III. FEDERAL GIFT TAX

A. Introduction

Clients seek to make lifetime gifts for a variety of reasons. The reasons can be personal, tax-motivated or both. Certain transfers can inadvertently result in unintended gifts with transfer tax consequences. A basic understanding of the gift tax system will help practitioners recognize when a transfer constitutes a gift for gift tax purposes, and to recognize the significant transfer tax advantages that can be achieved through the utilization of lifetime gifts.

This Chapter discusses the following issues relating to the federal gift tax:

- Transfers subject to the federal gift tax.
- Valuation for federal gift tax purposes.
- Federal gift tax exclusions and deductions.
- Gift-splitting.
- Calculation of federal gift taxes.
- Gift tax returns and payment of gift taxes.
- Practical effects of lifetime giving.

B. Transfers Subject to the Federal Gift Tax

1. "Gift" for Federal Gift Tax Purposes

The definition of a "gift" for gift tax purposes is very broad. The regulations state that "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to gift tax." Treas. Reg. § 25.2511-1(c). The elements of a "gift" for gift tax purposes coincide with many (but not all) of the elements of a "gift" for property law purposes:

a. **Competent Donor**. The individual making the gift is the "donor." The donor must be competent at the time the gift was made.

b. **Identity of Donee Not Necessary.** The individual receiving the gift is the "donee." The fact that the identity of the donee is not known or ascertainable does not matter for gift tax purposes. Treas. Reg. § 25.2511-2(a).

c. **Donative Intent Not An Essential Element.** The definition of a "gift" for property law purposes requires the donor to have donative intent. For gift tax purposes, however, donative intent is not an essential element of a transfer subject to gift tax. Treas. Reg. § 25.2511-1(g)(1).

> **EXAMPLE:** B furnishes the entire purchase price of a $100,000 vacation home. B adds C to the title so that B and C own the vacation home as tenants in common. Although B did not intend to make a gift

to C, B has made a gift to C for gift tax purposes of one-half of the purchase price of the vacation home, $50,000.

d. **<u>Complete and Irrevocable Gift</u>.** For a gift to be subject to gift tax, it must be complete and irrevocable. This occurs when "the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another…." Treas. Reg. § 25.2511-2(b). As a general rule, to the extent that the transferor retains any power to revoke the gift or to change the disposition of the property, the gift is either incomplete or partially complete and partially incomplete. To determine whether a donor has relinquished sufficient dominion and control over transferred property to effect a completed gift, a court will look to the applicable state law and evaluate the extent to which a donor has retained or relinquished control over the property. <u>See, e.g.</u>, *Devlin Estate v. Comm'r*, T.C. Memo. 1999-406; *Estate of Gore v. Comm'r*, T.C. Memo. 2007-169 (June 27, 2007). If a transfer of any interest is not complete, the transfer can become complete when and if, during the lifetime of the transferor, the property ceases to be subject to the power that caused the transfer to be incomplete.

The tests for determining whether a transfer is complete for gift tax purposes and estate tax purposes are similar, but not identical. Consequently, a transfer may be complete and subject to the gift tax, even though it is an incomplete gift for estate tax purposes, with the result that the property may be included in the gross estate of the transferor. This can occur when a donor transfers property to an irrevocable trust while retaining an income interest and transferring the remainder interest to other beneficiaries. In this case, the transfer is a completed gift as to the value of the remainder interest only (assuming IRC § 2702 is inapplicable, as discussed below). For estate tax purposes, the transfer is entirely incomplete under IRC § 2036 if the donor dies during the term of the income interest. Thus, the transfer will be subject to both gift and estate taxes. <u>See, e.g.</u>, *Chambers v. Comm'r*, 87 T.C. 225 (1986).

(1) **<u>Gifts By Attorney-in-Fact / Agent</u>.** A gift made by an attorney- in-fact (or agent) on behalf of a principal will be complete only if the attorney-in-fact has authority to make such gifts under state law. If state law allows the donor's power of attorney to authorize gifts, and if the donor's power of attorney explicitly authorizes the attorney-in-fact to make gifts, the gift will be treated as complete.

➔ **<u>Planning Point</u>:** Practitioners should check applicable state law concerning an attorney-in-fact's authority to make gifts under a durable power of attorney. If state law requires an explicit grant of authority to the attorney-in-fact to make gifts on behalf of the principal, the benefits and drawbacks of explicitly granting this power to a trusted attorney-in-fact should be considered.

(2) **<u>Gifts By Check</u>**. Generally, a gift by check is complete on the earlier to occur of: (a) the date the donor no longer has any control over the check; or (b) the date the donee deposits or cashes the check, but only if:

- The check is honored by the donor's bank when presented.
- The donor is alive when the bank pays the check.
- The check is delivered unconditionally to the donee.

- The check is cashed or deposited within a reasonable time of receipt.

  <u>EXAMPLE</u>: On Monday, A gives a $50,000 check to A's child, B. A dies on Wednesday in an auto accident before B has deposited the check. A's gift is not complete, because A could have cancelled the check and, thus, A retained control over the check at the time of death.

There is an exception to the general rule that "deathbed gifts" by check will not relate back to the date of delivery. A gift by check to a <u>charitable</u> donee will be treated as complete on the date of delivery even if the donor dies before the check is cashed or deposited. *Rosano Est. v. Comm'r.*, 245 F.3d 212 (2d Cir., Apr. 6, 2001), *aff'g* 67 F.Supp. 113 (E.D.N.Y., 1999).

➔ **<u>Planning Point</u>:** Practitioners should alert clients, especially terminally ill clients, that their gifts by check to a noncharitable donee will not be complete upon delivery of the check. Practitioners should advise clients to instead consider making such "deathbed gifts" by wire transfers, money orders or certified checks.

(3) <u>Gifts of Stock</u>. A gift of stock is complete on the date the donor delivers the properly endorsed stock certificate to the donee or the donee's agent. If the donor delivers the certificate to the donor's bank or broker or to the issuing corporation for transfer into the name of the donee, however, the gift is not complete until the date on which the stock is transferred on the corporation's books. Treas. Reg. § 25.2511-2(h).

(4) <u>Joint Interests</u>. The creation or termination of a joint interest can result in a completed gift under certain circumstances. The form of ownership and the consideration furnished by each joint tenant are the critical factors.

(a) <u>Forms of Joint Ownership</u>. Most states allow the co-ownership of property as tenants in common, as joint tenants with rights of survivorship and as tenants by the entirety. Each form of ownership has different effects at the death of a co-owner. When a tenant in common dies, his or her interest in the property may be disposed of by will. When a joint tenant with rights of survivorship dies, his or her interest in the property passes to the surviving joint tenant(s) by operation of law. A tenancy by the entirety is a special form of joint ownership for married couples, and works the same way at death as joint tenancy with rights of survivorship.

<u>EXAMPLE</u>: A and B own a home. A dies first. If they own the home as tenants in common, A's interest will pass by A's will (or to his heirs under state law if A has no will). If they own the home as joint tenants with rights of survivorship, or if A and B are married and own the home as tenants by the entirety, A's interest will pass to B by operation of law.

(b) <u>Gift Tax Consequences</u>. If a co-owner provides more or all of the consideration for a purchase and takes title with another person as joint tenants or tenants in common, and either owner can unilaterally sever the joint ownership and receive a pro rata interest in the property, the individual providing the consideration has made a gift.

