assets and, at the same time, avoid forfeiting the annual exclusion by giving the donee, at age 21, a right for a limited but reasonable period to require immediate distribution by giving written notice to the trustee. If the beneficiary fails to give written notice, the trust can continue automatically for whatever period the donor provided when he established the trust. Some states have lowered the age of majority from 21 to age 18 or some in between age. A trust can provide that the distribution can be made between the age of majority and age 21 without jeopardizing the Section 2503(c) exclusion. (The rule is that age 21 is the maximum, rather than the minimum, age at which the right to trust assets must be made.)

A 2503(c) trust has a number of advantages over the type of custodianship found in the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act arrangements, as shown in Figure 17.4.

**Figure 17.4**

|  |  |  |  |
| --- | --- | --- | --- |
| **Factor** | **Trust** | **UGMA** | **UTMA** |
| Type of property | Donor can make gifts of almost any type of property | Type of property must be permitted by appropriate statute. Gift of real estate may not be  permitted | Donor can make gifts of almost any type of property |
| Dispositive provisions | Donor can provide for disposition of trust assets if donee dies without having made disposition | Disposition must follow statutory guideline | Disposition must follow statutory guideline |
| Investment powers | Trustee may be given broad virtually unlimited investment powers | Custodian limited to investment powers specified by statute | Custodian limited to investment powers specified by statute |
| Time of distribution  of assets | Trust can continue automatically even after beneficiary reaches age 21. Trustee can make distribution between state law age of majority and age 21 | Custodial assets must be paid to beneficiary upon reaching statutory age | Custodial assets must be paid to beneficiary upon reaching statutory age |

*Uniform Gifts (Transfers) to Minors Act.* The Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act (reference to either Act herein is simply to the Uniform Act–see chapter 23 for background) provides an alternative to the Section 2503(c) trust. The Uniform Act is frequently utilized for smaller gifts because of its simplicity and because it offers the benefits of management, income and estate tax shifting, and the investment characteristics of a trust, with little or none of the setup costs.

The Uniform Act is also indicated over a trust if the gift consists of stock in an S corporation. That’s because, generally speaking, a trust (other than a voting, electing small business trust, QSST, or grantor trust) cannot hold S corporation stock without causing a loss of the election privilege. The result might be double taxation of corporate profits and forfeiture of the privilege of passing through profits (and losses) to shareholders. (See the discussion of QSSTs and IRC Section 678 Trusts in Chapter 46.)

The original Uniform Gifts to Minors Act was approved in 1956 and provided for gifts of money and securities to minors. In 1966, the Uniform Act was revised to accommodate gifts of life insurance policies and annuity contracts. Over the years between 1956 and 1984, all states adopted one or other of the Uniform Acts or variations thereof. Most states, from time to time, added to the kinds of property that could be given under the Act. In 1983, the National Conference of Commissioners on Uniform State Laws, concerned about the lack of uniformity among the states with respect to the Uniform Gifts to Minors Act, yielded to the expansive approach taken by most of the states and approved the Uniform Transfers to Minors Act.

The 1983 Act accommodates gifts, lifetime and testamentary, of any interest in property. At this writing, nearly all of the states have replaced their Uniform Gifts to Minors Act with the Uniform Transfers to Minors Act.

By way of example, in Pennsylvania, a state that has a variation of the Uniform Transfers to Minors Act, a custodianship gift may be made as follows

|  |
| --- |
| **20 Pa C.S. §5309. Manner of creating custodial property and effecting transfer** |
|  |
| **(a) Creation of custodial property**.–Custodial property is created and a transfer is made whenever: |
| (1) An uncertificated security or a certificated security in registered form is either: |
| (i) registered in the name of the transferor, an adult other than the transferor or a trust company, followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act”; or |
| (ii) delivered if in certificated form, or any document necessary for the transfer of an uncertificated security is delivered, together with any necessary endorsement to an adult other than the transferor or to a trust company as custodian, accompanied by an instrument in substantially the form set forth in subsection (b). |
| (2) Money is paid or delivered to a broker or financial institution for credit to an account in the name of the transferor, an adult other than the transferor or a trust company, followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act.” |
| (3) The ownership of a life or endowment insurance policy or annuity contract is either: |
| (i) registered with the issuer in the name of the transferor, an adult other than the transferor or a trust company followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act”; or |
| (ii) assigned in a writing delivered to an adult other than the transferor or to a trust company whose name in the assignment is followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act.” |
| (4) An irrevocable exercise of a power of appointment or an irrevocable present right to future payment under a contract is the subject of a written notification delivered to the payor, issuer or other obligor that the right is transferred to the transferor, an adult other than the transferor or a trust company, whose name in the notification is followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act.” |
| (5) An interest in real property is recorded in the name of the transferor, an adult other than the transferor or a trust company, followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act.” |
| (6) A certificate of title issued by a state or the Federal Government which evidences title to tangible personal property is either: |
| (i) issued in the name of the transferor, an adult other than the transferor or a trust company, followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act”; or |
| (ii) delivered to an adult other than the transferor or to a trust company, endorsed to that person followed in substance by the words: “as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act.” |
| (7) An interest in any property not described in paragraphs (1) through (6) is transferred to an adult other than the transferor or to a trust company by a written instrument in substantially the form set forth in subsection (b). |
|  |
| **(b) Form**.–An instrument in the following form satisfies the requirements of subsection (a)(1)(ii) and (7): |
|  |
| TRANSFER UNDER THE PENNSYLVANIA |
| UNIFORM TRANSFERS TO MINORS ACT |
|  |
| I, (name of transferor or name and representative capacity if a fiduciary), hereby transfer to (name of custodian), as custodian for (name of minor) under the Pennsylvania Uniform Transfers to Minors Act, the following: (insert a description of the custodial property sufficient to identify it). |
| Dated:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (Signature) |
|  |
| (name of custodian) acknowledges receipt of the property described above as custodian for the minor named above under the Pennsylvania Uniform Transfers to Minors Act. |
| Dated:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ |
| (Signature of custodian) |
|  |
| **(c) Control of Custodial Property**.–A transferor shall place the custodian in control of the custodial property as soon as practicable. |

