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Lifetime Gifting: The Fundamentals and Traps for the Unwary*

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Lifetime Gifting: The Fundamentals and Traps for the Unwary

Note: Beyond the scope of this outline are the gift tax rules which apply to nonresident aliens, expatriates and termination of residency by long-term lawful residents.

A. Questions to Ask Before Making Lifetime Gifts

Here are several questions that should be considered before a client makes a gift:

Will the donor, post-gift, have sufficient assets for his or her current and projected needs?

What impact will the gifts have on the children and grandchildren?

Will the gifted assets be subjected to the claims of a current or future ex-spouse of the donee?

Will the gifted assets be subjected to the claims of donee's current or future creditors?

Will the gift save transfer taxes?

Will the gift result in the inability to, later on, make gift tax free gifts using a client's GST exemption?

Will the gift save donor or donor's family income taxes?

What will be income tax basis for the gifted asset?

Will the gift trigger capital gains tax being due?

Will the gift result in loss of student financial aid to donee or donee's family?

Will the gift result in the loss of governmental (e.g., disability) benefits?

This list of questions is not exhaustive. There are certainly other factors that should be considered prior to making a gift.

B. Tax Purposes for Making Lifetime Gifts

1. Post-Gift Appreciation Not Subject to Estate Tax

Example (An Unbelievable Result): A January 2002 gift of Apple shares worth approximately $1 million would have shifted $78 million of appreciation out of donor's estate, based on the highest closing price in 2015.

See, http://www.investopedia.com/articles/markets/021316/if-you-had-purchased-100-apple-2002-aapl.asp.

Example (A Terrible Result): 2008 gift of $1 million worth of shares in a closely held family business fully using the then gift tax exemption. Business had been in family for two generations and gift was part of transitioning business to the next generation. In 2014, business declared bankruptcy and was dissolved. $1 million of exemption wasted on an asset which became worthless.

2. Tax Exclusive. Unlike the Estate Tax the Gift Tax is Not Part of the Tax Base.

   Example: Assume Client has a $10 million of assets. On 1/2/13 Client makes a $5.25 million taxable gift of cash to Niece. Client previously used all of his gift tax exemption and 2013 annual exclusion amount. In 4/14, Client pays $2.1 million of gift tax to IRS on $5.25 million gift to Niece. Client's total out of pocket amount to make the gift is $7.35 million. Client dies in 7/17 with an estate of $2.65 million and leaves his entire estate to his Niece having previously utilized his entire exclusion amount. The estate will owe estate tax of $1.06 million leaving $1.59 million for Niece. In total $3.16 million of transfer taxes were paid and, in total, Niece received $6.84 million.

   Assume, alternatively, that Client did not make any lifetime gifts to Niece and then Client dies in 2017 with an estate of $10 million and leaves his entire estate to his Niece having previously utilized his entire exclusion amount. The estate will owe estate tax of $4 million leaving $6 million for Niece.

   By making a lifetime gift, Client was able to increase the amount transferred to Niece by $840,000; i.e., $2.1 million of gift taxes paid times 40% tax rate.

   Note: Client must survive 3 years from date of gift for gift to be tax exclusive. See below discussion of §2035(b).

3. Leveraged Use of GST Exemption, if Gifted Assets Appreciate in Value.

   Example: On 1/1/11 Client makes a $5 million cash gift to an irrevocable grantor trust for the benefit of grandchildren allocating GST exemption to the gift. Value of trust as of 12/31/16 is $8 million. On 1/1/17 Client gifts an additional $490,000 to the trust, allocating GST exemption to the gift, bringing the total trust value to $8.49 million. Thus, the $5.49 million of gifts leveraged Client's GST exemption by $3 million (as compared to "doing nothing" and use of GST exemption at death, or an initial funding of the irrevocable grantor trust in January of 2017).

4. Reducing Income Taxes.

   Example: Client transfers vacation home and other income generating assets to a non-grantor trust for the benefit of his descendants. Property taxes on the vacation

home are roughly $9,000 per year. The property tax bill on Client's primary residence, which he continues to own, is also around $9,000 annually.

2017 Tax Act caps a taxpayer's state and local tax deduction at $10,000 (for joint filers and unmarried taxpayers). IRC §164(b)(6).

The above strategy (i.e., gift of vacation home to a non-grantor trust) should allow the non-grantor trust to deduct the property taxes on the vacation home with Client able to deduct the property taxes on his primary residence.

Example: The annual property tax bill on Client's vacation home is around $40,000 per year. Client transfers income producing assets and fractional interests in her vacation home to several non-grantor trusts, each of which have different beneficiaries. Each trust may be able to deduct its share of the property taxes on the vacation home (capped at $10,000 per trust). See, however, §643(f) and Prop. Treas. Reg. §1.643(f)-1which aggregate multiple trusts for income tax purposes into a single trust if the principal purpose of the trusts is to avoid income tax.

Similar non-grantor trust strategies may be available to increase §199A and charitable contribution deductions and maximize overall deductions (particularly in light of the increased standard deduction). See, however, REG-107892-18, 83 Fed. Reg. 40884 (Aug. 16, 2018) which proposes to treat multiple non-grantor trusts as one trust for purposes of the §199A deduction if they have they have substantially the same grantors, substantially the same primary beneficiaries, and a principal purpose of taking advantage of multiple thresholds for purposes of §199A.

Also, a non-grantor trust may maximize the 100% gain exclusion for qualified small business (C corporation) stock. IRC §1202. As mentioned, §643(f) and Prop. Treas. Reg. §1.643(f)-1 could treat multiple trusts for income tax purposes as a single trust, if the principal purpose of the trusts is to avoid income tax.

5. Gifts to Parents to Obtain Basis Step Up and to Use GST Exemption ("Upstream Gifts").

   Example: Client establishes a GRAT which has a trust for her parent as its remainder beneficiary. Client funds GRAT with an interest in a closely held business. Trust for parent provides parent with a general power of appointment and, in default of exercise of GPOA, trust assets pass into a further "dynasty" trust for client's descendants. At termination of the GRAT annuity period, interests in the closely held business are transferred to the trust for parent. Shortly thereafter parent dies and, due to GPOA, assets are included in parent's gross estate and parent's GST exemption is allocated to the continuing dynasty trust. Subject to §1014(e), this technique also provides the assets subject to the GPOA with a basis adjustment at parent's death, per §1014(a).

C. Gift Planning Under 2017 Tax Act

Below are several gifting techniques to consider in light of the 2017 Tax Act increasing the estate, gift and GST exemptions to $11.18 million. Most of these ideas are set forth on pages 51through 56 of the following outline prepared by Steve Akers: September, 2018 Bessemer Trust Estate Planning Current Developments and Hot Topics.

1. Gifts to dynasty trusts to utilize increased GST exemption.
2. Making a late allocation of GST exemption to previously created trusts.
3. Forgiving outstanding loans to children or equalizing gifts to children or grandchildren.
4. Fully or partially forgiving prior loans made in sales to grantor trusts to increase the trusts "equity", which could reduce the risk of a §2036 attack.
5. Gifts to grantor trusts and leveraging grantor trusts with loans or sales from the grantor.

   Steve Akers notes that these types of leveraged transactions can be very large based on the 10% "seed money" rule of thumb. Steve notes that spouses could gift $22 million of assets to a grantor trust and then could sell around $200 million of assets to the trust in exchange for a promissory note.

   Steve also suggests making additional gifts to a grantor trust which previously entered into note sale with the grantor. This will "bolster the equity value of the trust", which could reduce the §2036 risk.

6. Gifts to save state estate taxes. Steve notes that "very few states treat gifts as reducing estate exemption amounts, even for gifts made within three years of death in gross estates."

   Comment: This provides an excellent opportunity for a Florida resident to make a gift, including a gift by way of QPRT, of his or her residential property in a state which has state estate tax.

7. Life insurance transfers, as well as split dollar "roll outs".
8. Deemed §2519 transfers from QTIP trusts. [See below discussion at "Gift of Interest in QTIP Trust".]
9. Nonqualified disclaimers (depending on state law treatment of disclaimers). Note: Chapter 739, Florida Statutes, authorizes nonqualified disclaimers.
10. Gifts to Spousal Limited Access Trusts ("SLATs"). [See, however, below discussion of the repeal of §682.]
11. Gift to Intervivos QTIP Trusts to utilize GST exemption. [See, however, below discussion of the repeal of §682.]