> **<u>EXAMPLE</u>:** A buys a house for $250,000 and takes title with A's sister, B, as tenants in common. A provided all of the consideration for the house. Under state law, either A or B can unilaterally sever the tenancy in common. A has made a completed gift to B of one-half of the interest ($125,000).

(c) **<u>Joint Bank Accounts</u>**. If the accountholders of a joint bank account can unilaterally withdraw funds from the account, a completed gift does not occur when one of the accountholders deposits money into the joint account, because the depositor can simply withdraw the deposited funds. Thus, the depositor has not given up dominion and control over the funds. A completed gift will occur, however, when the accountholder (*i.e.*, the accountholder who did not make the deposit) withdraws the deposited funds from the account.

> **<u>EXAMPLE</u>:** P has a bank account with $100,000. On Date 1, P added C's name to the account. Under state law, either P or C can withdraw funds from the account. On Date 2, C deposits $10,000 to the account. On Date 3, C withdraws $20,000 from the account. On Date 1, P did not make a gift by adding C's name to the account. Similarly, C did not make a completed gift on Date 2 when C added funds to the account. P did, however, make a completed gift of $10,000 on Date 3 when C withdrew $20,000 from the account, because C withdrew $10,000 more than C contributed to the account.

(5) **<u>Joint and Mutual Wills</u>**. Some states allow joint and mutual wills. Joint and mutual wills are identical wills created by two or more persons (usually spouses). In some states, joint and mutual wills become irrevocable and binding at the death of the first testator to die, resulting in a completed gift.

> **<u>EXAMPLE</u>:** H and W create identical wills that state that they are joint and mutual. The wills provide that the surviving spouse will receive a life estate in the deceased spouse's estate, and both estates will go outright to their children at the death of the surviving spouse.
>
> Under state law, the wills become binding and irrevocable at the first death. At W's death, there is a completed gift by H of a remainder interest in H's property to the children.

(6) **<u>Gifts in Trust</u>**. In determining whether a donor's transfer in trust is a completed gift, the terms and the scope of the donor's powers must be examined. Treas. Reg. § 25.2511-2(b). Some of these powers include the following:

(a) **<u>Donor's Power to Revoke Trust or Revest Trust Property in Him or Herself</u>**. A transfer to a trust is an incomplete gift if the donor has the power to revoke the trust or otherwise revest the trust property in him or herself. Treas. Reg. § 25.2511-2(c); Rev. Rul. 94-69, 1994-2 C.B. 241 (designation of life insurance beneficiary is not a completed gift to the beneficiary until the death of the insured since the policy owner retains the right to change the beneficiary). Such power might arise from the express terms of the transfer or where the grantor gives a trustee the power to pay the principal to the grantor in the trustee's discretion and the grantor then names him or herself as trustee. Alternatively, it can arise where there is a more definite standard for the trustee to follow and the surrounding circumstances indicate that it is probable that the principal will be invaded for the benefit of the grantor. <u>See, e.g.</u>, *Holtz Estate v. Comm'r*, 38 T.C. 37 (1962); *Gramm v. Comm'r*, 17 T.C. 1063 (1951).

> **<u>EXAMPLE</u>:** D transfers $100,000 to D's revocable trust. D's transfer is not a completed gift because D retained the power to revoke the trust.

In PLR 9016079, X and Y established an irrevocable trust naming themselves as beneficiaries and trustees. X and Y, as trustees, were to distribute both income and principal to themselves or to the other identified beneficiaries of the trust in their absolute discretion. On termination of the trust, X held a limited power of appointment. The IRS held that, because X and Y retained dominion and control over the principal of the trust as trustees, the transfer of property to the trust was an incomplete gift. The IRS stated that subsequent distributions of income or principal to beneficiaries other than X or Y would be completed gifts, and distributions to X or Y in excess of their respective contributions would be a gift from the one to the other. <u>See also</u> *Vak Estate v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992).

A gift is also incomplete if a donor retains a power to revoke or to control beneficial enjoyment that is subject to a condition that can be accomplished through the exercise of an act within the control of the grantor. Rev. Rul. 54-537, 1945-2 C.B. 316. In PLR 200308046, the IRS ruled that a father's conveyance of a personal residence to his sons subject to a retained life estate and an oral agreement that the sons would reconvey the property to the father if he wanted it returned was not a completed gift and that the sons' reconveyance of the residence to the father several years later was not a gift by the sons. However, if a contingent power to revoke or to control beneficial enjoyment becomes exercisable only upon the occurrence of an event over which the grantor has no control, the gift is complete. <u>See, e.g.</u>, *Ward v. Comm'r*, 87 T.C. 78 (1986).

Even though an independent trustee may have an unrestricted power to distribute income or principal to a donor, which would normally make the gift complete, the gift is incomplete if, under state law, the donor's creditors can reach the trust assets. Rev. Rul. 76-103, 1976-1 C.B. 293.

(b) <u>Donor's Power to Name New Beneficiaries or Change Interests</u>. A transfer to a trust is an incomplete gift if the donor has the power to name new beneficiaries or to change the interests of the beneficiaries *unless* the power is a fiduciary power limited by a fixed or ascertainable standard relating to the health, education, maintenance and support of the beneficiary such that the amount is capable of being quantified. Treas. Reg. §§ 25.2511-2(c); -2(g); <u>see, e.g.</u>, *Chambers v. Comm'r*, 87 T.C. 225 (1986). The powers retained by the donor that preclude a completed gift include the following: (1) the power to add one or more new beneficiaries, (2) the power to remove one or more beneficiaries and (3) the power to sprinkle income or principal distributions among current beneficiaries. Treas. Reg. § 25.2511-2.

> **<u>EXAMPLE</u>:** D transfers $100,000 to a trust for the benefit of A and

B. D, as trustee, retains the power to allocate income and principal to or for the benefit of A or B for their support and maintenance. D's transfer is a completed gift because D's fiduciary power to reallocate property between the beneficiaries is limited by an ascertainable standard.

In TAMs 9536002 and 9535008, the grantor of an irrevocable trust retained a limited power to appoint to family members. The IRS concluded that the grantor retained a power to change the trust beneficiaries and, thus, because the grantor continued to possess dominion and control over the trust property, the transfers to the trust were incomplete gifts. The IRS provided the following nonexclusive list of events that would result in a completed gift: (1) the grantor exercises or relinquishes (to any extent) the power of appointment, (2) any action by the trustees that would effectively terminate the grantor's power of appointment with respect to any part of the trust property (including the trustees' distribution of income or principal to anyone other than the grantor) and (3) any action or inaction by the trustees with respect to any of the trust property whereupon the property is no longer accounted for in the trust. See also PLR 200403094.

If the donor retains a power to change beneficial interests and such power is not a fiduciary power limited by an ascertainable standard, the transfer to the trust is not a completed gift. Actual distributions to beneficiaries will be completed gifts that are subject to gift tax. Treas. Reg. § 25.2511-2(f); *Higgins v. Comm'r*, 129 F.2d 237 (1st Cir. 1942). In addition, if the grantor who is also the trustee has a power to accumulate income and add it to principal, the transfer of the income interest is incomplete because any accumulation would shift the enjoyment of the income to the remainder beneficiaries (unless the remainder beneficiaries were the same persons as the holders of the income interest). Treas. Reg. § 25.2511-2(c), (f). However, the gift of the remainder would not be rendered incomplete on account of a power of accumulation.

