The Federal Gift Tax

The Internal Revenue Code imposes a graduated tax on taxable gifts. Primary liability to pay the gift tax is imposed on the donor under §2502(c), but transferee liability is imposed on the donee under §6901(a) to the extent the donor fails to pay the tax. Under §6019 a gift tax return must be filed for any gift (1) not excluded under §2503(b) (the annual exclusion) or §2503(e) (the education and medical expense exclusion), or (2) any gift not qualifying entirely for the §2523 gift tax marital deduction or the §2522 gift tax charitable deduction. Note that taxable inter vivos gifts that do not in the aggregate exceed the applicable exclusion amount must be reported, notwithstanding that a similar amount left at death would not require a return at all. The due date under §6075(b) for filing the gift tax return is April 15 following the close of the calendar year in which the gift was made (with an automatic extension to file if the taxpayer is granted an extension of time to file the taxpayer's income tax return). If the donor dies during the calendar year in which the gift was made, the time for filing the gift tax return is delayed until the due date for the donor's estate tax return.

The federal gift tax helps to preserve the integrity of the income tax system. The owner of income producing property is burdened with the income tax on the income it produces, and the gift tax impedes gratuitous transfers of property designed to shift that income tax liability. There is relatively little incentive for income shifting in the form of gifts or otherwise under current law given the relatively low income tax rates and, more importantly, the compressed income tax brackets in which income is taxed. Nevertheless, the estate tax is slated for repeal in 2010 (under legislation adopted in 2001), but the gift tax will remain on the books after 2009 to continue this income tax deterrence.

Gift Defined

According to §2512(b), a gift is any voluntary and complete transfer of property to the extent fair market value of the property transferred exceeds the value of any consideration received in money or money's worth. An exception applies if that differential in value meets the business transaction exception established in Treas. Reg. §25.2512-8 (meaning that the transaction is bona fide, at arm's length, and free from donative intent). Other exclusions or exceptions also may apply, such as the annual exclusion. But transfers for full and adequate consideration need no exclusion because they are not gifts in the first instance.

Thus, for example, outright gratuitous transfers of money, realty, tangibles, or intangibles normally would be taxable gifts. Some taxable transfers are less obvious than these, some transfers that look like gifts are not, and others that do not appear to be gifts are taxable transfers. In general, the test is whether an economic benefit has been transferred gratuitously, but this is only a rough description. Consider the following illustrations:

(1) P transferred $100,000 to a trustee in trust to pay the income to child C for life, remainder to C's descendants. P reserved a power to revoke the trust and therefore did not make a completed transfer for gift tax purposes. However, income distributed from the trust to C constitutes a gift, and a completed gift would occur if P released the retained power of revocation. This gift would consist of a transfer to C of the then value of C's life estate and a transfer to C's descendants of the value of the remainder interest, both valued when the power is relinquished on the basis of C's actuarial life expectancy and an assumed rate of return on trust assets dictated by §7520.

(2) X sold a house and lot to Y for 40% of its fair market value. This is a gift to Y of 60% of the fair market value unless X can establish that the sale was made in the ordinary course of business, in a transaction that was bona fide, at arm's length, and free from donative intent. This would be difficult to prove if Y is a natural object of X's bounty.

(3) A and B, sole owners of a corporation, each transferred stock they owned in the corporation to key employees who they considered important to the continued success of the corporation. A and B are not related, nor is any employee related to them. For income tax purposes the employees must include in income the fair market value of the stock they received, and their income tax basis in the stock is the same amount. A and B are treated as having made a capital contribution to the corporation, and the corporation is entitled to a deduction for compensation paid to the employees to the extent allowed by §§162 and 83(h). No gift has been made for gift tax purposes because these transfers were made for full and adequate consideration in money or money's worth. See Rev. Rul. 80-196.

(4) Assume that in example (3) only A transferred stock to the unrelated key employees and B did not make a matching contribution. A's transfer still constitutes a capital contribution to the corporation that generates an increase in basis for A's stock in the corporation. Because A alone made a transfer, however, A is deemed to have made an indirect gift to B of half the value contributed to the corporation.[5]

(5) P gratuitously guaranteed loans made by Bank to P's children. According to Private Letter Ruling 9113009:

5. See Treas. Reg. §25.2511-1(h)(1); Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956); Tilton v. Commissioner, 88 T.C. 590 (1987); Ketteman Trust v. Commissioner, 86 T.C. 91 (1986); Estate of Hitchon v. Commissioner, 45 T.C. 96 (1965); Private Letter Ruling 9114023. This gift does not qualify for the annual exclusion because B does not have an immediate right to possession or enjoyment of the capital increase represented by A's transfer. A would be in a better position if there were no other shareholder, or if B made a matching proportionate transfer that would net out the gifts made by each. Indeed, the results would be more favorable if A made gifts to the employees out of affection or other nonbusiness related motives because, presumably, the gift tax annual exclusion would be applicable. As accomplished, however, all A gained from this transfer was a basis increase for the value of the deemed capital contribution.

The agreements . . . to guarantee payment of debts are valuable economic benefits conferred upon [the children] . . . . Consequently, when [the taxpayer] guaranteed payment of the loans, [the taxpayer] transferred a valuable property interest to [the children]. The promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made.

According to the Ruling, this gift was taxable immediately, with the gift amount being "the economic benefit conferred" by the guarantee. The government gave no indication of the gift tax value of the economic benefit bestowed. It might consist of the value of any reduction in interest rate attributable to the added security provided by the guarantee, the amount the borrower did not pay a third party for the guarantee, or the diminution in value of the guarantor's collateral pledged to secure the guarantee. If the taxpayer subsequently is required to make good on the guarantee, an additional gift would be made to the extent the taxpayer could, but does not, seek reimbursement from the borrower.[6]

Annual Exclusion and Exclusion for Education and Medical Care Expenses

12,000 in 2006 4 2007

Every year a taxpayer may give up to $11,000 (indexed for inflation in $1,000 increments) to each of an unlimited number of different donees without incurring a gift tax or even being required to file a gift tax return. This §2503(b) "annual exclusion" does not apply to future interests, such as a gift in trust to pay principal to the beneficiary at some future date. However, certain gifts to minors that are future interests are treated by §2503(c) as gifts of a present interest that qualify for the annual exclusion if the gift property and the income therefrom may be expended for the benefit of the donee before the donee attains the age of 21 and, (1) to the extent not so expended, the gift property and the income therefrom will pass to the donee when the donee attains the age of 21 or, (2) if the donee dies before attaining the age of 21, the gift property will be payable to the donee's estate or as the donee appoints under a general power of appointment.

In addition, §2503(e) provides that amounts paid on behalf of an individual as tuition to an educational organization for "education or training" or to any "medical" care provider also are not taxable. These "ed/med exclusion" payments may be made without reducing the per donee annual exclusion.

6. It is notable that the benefit to the borrower from receiving a guarantee does not constitute an immediate cost to the taxpayer who provides the guarantee. The government previously took the position that the value of a gift is not what the donee receives but what the donor relinquishes. In this case the government took the opposite position, stating that value to the donee measured the gift, which is a more traditional holding. It may be that either valuation is correct in appropriate situations, although it is difficult to see what property transfer has occurred in the guarantee situation to which the gift tax should apply.