12. Making "Upstream" gifts to parents to use their estate and GST exemptions and to obtain basis step up. See above example in "Tax Purposes for Making Lifetime Gifts" portion of this outline.

13. Gifts of "common" partnership interests to children while retaining "preferred" interests.

14. Possible funding of a nongrantor trust to "shelter" taxable income by way of §642(c).

15. Funding a "HEET" trust which can make distributions on behalf of a skip-person beneficiary to educational institutions free of GST tax. See, Zaritsky / Tax Planning for Family Wealth Transfers During Life: Analysis With Forms (WG&L), ¶ 4.11 Dynasty and Other Generation-Skipping Trusts for Grandchildren and Other Skip Persons.

D. Treasury Priority Guidance Plan

Worth noting are the following items contained in Treasury's Priority Guidance Plan:

1. Guidance on basis of grantor trust assets at death under §1014.

2. Guidance on the valuation of promissory notes for transfer tax purposes.

3. Guidance on the gift tax effect of defined value clauses.

4. Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount.

Estate Planning Current Developments and Hot Topics (September, 2018), p. 64, Steve R. Akers of Bessemer. See, also, https://www.irs.gov/privacy-disclosure/priority-guidance-plan, for links to the Priority Guidance plan and its quarterly updates.

E. Actual and Potential Disadvantages of Lifetime Gifts

1. Loss of Basis Adjustment on Date of Death. §1014(a).

   Side note: No adjustment to basis with gift made to a decedent within 1 year of death. §1014(e).

2. <u>Payment of Gift Tax Followed by Estate Tax Repeal or Increase in Exemption</u>: Paying gift tax and then later repeal of the estate tax or there being a substantial increase in the estate or gift tax exemption.

F. Donor's Remorse

1. Example (Madoff): Client held a concentrated position with Madoff. On January 1, 2006 Client made a taxable gift of a substantial amount of cash to Children, based on the assumption that Madoff would continue to generate substantial returns each year. In December 2008, the Madoff Ponzi scheme was revealed and Client's Madoff investment became worthless and Client was left with no liquid assets and was required to sell her house on Palm Beach. Client now relies on children for her day to day living expenses.

2. Example (A "Too Successful" Gifting Program): Prior to engaging in a gifting program to trusts for their children and grandchildren, Mom and Dad had a $30 million net worth. After many years of gifting, including use of their gift tax exemptions and annual exclusion gifts, sales to grantor trusts, coupled with paying the income taxes on the irrevocable grantor trusts, the family net worth has shifted. A big part of the shift is attributable to an asset sold to a grantor trust which skyrocketed in value. Today, Mom and Dad's net worth is $25 million and the grantor trusts established for their children and grandchildren are worth $60 million. Mom and Dad are upset, saying that they gave away too much and that the new-found wealth of the children and grandchildren has changed the family dynamics – for the worse!

G. Lifetime Gifting Fundamentals

1. §2501(a) - Gift Tax Imposed on the Transfer of Property by Gift.

   Note: Education and medical expense gifts which are "qualified transfer[s]" are not treated as "transfer[s] of property by gift". §2503(e). See below discussion of education and medical expense gifts.

2. Donative Intent Not Necessary.

   Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer. The application of the tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor. Treas. Reg. §25.2511-1(g)(1). See, however, Housman v. Commissioner, 105 F.2d 973 (2d Cir. 1939), discussed below, where Court held that payments to son were donative in character and subject to gift tax.

3. Gift Tax Applies with Transfer for Less than Adequate and Full Consideration.

   Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property

exceeded the value of the consideration shall be deemed a gift and shall be included in computing the amount of gifts made during the calendar year. §2512(b).

Taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. Wemyss, 65 S.Ct. 652 (1945).

4. Complete v. Incomplete Gifts.

A gift is complete if donor has relinquished all powers to change its disposition. Treas. Reg. §25.2511-2(b).

Completed Gift When Donor Abandons Dominion and Control / Proposed Gift to Museum Would Constitute a Completed Gift: Taxpayer and museum intended to enter into a binding agreement in which taxpayer would make a gift of artwork to museum while retaining a life estate in the artwork. Proposed agreement imposed conditions that would cause revocation of the transfer (e.g., housing, display and exhibition requirements imposed on museum). Service ruled that such conditions where beyond taxpayer's control and do not amount to dominion and control over the property and, accordingly, the gift would constitute a completed gift. PLR 201825003.

With a transfer of property (whether in trust or otherwise), if the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Treas. Reg. §25.2511-2(b).

A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries, or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard. Treas. Reg. §25.2511-2(c).

Example (Incomplete Gift Due to Lack of Authority Under Durable Power of Attorney): Son, as durable power of attorney agent for Mother, contributes Mother's 99% limited partnership interest to a charitable lead trust. Durable power of attorney does not authorize gifts and, therefore, gift to charitable lead trust is an incomplete gift. Limited partnership interest included in Mother's gross estate. Estate of Powell v. Commissioner, 148 T.C. No. 18 (2017); Fla. Stat. §709.2202(c).

Example (Application of Florida Self-Settled Trust Law Makes Gift Incomplete): Client establishes an irrevocable trust in Florida in which Client and Client's children are discretionary beneficiaries of income and principal. Funding of trust is an incomplete gift since a creditor of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit. F.S. §736.0505(b); Paolozzi v. Commissioner, 23 T.C. 182 (1954); see, however, F.S. §736.0505(3)(Gift to lifetime QTIP Trust for the benefit of donee spouse in which donor spouse is a remainder beneficiary, if donor spouse survives donee spouse, is a completed gift, since donee spouse is deemed to be the settlor.)

Example (Ability of Grantor Trust Trustee to Pay Settlor's Taxes Does Not Make Gift to Trust Incomplete): Client establishes an irrevocable grantor trust for the benefit of Client's descendants. Independent Trustee is provided discretionary power to pay directly to the taxing authorities or to reimburse Client for any tax on trust income or principal which is payable by the settlor under the law imposing such tax. This discretionary power held by the trustee does not subject the trust assets to Client's creditors and, therefore, would not cause the funding of the trust to be incomplete. Fla. Stat. §736.0505(c) and Rev. Rul. 2004-64 (which is discussed below).

Example (Incomplete Gift Non-Grantor "ING" Trust): Client lives in state which imposes a substantial state income tax. Client has no desire to move to Florida. Client owns shares in a closely held business worth millions, which Client desires to sell. Client wishes to avoid state capital gains tax on the sale of these shares. Client establishes an ING trust in Delaware, funds it with 100% of the shares in the closely held business and a year later the ING trust sells these shares. State of Client's residence does not subject irrevocable non-grantor trusts, established by its residents, to its state income tax. ING trust is a non-grantor trust for federal and state income tax purposes. Funding of trust does not constitute a completed gift because Client must consent to trust distributions during his lifetime and Client retained testamentary non-general power of appointment over the trust. PLR 201628010; see, however CCA 201208026 where trust did not require settlor to consent to distributions made during settlor's lifetime. Settlor only retained testamentary non-general power of appointment. IRS concluded that there was an incomplete gift with respect to the remainder interest but that there was a completed gift with respect to the income interest.

Example (Completed Gift with Real Estate): Client purchases a residence with her son as joint tenants with rights of survivorship and Client pays for residence. Unless Client can overcome the gift presumption, there is a completed gift to son at the moment Client and son take title to the residence, since Client's son can

thereafter alienate or encumber his interest. Hurlbert v. Shackleton, 560 So.2d 1276 (1st DCA 1990), O'Donnell v. Marks, 823 So.2d 197 (4th DCA 2002), and Treas. §25.2511-1(h)(5).

Example (Completed Gift with Joint Bank Account): Client opens a joint bank account with son and 100% of the funds are attributable to Client. In Florida, there is a presumption of a gift to the other person which may be rebutted only by clear and convincing evidence to the contrary; i.e., son's name added solely for survivorship purposes or as a "convenience" signor. Julia v. Russo, 984 So.2d 1283 (4th DCA 2008). Even if the presumption can be overcome, there would be a completed gift as to any funds withdrawn by son, if Client does not assert her rights for return of the funds. Treas. Reg. §25.2511-1(h)(4).