(c) Donor's Power to Change Manner and Timing of Enjoyment. A transfer to a trust is a completed gift if the donor only has the power to determine the manner or timing of the enjoyment of a gift. Treas. Reg. § 25.2511-2(d).

EXAMPLE: D transfers $100,000 to a trust for the benefit of A. All income will be distributed to A annually for 10 years, and the trust property will be distributed to A at the end of 10 years. D retains the power to require that income be accumulated and added to principal until the end of the 10 years. D's transfer is a completed gift because D only has a power to determine the timing of A's enjoyment of D's gift.

(d) Transfers That May be Revoked or Amended by the Grantor and a Non-Adverse Party. A transfer that may be revoked or amended by the donor is an incomplete gift without regard to whether the power is held solely by the donor or is exercisable only with the consent of another person who does not have a substantial interest that is adverse to the donor's exercise of the power. Treas. Reg. § 25.2511-2(e). If, however, the donor's power to revoke is exercisable only in conjunction with a person having a substantial adverse interest in the disposition of the trust property or the income from the trust, the gift is complete. Because the person with the adverse interest generally will not acquiesce in any exercise of the revocation power by the donor, the donor is considered as having relinquished dominion and control over the property transferred.

(e) **IRC § 2702 and Incomplete Gifts**. IRC § 2702 provides rules to determine the value of a gift when an individual makes a "transfer in trust" for the benefit of a "member of the individual's family" and the individual transferor or an "applicable family member" of the transferor retains an interest in the trust. Treas. Reg. § 25.2702-1(a). In general, if IRC § 2702 applies, the interest retained by the transferor or an applicable family member is valued at zero. The gift tax value of the transferred interest is therefore equal to the full fair market value of the property in which the donee receives an interest. IRC § 2702(a)(2); Treas. Reg. § 25.2702-6(c), Ex. 6. Thus, the entire value of the property transferred in trust is immediately subject to gift tax.

One instance in which IRC § 2702 does not apply is if the gift is wholly incomplete for gift tax purposes because the donor or grantor retained one or more powers. Section 2702(a)(3)(A)(i), (B). The term "incomplete gift" means "any transfer which would not be treated as a gift whether or not consideration was received for such transfer." If a transfer is wholly incomplete as to an undivided fractional share of the property transferred without regard to any consideration received by the grantor, the transfer is treated as incomplete as to that share. Treas. Reg. § 25.2702-1(c)(1). If IRC § 2702 does not apply to a completed gift as to which the donor retains a mandatory income interest, the amount of the gift is the value of the property transferred less the value of the retained income interest. This value is generally calculated by using the actuarial tables issued by the IRS under IRC § 7520.

2. Less Than Full and Adequate Consideration

a. **General Rule**. A transfer qualifies as a gift for gift tax purposes if the value transferred exceeds the consideration given. That is, a transaction such as a sale or exchange that is made for less than adequate and full consideration in money or money's worth will result in a gift. Internal Revenue Code ("IRC") § 2512(b); Treas. Reg. § 25.2512-8. The corollary of this rule is that a transfer for full and adequate consideration in money or money's worth is not a gift for gift tax purposes.

b. **Ordinary Course of Business Exception**. A sale, exchange or other transfer of property made in the ordinary course of business (*i.e.*, a transaction which is bona fide, at arm's length and free from donative intent) is not a gift, even if it is not for full and adequate consideration. Treas. Reg. §§ 25.2511-1(g)(2); 25.2512-8.

> **EXAMPLE:** B purchased a used car from a dealership for $15,000 even though the blue book price of the car was $17,000. Even though B did not pay the exact blue book price, there was no gift because the transaction was an arm's length business transaction.

3. Indirect Gifts

An indirect gifts is a transaction that does not look like a typical outright gift but confers an economic benefit on another person. Treas. Reg. § 25.2511-1(c).

a. **Interest-Free and Below-Market Interest Rate Loans**. Certain interest-free and below-market interest rate loans can result in a gift from the lender to the borrower.

(1) ***Dickman* Principle**. In *Dickman v. Comm'r*, 465 U.S. 330 (1984), the Supreme Court concluded that an interest-free loan of funds is a transfer of property by gift for gift tax purposes. The rationale was that the transaction conferred an economic benefit on the borrower.

(2) **Statutory Response**. In response to *Dickman*, IRC § 7872 was enacted. Section 7872 codifies the gift tax treatment of interest-free and low-interest rate loans.

(a) **Applicability**. IRC § 7872 applies to interest-free loans and loans with an interest rate below the applicable federal rate (AFR).

(b) **Amount of Gift**. Generally, the amount of the gift is the amount of the forgone interest, the difference between the amount of interest that would have been payable at the AFR and the interest actually paid. IRC § 7872(e)(2).

> **EXAMPLE:** P lends P's child, C, $100,000 at a 2% interest rate. The AFR is 8%. The amount of the gift in a given calendar year is the difference between the interest actually paid in that year and the interest that would have been paid at the 8% AFR.

(c) **Exceptions**. IRC § 7872 excepts certain loans between family members where tax avoidance is not the primary purpose. For example, a general de minimis exception allows certain gift loans between individuals of up to $10,000. IRC § 7872(c)(2)(A).

b. **Gift of Services.** An individual's personal services can sometimes result in a taxable gift. This issue often comes up when a personal representative foregoes a fee so that the beneficiaries will receive more from the estate. Such a fee would normally be included in the personal representative's gross income. In order for a personal representative to waive the fee without triggering income to himself and a deemed gift to the beneficiaries, the timing, purposes and effect of the personal representative's waiver of the fee must constitute evidence of an intent to render gratuitous services. An intention to serve gratuitously can be evidenced by an executor's waiver within six months of appointment or the executor's failure to claim fees or commissions as deductions. Rev. Rul. 66-167.

c. **Powers of Appointment.** A "power of appointment" is simply the power to decide who will take the trust property next, and the time, terms, shares and conditions under which they will receive it.

(1) **General Powers of Appointment**. IRC § 2514 provides that the exercise, release or lapse of certain general powers of appointment will result in a taxable transfer. IRC § 2514(c). Subject to certain exceptions, a "general power of appointment" is a power of appointment exercisable in favor of the holder of the power, the holder's estate, the holder's creditors or the creditors of the holder's estate. Treas. Reg. § 25.2514-1(c).

(a) **<u>Ascertainable Standard Exception</u>**. The ascertainable standard exception provides that a holder's power to appoint the property to himself that is limited by an ascertainable standard (relating to the holder's health, education, support or maintenance) is *not* a general power of appointment. Certain other standards (such as "welfare" or "happiness") are *not* considered an ascertainable standard.

> **<u>EXAMPLE</u>:** A trust provides that beneficiary B has a power to invade principal for B's health. B's power is not a general power of appointment because B's power to invade principal for himself was limited by an ascertainable standard (health). If B had the power to invade principal for his health and welfare, B's power would be a general power of appointment because "welfare" is not an ascertainable standard.