Charitable Deduction

Transfers to qualified charities are deductible under §2522(a) regardless of amount, and the same is true for estate tax purposes under §2055(a). Only the §170 *income* tax charitable deduction is limited to certain percentages of the donor's contribution base. See Chapter 8. Qualified charitable donees are described in §§2055 and 2522 and include organizations designed to promote good government or world peace or to attain other political, economic, or social ends (if no substantial part of the organization's activities is carrying on propaganda or otherwise attempting to influence legislation). But a particular family in need is not a qualified charity because a general distinction is drawn between public and private charity.

Organizations customarily submit their charters and bylaws to the Treasury Department for a ruling that they are qualified charities, gifts to which are deductible for federal income, estate, and gift tax purposes. An organization typically will make such a determination known in its solicitation of funds, and it always makes sense to verify this fact before making a sizable charitable gift.

Split interest charitable gifts benefit charities and individuals, with the charity benefiting exclusively for a term and the remainder then passing to individuals, or vice versa. Very technical rules must be observed to obtain a charitable deduction for split interest charitable gifts, also as discussed in Chapter 8.

Marital Deduction

The gift tax marital deduction was enacted in 1948 along with joint income tax returns and gift splitting to provide parity between the taxation of spouses in community property and noncommunity property states. Beginning in 1976 and culminating with a change in 1981, Congress expanded the deduction to now make interspousal transfers totally free of tax. See Chapter 7. Transfers between spouses qualify for the gift tax marital deduction ~~only to the extent the donee~~ spouse receives a qualifying interest and is a citizen of the United States.[7] Qualifying interests include property transferred outright or property placed in a trust that meets the technical requirements of §2523(e) or (f).

Gift Splitting by Spouses

Also adopted in 1948 was the gift splitting authority now found in §2513, which applies to gifts by a married donor to a third party. Because a gift by spouses of community property is a gift by each of half the value

7. Gifts to a noncitizen spouse cannot qualify for the gift tax marital deduction. See §2523(i). However, §2523(i)(2) increases the §2503(b) gift tax annual exclusion for gifts to a noncitizen spouse, provided the interest transferred otherwise would qualify for the marital deduction. Treas. Reg. §25.2523(i)-1(c).

of the property, §2513 grants spouses the ability to elect to treat a gift of noncommunity property to a third party as made half by each as well.

Concurrent Interests

Joint ownership of property with the right of survivorship is quite common, particularly between spouses. A completed gift results from creation of a joint ownership to the extent the respective owners' contributions are not equal. However, any gift represented by unequal contributions is not complete and therefore is not taxable to the extent the joint owners' respective contributions are withdrawable without consent of the other joint owners. This normally occurs with respect to joint bank accounts, brokerage accounts, and jointly owned United States Savings Bonds. In addition, between spouses, even if the contribution constitutes a completed gift, the unlimited gift tax marital deduction makes the transfer tax free if the donee spouse is a citizen of the United States.

Preventing Valuation Freezes

Certain transactions minimize the value of transferred property in ways that Congress regards as improper. Chapter 14 of the Internal Revenue Code precludes a number of these devices, principally through application of valuation rules that negate the opportunity to minimize or freeze value.

The Unified Estate and Gift Taxes

The tax on those transfers that are *not* deductible or excepted is computed under a unified rate system found in §2001 and incorporated by reference by §2502 for both estate and gift tax purposes. This approach reflects the progressive nature of the estate and gift taxes and the policy that similar amounts of wealth should incur similar tax liability regardless of whether the transferor conveys it during life, at death, or some of each. Thus, gifts made during life are added to gifts made previously during life to determine the appropriate graduated tax rate to impose on the latest transfer, and lifetime gifts are reflected when computing the estate tax at death.

For example, because the gift tax rate on a gift of $150,000 is less than the rate on a gift of $250,000, it is necessary to consider the progressive rate that must be imposed if a gift of $150,000 is made after a prior gift of $100,000. Similarly, all taxable transfers made during a transferor's life must be considered in determining the proper rate for taxing transfers at death. To illustrate, if Donor transferred $X in year 1 and another $Y in year 2 and died with $Z in year 3, the tax on the year 2 gift would be computed as the tax on $X plus $Y and, because the tax on $X already was incurred in year 1, only the increase in tax attributable to the year 2 gift of $Y would be imposed. Similarly, the estate tax would be computed as the tax on $X plus $Y plus $Z and, again reflecting that the tax on $X and $Y was incurred during life, only the increase in tax attributable to the $Z taxable at death would be imposed for estate tax purposes.

There is a quirk in this unified rate system, attributable to the fact that the estate and gift taxes were not unified until 1976 but this integrated gift tax computation regime existed beginning in 1932. Thus, taxable gifts made before 1977 must be reflected in determining the applicable tax for taxable gifts but not for determining the estate tax for any decedent.

To illustrate, assume that Donor made taxable gifts before 1977 totaling $150,000 and a taxable gift after 1976 of $100,000. The gift tax on the $100,000 gift would be computed by determining the gift tax under the unified rate schedule on a gift of $250,000 and then subtracting the gift tax under the same schedule on a gift of $150,000; the difference is the gift tax on the post 1976 taxable gift of $100,000. Donor's estate tax, however, would be determined without regard to the gift made before 1977. Thus, if Donor's taxable estate were $700,000 at death, it would be added to the taxable gift made after 1976 of $100,000 but not to the taxable gift made before 1977 of $150,000. The tax on only $800,000 would be computed, and the tax on that amount would be paid to the extent it exceeds the tax on the $100,000 taxable gift made after 1976.

The tax computed under the unified rate schedule need not be paid until the aggregate tax incurred during life and at death exceeds the unified credit granted by §§2010 and 2505. In this example the tax would be satisfied by applying the unified credit and no tax payment actually would be remitted.

The Federal Estate Tax

As noted in Chapter 11, the federal estate tax is an obligation of the residue of the decedent's probate estate and must be paid by the "executor" of the estate,[8] which distinguishes the tax from an inheritance tax like that imposed by some states on recipients of a decedent's property.

The federal estate tax is imposed on a decedent's taxable estate and requires answers to three basic questions:

(1) What property is includible in the decedent's "gross estate"?

(2) What amounts are deductible from the gross estate in determining the "taxable estate"?

(3) How much tax is imposed on the taxable estate?

The Gross Estate

A decedent's gross estate includes "the value of all property to the extent of the interest therein of the decedent at the time of . . . death." §2033. Property a person owns at death is includible in the decedent's

8. §§2002 and 2205. The term "executor" is defined in §2203 as the fiduciary charged with administration of the decedent's estate or, if there is none, then any person in possession of the decedent's property.

Chapter 12

INTER VIVOS TRANSFERS

Most estate planning involves transfers made (or that become irrevocable) at death. Revocable inter vivos trusts serve important lifetime purposes, such as to provide asset management and protection against incapacity, but they generate no demonstrable income *or* wealth transfer tax benefits. Thus, in this Chapter we consider *irrevocable* inter vivos transfers that, in addition to family and business planning objectives, often represent tax minimization opportunities by shifting future income or reducing wealth transfer tax, usually by incurring gift tax instead of a more expensive estate tax.

The most immediate costs of irrevocable inter vivos transfers are acceleration of wealth transfer tax and loss of the income tax §1014 new-basis-at-death adjustment. We will see that gift tax can be cheaper than estate tax and that deferral will not alter that economy of inter vivos transfer. The loss of new basis is a detriment to the extent §1014 would eliminate unrealized appreciation and thereby avoid capital gain income tax on appreciated assets. On balance, we will learn that acceleration is not detrimental because deferral of the wealth transfer tax is almost never economically preferable, and new basis at death does not outweigh the economic advantages of inter vivos transfers. Nevertheless, many clients simply will not embrace the following concepts, even if the transfer would incur no immediate gift tax, particularly as we await the promised repeal of the estate tax (effective in 2010, for just that one year, and with it loss of §1014 new basis at death). Thus, this Chapter may have little value until the law "settles down" and a better view of the future materializes.