*The Effect of Type of Asset*

The type of asset given and restrictions placed on that asset may prevent the donor from obtaining the annual exclusion.

An outright no strings attached gift of life insurance will qualify for the annual exclusion. Life insurance policies (and annuity policies) are subject to the same basic test as any other type of property in ascertaining whether the interest created is “present or future,” even though the ultimate obligation under a life insurance policy, payment of the death benefit, is to be discharged in the future. A policy does not have to have cash value at the time of the gift to make the transfer one of a present interest. But the annual exclusion would be lost if the donor prevented the donee from surrendering the policy or borrowing its cash value or limited the donee’s right to policy cash values in any way.

When a life insurance policy is transferred or otherwise assigned to a trust, will the transfer of policy cash values constitute a present interest? The answer depends on the terms of the trust. Generally, the gift will be one of a future interest, since beneficiaries are not usually given an immediate right to possession or enjoyment of the policy values or other items constituting trust corpus. For example, a trust will typically provide no payments to beneficiaries unless they survive the insured. Furthermore, there is generally no actuarially sound method of making an allocation between the value of a present interest and future interest. Unless the given beneficiary’s present interest can be ascertained, no exclusion is allowed. (A related attack used by the IRS is that insurance is nonincome-producing property. This concept is discussed further below.)

Premium payments will usually be considered present- or future-interest gifts depending on the classification of the policy itself; if the assignment of the policy was considered a present interest, premiums paid by the donor after the transfer will qualify for the annual exclusion. For instance, if a person makes an absolute assignment of a policy on his life to his daughter but continues to pay premiums, premiums paid subsequent to the transfer would be present-interest gifts. Conversely, if the gift of the policy was a future interest, premium payments made by the donor after the transfer may also be considered future-interest gifts.

A gift in trust of a life insurance policy or of premiums can be made a present interest by inserting a Crummey power (named after the major case in this area). A Crummey power gives the named individual(s) an immediate, unfettered, and actuarially ascertainable right; in short, the absolute right to withdraw a specified amount or portion of the assets contributed to the trust. This withdrawal right (essentially, a general power of appointment over a specified amount or portion of each year’s contribution to the trust) makes the gift in trust of a life insurance policy or of premiums qualify for the gift tax annual exclusion. The holder of the Crummey power must be made aware of any contribution to the trust and the limited time period within which he or she has the right to withdraw the contribution. Obviously, the person who made the gift does not want the child withdrawing the gift (or the donor would have made an outright gift in the first place).

Clearly, an outright gift of nonincome-producing property will qualify for the gift tax exclusion. Will the same property qualify if placed in a trust? The IRS uses three arguments to disallow annual exclusions:

(1) the right to income (which is the only current right given to a life beneficiary) from a gift of nonincome-producing property is a future interest, since its worth is contingent upon the trustee’s converting it to income-producing property;

(2) it is impossible to ascertain the value of an income interest in property that is not income-producing at the time of the gift; and

(3) if a gift tax exclusion *is* allowable, the exclusion must be limited to the actual income produced by the property (or expected to be produced) for the number of years over which the income beneficiary is expected to receive the income, discounted to its present value.

Nondividend-paying stock is a good example of property that may not qualify for the gift tax exclusion when it is placed into a trust. The IRS has been successful in a number of cases in disallowing an exclusion for gifts in trust of stock in closely held corporations paying no dividends.

Gifts in trust of life insurance policies pose the same problem: a mother assigns policies on her life to a trust created to provide financial protection for her daughter. Upon the mother’s death, the policy proceeds will be reinvested and the daughter will receive the net income of the trust for life. Will the mother be allowed the exclusion for the present value of her daughter’s income interest? The regulations answer in the negative, since the daughter will not receive income payments until her mother dies.

But even these last two types of property can qualify for the annual exclusion if the beneficiary is given the power to require the trustee to make assets in the trust income-producing. Consider, however, the potential adverse implications of that power if the beneficiary chooses to exercise it.











Gift Tax Marital Deduction

An individual who transfers property to a spouse is allowed an unlimited deduction (subject to certain conditions) known as the gift tax marital deduction.

The purpose of the gift tax marital deduction is to treat spouses as a single economic unit.