Incomplete Gift Only for the Remainder Interest: Taxpayer asserted that his testamentary limited power of appointment resulted in the entire gift in trust for his children being incomplete. The IRS disagreed and ruled that taxpayer's transfers to the trust constituted a completed gift of beneficial term interests, since his testamentary limited powers of appointment related only to the trust remainder. CCA 201208026.

Rescission Based on Mistake of Tax Consequences: The IRS generally does not honor a post-gift rescission which is based on a taxpayer claiming that he or she was not aware of the corresponding tax consequences.

For instance, sons proposed re-transfer of property back to their mother. Mother originally transferred real property to her sons to avoid inheritance tax and at the time she was unaware of the consequent gift tax liability. In this case, the IRS concluded that when the mistake is one of federal tax law, the gift is complete for federal gift tax purposes. Therefore, the Service ruled that the original transfer by donor to her sons was a completed gift subject to gift tax and any later transfer of property by sons to their mother would also be a completed transfer subject to gift tax. PLR 8205019; but see Breakiron v. Gudonis, 106 AFTR 2d 2010-5999 (D.C. Mass. 2010) (District Court applied state law and rescinded disclaimers nunc pro tunc and held that the rescission abrogated the beneficiary's duty to pay federal gift taxes. In this case, the beneficiary executed an untimely disclaimer based on his lawyer's mistaken advice that the disclaimer would be a qualified disclaimer.)

5. Gift Tax is Not Applicable to Ordinary Business Transactions or to Transfers Made for Full and Adequate Consideration.

The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions. Treas. Reg. §25.2512-8.

Example (Settlement of a Will Contest): In settlement of a potential Will contest, Step-Mom transferred a remainder interest in real property to Step-Son. There is no gift from Step-Mom to Step-Son so long as the transfer was in settlement of a bona fide dispute. Estate of Friedman v. Commissioner, 40 T.C. 714 (1963) (Gertrude and the children were in serious disagreement over the content of Jacob's estate. The children further believed that they were entitled to at least a part of the Florida and Indiana properties and apparently were willing to institute suit to determine their rights. Gertrude might successfully have resisted this suit, but as with all litigation, the outcome could not be predetermined. The settlement was made upon advice of her attorney under circumstances which it may be assumed both Gertrude and her attorney regarded as "advantageous economically." Therefore, it is our view that the transfer by Gertrude of a remainder interest in the properties in question was made for an adequate and full consideration in money or money's worth.); see, however, Housman v. Commissioner, 105 F.2d 973 (2d Cir. 1939) (where court held that payments made from mother to son to settle Will contest were gifts since there was no bona fide dispute. Court stated, "In view of these facts we are not impressed by the petitioner's argument that [mother and son] were hostile, were dealing at arm's length, and were compromising a bona fide Will contest. The more reasonable inference is that the petitioner's expression of a willingness to pay $100,000 a year, with annual birthday and Christmas presents in addition, was motivated by the kinship between the payor and the receiver. It was essentially donative in character, a promise or agreement to make gifts…".)

Warning! "Cottage Savings" Private Letter Ruling: In 2002, for income tax purposes, the IRS ruled that a court approved trust modification resulted in a taxable exchange of the beneficiary's interest. The Service concluded that a consequence of the modification was that the beneficiary exchanged his original interest for a new interest, since they were materially different. PLR 200231011. I am not aware of any similar rulings being issued by the Service since this Private Letter Ruling and this may be due to the adoption of the Uniform Trust Code by at least 35 states. The Uniform Trust Code contains several statutes authorizing trust modifications, including §411 (modification or termination by consent), §412 (modification or termination because of unanticipated circumstances or inability to administer trusts effectively), §414 (reformation to correct mistakes) and §415 (modification to achieve the settlor's tax objectives).

6. Gift Tax Applies to Direct and Indirect Gifts.

The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift *is direct or indirect*. For example, a taxable transfer may be affected by the creation of a trust, the forgiving of a debt, the assignment of a judgment, the assignment of the benefits of an insurance policy, or the transfer of cash, certificates of deposit, or Federal, State or municipal bonds. Treas. Reg. §25.2511-1(a).

Example (Statute of Limitations Runs on Loan): On 1/1/2005 Client loaned $200,000 to son evidenced by a Promissory Note. Note called for interest and principal to be paid in one lump sum on 1/1/2010. Despite having the financial wherewithal to do so, son did not repay the loan. Under the governing state law, the Statute of limitations on collecting the Note ran on 1/1/2015 and at that time Client made a gift to Son. Rev. Rul. 81-264; GCM 38584.

Example (Release of Income Interest in Trust): Client is a mandatory beneficiary of the income from Trust and Son is the remainder beneficiary. Client relinquishes his interest in Trust. Relinquishment constitutes a taxable gift based on actuarial value of income interest. Treas. Reg. 25.2512-5A(d)(3).

Interest Free / Below-Market Loans are Subject to Gift Tax: A gift loan is a below-market loan in which the forgoing of interest by a lender is in the nature of a gift. §7872(f)(3). In general, to avoid there being a gift, the lender must charge interest at the applicable federal rate. Prop. Treas. Reg. §1.7872-3(c)(1).

a. Key Non-Gift Revenue Ruling – Rev. Rul. 2004-64.

Example (Settlor's Payment of Income Tax on Grantor Trust is Not a Gift): Client established an irrevocable grantor trust for Client's spouse and his descendants ("Trust"). Since its establishment, each year, Client has been paying the income tax liability attributable to the Trust's income. Client is not making a gift each time Client pays the tax attributable to the Trust's income. Rev. Rul. 2004-64.

Example (Payment by Trustee of Settlor's Grantor Trust Income Tax Liability is Not a Gift): Client established an irrevocable grantor trust for Son ("Trust"). Trust provides independent trustee with the authority to reimburse Client, or to pay directly on Client's behalf, the tax on trust income which Client is responsible for under the grantor trust rules. Trustee exercises its discretion and reimburses Client for the taxes Client paid attributable to the trust income. This payment is not a gift from Son to Client. Rev. Rul. 2004-64.

b. Repeal of §682 (Income of Trust in Case of Divorce).

   Example (Impact of Repeal of §682): Client established an irrevocable grantor trust providing mandatory distributions of income to Client's spouse with the trust assets passing to his descendants at spouse's death ("Trust"). Trust is a grantor trust, since the income of the trust is distributed to Client's spouse. §677(a). Each year, Client has been paying the income tax liability attributable to the Trust's income. In accordance with Rev. Rul. 2004-64, Client is not making a gift each time Client pays the tax attributable to the Trust's income.

   Client and spouse divorce in 2018. §682 eliminates the grantor trust treatment for Trust. After the divorce, §682 taxes the ex-spouse on the income distributed from Trust to the ex-spouse.

   Instead, let's assume Client and spouse divorce in 2019. The 2017 Tax Act repealed §682 for divorces occurring after 2018. As a result of the repeal, Trust continues to be a grantor trust with Client responsible for Trust's income tax liabilities. For an excellent discussion of the repeal of §682, see Karbjanian, Franklin, & Law, Alimony, Prenuptial Agreements, and Trusts Under the 2017 Tax Act, BNA TAX MNGT. ESTATES, GIFTS & TRUSTS J. (May 10, 2018).

7. §§2502(a), 2001(c) and 2504 - Gift Tax Rate; Calculation of Gift Tax Amount.

   The current gift tax rate is a flat 40%. §§2502(a) and 2001(c).

   Example: In 2016, Client made a $5.7 Million taxable gift to daughter. Prior to the gift, Client did not make any taxable gifts. Gift tax due on the described 2016 gift is $100,000, i.e., $5.7 Million less $5.45 Million exemption times 40% rate.

   Gift tax is due once the taxable gifts exceeds the applicable exclusion amount. §§2502 & 2505. (See above discussion of tax exclusivity with payment of gift tax, as compared to payment of estate tax.)

   The gift tax is based on cumulative lifetime gifts. In particular, the gift tax for the current year is arrived at by calculating the tax on all cumulative taxable gifts, including those made in the current year, and then subtracting from that amount the tax on all prior year cumulative gifts. §§2502 & 2504.