Basis

We begin with the income tax concept of basis, which measures appreciation or depreciation in the value of an asset. The difference between any amount realized on a taxable transfer and the basis of the transferred asset measures the gain or loss that may be subject to §1001 recognition for income purposes (in the year of the transfer). Basis essentially is the taxpayer's investment in the asset, usually the cost or amount paid for it. Basis "carries over" in property transferred by gift inter vivos. That is, gifted property retains its basis in the hands of the donee, meaning that any appreciation generated in the hands of the donor is preserved and may be realized by the donee and subjected to the capital gains income tax in the future.[1]

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1. See §1015(a). Closely related to this "carryover of basis" rule is "tacking" of holding periods following a gift, meaning that the donor's long term ownership will produce long term gain or loss when the donee engages in a taxable transaction. See §1223(2),

On the other hand, under §1014(a) most property includible in a decedent's gross estate for federal estate tax[2] purposes receives a new basis at death equal to the includible fair market value of the asset. Sometimes inaccurately known as the "step-*up* in basis" rule (because it eliminates any unrealized capital gain in appreciated assets held at death), this rule also can have a step-*down* in basis consequence (if the fair market value of includible property is less than the owner's premortem basis).[3]

Even assuming appreciation is the case, however, this new-basis-at-death rule does not inform a strategy of holding property until death to avoid capital gain income tax on the appreciation. This counterintuitive notion reflects the reality that the advantages of making gifts that incur no gift tax, or of actually paying gift tax inter vivos, both outweigh the new-basis-at-death opportunity to eliminate capital gain by holding appreciated property until death. We explore that notion next below. Moreover, if the estate tax is repealed in 2010, the new-basis-at-death rule also will be repealed (it is replaced with §1022 carryover of basis), making new basis an even less informed reason to retain property until death.

The Economics Of Prepaying Wealth Transfer Tax

Everything (purportedly) changes in 2010, so the following discussion must be tempered with a clear eyed assessment of political realities. Will those changes ever take effect and will they be made permanent? Because that crystal ball gazing is too difficult, the following illustrations are premised on the law in 2004 and do not reflect the promise of estate tax repeal in 2010 (for just that one year). They also do not reflect the phased reduction of the highest marginal wealth transfer tax rate or increase in the applicable exclusion amount. All of these are moving targets that Congress may alter at any time.

As a result, this Chapter is more useful as a learning tool than as a way to model predictable results for particular situations. And it is presented with the caution that current uncertainty about the stability of wealth transfer tax changes will prevent most clients from making taxable inter

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applicable if the basis in the hands of the taxpayer is the same "in whole or in part" as that of the taxpayer's transferor. As a result of both rules the donee effectively steps into the shoes of the donor, with one limitation. Under §1015(a) basis for property transferred inter vivos is the lesser of the donor's basis or the asset's fair market value for gift tax purposes, meaning that losses cannot be shifted from donor to donee.

2. Two important variations from the general rule are §1014(b)(6), which grants both halves of community property a new basis on the death of the first spouse to die, notwithstanding that only the decedent's half of the community property is includible in the gross estate, and §1014(c), which denies the new-basis-at-death rule with respect to §691 income in respect of a decedent. See Chapter 17 at pages 11-12 for a summary of common forms of income in respect of a decedent.

3. As explained in note 1, that loss of basis cannot be precluded by a premortem transfer because carryover basis for property transferred inter vivos is the lesser of the donor's basis or the asset's fair market value for gift tax purposes, meaning that losses cannot be shifted from donor to donee. The way to avoid loss of the loss therefore is to sell the asset before death. By the way, we all would prefer not to have economic losses, but if you have income tax losses you don't want to lose them. Losses are *good* for income tax purposes because they offset taxable gains.

vivos transfers, at least if the client expects to outlive the estate tax. Still, please don't stop reading! This will be valuable for you to know.

Even if doubt about the future were not our reality, most taxpayers with wealth will attest that there are lots of *other* reasons to resist making gifts during life. Leading the list for most people are loss of control over the transferred funds, lack of liquidity to pay any resulting gift tax, and a fear that the remaining wealth will be inadequate to finance the balance of the donor's life. These concerns are undeniable and frequently paralyze wealthy and less wealthy clients alike.

In addition, another reason commonly is given for not incurring wealth transfer tax earlier than necessary (for example, by making a completed taxable gift), but it is wrong minded, as the following discussion illustrates. That inappropriate justification is the "time-value of money" notion. It assumes that wealth transfer tax is deferred during the interim and that the taxpayer will invest the tax dollars that ultimately will be paid to the government. The hope is that the taxpayer will earn more on those deferred tax dollars over a sufficient period of deferral than any increase in tax attributable to deferral and differences in the estate and gift tax systems. This time-value notion not accurate. Even if just for educational purposes, it is good to understand why this "urban myth" is wrong. But first, let's illustrate why gifting itself is tax favored.

The Tax Exclusive Gift Tax Computation Outweighs New Basis at Death

One disparity between the gift and estate taxes (it also exists as among the three different forms of generation-skipping taxable transfer) is the tax base against which each tax is computed. The gift tax (and the generation-skipping direct skip tax) is computed "tax exclusive," which means that the tax is computed only on the value received by the donee. The dollars used by the donor to pay the gift tax (or the direct skip generation-skipping transfer tax) are not themselves subject to the tax.[4] On the other hand, the estate tax (and the generation-skipping taxable distribution and termination taxes) are computed "tax inclusive," meaning that the dollars used to pay the tax are subject to the tax.

Stated another way, under the estate tax the decedent's taxable estate includes some wealth that passes to the government in the form of taxes paid on the entire estate. The estate tax is computed on the entire taxable estate, not just on the residue that passes to beneficiaries after payment of the estate tax. (The generation-skipping taxable distribution and taxable termination rules work in the same manner.) The gift tax (and generation-skipping direct skip tax) is incurred only on what the donee receives. The

4. Only if the donor dies within three years after a gift are the gift tax dollars subject to wealth transfer tax, under the "gross up rule" of §2035(b). The wealth transfer tax incurred is an estate tax, not an additional gift tax. There is no counterpart to §2035(b) for generation-skipping transfer tax purposes, although §2515 provides that a donor's payment of the generation-skipping transfer tax is an additional gift for gift tax purposes.

dollars used to pay that tax are not themselves subject to the tax. This means that gifts (and direct skips) always are less expensive than taxing the same wealth at death (or under the generation-skipping taxable distribution or termination rules), because of the different method of computing the amount taxable.