*Requirements to Qualify for Gift Tax Marital Deduction*

For a gift to qualify for the gift tax marital deduction, the following conditions must be satisfied: (1) The donor’s spouse must be a United States citizen at the time the gift is made. [While the marital deduction is not available for gifts to noncitizen spouses, a form of the gift tax annual exclusion is allowed for up to $147,000 (in 2015) of such gifts if they would otherwise qualify for the marital deduction.] (2) The recipient of the gift must be the spouse of the donor at the time the gift is made. (3) The property transferred to the donee-spouse must not be a terminable interest that will disqualify the gift for the marital deduction.

Most of the qualifications above are self-explanatory. The terminable interest rule for marital deduction gifts is similar to the rule employed for estate tax purposes. Essentially, no marital deduction will be allowed where (a) the donee-spouse’s interest in the transferred property will terminate upon the lapse of time or at the occurrence or failure of a specified contingency, (b) where the donee-spouse’s interest will then pass to another person who received his interest in the property from the donor-spouse, and (c) that person did not pay the donor full and adequate consideration for that interest.

The exception to the terminable interest rule is a Qualifying Terminable Interest Property (QTIP). If a donor spouse gives a donee spouse a qualifying income interest for life, it will qualify for a gift (or estate) tax marital deduction. To qualify:

(1) the surviving spouse must be entitled to all the income from the property (and it must be payable annually or more frequently);

(2) no person can have a power to appoint any part of the property to any person other than the surviving spouse; and

(3) the property must be includible in the donee-spouse’s gross estate (in the case of a bequest, the first decedent’s executor makes an irrevocable election that the property remaining in the QTIP at the surviving spouse’s death is includible in her gross estate).

Also, as another exception to the terminable interest rule is a life estate created for the surviving spouse in which he or she has a general power of appointment with respect to the underlying property qualifies for the marital deduction. Marital deduction trusts are discussed in detail in Chapter 24.

Gift Tax Charitable Deduction

A donor making a transfer of property to a qualified charity may receive a charitable deduction equal to the value of the gift. The net effect of the charitable deduction is that all gifts to charity are exempt from gift tax. Thus, there is no limit on the amount that can be passed, gift tax free, to a qualified charity.

The gift tax deduction is allowed for all gifts made during the calendar year by U.S. citizens or residents if the gift is to a qualified charity. A qualified charity is defined as (a) the United States, a state, territory, or any political subdivision or the District of Columbia if the gift is to be used exclusively for public purposes; (b) certain religious, scientific, or charitable organizations; (c) certain fraternal societies, orders, or associations; and (d) certain veterans’ associations, organizations, or societies.

Technically, although all charitable gifts are exempt from gift tax, the charitable deduction is limited. A charitable deduction is allowed only to the extent that each gift exceeds the annual exclusion. For example, in 2015, a single client makes total gifts of $56,000: $28,000 to his daughter and $28,000 to The American College. After taking annual exclusions, gifts qualifying for the charitable deduction would amount to $14,000 (the $28,000 gift to The American College less the $14,000 (in 2015) annual exclusion). Therefore the client’s charitable deduction would be limited to $14,000.

In certain cases a donor will transfer a remainder interest to a qualified charity. A non-charitable beneficiary will be given all or part of the income interest in the transferred property, and the charity will receive the remainder at the termination of the income interest. Where a charitable remainder interest is given to a qualified charity, a gift tax deduction is allowable for the present value of that remainder interest only if at least one of the following conditions is satisfied:

(1) the transferred property was either a personal residence or a farm; or

(2) the transfer was made to a charitable remainder annuity trust; or

(3) the transfer was made to a charitable remainder unitrust; or

(4) the transfer was made to a pooled income fund.

The terms Charitable Remainder Annuity Trust (CRAT), Charitable Remainder Unitrust (CRUT), and Pooled Income Fund (PIF) are defined in essentially the same manner as they are for estate and income tax purposes. They are discussed in detail in Chapter 33.

Calculating Gift Tax Payable

The process of computing the gift tax payable begins with ascertaining the amount of taxable gifts in the current reporting calendar year. In order to find the amount of taxable gifts, it is first necessary to value all gifts made. If appropriate, the gift is then split. Annual exclusions and marital and charitable deductions are then applied. An example computation will illustrate the process.

Assume a single donor in the last month of 2015 makes certain outright gifts: $160,000 to his son (full $14,000 annual exclusion), $125,000 to his daughter (full $14,000 annual exclusion), $8,000 to his grandson (only $8,000 annual exclusion due to amount of the gift), and $25,000 to The College for Financial Planning (a charity) (full $14,000 annual exclusion) for a total of $318,000).

|  |  |  |  |
| --- | --- | --- | --- |
| **Computing Taxable Gifts** | | | |
|  |  |  |  |
| Step 1 | *List* total gifts for year |  | $318,000 |
|  |  |  |  |
| Step 2 | *Subtract* one-half of gift deemed to  be made by donor’s spouse (split gifts) | $ 0 |  |
| Gifts deemed to be made by donor |  | $318,000 |
|  |  |  |  |
| Step 3 | *Subtract* annual exclusion(s) | $ 50,000 |  |
| Gifts after subtracting exclusion(s) |  | $268,000 |
|  |  |  |  |
| Step 4 | *Subtract* marital deduction | $ 0 |  |
|  |  |  |  |
| Step 5 | *Subtract* charitable deduction | $ 11,000 |  |
|  |  |  |  |
|  | Taxable gifts |  | $257,000 |

Note that, although there were four donees, the annual exclusion was $50,000 [(3 x $14,000) + $8,000] and did not total four times $14,000, or $56,000. This is because the annual exclusion is the lower of (a) $14,000 (in 2015) or (b) the actual net value of the property transferred. In this example the gift to the grandson was only $8,000, which limits the annual exclusion for that gift to $8,000.