   Modifications to "Gift Tax Payable" in Computing Estate Tax - Example: In 2001, Client made a $10 Million taxable gift to son. $4,920,250 of gift tax was paid. Client died in 2016 with a taxable estate. Prior to death, Client made no other gifts beyond the described 2001 gift. The gift tax payable amount on Part 2, Line 7 of Client's Form 706 is $3,725,250 (and not the actual gift tax paid of $4,920,250). §2001(g)(gift tax rates for the year of death are used in calculating gift tax payable amount credited

against the estate tax, including with respect to calculating applicable credit amount used in determining gift tax payable amount).

Estate Tax Return Filing Threshold. The personal representative is required to file an estate tax return when the sum of the gross estate and adjusted taxable gifts exceeds the basic exclusion amount for the year of death. §6018(a).

8. §2505(c) – Donor is Liable for Payment of Gift Tax.

The Donor is liable for the payment of the gift tax. §2502(c).

9. §2035(b) – Three Year Rule; Gross Estate Inclusion; Application of Florida Apportionment Statute.

Example: Client gifts $5 million to Nephew on May 1, 2015 and remits $2 million of gift tax to IRS in April of 2016. Client dies on April 30, 2017. The $2 million of gift tax paid by Client is included in his gross estate for federal estate tax purposes. This gross estate gift tax inclusion results in the gift no longer being tax exclusive. §2035(b)(Gift tax paid by decedent or his estate on any gift made by the decedent or his spouse during 3-year period ending on the date of decedent's death included in gross estate.)

Under Florida's apportionment statute, the estate tax attributable to gift tax being included in the gross estate is not allocated to the donee of the subject gift. In most cases, the residue of the estate will be responsible for the estate tax on the gift tax included in the gross estate under §2035(b). Fla. Stat. §733.817(1)(e)3, (2), (3)(c) & (4)(c). The Florida Legislative Staff Analysis of the 2015 revisions to Fla. Stat. §733.817 provides that the definition of "included in the measure of the tax," is amended to "exclude gift taxes paid within three years of the decedent's death and gifts to a 529 Plan". Recipients of the gift will not be allocated the estate tax upon such gifts even though the gift taxes remain a part of the amount upon which the estate tax is calculated. The effect is that the allocation of tax on all other interests remaining in the measure of the federal estate tax will be increased.

Side note: Tax Court recently denied an estate a deduction for gift tax paid and included in gross estate under §2035(b), since donees were liable for the gift tax pursuant to a net gift agreement. Estate of Sommers, 149 T.C. No. 8 (2017).

10. §2503(a) - "Taxable Gifts" – Defined.

The term "taxable gifts" means the "total amount of gifts" made during the calendar year, less amounts allowed as charitable and marital deductions. §2503(a).

11. §2503(b) - Annual Exclusion.

The "total amount of gifts" does not include gifts that qualify for the annual exclusion. §2503(b).

With respect to a "present interest" gift, the first $15,000 of such gift does not constitute a taxable gift. $15,000 is increased for inflation. §2503(b) and Rev. Proc. 2017-58.

If spouses elect split gift treatment, then the annual exclusion can be doubled (i.e., $30,000 in 2018). §2513. Split gifts are discussed below.

<u>Example (A Mandatory Income Interest in a Trust Constitutes a Present Interest)</u>: In September of 2018, Client gifts $100,000 to Trust which provides Daughter (age 21) with mandatory distributions of income. The mandatory income interest in the trust constitutes a present interest. In this Example, applying the §7520 valuation rules, the income interest is worth $82,862. Therefore, the contribution qualifies for the $15,000 annual exclusion. Estate of Herrmann v. Commissioner, 235 F.2d 440 (5th Cir. 1956).

With this Example, assume $19,000 was contributed to the Trust, not $100,000. Under the §7520 valuation rules the value of income interest is $15,744. Further assume the Trust provided Daughter with the power to withdraw contributions to the Trust, limited to an amount equal to the greater of $5,000 or 5% of trust value, immediately after the contribution. Could Client's contribution qualify for the annual exclusion by combining the $5,000 withdrawal right with the $15,744 value of the income interest? Or is that a "double dip"? You could remove the potential "double dip" aspect by valuing the income interest net of the $5,000 withdrawal right. Here, the value of an income interest in $14,000 (which is $19,000 less the $5,000 withdrawal right) is $11,601. Does the $5,000 withdrawal right combined with $11,601 the §7520 value (totaling $16,601) qualify for the annual exclusion?

<u>Establishing a "Crummey Trust" to Use Annual Exclusion</u>: A Crummey trust is a trust that qualifies for the gift tax annual exclusion because it gives a beneficiary a special withdrawal power, which gives the beneficiary a present interest in the transferred property. The withdrawal power allows the beneficiary, for a limited time, to insist that the trustee distribute the beneficiary's share of any gift to the trust, or its equivalent in other assets, to the beneficiary outright and free of trust. The beneficiary's withdrawal power lapses if the beneficiary fails to exercise it within the specified time, after which the gift becomes a permanent part of the trust fund, subject to the trustee's control. The lapse of the withdrawal power terminates the beneficiary's power over the trust funds. The Crummey trust derives its name from Crummey v. Commissioner, 397 F.2d. 82 (9th Cir. 1968). Zaritsky / Tax Planning for Family Wealth Transfers During Life: Analysis With Forms (WG&L), ¶ 4.08 Crummey Trusts. Below in the outline is an example of a Crummey trust.

Contributions to a §2503(c) trust for a beneficiary under 21 constitute present interest gifts. A gift to a Florida Uniform Transfers to Minor Account qualifies as a present interest under §2503(c). Rev. Rul. 59-357 and Rev. Rul. 73-287.

There is no gift tax marital deduction for a gift to a non-citizen spouse. §2523(i)(1). Instead, such gifts are eligible for an expanded annual exclusion exception to taxable gifts. §2523(i)(2). For 2018, the expanded amount is $152,000. Rev. Proc. 2017-58. To qualify, the gift must be a present interest gift and it cannot be a terminable interest. §2523(i)(2).

The annual exclusion may not be available with respect to a gift of an interest in a family limited partnership or LLC. See, Hackl, 335 F.3d 664 (7th Cir. 2003).

To Be a Present Interest, a Withdrawal Right Must be Legally Enforceable; Impact of "No Contest" Clause: In CCA 201208026, the IRS noted that the beneficiary could not enforce his withdrawal rights in state court, due to the trust containing an "alternative forum" clause. The CCA summarized this clause as stating "that all questions and disputes concerning the trust must be submitted to the Other Forum that is charged with enforcing the trust. A beneficiary filing or participating in a civil proceeding to enforce the trust will be excluded from any further participation in the Trust." The Service ruled that these withdrawal rights were not the type of legally enforceable rights necessary to constitute a present interest because the threat of severe economic punishment looms over a beneficiary contemplating a civil enforcement suit.

12. §2503(e) - Education and Medical Expense Exclusion.

Education and medical expense gifts which are "qualified transfer[s]" are not treated as "transfer[s] of property by gift". §2503(e).

Note: Payment of medical insurance on behalf of any individual constitutes a qualifying medical expense. Treas. Reg §25.2503-6(b)(3).

A "qualified transfer" means any amount paid on behalf of an individual as tuition to an educational organization described in §170(b)(1)(A)(ii) for the education or training of such individual, or to any person who provides medical care (as defined in §213(d)) with respect to such individual as payment for such medical care.

Amounts must be paid directly to the education or medical provider. Treas. Reg §25.2503-6(b)(2) & (c). Dorm fees, books, supplies and board do not qualify for the exclusion. Treas. Reg §25.2503-6(b)(2).

Example (Lump Sum Payment of Tuition Cost for Several Years): Grandmother writes a check payable to Grandson's school to pay his 8th grade through 12th grade tuition costs, under an agreement with the school, specifying that no portion of the payment was refundable even if Grandson no longer attended the school. Payment is a qualifying transfer under §2503(e). TAM 199941013 and PLR 200602002 (which also provided that payment was not a generation-skipping transfer pursuant to §2611(b)).

a. §529 - Qualified Tuition Plan: Gifts to §529 Qualified Tuition Plan. Contribution to Plan treated as completed gift and is not included in the gross estate (even if donor is the owner). §529(c)(2)(A)(i) & (c)(4)(A). However, there is gross estate inclusion if donor dies within 5-year election period, as is described below. Contributions do not qualify for the §2503(e) education exclusion to the imposition of gift tax. Contributions to a §529 Qualified Tuition Plan can be treated as gifts made ratably over a 5-year period. 2017 Tax Act expanded to include in the definition of "qualified higher education expenses" elementary and secondary schools, capped at $10,000 per student, per year. §529(c)(7).