To illustrate, assume a taxpayer is willing to part with $1 million during life rather than holding it until death. That is, between the gift tax incurred and the actual gift made, the taxpayer is willing to suffer a diminution in net worth of $1 million. The gift tax in this case is computed on that portion of the $1 million that passes to the donee after reserving the dollars needed to pay the tax on that gift. Although this creates a circular computation (the amount of the gift is not known until the amount of the tax is computed, and the tax cannot be determined until the amount of the gift is known), an algebraic formula is available to solve the math, in our hypothetical being:

gift

$$\text{taxable transfer} = \frac{\$1{,}000{,}000}{1+\text{rate of tax}}$$

In this case, if the tax rate is (let's assume) 48%, the taxable transfer would be $675,676, the gift tax at 48% on that amount would be $324,324 (computed without subtracting any available credits), and the total of the tax paid and the amount given to the donee would equal the $1 million the taxpayer is willing to relinquish. tax

As a percentage of the $1 million that would have existed in the donor's estate at death if no gift were made, the $324,324 gift tax is an effective 32.43%. This compares to the 48% effective rate that would apply for estate tax purposes on the same wealth at death: the $1 million would have incurred an estate tax of $480,000 if held until death. Notwithstanding that the nominal tax rate (48%) is the same in both cases, the difference in tax is $155,676, attributable purely to the different base against which the tax is applied (and this differential is the same regardless of the amount of any available credits).

To honestly compare gifts to transfers taxable at death, this inter vivos gift tax saving should be discounted by any income tax that might be incurred on appreciation that would escape the income tax if the property were held until death and qualified for the §1014(b)(9) new-basis-at-death adjustment (if it still is the law).[5] Notice that the current 15% long-term *capital gains* income tax would not exceed the wealth transfer tax saving attributable to the tax exclusive computation of the gift tax. This would be true even if the income tax adjusted basis in the full $1 million of transferred property was zero and even in the unlikely circumstance in

5. It also would be offset by any income tax that the donor would incur in generating liquidity to pay any gift tax incurred, versus waiting until death and using new basis assets to provide cash with which to pay estate tax at little or no income tax cost. The liquidity equation is virtually impossible to quantify from one case to another, so the focus here is on only the income taxation of the gifted property itself.

which all the transferred property was subjected to a realization event (such as a sale, which is unlikely in many cases because the gifted assets are stock in the family business, the family farm, or other property the family intends to retain).

Put another way, retaining property until death to obtain the new-basis-at-death adjustment is no reason to forego the benefits of the tax exclusive gift tax computation. Deferring wealth transfer tax is not favored because of new basis at death. Instead, deferral would make sense only if the income tax capital gain rate is higher than the percentage saving attributable to the difference in the effective wealth transfer tax rates under the two different systems of computation. That *can* occur, but only if the wealth transfer tax marginal rate is sufficiently low[6] and the income tax will be computed at a higher than 15% long-term capital gain rate.[7]

The Time-Value-of-Money Myth

Now let's analyze the time-value-of-money notion. We considered this in Chapter 7 at page 23 in the context of marital deduction planning, and the same concept is relevant here as well. This is the wrong-minded assumption that deferral of wealth transfer tax is beneficial because, during the interim, the taxpayer may invest and enjoy the use of money destined to go to the government in the form of taxes.

Assume for illustration purposes that the estate and gift taxes are computed in the same manner, so that the tax exclusive advantage of gifting does not skew the example. Thus, assume again that the taxpayer has $1 million that will be relinquished (by transfer and the tax payment thereon) inter vivos or at death. Also assume that whatever amount that exists during life (that is, after payment of any gift tax incurred inter vivos, or before a taxable transfer at death) will earn income or produce capital appreciation over a sufficient period of time that the wealth doubles prior to the donor's death.[8]

If the time-value-of-money notion is correct, any favorable difference in wealth transfer tax attributable to gifting would be offset by the benefits of investing the dollars (that eventually will be paid to the government) during the period of any deferral in tax payment. Given long enough the time-value notion expects the investment return to exceed any tax saving from accelerating payment of the tax. So, assume the taxpayer could transfer the

6. A discussion such as this is not very meaningful if the wealth transfer tax rate is low because the client has very little wealth, because the taxpayer is not likely to consider gifts in any event: there simply is not enough wealth to afford taxable inter vivos transfers subject to the gift tax.

7. A little number crunching quickly will reveal whether the gift tax advantage will outweigh the potential income tax detriment if the donee ultimately realizes the appreciation on the asset. You just need to push a pencil and compare results.

8. Rather than engage in speculation whether the taxpayer will live x years and earn income after income tax at y% and generate capital appreciation after capital gains tax at z%, this assumption merely eliminates guess work and avoids suspect illustrations by assuming that the combination of relevant factors is adequate to produce the stated result of doubling the available wealth.

$1 million inter vivos by gift, or make no gift and instead hold it until death:

Gift		*Death*
$2,000,000	initial wealth	$2,000,000
1,500,000	gift	0
555,800	gift tax (before credits)	0
(345,800)	unified credit[9] 1,000,000 gift tax exemption	
210,000	gift tax paid	0
290,000	wealth remaining to invest	2,000,000
× 2	growth	× 2
580,000	wealth taxable at death	4,000,000
1,500,000	adjusted taxable gift in tax base	0
(263,400)	estate tax after all credits	(1,185,000)
316,600	estate remaining after estate tax	2,815,000
3,000,000	gifted property (plus its growth)	0
$3,316,600	family wealth remaining	$2,815,000

If the time-value notion were correct, the deferral result in the Death column should exceed the result in the Gift column, but that does not happen.

Assume that the gifted asset has zero basis and the full $3 million value of it is realized for income tax purposes in a taxable sale or exchange (which growth escapes tax in the Death column because it is eliminated by estate tax inclusion and the new-basis-at-death adjustment). A *capital gain* income tax of 15% ($450,000 on $3 million of gain) would not offset the $501,600 saving attributable to the gift and prepayment of wealth transfer tax. Thus, even if that gifted property had zero basis before the gift and would enjoy a full basis increase at death if retained, the capital gain income tax on realization of the full $3 million of gifted value would not consume the full saving until the tax rate on the gain exceeds 16.72%. And these are "worst case" illustrations (zero basis, full realization), which may be far from realistic.

A different illustration might be more relevant during the period prior to the promised repeal of the estate tax, this time illustrating a gift that does not require payment of gift tax (instead relying just on the unified credit).

9. Notice that each tax has been computed on the basis of the unified credits in effect in 2004, which shelters only $1 million for gift tax purposes (even through it shelters $1.5 million for estate tax purposes). Rather than predict the added phase-in of the unified credit to the amount that would shelter more than $1.5 million at death in a later year, this example uses the year 2004 figures for each tax, and they differ. The principle being illustrated will not change, even as the dollar amounts change over time, except that the illustration will no longer be revealing if the gift or the estate ever becomes entirely tax-free, because the unified credit will shelter the full transfer. New conclusions will need to be drawn in that case. For example, if the inter vivos transfer imposes no gift tax cost, then *any* delay in making the transfer — if appreciation is assumed — must produce a worse result if an estate tax *would* apply. This is because, if no inter vivos transfer were made, estate tax would be incurred at death that would not be fully sheltered by the available credit. Which is to say, any wealth transfer tax on appreciation generated during the deferral period would be a net loss to the taxpayer. The point is that during these changing times static assumptions need to be reconsidered and tested periodically against the then current tax environment.