A slight change in the fact pattern above will illustrate the computation where the donor is married and his spouse consented to split their gifts to third parties. In this case, only half the gifts made by the donor would be taxable to the donor (half the gifts made by the donor’s spouse to third parties would also be included in computing the donor’s total gifts).

A separate (and essentially identical) computation is made for the donor’s spouse. That computation would show (a) the other half of the husband’s gifts to third parties plus (b) half of the wife’s actual gifts to third parties (since all gifts must be split if any gifts are split).

|  |  |  |  |
| --- | --- | --- | --- |
| **Computing Taxable Gifts** | | | |
|  |  |  |  |
| Step 1 | *List* total gifts for year |  | $318,000 |
|  |  |  |  |
| Step 2 | *Subtract* one-half of gift deemed to be made by donor’s spouse (split gifts) | $159,000 |  |
| Gifts deemed to be made by donor |  | $159,000 |
|  |  |  |  |
| Step 3 | *Subtract* annual exclusion(s) | $ 44,500 |  |
| Gifts after subtracting exclusion(s) |  | $114,500 |
|  |  |  |  |
| Step 4 | *Subtract* marital deduction | $ 0 |  |
|  |  |  |  |
| Step 5 | *Subtract* charitable deduction | $ 0 |  |
|  |  |  |  |
|  | Taxable gifts |  | $114,500 |
|  |  |  |  |
| (The calculation on the wife’s return would parallel this return.) | | | |

Note that in this example the annual exclusions were computed *after* the split. Because after the split, each donor’s portion of the gift was in excess of the annual exclusion (with the exception of the gift to the grandson and charity), each donor was able to use the full annual exclusion for that split gift. Thus, each donor’s exclusions would be:

|  |  |  |
| --- | --- | --- |
| (a) | Gift to son | $14,000 |
| (b) | Gift to daughter | 14,000 |
| (c) | Gift to grandson | 4,000 |
| (d) | Gift to The College for Financial Planning | 12,500 |
|  |  | $44,500 |

The charitable deduction for each spouse would be $0 [($25,000 ÷ 2) - $14,000 ($14,000 limited to the amount of the gift)].

If the married donor in the fact pattern directly above had also made an outright gift of $200,000 to his wife, the computation would be as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| **Computing Taxable Gifts** | | | |
|  |  |  |  |
| Step 1 | *List* total gifts for year |  | $518,000 |
|  |  |  |  |
| Step 2 | *Subtract* one-half of gift deemed to be made by donor’s spouse (split gifts) | $159,000 |  |
| Gifts deemed to be made by donor |  | $359,000 |
|  |  |  |  |
| Step 3 | *Subtract* annual exclusion(s)  (which includes an annual exclusion for the spouse) | $ 58,500 |  |
| Gifts after subtracting exclusion(s) |  | $ 300,500 |
|  |  |  |  |
| Step 4 | *Subtract* marital deduction | $186,000 |  |
|  |  |  |  |
| Step 5 | *Subtract* charitable deduction | $ 0 |  |
|  |  |  |  |
|  | Taxable gifts |  | $114,500 |

When the total value of taxable gifts for the reporting period is found, the actual tax payable is computed using the following method:

|  |  |  |
| --- | --- | --- |
| **Computing Gift Tax Payable** | | |
|  |  |  |
| Step 1 | Compute gift tax on all *taxable* gifts regardless  of when made (use gift tax rate schedule) | $\_­­\_\_\_\_\_\_ |
|  |  |  |
| Step 2 | Compute gift tax on all *taxable* gifts made prior to the present year’s gift(s) (use gift tax rate schedule) | $\_\_\_\_\_\_\_ |
|  |  |  |
| Step 3 | Subtract Step 2 result from Step 1 result | $\_\_\_\_\_\_\_ |
|  |  |  |
| Step 4 | Enter gift tax credit remaining | $\_\_\_\_\_\_\_ |
|  |  |  |
| Step 5 | Subtract Step 4 result from Step 3 result to obtain *gift tax payable* | $\_\_\_\_\_\_\_ |