(b) **<u>General Powers of Appointment Created After October 21, 1942</u>**. The exercise or release of a general power of appointment created after October 21, 1942 is a taxable transfer for gift tax purposes. IRC § 2514(b). A lapse of such a power is also treated as a release and, thus, as a taxable transfer, but only to the extent that the value of the property subject to the lapse exceeds the greater of $5,000 or 5% of the aggregate value of trust property out of which the power could have been satisfied. IRC § 2514(e).

➔ **<u>Planning Point</u>:** In trusts, a power given to take advantage of this rule is the "5 and 5 power." The 5 and 5 power gives the powerholder the right to withdraw the greater of $5,000 or 5% of the trust property each year. The power lapses at the end of the year if not exercised. The annual lapse of the 5 and 5 power is excluded from gift tax under IRC § 2514(e).

> **<u>EXAMPLE</u>:** P has a general power to appoint $100,000 out of a trust with a total value of $200,000. The trust was created in 1997. P permits the power to lapse. P is treated as having made a transfer of $90,000 (the excess of $100,000 over 5% of the trust).

(c) **<u>General Powers of Appointment Created Before October 22, 1942</u>**. Only the exercise of a general power of appointment created before October 22, 1942 is a taxable transfer for gift tax purposes. IRC § 2514(a).

(2) **<u>Special Powers of Appointment</u>**. Basically, a special power of appointment is a power of appointment that is *not* a general power of appointment (*i.e.*, not exercisable in favor of the holder, the holder's estate, the holder's creditors or the creditors of the holder's estate). The exercise or release of a special power of appointment is not a taxable transfer for gift tax purposes. A special power of appointment is often used when the donor wants to give the holder the flexibility to control the disposition of trust property but still limit the group benefiting from the holder's exercise of the power.

> **<u>EXAMPLE</u>:** A trust gives beneficiary A a power to appoint trust principal in favor of anyone other than A, A's estate or the creditors of either. A exercises the power in favor of A's children. A's exercise is

not a taxable transfer.

d. **Disclaimers**. A disclaimer occurs when a donee refuses to accept property or a property interest transferred to the donee. The donee disclaiming the interest is called the "disclaimant." Certain disclaimers of property can result in a gift by the disclaimant to the person who receives the interest instead.

(1) **Qualified Disclaimers**. IRC § 2518 provides that a "qualified disclaimer" is not a taxable transfer subject to gift tax. A disclaimer is "qualified" if it meets all of the following requirements. IRC § 2518(b).

➔ **Planning Point:** Qualified disclaimers are useful for post mortem planning purposes. They can be used to correct planning mistakes or omissions.

EXAMPLE: H leaves his entire estate to H's child, C. C can disclaim a portion of his interest in favor of W to take advantage of the unlimited marital deduction.

(a) **Irrevocable and Unconditional**. The disclaimant must irrevocably and unconditionally refuse to accept an interest in property.

(b) **In Writing**. The disclaimer must be in writing.

(c) **Timing**. The disclaimer must be received by the transferor (or legal title holder) of the interest within 9 months of the date on which the transfer creating the interest in the disclaimant is made. For a disclaimant under age 21, the period is extended until 9 months after the disclaimant reaches age 21.

EXAMPLE: D died on March 1, 2008 and left his entire estate to D's children, B (who is 25 years old) and C (who will turn 21 on April 4, 2008). Assuming B and C meet the other requirements of a qualified disclaimer, B can disclaim his interest in D's estate up until December 1, 2008 (9 months after D's date of death), and C can disclaim his interest in D's estate up until January 4, 2009 (9 months after C turns age 21).

(d) **No Acceptance or Benefit**. The disclaimant must not have accepted any interest or benefit with respect to the disclaimed property.

➔ **Planning Point:** Immediately after a client's death, practitioners should consider whether a qualified disclaimer needs to be made *before* a beneficiary benefits from or accepts property.

(e) **Pass Without Direction or Control by Disclaimant**. The interest must in fact pass to another person without any direction or control by the disclaimant.

(2) **Non-Qualified Disclaimers**. A disclaimer of property that is not qualified will be treated as a taxable gift by the disclaimant.

4. Net Gifts

A "net gift" occurs when a donor makes a gift on the condition that the donee pays the gift tax.

a. <u>Gift Tax Consequences</u>. Because the donee's enjoyment of the gift is reduced by the amount of gift taxes paid, the "net gift" that is taxable is the difference between the amount of the gift and the gift taxes paid. Rev. Rul. 75-72 describes the interrelated calculation necessary to determine the amount of the gift and the amount of the gift tax due.

> **<u>EXAMPLE</u>:** P requires C to pay the gift tax liability of $200,000 on a $1,000,000 gift. The net gift principle says that P has made a net gift of $800,000.

b. <u>Income Tax Consequences</u>. An income tax issue arises with a net gift if the amount of gift tax discharged by the donee exceeds the donor's basis in the property transferred. In *Diedrich v. Comm'r*, 457 U.S. 191 (1982), the Supreme Court treated such a transaction as a sale for income tax purposes, and the excess was treated as the amount realized by the donor.

➔ **<u>Planning Point</u>:** In order to avoid income tax gain, the basis of gifted property in a net gift transaction should be equal to at least the amount of gift tax.

C. Valuation for Federal Gift Tax Purposes

1. General Rule

Generally, a gift is subject to gift tax based on its fair market value on the date of transfer (the date the gift becomes complete). IRC § 2512(a). "Fair market value" is 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 the relevant facts. Treas. Reg. § 25.2512-1.

2. Valuation of Specific Types of Property for Gift Tax Purposes

The regulations provide guidelines on the valuation of different types of property for gift tax purposes:

- Treas. Reg. § 25.2512-1 (property in general).
- Treas. Reg. § 25.2512-2 (stocks and bonds).
- Treas. Reg. § 25.2512-3 (business interests).
- Treas. Reg. § 25.2512-4 (notes).
- Treas. Reg. § 25.2512-5 (annuities, unitrust interests, interests for life or term of years, and remainder or reversionary interests).
- Treas. Reg. § 25.2512-6 (certain life insurance and annuity contracts and share in an open-end investment company).
- Treas. Reg. § 25.2512-7 (items subject to excise tax).

- Treas. Reg. § 25.2512-8 (transfers for insufficient consideration).

3. Discounts & Restrictions Affecting Valuation

Certain valuation discounts can be applied to *reduce* the value of a gift. For example, common discounts include (i) discounts for lack of marketability, (ii) discounts for minority interests and (iii) discounts for fractional interests. The rules in IRC §§ 2701-2704 (gifts of certain property subject to restrictions on the use of the property) can effectively establish a *higher* valuation than the fair market value standard.

D. Federal Gift Tax Exclusions

1. Gift Tax Annual Exclusion

The gift tax annual exclusion under IRC § 2503(b) permits an individual to give an amount equal to the annual exclusion ($13,000 in 2009 and 2010) per donee without incurring gift tax liability, provided that the gift is of a present interest. A married donor can annually give up to $26,000 per donee if the donor's spouse agrees to apply his or her annual exclusion amount by gift-splitting. IRC § 2513.

> **EXAMPLE:** In 2010, A gave $15,000 in cash to B. The first $13,000 is not subject to gift tax because of the annual exclusion. If A and A's spouse had elected to split their gifts, the entire $15,000 gift would be covered by the annual exclusions of A and A's spouse.

a. **Donee**. Generally, the donee of an annual exclusion gift can be anyone. The donee need not be a relative in order to qualify for the annual exclusion. The number of potential donees is unlimited.