Assuming the same situation, now with a nontaxable gift, the results are dramatic and still favor the taxpayer who makes the inter vivos transfer:

Gift		*Death*
$2,000,000	initial wealth	$2,000,000
1,000,000	gift	0
345,800	gift tax (before credits)	0
(345,800)	unified credit	
0	gift tax paid	0
1,000,000	wealth remaining to invest	2,000,000
× 2	growth	× 2
2,000,000	wealth taxable at death	4,000,000
1,000,000	adjusted taxable gift in tax base	0
(705,000)	estate tax after all credits	(1,185,000)
1,295,000	estate remaining after estate tax	2,815,000
2,000,000	gifted property (plus its growth)	0
$3,295,000	family wealth remaining	$2,815,000

Again, the $480,000 difference in remaining wealth is not consumed even if $300,000 of capital gain tax is incurred on sale of the $2 million of gifted property (assuming a worst case basis of $0). Indeed, if capital gain is a fair element, this gift is more favorable than the last, because more savings remain after the capital gain tax is paid.

To the question whether there simply was not enough growth in these illustrations to offset the gift tax advantage, the answer is that the greater the growth, the greater the advantage to an inter vivos transfer. To illustrate, do your own calculation by assuming that all the wealth triples (rather than just doubles, as first illustrated) and recompute the respective tax savings. Counter to the time-value-of-money notion that the wealth transfer tax savings will be recovered and that deferral will be preferable the longer the deferral period or the more the taxpayer can earn during it, the disparity in net worth *increases* rather than shrinks during a more profitable deferral. This is simply because the time-value-of-money notion is exactly wrong in the wealth transfer tax context. Put another way, in an appreciating environment, the sooner the tax is paid, the better the result.

The only exception to this conclusion applies if the capital gain income tax rate on growth (as opposed to the tax on income earned, which will be taxable to someone in all events) is sufficiently large and the wealth transfer tax saving is sufficiently small. In that case a failure to generate a new basis on the growth element by subjecting the transferred asset to the estate tax in these illustrations could result in an income tax that consumes some (or all) of the wealth transfer tax saving in the gift illustration. This will occur if appreciation subject to income tax is not eliminated by the §1014(b)(9) new-basis-at-death rule, but only if there is a realization event (such as a sale) and then only if the income tax rate is sufficiently higher than the wealth transfer tax effective rate (which is not often the case).

Otherwise, even after subtracting an income tax on the full appreciation, what we see is that the time-value-of-money explanation for favoring deferral of wealth transfer tax simply is not correct. As a consequence, unless there are other (nontax) reasons to favor deferral, inter vivos transfers that trigger the gift tax and avoid a subsequent estate tax (prepayment as it were) are preferable to the estate tax at death.[10]

Other Reasons to Favor Inter Vivos Transfers

Were it not for the promise of estate tax repeal (and retention of the gift tax) the tax exclusive method of computing the gift tax would be only one of several demonstrable reasons to favor an early and complete taxable transfer of wealth that will incur a transfer tax. Another reason to favor inter vivos transfers is the §2503(b) gift tax annual exclusion or the §2503(e) education and medical expense (ed/med) exclusion, which make it possible to transfer some wealth during life entirely tax free. A corollary is split annual exclusion gifts and gifts to use or to shelter a spouse's unified credit. Yet another is the ability to shift future income and appreciation from the transferred property to the new owner for income tax purposes (and in the process to avoid a future wealth transfer tax to the transferor on that income or the appreciation).

Income tax savings are a function of the spread between the marginal brackets applicable to the transferor and the transferee. In many cases this is not significant. And the opportunity to shift appreciation should be weighed against the different potential for consumption by the transferor or the transferee (in ways that, unlike investments, show *no* value for subsequent wealth transfer tax purposes). A consumption analysis should consider the transferor's ability to consume other retained wealth and even further reduce the amount subject to wealth transfer tax at death.

Notice also that shifting appreciation does *not* reduce wealth transfer tax when the tax is a flat rate excise (i.e., after 2005, when the maximum rate is no more than 46% and the applicable exclusion amount is at least $2.0 million). In a flat tax environment no saving is available from an inter vivos gift that shifts appreciation (other than the dollars saved by the tax exclusive feature of the gift tax). To illustrate, compare owning an asset worth $100x that is expected to double in value. If a 45% tax rate is imposed, leaving $55x that will double to $110x, the taxpayer is in no better position than if the $100x were held, it doubles to $200x, and 45% of that is paid in tax, leaving the same $110x. So, depending on whether Congress allows various phase-in changes to operate as adopted in 2001, shifting appreciation may be a tax neutral gambit in the future.

A related but slightly different opportunity *will* remain, however, even after the wealth transfer tax has become flat. That opportunity is to pay tax

10. For a more detailed discussion see Pennell & Williamson, *The Economics of Prepaying Wealth Transfer Tax*, 136 TRUSTS & ESTATES 49-60 (June 1997), 40-51 (July 1997), and 52-56 (Aug. 1997), the July issue being the most relevant to the gifting illustration.

early with assets that will not themselves grow in value. The "Half Hot Example" in Chapter 7 at page 27 illustrates this notion, and it is most likely available to a taxpayer who is using a frozen value asset (such as cash or the unified credit) to pay any gift tax. The concept is that the unified credit will shelter all of the gift tax on $1 million of value transferred inter vivos, but the same amount of credit would not offset all of the tax on the includible value if the property doubled in value before a deferred estate taxable event. This concept is not about freezing the value of the transferred property for wealth transfer tax purposes; it is about paying the tax with dollars that are frozen in value. This opportunity is the same even after the law imposes a flat tax.

A further example of the benefits of inter vivos transfers is to prepare for valuation discounts at death. A good illustration is conversion of joint tenancy between spouses into tenancy-in-common ownership that will generate a fractional interest discount in the estate of each spouse (which requires only that the two halves of that property not be aggregated in the estate of the surviving spouse, in the manner unsuccessfully sought by the government in the *Bonner* line of cases, as discussed in 3 Casner & Pennell, ESTATE PLANNING §13.7.3.1.1 n.25 and accompanying text (6th ed. 2001).

A final advantage relates to a major and apparently intentional distinction in the law between the method for valuing gifts and for valuing property at death. Consider Rev. Rul. 93-12, which involved a donor who transferred 100% of the stock in a corporation in five equal inter vivos gifts during one year. The Ruling stated that a minority interest valuation adjustment would not be denied to any of those five separate gifts, even though the donees were related family members. The Ruling did not even mention the fact that the estate tax would be imposed on the one undivided control block if the 100% were held at death and it passed to the same five donees then.

As explained by the government in Technical Advice Memorandum 9449001:

> Although the estate tax and the gift tax are generally construed in pari materia, there are some material differences in the administration of the two taxes. . . .
>
> Unlike the estate tax where the tax is imposed on an aggregation of all the decedent's assets, the gift tax is imposed on the property passing from the donor to each donee and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift. Accordingly, the value of property that is the subject of multiple simultaneous gifts may be different from the value of that same property if that property were included in the donor's gross estate at his death. . . .

Significant about the government's conclusion that value is determined for gift tax purposes by the property each donee receives is that this concept fundamentally is unlike the estate tax (which does not consider whether a decedent disposes of property in a single bequest or divides the property between numerous legatees). Furthermore, Congress is aware of this disparity, which is just one of several subtle and not so subtle ways by which Congress preserves a system that provides benefits exploitable only by taxpayers with enough wealth to make inter vivos transfers.

To illustrate, consider a hypothetical: C owns the world's largest diamond and provides in C's will that C's personal representative shall hire a diamond cutter who will split the stone into several smaller diamonds of equal value, to be distributed to C's children. For estate tax purposes the value of the single undivided stone would be includible in C's gross estate, because that is what C could transfer to a single donee. If instead C called the diamond cutter to C's deathbed and directed that the stone be split and the niblets delivered before C's death, those gifts each would be valued separately for gift tax purposes and only the aggregate of the values of the smaller stones would be subject to gift tax. Together they would not equal the value of the undivided stone. The same opportunity exists with stock in a family corporation or any other asset with minority or fractional interest discount potential.