For instance, a widow gives $1,400,000 to her daughter and $100,000 to The College for Financial Planning in 2015. Both transfers are present-interest gifts. If she had made no previous taxable gifts in the current or prior years or quarters, the computation would be as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| **Computing Taxable Gifts** | | | |
|  |  |  |  |
| Step 1 | *List* total gifts for year |  | $1,500,000 |
| Step 2 | *Subtract* one-half of gift deemed to be made by donor’s spouse (split gifts) | $ 0 |  |
|  | Gifts deemed to be made by donor |  | $1,500,000 |
| Step 3 | *Subtract* annual exclusion(s) | $ 28,000 |  |
| Gifts after subtracting exclusion(s) |  | $1,472,000 |
| Step 4 | *Subtract* marital deduction | $ 0 |  |
| Step 5 | *Subtract* charitable deduction | $ 86,000 |  |
|  | Taxable gifts |  | $1,386,000 |

To find the gift tax payable on this amount, the procedure would be as follows:

|  |  |  |
| --- | --- | --- |
| **Computing Gift Taxable Payable** | | |
|  |  |  |
| Step 1 | Compute gift tax on all *taxable* gifts regardless of when made ($1,386,000) | $ 500,200 |
|
| Step 2 | Compute gift tax on all *taxable* gifts made prior to the present gift(s) |  |
| $ 0 |
| Step 3 | Subtract Step 2 result from Step 1 result | $ 500,200 |
| Step 4 | Enter gift tax (unified) credit remaining (2015) | $2,117,800 |
| Step 5 | Subtract Step 4 result from Step 3 result to obtain *gift tax payable* | $ 0 |

The Step 1 entry, $500,200, is found by using the gift tax rate schedule in effect for the year of the gift (see Appendix A). Note that the current rate table is used regardless of when the earlier gifts were made.

If the donor in the example above had made $100,000 of additional taxable gifts in 2000 (a total of $1,486,000), the computation would be as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| **Computing Gift Taxable Payable** | | | |
|  |  |  |  |
| Step 1 | Compute gift tax on all *taxable* gifts regardless of when made ($1,486,000) | | $ 540,200 |
| Step 2 | Compute gift tax on all *taxable* gifts made prior to the present gift(s) | | $ 23,800 |
| Step 3 | Subtract Step 2 result from Step 1 result | | $ 516,400 |
| Step 4 | Enter gift tax credit remaining (2015) | | $2,022,000 |
| Step 5 | Subtract Step 4 result from Step 3 result to obtain *gift tax payable* | | $ 0 |

This illustrates the cumulative nature of the gift tax and the progressive rate structure (the $100,000 prior taxable gifts initially generated a tax of $23,800 – an effective tax rate of 23.8%. The subsequent year gifts, however, are stacked on top of the $100,000 prior year gift to increase the total amount of gifts subject to progressively higher tax rates. Ultimately, this rate becomes 40% when the total amount transferred exceeds $1,000,000. Therefore, the prior gifts push the present $1,486,000 of taxable gifts into a higher bracket at an earlier point. Also, since the taxable gifts in prior years used up part of the available credit, the “consumed credit” is not available to reduce the tax liability for the present gifts. Once cumulative taxable gifts exceed $5,250,000 (as indexed) for a single person with no DSUE, all gift taxes owing will be payable.

Credits

A unified credit can be applied against the tax on gifts made either during lifetime or at death or part can be applied against each. The gift tax credit, which provides a dollar-for-dollar reduction of the tax otherwise payable, is as follows:

|  |  |
| --- | --- |
| **Donors Making Gifts in** | **Receive a**  **Credit of** |
| 1982 | $62,800 |
| 1983 | 79,300 |
| 1984 | 96,300 |
| 1985 | 121,800 |
| 1986 | 155,800 |
| 1987-1997 | 192,800 |
| 1998 | 202,050 |
| 1999 | 211,300 |
| 2000-2001 | 220,550 |
| 2002-2009 | 345,800 |
| 2010 | 330,800 |
| 2011  2012 | 1,730,800  1,772,800 |
| 2013 2014 2015 | 2,045,800 2,081,800 2,117,800 |
|  |  |

The unified credit is substantially greater for estate tax purposes than it was for gift tax purposes for 2004 to 2009 (see Appendix A).

REPORTING OF GIFTS AND PAYMENT OF THE TAX

Split-Gifts

A return must be filed with respect to any year in which a married couple elects to split gifts; however the return may be filed late if the only reason for filing the return is to show that the couple split gifts. However, if a spouse dies in the year of the gift, the return can also be filed up to the due date of the Federal estate tax return for such spouse.

Future-Interest Gifts

A gift tax return is required for a gift of a future interest, regardless of the amount of the gift. For example, if an individual transfers $100,000 to an irrevocable trust, income payable to the grantor’s wife for life and remainder to the grantor’s son, the son’s remainder interest would be a future interest gift. Therefore, a gift tax return would be required regardless of the value of the son’s remainder interest.

The term “future interest” is defined the same as for annual exclusion purposes: a gift in which the donee does not have the unrestricted right to the immediate use, possession, or enjoyment of the property or the income from the property.

Present-Interest Gifts

No gift tax return is due (if gifts are not split and no future interest gifts are made) until present-interest gifts made to one individual for the year exceed $14,000 (in 2015). When present-interest gifts made to one individual for the year exceed that limit, a return must be filed for such year, even if no gift tax would be due (e.g., if gift splitting provisions eliminated the tax). For example, if a married woman gave $18,000 to her son and split the gift, the transfer would be tax free. However, a gift tax return would be required because the gift exceeded the annual exclusion limit (and because the gift was split).