   Example (Contributions to §529 Plan by Grandfather): Grandfather contributes $70,000 to a §529 Plan account for Granddaughter. Contribution is a completed present interest gift to Granddaughter. Grandfather may elect to treat the contribution as being made ratably over the 5-year period. If Grandfather were to die prior to the end of the 5-year period, the portion treated as being made after his death will be included in his estate. §529(c)(2)(A), Prop. Reg. §1.529-5(b), §529(c)(2)(B), §529(c)(4)(C), ¶10.03 (Annual Exclusion Gifts), Henkel / Estate Planning and Wealth Preservation: Strategies and Solutions (WG&L). See above discussion of apportionment of estate tax under Florida law on §529 Plan gift included in the gross estate.

b. §529A - ABLE Accounts: See §529A for ability to make gift tax free contributions to an ABLE Account established for certain disabled persons. Begley & Hook / Representing the Elderly or Disabled Client: Forms and Checklists with Commentary (WG&L), ¶ 16.08 ABLE Accounts.

13. §2505 - Applicable Exclusion Amount (Including DSUE Amount).

There is a credit against the gift tax equal to the applicable credit amount for the year of gift reduced by the applicable credit allowable for preceding calendar periods. §2505(a). The applicable credit amount is as is set forth in § 2010(c). § 2505(a)(1).

The applicable credit amount is the amount of the tentative tax which would be determined under §2001(c) if the amount with respect to which such tentative tax is to be computed were equal to the applicable exclusion amount. §2010(c)(1).

The applicable exclusion amount is the sum of the "basic exclusion amount" and the "deceased spousal unused exclusion amount". §2010(c)(2).

$11.18 million is the current basic exclusion amount. The basic exclusion amount is adjusted annually for inflation. §2010(c)(3). The 2017 Tax Act adjusts the exclusion based on new "chained CPI" approach which apparently will lead to lower inflation adjustments (as compared to the prior method). The 2017 Tax Act "sunsets" this $11.18 million inflation adjusted exemption at the end of 2025 and it will then revert back to the prior $5 million (inflation adjusted) exemption. The chained CPI portion of the 2017 Tax Act does not sunset.

The deceased spousal unused exclusion ("DSUE") amount applies with respect to "last such deceased spouse of [a] surviving spouse". §2010(c)(4). There is no adjustment for inflation for the DSUE amount.

For the surviving spouse to utilize the DSUE of the deceased spouse, the personal representative of the deceased spouse's estate must make a "portability election" on the deceased spouse's estate tax return. §2010(c)(5).

<u>Example (Deceased Spousal Exclusion Amount)</u>: Client's husband (H1) died in 2011. H1's Will appoints Client as the personal representative of his estate and Client timely filed the estate tax return for H1 making a portability election under §2010(c)(5) for H1's full $5 million exemption.

In 2012, Client makes a $2 million taxable gift to Son. The DSUE amount from H1 (and not Client's basic exclusion amount) is applied against gift to Son. Treas. Reg. §25.2505-2(b) & (c)(2).

Client marries H2 in 2013. H2 dies on June 30, 2015. H2's personal representative elects portability for H2's $2 million DSUE amount on H2's estate tax return. Client's DSUE amount is $4 million, comprised of $2 million from H2 and the $2 million portion of H1's DSUE that is applied to Client's 2012 taxable gifts. Treas. Reg. §25.2505-2(b) & (c)(2). Treas. Reg. §25.2505- (c)(2) eliminates the future use of the $3 million portion of H1's DSUE amount which was not used prior to H2's death.

DSUE Audit of First Spouse's 706. The Tax Court recently held that the IRS has authority to re-examine the first to die spouse's 706 for the limited purpose of re-

determining the DSUE amount even though a closing letter had been issued for the deceased spouse's estate. The first to die spouse's 706 failed to subtract lifetime taxable gifts in determining the DSUE amount. Sower v. Comm'r., 149 T.C. No. 11 (2017).

a. 2017 Tax Act "Clawback" and Related Issues: What will happen if a taxpayer makes a gift using his or her increased (i.e., 2018 $11.18 million) exemption amount and then dies in a year after the sunset? Will estate tax be due on the gift made prior to the sunset?

   Similarly, what happens, if for instance, in 2018 a taxpayer with a $11.18 million estate and gift tax exemption makes a $5 million gift and then dies in a year after the sunset? Will his or her remaining exemption be $0 (or close to $0, depending on indexing) or $5 million (indexed for inflation)? A remaining exemption of $5 million (indexed) is referred to by Steve Akers as "off the top" treatment. Estate Planning Current Developments and Hot Topics (September, 2018), p.8, Steve R. Akers of Bessemer.

   Likewise, what if the portability election is made for a spouse dying in 2018, the surviving spouse does not make any lifetime gifts using this DSUE amount, and he dies after the sunset? Is the portability amount $5 million (indexed) or $11.18 million?

   Treasury is expected to issue guidance to answer some, if not all, of these "clawback" and related questions based on §2001(g)(2), which provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent." §2001(g)(2) is listed on Treasury's Priority Guidance Plan, which is discussed above in this outline.

b. GST Annual Exclusion and Education/Medical Expense Transfers.

   Example: Grandfather makes a $15,000 cash gift to Granddaughter and a $15,000 cash gift to Grandson. These gifts qualify for the gift tax annual exclusion as well as the GST annual exclusion. §§2503(b) and 2642(c)(1) & (3).

   Example: Grandmother pays annually directly to Blue Cross the health insurance premiums for Granddaughter. These payments are qualified transfers (not subject to gift tax) under §2503(e) and are not generation-skipping transfers

pursuant to §2611(b)(1). See also, §2642(c)(1) & (3)(B)(which provides that transfer is a direct skip with a zero inclusion ratio).

Example: Grandfather establishes a trust with $30,000 of cash, the beneficiaries of which are Granddaughter and Grandson. The trust terminates upon the death of the survivor of Granddaughter and Grandson and any remaining principal will be distributed to the estate of the last-to-die grandchild. Each grandchild may withdraw $15,000 within 30 days of contribution. Gifts to the trust qualify for the gift tax annual exclusion but do not qualify for the "GST tax annual exclusion" since Grandfather did not establish separate trusts for each grandchild, each of which would be includible in the deceased grandchild's gross estate. §2642(c)(2)(There is no zero GST inclusion ratio for a transfer to a trust for an individual unless during the life of the individual, no portion of the corpus or income of the trust may be distributed to, or for the benefit of, any person other than such individual, and if the trust does not terminate before the individual dies, the assets of such trust will be includible in the gross estate of such individual.)

14. §2512 - Valuation.

The amount of the gift equals the value of the property on the date of gift. §2512.

a. <u>General Rule: Willing Buyer / Willing Seller Test</u>: The value of the property subject to a gift is the price at which such property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas. Reg. §25.2512-1.

b. <u>Defined Value Gift Clauses</u>: To guard against a client having to pay gift taxes, particularly for hard to value assets, consider making the gift using a "defined value clause". For instance, "I hereby give to my son a sufficient number of units in XYZ LLC in order to make a gift equal to $1 million". Wandry, TC Memo 2012-18. [Treasury is intending to issue guidance on the gift tax effect of defined value formula clauses. The Treasury Priority Guidance Plan is discussed above in this outline.]

c. <u>Valuing an Existing Life Insurance Policy</u>: The gift tax value of a life insurance policy, in force for some time, may be approximated by adding to the interpolated terminal reserve, at the date of the gift, the proportionate part of the gross premium last paid before the date of gift. If, however, because of the unusual nature of the contract such approximation is not reasonably close to full value, this method may not be used. Treas. Reg. §25.2512-6(a).