As thus revealed, the gift tax considers each gift separately, producing a different valuation result for transfers made before death as opposed to transfers made testamentarily, notwithstanding that the ultimate destination of the property and the property itself are the same in either event. Gifts are the way to go if valuation opportunities like this would apply (for example, by dividing the stock in a family corporation among multiple beneficiaries). The gift tax and estate tax differ, and that difference significantly favors the gift tax in cases in which fractional or minority interest discounts could be available.

Transfers That Avoid Gift Tax

So far our discussion has illustrated advantages of inter vivos taxable transfers. The following discussion addresses various consequences of making lifetime gifts, particularly those made without immediate wealth transfer taxation.

The purported repeal of the estate and generation-skipping transfer taxes (but not the gift tax) requires no more than passing comment here because it will not be effective until 2010, and then only for one year. It may be much later in this decade before it becomes clear whether repeal actually will become effective as promised. Until that is more certain, lifetime planning that incurs a gift tax likely will be curtailed significantly, and readers and their clients naturally will exercise caution in that regard. After all, why pay a gift tax inter vivos if you expect to live long enough to die with no estate tax? This just exacerbates the interest in inter vivos transfers that do *not* incur gift tax.

Among a slew of changes that do not become effective until 2010 is adoption of a definition in §2511(c) that ties completed gift treatment to the income tax grantor trust rules. Congress figured that the gift tax should be retained to preclude tax free income shifting and, as a backstop to the income tax, that the gift tax ought to define completion according to the same rules that apply for income tax purposes. That new definition will apply only for gift tax purposes, only for purposes of the completed gift provision (and not for such things as annual exclusion qualification), and in any event it is not yet (and may never be) the law.

The change in §2511(c) does, however, spotlight the current reality that the gift tax definition of a gift is difficult to cobble together. There is no single articulation of it in the Code or Regulations. By collecting requirements from a number of sources, however, the present definition of a gift for wealth transfer tax purposes[11] can be stated as "a voluntary and complete transfer of property by an individual for less than full and adequate consideration in money or money's worth."[12] For this discussion the gift tax definition is our premier focus because the only inter vivos transfer that is subject to immediate generation-skipping transfer taxation is a direct skip and the §2612(c)(1) definition of a direct skip requires that the transfer be "subject to" the gift tax. Furthermore, there is no need for a definition of a gift for estate tax purposes separate from that for gift tax purposes.

Considered in this exploration of pre-2010 law are transfers that are "subject to" the gift tax but that may not incur a tax payment obligation. This may occur for a wide variety of reasons, such as the transfer is not yet complete and therefore not yet ripe for taxation or because the transfer qualifies for an exclusion from the tax or a deduction. Also considered are gifts that are subject to taxation presently, along with valuation aspects that

11. The familiar income tax definition of a gift, found in Commissioner v. Duberstein, 363 U.S. 278 (1960) ("a gift proceeds from a 'detached and disinterested generosity' . . . 'out of affection, respect, admiration, charity or like impulses'") is *not* the proper definition for wealth transfer tax purposes. Indeed, there are cases in which a gift for gift tax purposes was a sale or income for income tax purposes, showing the inconsistent treatment attributable to the two different definitions. See, e.g., Technical Advice Memorandum 7921017:

> The definition of a gift for gift tax purposes is not dependent upon donative intent or the common law concept of a gift. The definition is based upon whether consideration in money's worth is received by the transferor when the property is transferred. This definition is substantially different from the one applied to the income tax concept of a gift, namely, whether the transfer is primarily motivated by the donative intent of the transferor.

Fared-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947) (a sale to a transferee for income tax basis determination purposes was a gift for the transferor's gift tax purposes); Getty v. Commissioner, 91 T.C. 160 (1988), rev'd, 913 F.2d 1486 (9th Cir. 1990) (a lump sum settlement paid to a child of the decedent by the residuary beneficiary of the decedent's estate, against whom the child had brought suit, was taxable income under §102(b) because it replaced taxable income the child would have received from the decedent; reversal was based on a determination that the Tax Court's factual determination about the nature of the payment was in error).

12. See §2512(b) and Treas. Reg. §§25.0-1(b); 25.2501-1(a)(1); 25.2511-2(b). The full and adequate consideration element is really a subset of the valuation rules.

often are the most significant issues and that may present the most attractive reasons to engage in inter vivos planning.

Before undertaking this journey, however, consider one additional introductory notion. The prospect of making inter vivos transfers based on known and reliable tax consequences to accomplish desirable long-term results is troubled by the fact that change is the only constant in this area of the tax law. If a taxpayer engages in a transaction based on the current state of the law, one persistent consideration must be whether Congress will change the rules in such a manner as to negate the taxpayer's reliance.

There also is the possibility that Congress may freeze the phase in to repeal in 2010, or even accelerate that change, and then there is concern about whether sunset of the repeal in 2011 will occur. Few observers believe that repeal and restoration of the estate and gift taxes both will occur, but it is pure speculation whether Congress is more likely to repeal the repeal, or eliminate the repeal of the repeal. Thus, those who can delay making taxable transfers might be well advised to avoid incurring these taxes entirely. The latter is a notion about which anyone foolish enough can speculate.[13]

Note that a gift tax may not be payable even if a transfer meets the definition of a taxable gift for federal gift tax purposes. Transfers that do not require a tax payment are discussed first because frequently they are the most appealing forms of inter vivos planning, and likely will be more so if repeal of the estate tax seems likely — because there is little value in paying gift tax if there is no estate tax to be avoided by early payment.

Exclusions and Exceptions

One form of transfer is excepted from gift taxation notwithstanding that it meets the technical definition of a gift (it was a voluntary transfer for less than full and adequate consideration). The "business transaction" exception protects such transfers from taxation if they are not meant to be gratuitous; instead, they merely represent bad business bargains. Thus, a transfer that is "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), [is] considered as made for an adequate and full consideration in money or money's worth" and therefore does not constitute a taxable gift. Treas. Reg. §25.2512-8.

By way of example, a purchaser of a used car who pays too much does not make a gift of the amount paid in excess of the fair market value of the automobile, unless the seller is a natural object of the buyer's bounty and the excess payment is motivated by donative intent in a less than arm's length transaction. This subjective test is the only place in the gift tax in which motive or intent is relevant to the evaluation of whether a gift was made. Otherwise any shortfall from full and adequate consideration is a gift.

13. This topic is much talked about, sometimes with prescience but usually just with a political agenda or prejudice. The prospect of repeal is tortured even now that Congress has spoken. For one fool's crystal ball gazing, see Pennell, Repeal? The Wealth Transfer Taxes?, 138 Trusts & Estates 52 (Jan. 1999).

The existence of a family relation between the parties normally is an indication that the exception cannot apply, although that relation will not necessarily defeat qualification for the business transaction exception.

Certain additional inter vivos transfers are excluded entirely from the gift tax calculation. These transfers constitute otherwise taxable gifts but they qualify for either the §2503(b) annual exclusion or the §2503(e) education or medical expense (ed/med) exclusion. As such, they do not exhaust any of the donor's unified credit and do not increase the tax base upon which the tax is determined for subsequent taxable transfers.