A gift tax return must be filed and the gift tax due, if any, on reported gifts must be paid by April 15 of the year following the year in which the taxable gifts were made. When an extension is granted for income tax return filing, the time limit for gift tax return filing is automatically extended.

Gifts to Charities

No return must be filed and no reporting is required for charitable contributions of $14,000 (in 2015) or less in value unless a noncharitable taxable gift is also made. In that case, the charitable transfer must be reported at the same time the noncharitable gift is noted on a gift tax return. If the value of the charitable transfer exceeds $14,000, the general rule is that the transfer must be reported on a gift tax return for that year unless the transfer is of the donor’s entire interest in the property.

If a split-interest gift is made to a charity (where there are charitable and noncharitable donees of the same gift), the donor will not be able to claim a charitable deduction for the entire value of the transfer. In this case, the donor must file and report the transfer subject to the filing requirements discussed above. For example, if an individual establishes a charitable remainder trust with payments to his daughter for life and the remainder payable to charity at her death, a gift tax return would have to be filed.

Liability for Payment – Net Gift

The donor of the gift is primarily liable for the gift tax. However, if the donor for any reason fails to pay the tax when it falls due, the donee becomes liable to the extent of the value of the gift. This liability begins as soon as the donor fails to pay the tax when due.

If a donor makes a gift and the donee decides, voluntarily, to pay the gift tax out of the property just received, the gift tax value of the gift is the entire fair market value of the property. In other words, if the donee is not obligated by the terms of the gift to pay the gift tax but chooses to pay it anyway, the donee must pay a tax based on the full fair market value of the property received based on the donor’s gift tax bracket.

Conversely, if the terms of the gift obligate the donee to pay the gift tax, the value of the gift (and therefore the amount of the gift tax liability) is reduced. If a gift is made subject to an express or implied condition at the time of transfer that the gift tax is to be paid by the donee or out of the property transferred, the donor is deemed to have received consideration (taxable as income) in the amount of the gift tax to be paid by the donee.

The value of the net gift is measured by the fair market value of the property passing from the donor less the amount of any gift tax paid by the donee. In computing the donee’s gift tax liability, the donor’s unified credit must be used.

The formula used to compute the donee’s tax is:

tentative tax ÷ (1 + donor’s gift tax rate)

For instance, assume a retired, 66 year old, single donor living almost entirely from the income of $4,000,000 worth of tax-free municipal bonds who made no prior gifts made a gift of property worth $6,114,000 in 2015. The gift was made to his niece on the condition that she pay the federal gift taxes. As the calculation below illustrates, the tentative tax on a tentative taxable gift of $6,100,000 ($6,114,000 - $14,000 annual exclusion) is $ 268,000. But the gift tax actually payable is $162,857 a difference of $105,143. The gift tax is the same as if the donor had made a taxable gift of $ 5,937,143 and paid the gift tax himself.

|  |  |
| --- | --- |
| **TRUE TAX ON NET GIFT** | |
|  |  |
| Year | 2015 |
| Tentative Taxable Gift | $6,100,000 |
| Gift Tax on $6,100,000 | $2,385,800 |
| Unified Credit | $2,117,800 |
| Tentative Tax [$2,385,800-2,117,800] | $268,000 |
| Tax Rate | 40% |
| True Tax [$228,000 ÷ (1 + .40)] | $162,857 |
| Net Gift [$6,100,000 - $162,857] | $5,937,143. |

Note that the formula is not applicable if the gift is split between the donor and spouse who are in different gift tax brackets because either or both have made prior taxable gifts. Quite often, however, you can determine the correct tax bracket by inspection and adjusting for the bracket differential by computing the tentative tax in the correct lower bracket. In other situations, you’ll have to make trial computations using first the bracket indicated by the tentative taxable gift and then later using the next lower bracket.

Due Date of Tax

Generally, the gift tax must be paid at the same time the return is filed. However, reasonable extensions of time for payment of the tax can be granted by the IRS, but only upon a showing of undue hardship. This means more than inconvenience. It must appear that the party liable to pay the tax will suffer a “substantial financial loss” unless an extension is granted. (A forced sale of property at a sacrifice price would be an example of a substantial financial loss.)

RELATIONSHIP OF THE GIFT TAX SYSTEM TO THE INCOME TAX SYSTEM

When the gift tax law was written, one of the principal purposes was to complement the income tax law by discouraging taxpayers from making gifts to reduce their taxable incomes. It is true that, to some extent, the gift tax does supplement the income tax system and there is some overlap. However, it is important to note that the tax treatment accorded a given transaction when the two taxes are applied will not necessarily be consistent.

A lack of consistency between the gift and income tax systems forces the practitioner to examine five different issues:

(1) Is the transfer one upon which the gift tax will be imposed?

(2) Apart from gift tax, will the transfer constitute a taxable exchange subject to the income tax?

(3) If the transfer was made in trust, will the income from the transferred property be taxable to the donor, or will the tax obligation shift to the recipient of the property (the trust or its beneficiaries)?