> **EXAMPLE:** A makes cash gifts totaling $260,000 in 2010 ($13,000 to each of A's 5 children, 10 grandchildren, 4 friends and 1 doorman). None of the gifts is subject to gift tax by reason of the annual exclusion.

b. **Annual Exclusion Amount**. The annual exclusion amount referred to in the Code is $10,000. However, that amount was indexed for inflation after 1998, and, as a result, the current gift tax annual exclusion amount is $13,000 for 2010. IRC § 2503(b)(2).

c. **Annual Exclusion Gifts Not Subject to GST Tax**. Annual exclusion gifts are not subject to the generation-skipping transfer ("GST") tax for transfers to grandchildren or more remote descendants if the transfer is a "direct skip." IRC § 2642(c). Transfers directly (*i.e.*, not in trust) to grandchildren or more remote descendants always constitute "direct skips."

> **EXAMPLE:** On January 1, 2010, B gave $13,000 to B's grandchild, G. Because the annual exclusion covers B's gift to G, and because the transfer is a "direct skip," B's gift to G is not subject to gift tax or GST tax.

d. **Annual Exclusion Gifts Do Not Use Donor's Unified Credit**. Annual exclusion gifts do not use any portion of the donor's unified credit against gift and estate tax. Accordingly, such gifts essentially escape transfer tax altogether. A donor's annual exclusion is applied to a gift before the donor's unified credit.

> **EXAMPLE:** During D's lifetime, D made only annual exclusion gifts of $10,000 to B. At D's death, D's entire unified credit amount remains intact.

> **EXAMPLE:** D makes a gift of $50,000 to B in 2010. No gift tax is due because the first $13,000 of D's gift is covered by the annual exclusion, and the remaining $37,000 utilizes a portion of D's unified credit.

e. **No Carry Over to Subsequent Years**. Unlike the unified credit, the gift tax annual exclusion does not carry over to the next calendar year.

> **EXAMPLE:** P gave $1,000 to A in 2009 and gives $20,000 to A in 2010. P's 2010 annual exclusion covers $13,000 of the $20,000 gift. P cannot, however, use the unused $12,000 of exclusion from 2009 to cover the remaining taxable portion of his 2010 gift to A. As a result, P has made a taxable gift in 2010 of $7,000.

f. **"Present Interest" Requirement**. A gift of a "future interest" does not qualify for the annual exclusion. A gift must be of a "present interest" in order to qualify for the annual exclusion.

(1) **"Future Interest"**. A "future interest" is an interest in property, such as a reversion or remainder interest, that is limited in possession, use or enjoyment to a future date or time. Treas. Reg. § 25.2503-3(a).

(2) **"Present Interest"**. A "present interest" is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain). Treas. Reg. § 25.2503-3(b).

(a) **Outright Gifts**. Most outright gifts are present interest gifts that qualify for the annual exclusion because the donee has immediate use, possession or enjoyment of the gift. A substantial restriction, however, could prevent an outright gift from qualifying as a present interest gift.

➔ **Planning Point:** Practitioners advising clients who wish to make outright annual exclusion gifts of business interests should be sure that the operating agreement of the business does not prevent the donees from obtaining immediate use, possession or enjoyment of the transferred business interests. A member's (or partner's) inability, under the operating agreement, to; (1) unilaterally withdraw his or her capital account, (2) independently effectuate a dissolution of the business and (3) sell his or her business interest without the business manager's consent in the manager's sole discretion has been deemed to prevent transferred business interests from qualifying for the gift tax annual exclusion. *Hackl* *v. Comm'r*, 335 F.3d 664 (7th Cir. 2003).

This result might be avoided by giving a donee the unilateral right to sell his or her entire interest to third parties, subject to a right of first refusal by the entity and/or other interest holders to purchase the interest at the same price and terms as contained in a bona fide offer from a third party. In addition, perhaps the business manager's discretion to retain funds should be limited to amounts commensurate with the needs of the business with the balance of the funds being distributable to the interest holders. Alternatively, the business agreement could include a provision giving each donee the right to withdraw assets from the entity whenever gifts of entity interests are made. The right can be limited to the fair market value for the gifted interests and only be available for a limited period of time. Such a provision should foreclose any argument that the donee does not have the right to the immediate use, possession and enjoyment of the property in the economic sense.

(b) **Gifts in Trust**. Not all gifts in trust are gifts of present interests. A gift in trust must be a gift of a present interest to qualify for the annual exclusion. Certain gifts in trusts for the benefit of a minor qualify for the annual exclusion.

> **EXAMPLE:** P transfers $13,000 to a trust for A in 2010. The trust provides that the trustee may make discretionary distributions of income and principal to A until P dies, at which time the entire trust property will be distributed to A. P's gift is not a gift of a present interest and does not qualify for the annual exclusion because A must wait for P to die before A gets the right to possess the trust property.

2. Unlimited Exclusion for Tuition Expenses and Medical Expenses

IRC § 2503(e)(1) excludes from gift tax certain "qualified transfers," which include amounts paid by a donor directly to a qualifying education institution or a medical provider on behalf of an individual for tuition expenses or medical care. IRC § 2503(e)(2).

a. **Unlimited Exclusion Amount**. The amount of the exclusion for such tuition and medical care expenses is unlimited. The exclusion is in addition to the gift tax annual exclusion. Treas. Reg. § 25.2503-6(a).

> **EXAMPLE:** In 2010, P gave $5,000 to C, paid $20,000 directly to State University for C's tuition expenses and paid $2,000 directly to State Hospital for C's medical expenses. None of these gifts are subject to gift tax. The annual exclusion covers P's $5,000 gift, and the exclusions for tuition expenses and medical expenses cover P's $20,000 and $2,000 gifts.

b. **Exclusion Amount Not Subject to GST Tax**. Gifts that qualify for the exclusion for tuition or medical expenses are not subject to GST tax. IRC § 2642(c).

➔ **<u>Planning Point</u>:** This exclusion is especially valuable for grandparents because their payments of a grandchild's tuition and medical expenses are: (1) unlimited in amount; (2) free of gift tax; (3) free of GST tax; and (4) remove significant amounts from their estates. In addition, the grandparents control the use of the gifts by making payments directly to the educational institution or medical provider.

c. **<u>Payments Must Be Direct</u>**. Payments of tuition expenses must be made *directly* to the educational institution to qualify for the exclusion. Similarly, payments of medical expenses must be made *directly* to the medical care provider to qualify for the exclusion. Section 2503(e)(2).

> **<u>EXAMPLE</u>:** P gives $20,000 to P's child, A, to pay for tuition at Private University. P's gift does not qualify for the exclusion because P paid A instead of paying Private University directly.

d. **<u>Permitted Donee</u>**. Generally, the donee of a such a gift can be anyone. The donee need not be a relative in order to qualify for the exclusion for tuition and medical expenses. The number of potential donees is unlimited.

e. **<u>Qualifying Educational Institution</u>**. A "qualifying educational institution" is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried on. Treas. Reg. § 25.2503-6(b)(2).

f. **<u>Qualifying Education Expenses</u>**. Only tuition expenses qualify for the exclusion for educational expenses. Expenses for books, supplies, dormitory fees, board, or other similar expenses do not qualify for the exclusion. Treas. Reg. § 25.2503-6(b)(2).

g. **<u>Qualifying Medical Expenses</u>**. "Qualifying medical expenses" include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. In addition, amounts paid for medical insurance qualify. The exclusion does not apply, however, with respect to any amounts reimbursed by medical insurance. Treas. Reg. § 25.2503-6(b)(3).