Comment: There are companies, such as Ashar Group, who will value existing policies based on secondary market sale values and quotes. CPAs and attorneys are using these valuations for gift tax reporting purposes. These values are generally considerably lower than the interpolated terminal reserve. See, Rethinking Life Insurance Valuation for Seniors, Trusts & Estates, November, 2016, Jon B. Mendelsohn (of the Ashar Group). This article also recommends that a formal Form 712 should not be ordered from the insurance company without first requesting an estimated value and understanding the implications.

15. §2513 - Gift Splitting Election.

§2513 allows for a gift made by one spouse, to any person other than his spouse, to be considered as made one-half by him and one-half by his spouse. §2513(a)(1).

Each spouse must consent to split gift treatment. §2513(a)(2).

Gift splitting applies to <u>all</u> of the gifts made during the calendar year by either spouse while married to the other. Treas. Reg. §25.2513-1(b).

a. <u>Election is Irrevocable</u>: Once made, the consent to split gift treatment is very difficult to revoke. If the consent to split gifts was effectively signified on or before the 15th day of April following the close of the calendar year, either spouse may revoke the consent by filing in duplicate a signed statement of revocation, but only if the statement is filed on or before such 15th day of April. Therefore, a consent that was not effectively signified until after the 15th day of April following the close of the calendar year to which it applies may not be revoked. §2513(c); Treas. Reg. §25.2513-3.

b. <u>Joint and Several Liability</u>: If spouses elect split gift treatment, the corresponding gift tax liability of each spouse for such year is joint and several. §2513(d).

c. <u>Deadline to Elect Split Gift Treatment</u>: Consent may be signified after the close of the calendar year in which the gift was made, subject to two exceptions. §2513(b). Consent may not be signified after April 15 following the close of the calendar year in which the gift was made unless no return was filed for that year by either spouse before such April 15, in which case the consent may not be signified after the first return for such year is filed by either spouse. In other words, the consent may be signified on the first late-filed return. Consent may not be filed after a notice of deficiency as to the tax for that year is sent to either spouse. §2513(b)(2)(B), Tax Management Portfolio 845-3rd: Gifts, XIII(A)(2), Rev. Rul. 80-224, §2513(b)(2)(A) and Reg. §25.2513-2(b)(1).

d. <u>Split Gift Treatment and GST Tax</u>: For GST purposes, in the case of a transfer with respect to which the donor's spouse makes an election under §2513 to treat

the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under §2513. The donor is treated as the transferor of one-half of the value of the entire property. Treas. Reg. 26.2652-1(a)(4).

e. Gift Splitting "Trap" Example: Gift Splitting is a Complicated Area Filled with Traps for the Unwary.

Example (Split Gift Involving Failed QPRT): In 2014, Client establishes QPRT and funds it with his personal residence titled in his own name. Client retained a 5-year term for the exclusive use of residence. The QPRT trust provides that if Client survives the retained term, then trust property passes outright to his children. The trust also provides that if Client does not survive the retained term, the trust property is to be distributed to his revocable trust. The 2014 gift tax returns for Client and spouse make the split gift election, resulting in use a $1 million portion of each of their estate and gift tax exemptions. Client dies in 2016 and 100% of residence included in his gross estate. Pursuant to §2001(b), the $1 million QPRT gift is not included in Client's adjusted taxable gifts but spouse's use of a $1 million portion of her exemption is not restored. Zaritsky / Tax Planning for Family Wealth Transfers During Life: Analysis With Forms (WG&L), ¶ 6.02 Split Gifts, Example 6-15.

f. Application of §2035(b) "3-Year Rule" with Respect to Split Gifts: The gross estate includes any gift tax paid by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death. §2035(b).

Practice Tip: Married taxpayers may be able to reduce the risk of triggering §2035(b) with respect to split gifts by having the healthier spouse pay all resulting gift taxes from his or her own funds. This should not be accomplished by having the other spouse transfer the funds to the "healthier spouse"; rather, the funds used to pay the tax must truly belong to the "healthier" spouse. Tax Management Portfolio 818-3rd: Section 2035 Transfers, III(B)(4).

g. Steve Akers 2017 Tax Act Gift Splitting Recommendation: Steve Akers provides the following planning alternatives (1) a taxpayer should not make split gifts prior to sunset, in order to maximize the use of the donor's increased exemption amount before the sunset, or (2) a taxpayer might consider waiting to make large pre-sunset gifts until after Treasury issues its expected ["clawback"] guidance. Estate Planning Current Developments and Hot Topics (September, 2018), p.8, Steve R. Akers of Bessemer.

16. §2514(b) - Exercise or Release of a Post-10/21/1942 General Power of Appointment.

The exercise or release of a general power of appointment created after October 21, 1942 ("Post-'42 Power") is a transfer of property by the individual possessing such power. §2514(b).

Lapse of a Post-'42 Power: The lapse of a Post-'42 Power constitutes a release of such power during any calendar year, to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of $5,000 or 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied. IRC §2514(e).

"Crummey Trust", Providing Contribution Withdrawal Rights to Trust Beneficiary - Example: Son is the sole lifetime beneficiary of an irrevocable trust created by Client with Grandson as the remainder beneficiary. Client funded trust with $15,000 of cash and Son has power to withdraw $15,000. Trust provides for lapse of withdrawal power if not exercised within 30 days of contribution. Trust has no assets beyond the $15,000 of cash. Son did not exercise withdrawal power. Lapse resulted in Son making a $10,000 gift to the trust. Note: Although the lapse is considered a transfer under federal gift tax law, it is not treated as such under the Florida Trust Code. See, Fla. Stat. §736.0505(2)(b).

With this Example, the lapse subject to gift tax can be avoided with the trust specifying that a lapse occurs annually for all property subject to the withdrawal power in an amount equal to the greater of $5,000 or 5% of the trust property. Alternatively, trust could provide Son with testamentary non-general power of appointment. This would result in lapse not constituting a completed gift, since Son is the sole lifetime beneficiary of the Trust and he holds the power to dispose of the remainder interest.

17. §2515 – Direct Skip Gift Includes GST Tax on the Direct Skip Gift

In the case of any taxable gift which is a direct skip, the amount of such gift is increased by the GST tax imposed on the transferor with respect to such gift. §2515.

18. §2516 - Property Settlements With Ex-Spouse

Example (Transfer to Ex-Spouse After Divorce): Client and spouse were divorced on August 1, 2018. The divorce settlement agreement did not provide for any alimony payments but does provide for a lump sum payment by Client to her ex-spouse on January 1, 2019. Lump sum payment to ex-spouse is not a gift and is deemed to be made for full and adequate consideration. §2516 (where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into, whether or not such agreement is approved by the divorce decree, any transfers of property or interests in property made pursuant to such agreement to either spouse in settlement of his or her marital or property rights, or to provide a reasonable

allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth). See also, §1041 (no gain or loss on transfer of property between spouses incident to divorce).

a. Alimony Payments Under 2017 Tax Act: As a result of the 2017 Tax Act, alimony payments are no longer deductible and are not income to the recipient for post-2018 divorces.

Note: See discussion in this outline of the 2017 Tax Act's repeal of §682 (income of trust in case of a divorce).

19. §2518 - Disclaimers.

If a person makes a qualified disclaimer with respect to any interest in property, then such person shall be treated as if the interest had never been transferred to such person. A "qualified disclaimer" is an irrevocable and unqualified refusal by a person to accept an interest in property, but only if such refusal is in writing which is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of the day on which the transfer creating the interest in such person is made, or the day on which such person attains age 21 and such person has not accepted the interest or any of its benefits, and as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either to the spouse of the decedent, or to a person other than the person making the disclaimer. §2518.

Example (Ineffective Disclaimer of a Remainder Interest in Post-1976 Trust): In 1995 Grandfather establishes irrevocable trust for Daughter with remainder (at Daughter's death) to Daughter's issue. Daughter dies in January of 2017 survived by Granddaughter (age 38) and the children of Granddaughter. Granddaughter disclaims her interest in trust within 9 months of Daughter's death. The disclaimer is not a qualified disclaimer since Granddaughter did not disclaim her interest in the trust within 9 months of her becoming 21. Treas. Reg. §25.2518-2(c)(5), Example (3). Therefore, if the disclaimer constitutes a relinquishment under state law, Granddaughter has made a gift to her children equal to the value of the trust assets.