(4) If the income is taxable to the beneficiary, will it be taxable at the parent’s rate or at the beneficiary’s tax bracket (as it would be if (a) the income were earned income no matter what the beneficiary’s age, or (b) the beneficiary were age 18 (or in certain cases, 24) or older no matter whether the income was earned or unearned)?

(5) Does the gift constitute a cancellation of debt which could result in income tax consequences?

In summary, the treatment of a transaction for gift tax purposes is not necessarily consistent with the income tax consequences. Therefore it is important not to place undue reliance upon the provisions and interpretations of the income tax law when determining probable results or potential interpretations of the gift tax system (or vice versa).

DETERMINATION OF THE BASIS OF GIFT PROPERTY

When property is transferred from a donor to a donee and the donee later disposes of the property through a sale or other taxable disposition, gain depends on the donee’s basis. In return, the donee’s basis is carried over from the donor; i.e., the donor’s cost basis for the gift property immediately prior to the gift becomes the donee’s cost basis for that property.

*Example:* If an individual paid $5 a share for stock and transfers it when it is worth $25, and the donee sells it when it is worth $35, the donee’s cost basis for that property is the donor’s $5 cost basis. The gain, therefore, is the difference between the amount realized by the donee, $35, and the donee’s adjusted basis, $5, or $30.

An addition to basis is allowed for a portion of any gift tax paid on the transfer from the donor to the donee. The basis addition is for that portion of the tax attributable to the appreciation in the gift property from the time is was acquired by the donor until the date of the gift (the excess of the property’s gift tax value over the donor’s adjusted basis determined immediately before the gift). This increase in basis may be added to the donee’s carryover basis for the property.

Stated as a formula, the basis of gifted property is the donor’s basis increased as follows:

|  |  |
| --- | --- |
| Net Appreciation In  Value Of Gift | x Gift Tax Paid |
| Amount Of Gift |

This means the basis carried over from the donor is increased by only the gift tax on the net appreciation in the value of the gift. For example, an individual bought stock worth $40,000 and gave it to his daughter when it was worth $100,000. If the donor paid $18,000 in gift taxes at the time of the gift, the daughter’s basis would be $50,800.

|  |  |  |  |
| --- | --- | --- | --- |
| a. | Donor’s basis | | $40,000 |
| Plus | | | |
| b. | Gift tax on “net appreciation in value” (here, the difference between the $100,000 value of the gift at the time of transfer and the donor’s cost, $40,000) | |  |
| $60,000 | x $18,000 = | 10,800 |
| $100,000 |
| equals | | | |
| c. | Daughter’s basis | | $50,800 |

However, for purpose of determining loss, if the basis of the gifted property is lower than the fair market value of the property at the time of the gift, the basis is equal to such fair market value. For example, in 2010, Asher acquired land for $100,000. In 2015, Asher gifts the property then worth $60,000 to his cousin, Ashley. In 2016, Ashley sells the land for its then fair market value of $50,000. Obviously, the property was sold at a loss. However, because at the time of the gift, the fair market value of Asher’s property was $60,000 and his basis was $100,000, in computing loss, Ashley must use the lower of the property’s date of gift fair market value. So, in 2016, Ashley would recognize a $10,000 loss (the difference between the $60,000 basis and the amount realized of $50,000). On the other hand, had Asher not gifted the property and sold it for $50,000, he would have recognized a $50,000 loss (the difference between his $100,000 basis and the amount realized of $50,000).

The reason for the rule is to prevent a donor to shift a built in tax loss to a donee.For example, if at the time of the gift, Ashley had a large capital gain, being able to use Asher’s $100,000 basis would have generated a capital loss she could use to offset capital gain. In order to prevent this type of tax manipulation, Ashley’s basis is limited to the date of death fair market value. Obviously, if the value of the property further depreciates (as it did in this example), that post gift loss would be recognized by her.

RELATIONSHIP OF THE GIFT TAX SYSTEM TO THE ESTATE TAX SYSTEM

Going forward, the estate and gift tax system were fully unified in 2011. The unification correlates the estate and gift tax laws in three essential ways:

(1) Lifetime gifts and testamentary transfers are taxed by using the same tax rates (see Appendix A), rather than separate and different rates. The exemption for 2015 is $5,430,000, and the top rate is 40%.

(2) The unified credit can be applied to both lifetime and deathtime gifts. The unified credit is set at $2,117,800 for 2015.

(3) The estate tax imposed at death is computed y adding the taxable portion of gifts made during lifetime (after 1976) to the taxable estate to arrive at the tentative tax base (gift tax calculated on post-1976 taxable gifts can be subtracted to arrive at the estate tax liability).

In spite of the correlations of the two tax systems, gift tax law is not always consistent with estate tax law. When a gift is made, certain issues must be considered. For example, will property transferred during a decedent’s life be included in addition to his or her other assets in his or her gross estate? Will certain property transferred by a donor during life subject to gift tax be later included in the donor’s gross estate? For example, a donor who gifts a life insurance policy on his life to his son subject to potential gift tax who dies within three years of making the gift must include the life insurance policy in his or her gross estate.

Likewise, if the donor transfers property but retains a life interest, both gift and estate taxes will be payable. Although the gift tax paid may generally be subtracted in arriving at the estate tax liability, because of the time value of money (i.e., the donor’s loss of the use of gift taxes paid), the net result is less favorable than a mere washout (i.e., it is in essence a prepayment of the death tax).