Annual Exclusion

12,000 in 2006 + 2007

If a transfer constitutes a "present interest" in property, the transferor may exclude gifts of up to $11,000 (plus an inflation index amount) per donee, per year, made to as many separate individual donees as the transferor chooses. These annual exclusion gifts are entirely gift tax free under §2503(b)(2). They don't eat into the gift tax applicable exclusion amount, they are not included in the adjusted taxable gifts base to compute future gift tax or estate tax at death, they don't even need to be reported on a gift tax return. This is not a deduction; it is an exclusion. These transfers just don't "count," they are not recorded, they slip totally below the radar. But not without some qualification requirements.

Stopped Here

For example, the regulations reflect the §2503(b) parenthetical denial of the annual exclusion for gifts of "future interests in property" and refer to a qualifying present interest as "[a]n 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. §2503-3(b). Only present interests qualify. A future interest is a legal concept that includes "reversions, remainders, and other interests or estates, whether vested or contingent, . . . limited to commence in use, possession, or enjoyment at some future date or time." Treas. Reg. §25.2503-3(a). But for annual exclusion purposes this disqualification is broader than the legal terminology might suggest.

Examples of interests that appear to qualify as present interests but that may not be excluded from the gift tax under §2503(b) are interests that do not guarantee to any particular beneficiary any specific entitlement or enjoyment, typically due to trustee discretion. For instance, Treas. Reg. §25.2503-3(c) Example (3) posits a trustee that must distribute all trust income annually but has discretion to distribute that income among a class of beneficiaries, no one of whom is entitled to receive any distribution during any given year. The regulation concludes that no beneficiary of that trust has an interest that can be presently ascertained. Therefore, no annual exclusions are available with respect to transfers to that trust.

With respect to partial qualification for the annual exclusion, if income from a trust (or other transfer) is payable to a designated beneficiary and that income entitlement can be valued, the income interest alone may constitute a present interest and the value of that entitlement alone may qualify for the annual exclusion. This is true even if other elements of the trust (or other transfer) do not qualify. Such an income interest may qualify notwithstanding a spendthrift provision prohibiting the beneficiary from alienating, assigning, or otherwise anticipating the income, and even if the trustee has the power to distribute principal to the income beneficiary. Treas. Reg. §25.2503-3(b). But a trustee's power to divert income producing principal to a third party will preclude qualification of an income interest. Further, interests that entitle the beneficiary to present enjoyment of an identifiable portion of the income of a trust (or other transfer) will not qualify if the underlying assets are such that there is no guarantee that any present income will be generated.

Hackl v. Commissioner, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003), is a fine illustration of the present enjoyment requisite not involving a trust, holding that transferred interests in a limited liability company did not afford a substantial current economic benefit. Indeed, because the asset involved (a newly reforested timber plantation) was not likely to produce any income for quite some time, it was critically important that the court also found that the operating agreement foreclosed the donees' ability to presently access any substantial economic or financial benefit. This was because the agreement also precluded any transfer of the gifted units to third parties and therefore barred alienation as a means of reaching any present economic value. Therefore, the court disallowed annual exclusions for transfers of these interests.

A further example of transfers that cannot qualify for the annual exclusion because they are not present interests would be a transfer for less than full and adequate consideration in money or money's worth to an entity, such as a corporation. These transfers may fail to qualify as gifts of present interests if the real parties in interest are individuals (such as shareholders in the corporation) who cannot immediately benefit from the transfer. As articulated by Rev. Rul. 71-443, the logic for denial of the annual exclusion in such cases is that:

> Shareholders of [a] corporation do not have any present or immediate right to use, possess, or enjoy the donated property or the income from the property. This they can do only upon liquidation of the corporation or declaration of dividends, the first of which usually requires approval by the owners of a majority of the stock, and both of which usually require approval by a majority of the corporation's directors.

Crummey Withdrawal Power

Often the present interest requirement is satisfied by granting a beneficiary an immediate, albeit limited, power to obtain possession of transferred property, typically through exercise of a withdrawal power (referred to as a Crummey power after the decision in Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), which concluded that the power of withdrawal constituted a transfer as immediately available to the powerholder and therefore qualified as a present interest for annual exclusion purposes).

A spate of rulings and a series of cases reveal the government's antipathy to this planning, and periodic proposals for law reform would negate this planning opportunity, all of which *confirms* that the Crummey power can be a very useful device. Thus, notwithstanding the government's dislike for its use, and the potential for its repeal or alteration in the future, the Crummey power is one of the most used and useful planning devices in the current arsenal of most estate planners.

A Crummey power of withdrawal authorizes beneficiaries to withdraw property transferred to a trust that otherwise would not satisfy the annual exclusion present interest requirement. See Chapter 19 at page 40 for an illustration. The donor's contributions to the trust constitute gifts of a present interest to the powerholder to the extent of this power of withdrawal. As a result, those contributions are not precluded from qualifying for the annual exclusion by the present interest requirement or the future interest prohibition.

Most often the power of withdrawal lapses if it is not exercised within a certain time period. Because the lapse is a potentially taxable event to the powerholder under §2514, the most common form of this planning limits the power itself (or the amount as to which the lapse occurs) to the greater of 5% of the value of the trust or $5,000, so as to fit within the exceptions and avoid gift tax liability to the donee under §§2514(e) and 2041(b)(2). If no withdrawal is made, these rules specify that lapse of the power is not treated as a gift by the powerholder and, when the powerholder dies, the lapsed property is not includible in the powerholder's gross estate for federal estate tax purposes. Only any amount subject to a nonlapsed power of withdrawal still available at the date of death would be subject to estate tax, under §2041(a)(2).

explain & review 5 x 5 rule

In almost all cases it is expected that the powerholder will not exercise the power. Thus, it is expected that the full contribution will remain subject to trust terms that do not otherwise satisfy the present interest requirement. Nevertheless, the ability to withdraw, even for only a limited term and even if not exercised, is regarded as adequate to qualify for the annual exclusion. This is true even if the powerholder with the withdrawal right is a minor, unable under local law to exercise the power, provided that there is no impediment to appointment of a legal guardian who could exercise the power of withdrawal on the minor's behalf. This is such a well accepted estate planning principle that the government in no way challenges the initial proposition any longer.

Notice and Timing

Until the government promulgated Rev. Rul. 81-7, there was little assurance that a powerholder would either know about the Crummey power to withdraw or have a sufficient opportunity to exercise the power with respect to contributions made late in the year in which withdrawal was permitted. The subject trust in the Ruling gave an adult beneficiary a noncumulative power of withdrawal that lapsed at year end, which was two days after the trust was established. Moreover, the beneficiary was not informed of the withdrawal right with regard to the initial contribution to the trust before that right lapsed. Not unexpectedly, the Ruling concluded that the beneficiary's power to withdraw did not create a present interest with respect to the initial contribution to the trust, because the timing and lack of notice made it illusory.

Subsequently, Rev. Rul. 83-108 announced that the annual exclusion *will* be available if an adequate notice and time for withdrawal exist. Subsequent pronouncements reveal that 30 days is an ample window within which to exercise a withdrawal right before its lapse and at least one notable case has allowed the exclusion with a 15 day withdrawal window.[14]

Caution must be exercised to ensure that several years' withdrawal rights do not inadvertently lapse in a single calendar year, in amounts causing unexpected §2514(e) consequences to the powerholder. For planning purposes like this, and to guarantee that the annual exclusion opportunity is not lost for any year, normally it is preferable to take advantage of annual exclusion giving early in a new year rather than waiting until the final moment.