E. Federal Gift Tax Deductions

1. Unlimited Gift Tax Marital Deduction

IRC § 2523 allows an unlimited gift tax marital deduction for qualified interests that a donor gives to the donor's spouse.

➔ **<u>Planning Point</u>:** The gift tax marital deduction is useful for spouses who wish to equalize their estates to give the "poorer" spouse more property. This is important for estate tax planning purposes so that both spouses' unified credits can be used, regardless of who dies first.

a. **<u>Requirements</u>**. An interest transferred to a donee-spouse must meet all of the following requirements in order to qualify for the gift tax marital deduction.

(1) **<u>Donee-Spouse is a U.S. Citizen</u>**. The donee-spouse must be a U.S. citizen on the date of the gift. The gift tax marital deduction is not available for gifts to donee-spouses who are not U.S. citizens at the time of gift.

(2) **<u>Deductible Interest (Not a Nondeductible Terminable Interest)</u>**. The interest must not be a nondeductible terminable interest. See discussion below on terminable interests.

b. **<u>The Terminable Interest Rule: Nondeductible Terminable Interests</u>**. The terminable interest rule provides that the marital deduction is not available for interests that terminate or fail upon a lapse of time or the occurrence or nonoccurrence of an event if a person other than the donee-spouse receives the property after the termination of the donee-spouse's interest. IRC § 2523(b).

> **<u>EXAMPLE</u>:** H gives $300,000 to an irrevocable trust for W's benefit for 10 years, at which time the trust will terminate and be distributed to H's children. H is not entitled to a marital deduction for the $300,000 transferred to the trust for W because W's interest in the trust will terminate upon a lapse of time (10 years) and persons other than W (H's children) will receive the property from H.

c. **<u>Exceptions to the Terminable Interest Rule: Deductible Terminable Interests</u>**. Despite the terminable interest rule, certain terminable interests still qualify for the gift tax marital deduction. Some of these interests include the following:

(1) **<u>General Power of Appointment Trust Exception</u>**. Under IRC § 2523(e), a marital deduction is allowed for an interest that passes to a spouse if all of the following requirements are met:

- The donee-spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
- The income payable to the donee-spouse must be payable at least annually.
- The donee-spouse must have the power to appoint the entire interest or the specific portion to either himself or herself or to his or her estate.
- The power must be exercisable by the donee-spouse alone (whether by will or during life) and must be exercisable in all events.
- The entire interest or specific portion must not be subject to a power in any other person to appoint any portion or all of the interest in favor of any person other than the donee-spouse.

> **<u>EXAMPLE</u>:** H gives $500,000 to an irrevocable trust for W. All of the income of the trust is payable to W annually and W has the power to appoint property to anyone, including herself and her estate. The trust

qualifies for the gift tax marital deduction as a general power of appointment trust under IRC § 2523(e). If the trust had also provided that W's child, C, had a power to appoint the trust property in favor of C's children, the trust would not have qualified for the gift tax marital deduction.

(2) **QTIP Trust Exception**. Under IRC § 2523(f), a marital deduction is allowed for an interest that passes to a spouse in a lifetime qualified terminable interest property (QTIP) trust if all of the following requirements are met:

- The spouse is entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
- The income payable to the spouse must be payable at least annually.
- The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the spouse.
- A QTIP election must be made on the donor's gift tax return with respect to a specific portion or all of the trust.

➔ **Planning Point:** The QTIP trust is similar to the general power of appointment trust except that the spouse need not have a general power of appointment over a QTIP trust in order to qualify for the gift tax marital deduction.

EXAMPLE: H gives $500,000 to an irrevocable trust for W. All of the income of the trust is payable to W annually. W has a power to appoint the trust property in favor of W's descendants. If H makes a QTIP election on H's gift tax return, the trust will qualify for the gift tax marital deduction. If the trust had also provided that W's child, C, had a power to appoint the trust property in favor of C's children, the trust would not have qualified for the gift tax marital deduction.

2. Unlimited Gift Tax Charitable Deduction

IRC § 2522(a) allows an unlimited gift tax charitable deduction for transfers to the following types of recipients:

- Federal government, State government or subdivisions thereof for exclusively public purposes.
- IRC § 501(c)(3) corporations, trusts, community chests, funds or foundations, operated exclusively for religious, charitable, scientific, literary or education purposes, which do not attempt to influence elections and are not substantially engaged in carrying on propaganda or influencing legislation.
- IRC § 501(c)(3) fraternal or veterans organizations.

a. **Unlimited**. None of the percentage and other limitations on the income tax charitable deduction under IRC § 170 apply to the gift tax charitable deduction. In this sense, the gift tax charitable deduction is "unlimited."

b. **Nonresident Alien Donors**. If the donor is not a U.S. resident or citizen at the time of gift, corporate donees must be domestic corporations, and gifts to trusts, community chests, funds or foundations, or fraternal organizations must be for use within the U.S. in order to be deductible for gift tax purposes. IRC § 2522(b).

c. **Split Interests**. A split interest is simply a gift in which a charitable beneficiary and a noncharitable beneficiary share interests.

d. **Charitable Deduction for Qualified Conservation Transfer**. IRC § 2522(d) allows a gift tax charitable deduction for any transfer of a "qualified real property interest" under IRC § 170(h) to a qualified charity. A "qualified real property interest" includes the entire interest of the donor other than a qualified mineral interest, a remainder interest or a restriction (granted in perpetuity) on the use which may be made of the real property. IRC § 170(h)(2).

F. Gift Splitting

1. General Rule

Generally, IRC § 2513 allows one spouse to treat his or her gifts to any person other than his or her spouse as made one-half by each spouse.

> **EXAMPLE:** H makes a gift to A of $26,000. If H and W elect to split H's gift, one-half ($13,000) will be treated as made by H, and one-half ($13,000) will be treated as made by W.

2. Requirements

In order to "split gifts" under IRC § 2513, all of the following requirements must be met:

a. **U.S. Citizen or Resident Spouses**. Both spouses must be U.S. citizens or residents at the time of the gift. IRC § 2513(a)(1).

b. **Married and No Subsequent Remarriage in Same Calendar Year**. The donor must have been married at the date of gift. Further, the donor cannot remarry during the remainder of the calendar year in which the gift occurred. IRC § 2513(a)(1).

> **EXAMPLE:** H and W1 divorced on January 31, 2007. Prior to their divorce, H made a gift to A of $24,000. H subsequently married W2 on December 4, 2007. H cannot split his gift to A with W1. Although H and W1 were married at the date of gift, H subsequently remarried during the same year. H cannot split his gift with W2 either because H was not married to W2 when H made the gift.

c. **Consent of Both Spouses on Gift Tax Return**. Both spouses must elect to split their gifts on their gift tax returns. IRC §§ 2513(a)(2) and 2513(b).

➔ **<u>Planning Point</u>:** Gift splitting is often used to take advantage of both spouse's gift tax and GST tax annual exclusions.