FACTORS TO CONSIDER IN SELECTING APPROPRIATE SUBJECT OF A GIFT

Gift tax strategy must be part of a well-planned and carefully coordinated estate-planning effort. This in turn requires careful consideration as to the type of property to give. There are a number of strategies and factors that must be examined in selecting the types of property that are appropriate for gifts.

Some of the general considerations in selecting property to gift include:

(1) Is the property 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. The removal from the donor’s estate of the appreciation in the property (as well as the income from the property) should save a meaningful amount of estate and income taxes.

The best type of property will have 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 and estate-tax free.

(2) Is the donee in a lower income tax bracket than the donor? Income splitting between the donor and a donee age 18 or older can be accomplished by transferring high income-producing property to a family member in a lower bracket. Examples include high-dividend participating preferred stock in a closely held business or stock in a successful S corporation.

Conversely, if the donor is in a lower bracket than the donee (for instance, if the parent who is retired makes a gift to a financially successful middle-aged child), the use of low-yield growth-type property may be indicated. Typically, gifts to children under age 24 should emphasize growth.

(3) Is the property subject to indebtedness? A gift of property subject to indebtedness that is greater than its cost to the donor may result in a taxable gain. In other words, if by transferring the property by gift relieves the donor of the indebtedness (effectively shifting it to the done), it is as if the done purchased the property for the amount of the outstanding indebtedness. A gift of such property causes the donor to realize capital gain on the excess of the debt over basis. For example, the donor gift a building that cost her $10,000 subject to a $70,000 mortgage. At the time of the gift, the fair market value of the building is $100,000. Treating the transaction as a part-sale part-gift, the donor would recognize a gain of $60,000 (the difference between the shifted debt $70,000 and the donor’s basis $10,000). The difference between the fair market value of the building $100,000 and the debt $70,000 (that the donee essentially paid to the donor by taking on that liability) would be a taxable gift.

(4) Is the gift property’s cost basis above, below, or approximately the same as the property’s fair market value? As illustrated above, a pre-gift loss in gifted property cannot be passed along to the donee of the gifted property. So if the fair market value at the time of the gift is less than the donor’s basis in the gift, the donee’s basis would be the fair market value. As a result, neither the donor (who will not be selling the property)nor the donee (who takes a date of gift fair market value basis) would recognize the pre-gift capital loss with respect to such property. Furthermore, if the gift property’s cost basis exceeds the date of gift fair market value, there will be no gift tax addition to basis because that addition is in proportion to the pre-gift appreciation (of which there is obviously none). Thus, in absence of appreciation, no gift tax addition would be allowed.

Conversely, if the donor’s cost basis for income tax purposes is very low relative to the fair market value of the property, it might be advantageous to retain the property until death because of the stepped-up basis at death rules. (This is especially true if inclusion of the property will generate little or no gift tax because it will pass to a surviving spouse and qualify for a marital deduction, or if the donor’s estate is below the applicable exemption amount.) Due to a stepped-up basis provision, the capital gain the decedent would have recognized if he or she had sold the property during his or her lifetime would be avoided in the event the property is later sold by the estate or heir. But if the property must be sold during life, it may be prudent to gift it to a low-bracket age 24 or over family member by gift; that individual could then sell it and realize a lower tax.

A third possibility is that the donor’s cost basis is approximately the same or only slightly below fair market value. In this instance, the rules providing for a gift tax addition to basis are of little help. The addition to basis is limited to gift tax allocable to appreciation in the property at the time of the gift. One further factor that should be considered is the likelihood that the donee will want or need to sell the property in the foreseeable future. If this is not likely, the income tax basis (except for depreciable property) will be relatively meaningless.

CHAPTER ENDNOTES

1. . To read the differing opinions on donative promises, See LISI Estate Planning Newsletter No. 2033 (December 3, 2012 and LISI Estate Planning Newsletter No. 2022, 12/3/2012 at http://www.leimbergservices.com. [↑](#endnote-ref-1)
2. Treas. Reg. 1.2511-1(g)(1). [↑](#endnote-ref-2)
3. Duberstein v. Commissioner, 363 U.S. 278 (1960). [↑](#endnote-ref-3)
4. U.S. v. Kaiser, 363 U.S. 299 (1960). [↑](#endnote-ref-4)
5. Estate of Anderson v. Commissioner, 8 T.C. 706 (1947). [↑](#endnote-ref-5)
6. Another example of a no-gift situation would be where a group of businessmen convey real estate to an unrelated business corporation with the expectation of doing business with that corporation sometime in the future [↑](#endnote-ref-6)
7. IRC Section 453B. [↑](#endnote-ref-7)
8. Treas. Reg. 25.2512-1 [↑](#endnote-ref-8)
9. . This computation can be performed on NumberCruncher Software at http://www.leimberg.com. [↑](#endnote-ref-9)
10. Diedrich v. Commissioner, 457 U.S. 191 (1982). [↑](#endnote-ref-10)
11. 1954-2 C.B. 319. [↑](#endnote-ref-11)