Note: There is a different set of rules for taxable transfers creating an interest in the person disclaiming made before January 1, 1977. These rules have as their basis a beneficiary being able to make a disclaimer if made within a reasonable time after knowledge of the existence of the trust. Treas. Reg. §25.2511-1(c)(2); PLR 201831003 (Service ruled that taxpayer's renunciation of a remainder interest in a trust, due his being among the class of appointees, was not a taxable gift because it was made within nine months of learning of the existence of the trust. The Ruling notes that "other than a general awareness of the possible existence of numerous trusts established within the family, Taxpayer had no actual knowledge of Trust during

Beneficiary's lifetime. Taxpayer represents that he did not receive a copy of Trust, or know of any of the terms of Trust, during Beneficiary's lifetime.)

20. §2519 - Gift of Interest in QTIP Trust; Quasi Net Gift.

    Example (Termination of a QTIP Trust). Wife's estate made a §2056(b)(7) QTIP election for the trust established for husband. Remainder beneficiaries of trust are the children of wife and husband. Husband has determined that he does not need to remain as a beneficiary of the trust. Accordingly, husband relinquishes his interest in the trust with the result that the trust is collapsed with its $5 million of assets passing to children. Husband has a made a $5 million gross gift to children pursuant to §§2511 and 2519 with the value of the gross gift reduced by his §2207A(b) right of recovery for the gift tax attributable to the §2519 (remainder interest) portion of the gift. §§2511, 2519, 2207A(b), Treas. Reg. §25.2519-1(g), Example 1, Treas. Reg. §25.2511-2 and Treas. Reg. §25.2519-1(c)(4). Note: A QTIP Trust termination is a "quasi" net gift, since only the §2519 portion of the termination is subject to net gift treatment. See, for instance, PLR 201834011 (surviving spouse's renunciation of her interest in a QTIP trust was a gift pursuant to §§2511 and 2519).

    a. <u>Chuck Rubin – QTIP Trust Litigation Article</u>: A "must read" for all trusts & estates lawyers is Chuck Rubin's article, Tax Results of Settling Trust Litigation Involving QTIP Trusts, Estate Planning Journal (WG&L), Jan. 2009.

21. §2522(a) - Gift Tax Charitable Deduction.

    A charitable deduction is allowed in computing "taxable gifts". §2522(a).

    In general, split interest gifts need to be in the form of a charitable remainder annuity trust, charitable remainder unitrust, a pooled income fund, or a charitable lead trust. §2522(c)(2)(A) & (B).

    a. <u>Atkinson Case - Example (No Deduction When There is a Failure to Comply with Terms of CRAT)</u>: In 1991, Client established a charitable remainder annuity trust in which she was entitled to lifetime annuity payments. Upon her death, annuity payments were to continue for 4 individuals and upon each of their deaths the trust assets were to be distributed to charity. Client died in 1993 and prior to her death she did not receive any annuity distributions from the CRAT. Assets of CRAT reported on the 706 and the personal representative claimed an estate tax charitable deduction. Court held that since Client did not receive the annuity payments during her lifetime, the charitable remainder interest does not qualify for the estate tax charitable deduction. Atkinson, 309 F.3d 1290 (11th Circ. 2002).

    b. <u>Gift of Remainder Interest in Personal Residence - Example</u>: Client transfers her vacation home in Colorado to Charity X, retaining a life estate. Gift of remainder interest qualifies for the gift tax charitable deduction. Treas. Reg.

§25.2522(c)-3(c)(2)(ii) & (iii). Remainder interest in cooperative apartment also qualifies for a gift tax charitable deduction. §25.2522(c)-3(c)(2)(ii). Remainder interest in a farm also qualifies for a gift tax charitable deduction. §25.2522(c)-3(c)(2)(iii).

c. Charitable Reformations of "Technically Flawed" Split Interest Gifts: A split interest gift which does not meet the technical requirements of being a charitable remainder annuity trust, charitable remainder unitrust, or a charitable lead trust can be reformed provided the "non-qualifying" interest is a "reformable interest". §2055(e)(3).

d. Charitable Gift Tax Planning in Light of 2017 Tax Act – "Bunching" Strategy: As a result of the increased income tax standard deduction, a taxpayer might consider "bunching" his or her charitable contributions in a particular year. Estate Planning Current Developments and Hot Topics (September, 2018), p.10, Steve R. Akers of Bessemer. A donor advised fund might be helpful for effectuating "bunching" gifts for those organizations that expect to receive annual contributions.

22. §2523(a) - Gift to Spouse.

A marital deduction is allowed in computing "taxable gifts". §2523(a).

a. Intervivos QTIP and GPOA Trusts: Lifetime QTIP trusts and general power of appointment trusts are also deductible under §2523. §2523(e) and (f).

b. Absolute Requirement to Make Timely QTIP Election: No deduction is allowed for a lifetime QTIP trust when the QTIP election is not timely made on a gift tax return. §2523(f)(4). The IRS cannot grant an extension of time to make a lifetime QTIP election, since the filing deadline is set by statute. In PLR 201025021, IRS errantly allowed an extension of time to make the gift tax QTIP election under Treas. Reg § 301.9100-3. PLR 201025021 was revoked by PLR 201109012. (See below discussion of gift tax return due date and extended due dates.)

   Example (Failure to Make a Timely Lifetime QTIP Election): On July 1, 2015, Husband establishes an irrevocable trust for Wife's lifetime benefit with remainder to Husband's children from a prior marriage. In January of 2017, Client's new attorney discovers that Husband did not file a gift tax return for 2015 and attorney advises Client to "late file" the gift tax return and pay any gift tax attributable to funding the trust.

c. Example of Prenuptial Agreement Trust Which Does Not Qualify for the Gift Tax Marital Deduction: Mary and Bob enter into a prenuptial agreement which requires Mary to fund $1 million into an irrevocable trust for Bob, distributions to be made for Bob's benefit in the event of a divorce. If the trust is funded

prior to marriage, then the funding could be a taxable gift (since not eligible for §2523 marital deduction), unless deemed to be for adequate and full consideration (i.e., relinquishment of marital rights). If the trust is funded after marriage, then contribution is eligible for the marital deduction provided it qualifies as a general power of appointment trust or as a QTIP trust (in which a QTIP election made on a timely filed gift tax return).

d. No Gift Tax Marital Deduction for Gifts to Non-Citizen Spouse: There is no gift tax marital deduction for a gift to a non-citizen spouse. §2523(i)(1). Instead, such gifts are eligible for an expanded annual exclusion exception to taxable gifts. §2523(i)(2). For 2018, the expanded amount is $152,000. Rev. Proc. 2017-58. To qualify, the gift must be a present interest gift and it cannot be a terminable interest. §2523(i)(2).

H. Income Tax Basis, Gain and Related Items

1. Basis.

General Rule: Donee takes donor's basis in property received by gift. §1015(a).

Exception to General Rule: If basis in gifted property is greater than its value at the time of the gift, then for purposes of determining loss the basis is the property's fair market value. §1015(a).

Increase in Basis for Gift Tax Paid: Donee's basis is increased by the portion of the gift tax paid attributable to the appreciation in the property. §1015(d)(6) and Treas. Reg. §1.1015-5(c).

Example: Client gifts $2 million ABC stock to Sister. During the same year, Client previously made a gift of cash to Sister equal to the annual exclusion amount. Client's basis in the gifted shares was $750,000. $800,000 of gift tax was paid on this stock gift. Sister's basis in the ABC stock $1,070,000 calculated as follows:

FMV of shares on gift date	$2,000,000
Less; Client's adjusted basis	$ 750,000
Net appreciation in property	$1,250,000

Portion of gift tax attributable to appreciation:

Net appreciation	$1,250,000
Divided by taxable gift amount	$2,000,000*
Equals	62.50%
Multiplied by gift tax paid	$ 800,000
Equals §1015(d)(6) addition to basis	$ 500,000 **a**

Plus; Client's basis $ 750,000 **b**

Sister's Basis $1,250,000 (**a**+**b**)

*Note: Although there is no annual exclusion with the stock gift in this example, the Regulations reduce this denominator by any annual exclusion attributable to the gift. Treas. Reg. §1.1015-5(c)(2).

See Treas. Reg. §1.1015-4 for basis rules for part sale, part gift transactions. (Part sale, part gift transactions are discussed below.)