> **<u>EXAMPLE</u>:** H gives $26,000 to H's grandchild, G. If H and W split H's gift, one-half ($13,000) will be treated as made by H, and one-half ($13,000) will be treated as made by W. Each spouse's gift tax and GST tax annual exclusion will cover his or her one-half of the gift.

3. Joint and Several Liability

The non-transferring spouse who consents to split gifts is jointly and severally liable for the entire gift tax liability. IRC § 2513(d).

G. Nature, Scope and Calculation of Federal Gift Tax

1. Nature

Like the federal estate tax, the federal gift tax is an excise tax on the <u>transfer</u> of property. The federal gift tax is a tax on a donor's <u>privilege</u> of being able to transfer property by gift during a calendar year. IRC § 2501(a)(1); Treas. Reg. § 25.2511-2(a).

2. Scope

The gift tax applies to all gifts made by U.S. citizens or residents and to gifts made by nonresident aliens of property situated in the U.S. Subject to certain exceptions, it does not apply to gifts made by nonresident aliens of intangible property. Shares of stock issued by a domestic corporation and debt obligations of any U.S. citizen or any federal or state government, however, are deemed to be property situated in the U.S. IRC §§ 2501(a)(2), 2511(a), and 2511(b); Treas. Reg. § 25.2511-3.

> **<u>EXAMPLE</u>:** C, a Canadian citizen and resident, gives 500 shares of IBM stock to D. C's gift is subject to federal gift tax even though C is a nonresident alien, because the gifted shares are deemed to have a U.S. situs.

3. Calculation

IRC § 2502(a) and Treas. Reg. § 25.2502-1 describe the computation of a donor's gift tax liability.

a. <u>Calculated Annually</u>. A donor's gift tax liability for gifts made in the previous calendar year is calculated on an annual basis. IRC §§ 2501(a)(1) and 2502(a).

b. <u>Computation</u>. In general, a donor's gift tax liability is the amount equal to the excess of: (1) the tentative gift tax on the aggregate sum of the donor's taxable gifts for the current year and the donor's taxable gifts for all prior years; over (2) the tentative gift tax on the aggregate sum of the donor's taxable gifts for all prior years.

(1) **Total Gifts**. The first step is to determine the donor's total gifts during the calendar year in question.

(2) **Allowable Exclusions and Deductions**. The second step is to determine the donor's total allowable exclusions and deductions.

(3) **Total Taxable Gifts**. The donor's "total taxable gifts" is determined by adding the donor's taxable gifts for the calendar year in question to all of the donor's taxable gifts for prior calendar years.

(a) **Taxable Gifts for Calendar Year in Question**. The donor's taxable gifts for the current year is determined by subtracting from the value of the donor's total gifts the donor's total allowable exclusions and deductions. IRC § 2503.

(b) **Taxable Gifts for All Prior Years**. The donor's taxable gifts for a prior year is based on the donor's total gifts and exclusions, deductions and exemptions as were allowed under the gift tax laws applicable to that year. IRC § 2504.

(4) **Tentative Tax**. The donor's total tentative tax is determined by subtracting the tentative tax on taxable gifts for prior years from the donor's tentative tax on his total taxable gifts. IRC § 2502(a).

(a) **Tentative Tax on Total Taxable Gifts**. A tentative tax on the donor's total taxable gifts is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's total taxable gifts. IRC § 2502(a)(1).

(b) **Tentative Tax on Prior Taxable Gifts**. A tentative tax on the donor's taxable gifts from all prior years (excluding the current year) is determined by applying the applicable tax rate from the tax rate table in IRC § 2001(c) to the decedent's taxable gifts from all such years. IRC § 2502(a)(2).

(5) **Reduction by Unified Credit**. The donor's total tentative tax is then reduced by the unused portion of the donor's unified credit. IRC § 2505.

> **EXAMPLE:** D made a taxable gift in 2002 of $100,000 and a taxable gift in 2003 of $200,000. In 2009, D gave B $100,000 in cash and paid for B's $20,000 tuition expense. D's 2009 gift tax liability is calculated as follows. D's taxable gifts for 2009 are $87,000 ($120,000 total gifts, less $13,000 annual exclusion, less $20,000 exclusion for tuition expenses). D's total taxable gifts are $387,000 ($100,000 in 2002 plus $200,000 in 2003 plus $87,000 in 2009). Applying the tax rate table in IRC § 2001(c), the tentative tax on D's total taxable gifts of $387,000 is $117,380, and the tentative tax on D's prior gifts of $300,000 is $87,300. D's tentative gift tax liability for 2009 is $30,080. This amount is reduced by the unused portion of D's unified credit. No gift tax is due for 2009.

H. Payment of Gift Tax, Gift Tax Returns & Statute of Limitations

1. Liability

The donor is primarily liable for payment of gift taxes. IRC § 2502(c); Treas. Reg. § 25.2502-2. The donee is secondarily liable if the donor does not pay. IRC §§ 6324(b) and 6901(a)(1)(A)(iii).

2. Gift Tax Return

a. **__Who Must File__**. Generally, any individual donor who in any calendar year makes a gift must file a gift tax return (Internal Revenue Service ("IRS") Form 709). No return is required, however, if all of the donor's gifts fall into one or more of the following categories of gifts: (1) annual exclusion gifts (without gift-splitting) under IRC § 2503(b); (2) gifts to an educational institution or health care provider under IRC § 2503(e); (3) gifts that qualify for the marital deduction under IRC § 2523; and (4) certain outright gifts that qualify for the charitable deduction under IRC § 2522(d). IRC § 6019.

> **__EXAMPLE__:** D's only gifts in 2010 are cash gifts of $13,000 to each of D's children. D is not required to file a gift tax return because D's gifts qualify for the annual exclusion.

b. **__Due Date__**. The donor must file his or her federal gift tax return on or before April 15 of the year following the calendar year in which the gifts were made. IRC § 6075(b)(1). An extension to file the donor's individual income tax return is deemed an automatic extension of time to file the donor's gift tax return. IRC § 6075(b)(2). A donor can also request an extension of time to file. IRC § 6081. With respect to a donor who dies, the gift tax return must be filed no later than the time for filing the donor's estate tax return. IRC § 6075(b)(3).

> **__EXAMPLE__:** On January 3, 2009, D made a gift of $50,000 to A. D died on October 5, 2009. D's gift tax return reporting the gift is due at the same time as D's estate tax return on July 5, 2010.

c. **__Statute of Limitations and Adequate Disclosure.__**

(1) **__General Statute of Limitations Period__**. Generally, the IRS has three years to assess additional gift tax. The statute of limitations period begins to run on the filing date or the due date of the gift tax return, whichever is later. If the return is filed before April 15, the statute of limitations period begins on April 15. If the return is filed after April 15, the statute of limitations period begins on the actual filing date. IRC § 6501(a), (b).

> **__EXAMPLE__:** B files his 2009 gift tax return on March 30, 2010. The statute of limitations period begins on April 15, 2010.

> **__EXAMPLE__:** B files his 2009 gift tax return on July 30, 2010. The statute of limitations period begins on July 30, 2010.

(2) **<u>Exceptions</u>**. There are several exceptions to the general limitations period:

(a) **<u>Six Years</u>**. If the gift tax return omits more than 25% of the total amount of gifts, the statute of limitations period becomes six years. IRC § 6501(e)(2).