2. Tacking of Holding Period.

Donee takes donor's holding period in the property received by gift. §1223(2). The holding period of the property is relevant, for example, as to whether gain or loss with respect to the property qualifies as "short-term" or "long-term" capital gain or loss under §1222 or whether §1231 applies. Tax Management Portfolio, Gifts, No. 845-3rd, XV(A)(3).

3. Character of Asset in Donee's Hands.

The character of an asset in the hands of the donor does not appear to carry over to the donee. For instance, a "capital asset" is "property held by the taxpayer." §1221. In general, real estate rental activity is classified as a "passive activity" if the taxpayer does not materially participate. §469(c)(1). See, also Westfall & Mair/ Estate Planning Law and Taxation (WG&L), ¶2.01. Importance of, Character, and Holding Period and Ehrman v. Comm'r, 120 F2d 607, 41-2 USTC ¶ 9537 (9th Cir.), cert. denied, 314 US 668 (1941).

4. Possible Recognition of Gain by Donor in a Part Sale, Part Gift Transaction.

In a part sale, part gift transaction, donor realizes gain equal to the difference between the amount realized and the adjusted basis in the property.

Example: A property valued at $10 million is gifted by Mom to Son, contingent on Son agreeing to pay the gift tax. The basis in the property is $3 million and the gift tax is $4 million. The gift is a $1 million deemed sale, since the consideration of $4 million exceeds the $3 million adjusted basis by that amount. Treas. Reg. §1.1001-1(e). See Treas. Reg. §1.1015-4 for basis rules for part sale, part gift transactions.

5. Net Gifts.

The donor is liable for the payment of the gift tax. §2502(c). With a net gift, the donee agrees to pay the gift tax as a condition of the donor agreeing to make the gift. For gift tax purposes, the value of the gift is calculated by reducing the value of the gifted

property by the amount of the gift tax liability assumed by the donee. Sarah Helen Harrison, 17 T.C. 1350 (1952).

Example ("Net Gift"): In 2017, Client previously made gifts using her gift tax exemption and annual exclusion amounts. Client desires to make a taxable gift to Son and hopes to reduce the effective gift tax rate. Client owns a land parcel with a fair market value and adjusted basis of $5 million. In 2017, Client gifts land to Son subject to the condition that Son pays the gift tax. The value of the taxable gift is arrived at as follows: Gross gift of $5 million less $1,428,572 gift tax paid by Son. This "net gift" condition imposed on Son saved $571,428 of gift tax. (See below discussion of potential for income tax being due if gift tax obligation assumed by Son exceeds basis. Also see below discussion of net, net gift.)

This Example is a "Part Sale, Part Gift" transaction. §2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift and shall be included in computing the amount of gifts during the calendar year.

Example ("Net, Net Gift"): The Example is identical to the above example, except Son also agreed to pay any estate tax due on the §2035(b) inclusion of the gift tax paid on the gift in Client's gross estate if Client were to die within 3 years of gift. In addition to the gross gift amount being reduced by the gift tax, the gift amount is also reduced by the actuarial value of amount of estate tax that would be paid with any §2035 inclusion of the gift tax paid. Steinberg v. Commissioner, 141 T.C. 258 (2007). §2035(b) is discussed above. Side note: Tax Court recently disallowed an estate a deduction for gift tax paid and included in gross estate under §2035(b), since donees were liable for the gift tax pursuant to a net gift agreement. Estate of Sommers, 149 T.C. No. 8 (2017).

(Discussed above are part sale, part gift transactions which result in a taxable gain to the donor.)

6. Recognition of Gain by Donor with Gift of Encumbered Property.

   With a gift of an encumbered asset, a donor realizes a gain to the extent the liability exceeds donor's basis in property.

   Example: Donor transferred real property to trust he established for his grandchildren. Donor's adjusted basis in the property transferred was approximately $485,000 and at the time of the transfer the property was subject to liabilities totaling roughly $910,000. Donor realized an approximate $425,000 gain upon making transfer to the trust. See, Estate of Levine v. Commissioner, 72 T.C. 780 (1979), aff'd, 634 F.2d 12 (2d Cir. 1980). The Tax Court considered the transaction to be a "part-gift, part-sale" since taxpayer received a "tangible economic benefit" for the excess of the mortgage debts

(including nonrecourse debt), interest, and other liabilities over his adjusted basis in the property.

Example: Donor transferred a whole life insurance policy on her life to an irrevocable life insurance trust established for her children. At the time of the transfer Donor had a $200,000 basis in the policy and the policy was subject to loans against the policy totaling $350,000. Donor realized a $150,000 gain on transfer to ILIT.

7. Recognition of Gain of Gift of Partnership Interest with a Negative Basis.

   A gift of a partnership interest in which the partnership has mortgage or other debt could trigger a gain to the donor if the share of debt allocable to gifted interest exceeds donor's basis in the interest. Commissioner v. Tufts, 461 U.S. 300 (1983). For an excellent discussion of estate planning for negative basis assets, see, Estate Planning for Negative Capital, Trusts & Estates, May 2012, Stephen M. Breitstone.

8. GRATs and Negative Basis Assets.

   Potential Gain When Grantor Trust Status Ends: With a GRAT and any other grantor trust, ultimately the grantor trust status will end. Upon termination of grantor trust status, the tax consequences avoided at inception may be triggered. Stephen M. Breitstone, in his Trusts & Estates article "Estate Planning for Negative Capital", states that "the GRAT technique is unsuitable for negative capital assets assuming the GRAT ends during the grantor's lifetime, as this will trigger gain if the grantor trust assets are subject to liabilities in excess of basis. Estate Planning for Negative Capital, Trusts & Estates, May, 2012, Stephen M. Breitstone; Treas. Reg. §1.1001-2(c), Ex. 5; Rev. Rul. 85-13 (which is the key ruling which treats the grantor as the owner of the trust for all federal income tax purposes under the grantor trust rules).

I. Gift Tax Return Items

1. Due date.

   Rule if Donor Does Not Die During Year of Gift: Return must be filed by April 15th following the close of the calendar year. §6075(b)(1). However, in instances when April 15 falls on a Saturday, Sunday, or legal holiday, Form 709 will be due on the next business day. 2017 Instructions for Form 709.

   Rule if Donor Dies During Year of Gift: If the donor died during the year of gift, the personal representative must file the donor's 2017 Form 709 no later than the earlier of: (a) the due date for filing the donor's estate tax return, and (b) April 15 following the close of the calendar year. §6075(b)(3).

   Example: Client made a taxable gift on January 5, 2017 and then died on April 10, 2017. The Form 706 un-extended due date is January 10, 2017. The 2016 Form 709

must be filed on or prior to January 10, 2017, assuming the Form 706 does not go on extension.

2. Extension of time to file gift tax return.

The instructions to Form 709 describe the following two methods for extending the time to file the gift tax return:

(i) Any extension of time granted for filing a taxpayer's federal income tax return will also automatically extend the time to file taxpayer's federal gift tax return, using either a Form 4868 or Form 2350.

(ii) A taxpayer who does not request an extension for taxpayer's income tax return can use Form 8892 to request an automatic 6-month extension of time to file the federal gift tax return.

An extension of time to file a Form 709 does not extend the time to pay the gift tax. Instructions for Form 8892.

6-Month Form 709 Extension. A properly filed extension results in an automatic 6-month extension of time to file Form 709. Instructions to Form 8892.

3. Gift Tax Assessment Period and Need for Adequate Disclosure.

In general, the IRS has 3 years from the filing of the gift tax return to assess gift tax. §6501(a). The 3-year assessment period only applies if the gift is reported on the return and there is adequate disclosure. §6501(c)(9) and FAA 20172801F (Donor filed a Form 709 to report the Year 7 gifts, but failed to adequately report any of the Year 7 gifts because Donor did not describe the transferred property, nor did Donor provide a description of the method used to determine the value of the transferred property. Therefore, under §6501(c)(9) the period of limitations on assessing tax on the Year 7 gifts has not expired.)

4. Requirement to Report Charitable Gifts When Otherwise Required to Report Non-Charitable Gifts.

Example: In 2016, Client makes a $100,000 cash gift to son. Client also contributes $1,000 to the Red Cross. Client is required to report the charitable gift on his 2016 Form 709. Instructions to the 2016 Form 709 state: If you are required to file a return to report non-charitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return".