(b) **<u>Extension by Agreement</u>**. The statute of limitations period can be extended by agreement with the IRS. IRC § 6501(c)(4). The IRS, however, is usually the party that initiates such an extension.

(c) **<u>Assessment At Any Time</u>**. If no gift tax return is filed, if the gift tax return is false or fraudulent with intent to evade tax, or if there is a willful attempt to evade tax or defeat tax, the IRS may assess gift tax at any time. In addition, for transfers made on or after January 1, 1997, the IRS may assess gift tax at any time for transfers that are not "adequately disclosed" on the gift tax return. IRC § 6501(c); Treas. Reg. § 301.6501(c)-1(f)(1).

(3) **<u>Adequate Disclosure</u>**. Generally, a disclosure on a gift tax return is "adequate" if all five of the following requirements are met. Treas. Reg. § 301.6501(c)- 1(f)(2).

(a) **<u>Description of Gift</u>**. The gift tax return should describe the transferred property and any consideration received by the transferor.

(b) **<u>Transferor and Transferee</u>**. The gift tax return should disclose the identity and relationship of the transferor and each transferee.

(c) **<u>Gifts in Trust</u>**. For gifts in trust, the return should disclose the trust's tax ID number and a brief description of the trust terms (or a copy of the trust instrument).

(d) **<u>Valuation Method</u>**. The gift tax return must provide a detailed description of the method used to determine fair market value of the transferred property or provide a qualified appraisal. The regulations provide guidelines on what constitutes a detailed description and a qualified appraisal.

(e) **<u>Contrary Position</u>**. The return should disclose and describe any position taken by the taxpayer contrary to any proposed, temporary or final regulation or revenue ruling published at the time of the transfer.

➔ **<u>Planning Point</u>:** The IRS cannot challenge valuation or legal issues with respect to an adequately disclosed gift once the statute of limitations has run. Examples of legal issues that the IRS cannot challenge once the statute of limitations period has run include: (1) the availability of the annual exclusion; (2) a transfer in trust with an IRC §§ 2036 though 2038 string mistakenly treated as a completed transfer; and (3) a legal conclusion on the gift tax return that an incomplete transfer was complete.

I. Practical Effects of Lifetime Gifts

1. **Transferred Property (Including Appreciation and Income) Removed From Estate**

Property that a donor transfers by gift during lifetime is not included in the donor's estate. The donor's transfer tax liability for such a gift is calculated at the date of gift. Therefore, any post-gift income or appreciation generated by the transferred property will not be subject to gift tax or estate tax.

➔ **<u>Planning Point</u>:** Making lifetime gifts of property likely to appreciate or generate a significant amount of income can effectively reduce the donor's transfer tax liability at death.

> **<u>EXAMPLE</u>:** D gave a vacation home worth $100,000 to D's son, B. At D's death 20 years later, the vacation home had appreciated in value to $2,000,000. The vacation home was not included in D's estate. If D had retained the vacation home until death, the home would have been included in D's estate at a value of $2,000,000, and D's estate tax liability (assuming a 50% estate tax rate) would have increased by approximately $1,000,000.

2. **Gift Tax Out of Donor's Estate if Donor Survives at Least Three Years**

Assuming the donor survives at least three years after the date of gift, any gift tax paid on the gift is also removed from the donor's estate, even if the gift itself is included in the donor's estate. IRC § 2035(b).

> **<u>EXAMPLE</u>:** D paid gift taxes of $1,000,000 on a $2,000,000 gift to B in 2002. D dies in 2006. The gift taxes D paid on the gift are not included in D's estate because D survived at least three years after the gift.

3. **Tax Exclusive Gift Tax v. Tax Inclusive Estate Tax**

The gift tax is "tax exclusive" while the estate tax is "tax inclusive." That is, the tax used to pay gift tax is not itself subject to gift tax. The tax used to pay estate tax is itself, however, subject to estate tax. The tax exclusive nature of the gift tax makes the gift tax rate effectively lower than the estate tax rate. This is true even though the same tax rate schedule applies to both the gift tax and the estate tax.

> **<u>EXAMPLE</u>:** D makes a $2,000,000 gift to A and pays approximately $1,000,000 in gift taxes. It cost D $3,000,000 to give A a $2,000,000 gift. If D had not made the gift and instead bequeathed the amount to A, D's estate would be increased by $3,000,000. D's estate tax would be approximately $1,500,000, and A would only receive $1,500,000. As this example illustrates, D can pass more to A by making a lifetime gift to A.

4. **Taking Advantage of Gift Tax Exclusions Can Significantly Reduce Taxes**

As discussed earlier in this Chapter, an individual can give $13,000 each year to an unlimited number of donees, and may pay medical expenses and tuition expenses for another person free of gift tax and GST tax. All such property given away is also removed from the donor's estate. Therefore, such gifts are not subject to any transfer tax.

➔ **Planning Point:** A planned giving program that takes advantage of these exclusions can significantly reduce an individual's total transfer tax liability.

> **EXAMPLE:** D gave $10,000 a year in cash to each of D's 4 children, 8 grandchildren and 8 friends for each of the five years before D's death. D also paid tuition expenses for 2 of D's grandchildren totaling $100,000. None of these gifts were subject to gift tax or GST tax, and D effectively removed $1,100,000 from D's estate. All future income and appreciation from the transferred funds was also removed from D's estate.

5. Income on Transferred Property Generally Taxed At a Lower Rate

Income on property transferred by gift is generally taxed to the donee. If the donee is in a lower income tax bracket than the donor, then less income tax will be paid on the same property. The "kiddie tax," however, subjects children under age 19 to the same marginal income tax rate as their parents, limiting this benefit. IRC § 1(g).

6. Basis Not Increased Except Portion of Gift Tax Paid On Appreciated Gift

Under current law, in general, property transferred by gift retains the donor's basis, but property transferred at death, assuming the executor is able to allocate sufficient basis to the property, gets a step up in basis to the property's fair market value at death. IRC §§ 1015 and 1022. If the donor pays gift tax on appreciated property, however, the donee's basis increases by the portion of the gift tax attributable to the appreciation in the property. Treas. Reg. § 1.1015-1(a)(2). To calculate the increase, the gift tax paid is multiplied by a fraction, of which the numerator is the appreciation, and the denominator is the fair market value of the gift.

> **EXAMPLE:** D gives B a home worth $1,000,000 with a $300,000 basis. D pays gift tax of $500,000. The increase in basis of $350,000 is calculated by multiplying $500,000 (gift tax paid) by $700,000/$1,000,000 (appreciation over FMV). Therefore, B's basis is $650,000 (D's basis of $300,000 plus basis increase of $350,000).

➔ **Planning Point:** For property transferred by gift, all of the appreciation in excess of the donor's basis (plus any adjustment for gift taxes paid on appreciated property) will be subject to income tax on the sale of the property. For property transferred at death, assuming that the executor is able to allocate sufficient basis to the property under IRC § 1022, only the appreciation after the decedent's death will be subject to income tax on the sale of the property. In determining whether to make lifetime gifts of appreciated property versus retaining such property until death, practitioners should consider the amount of appreciation in the property, the likelihood of a sale in the near future and the likelihood the client will survive until 2010 when the basis step-up becomes limited.