Another interesting question is whether notice of each year's withdrawal right must be given. Many donors and trustees fail to actually notify the Crummey powerholders of their entitlement as transfers to a trust are made (or, at a minimum, they are unable to prove that the notice was given or that the beneficiary otherwise knew of the entitlement). All sorts of practices are employed to minimize the administrative hassle of giving notice on a periodic basis. One approach is to give one notice to the powerholder that recurring contributions will be made and that withdrawal powers will be available with respect to each of those transfers, with the notion being that the notice is an ongoing information until the powerholder is informed otherwise. Another is waiver by the powerholder of the right to receive future notices. In Technical Advice Memorandum 9532001 the government opined that:

> Without the current notice that a gift is being transferred, it is not possible for a donee to have the real and immediate benefit of the gift. The immediate use, possession, or enjoyment of property is clearly restricted if the donee does not know of its existence. Accordingly, a donee must have current notice of any gift in order for that gift to be a transfer of a present interest.

14. Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), acq. in result only, a reviewed opinion with no dissent. The time period issue was not central to the government's challenge to the exclusion, and the timing aspect of *Cristofani* is not relied upon by careful planners.

Without present interest status, the contribution will not qualify for the annual exclusion, resulting in gift tax and frustrating the donor's most fundamental purpose.

On the other hand, a number of authorities hold that the annual exclusion is available if actual knowledge existed, even if no formal notice was sent to the powerholder. For example, notice would be assumed if the powerholder also was a trustee of a trust granting the right of withdrawal, or if the donor also was the legal guardian of the powerholder.[15] Nevertheless, the better practice probably leaves nothing to chance in this important planning arena and seeks to have written confirmation from each powerholder that actual notice was timely given as to each withdrawal power that the powerholder allows to lapse (the exercised powers being rare but also obvious and not an abuse in the government's eyes).

In this respect it also is critical to remember that §2514(e) is a safe harbor only if a power lapses by its own terms and *not* if the powerholder *releases* the power. Thus, it is not wise for the powerholder to acknowledge receipt of the notice and state an affirmative intent to not exercise the withdrawal power. Instead, the powerholder should let the power lapse on its own terms due to a failure to exercise the power.

Contingent Beneficiaries

The last comment reveals a reality that makes the government crazy. No one expects the powerholder to exercise the withdrawal right, and seldom is that expectation defeated — and certainly not more than once! Indeed, often the desire is to make a transfer that exceeds the amount of a single gift tax annual exclusion but nevertheless avoids gift tax to the donor and to beneficiaries to whom withdrawal rights are given (which requires that the lapse of these Crummey rights not exceed the §2514(e) five or five limitation in any given year). To accomplish this, donors sometimes grant withdrawal rights to many more individuals than the primary beneficiaries of an intended transfer.

For example, it is not uncommon to grant powers to withdraw the greater of $5,000 or 5% of the value of the trust to every descendant of the donor, and their spouses, all with the expectation that none of these beneficiaries (primary or much more remote) will exercise their rights of

15. Estate of Holland v. Commissioner, 73 T.C.M. (CCH) 3236 (1997) (the court refused to disallow the annual exclusion notwithstanding that notice of withdrawal powers never was given, because testimony indicated that adult beneficiaries knew of the powers on their own behalf and that the trustees also were guardians of the minor beneficiaries); Private Letter Ruling 8022048 ("in your dual capacity as donor and natural guardian, you possess actual knowledge of the legal right to withdraw trust property you have contributed"); Private Letter Ruling 9030005 (no actual notice need be given to a minor powerholder if the minor's parent is trustee of the trust granting the power, is another beneficiary of the trust, and is the child's natural guardian; as beneficiary the parent would receive notice both personally and on behalf of the minor and, although the Ruling did not so hold, it ought to be the case that being a trustee *or* a beneficiary as well as the guardian should suffice if in either capacity the parent is aware of the minor's withdrawal right with respect to any contribution made to the trust).

withdrawal. In the pejorative, these rights in nonprimary beneficiaries are regarded as "dummy Crummey" rights because neither the powerholders nor the donor really regard them as a legitimate entitlement; they are a device to shelter a large transfer with annual exclusions.

The government understands this use of Crummey powers and regards the dummy Crummey technique as an abuse. Thus, it has attempted through a series of Technical Advice Memoranda and a string of cases to deny the effect of Crummey powers of withdrawal in certain individuals whom it regards as not having legitimate interests in the subject property.

The government is correct in noting that drafters of trusts such as these assume that the withdrawal rights will not be exercised (especially in irrevocable life insurance trusts in which the annual contributions being sheltered by the annual exclusion through the Crummey withdrawal rights technique will be used by the trustee to pay insurance policy premiums). Nevertheless, intent is not a relevant factor in qualifying for the §2503(b) annual exclusion. And notwithstanding that most attorneys who draft Crummey withdrawal rights concede that they create a fictional present interest (because the likelihood of an actual withdrawal is slight), the Tax Court has not embraced the government's objection.

Thus, for example, *Cristofani* held that the government's challenge was meritless because *Crummey* did not require trust beneficiaries to receive vested present or remainder interests in either trust corpus or income to qualify for the annual exclusion:

> As discussed in *Crummey*, the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment. . . . Based upon the language of the trust instrument and stipulations of the parties, we believe that each grandchild possessed the legal right to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand. We note that there was no agreement or understanding between decedent, the trustees, and the beneficiaries that the grandchildren would not exercise their withdrawal rights following a contribution to the . . . trust.

97 T.C. at 83. The court could not have more directly rejected the government's notion that intent should be relevant for §2503(b) annual exclusion purposes.

Nevertheless, the government announced in Action on Decision 1996-010 that it "will deny the exclusions for *Crummey* powers, regardless of the power holder's other interests in the trust, where the . . . facts indicate that the substance of the transfers was merely to obtain annual exclusions and that no bona fide gift of a present interest was intended." Almost simultaneously Technical Advice Memorandum 9628004 became public, dealing with the same issue and announcing that:

> where nominal beneficiaries enjoy only discretionary income interests, remote contingent rights to the remainder, or no rights whatsoever in the income or remainder, their nonexercise [of withdrawal rights] indicates that there was some kind of prearranged understanding with the donor that these rights were not meant to be exercised or that their exercise would result in undesirable consequences, or both.

Based on the reality that "[n]one of the rights were ever exercised, even by those who had no other interests in the trusts," the government denied annual exclusions for those withdrawal rights, stating that:

> we conclude that as part of a prearranged understanding, all of the beneficiaries knew that their rights were paper rights only, or that exercising them would result in unfavorable consequences. There is no other logical reason why these individuals would choose not to withdraw $10,000 [the then annual exclusion amount] a year as a gift which would not be includible in their income or subject the Donor to the gift tax.

At the same time, however, the Memorandum stated that:

> The Service generally does not contest annual gift tax exclusions for Crummey powers held by current income beneficiaries and persons with vested remainder interests. These individuals have current or long term economic interests in the trust and in the value of the corpus. It is understandable that in weighing these interests, they decide not to exercise their withdrawal rights.

The logical expectation, therefore, is that the government will challenge the annual exclusion on a selective basis in only the most egregious cases that it hopes even the Tax Court can agree are over the edge.

Other Forms of Artifice

On occasion taxpayers have engaged in other thinly disguised artifices designed to increase the number of annual exclusions available in any given year. One recurring theme involves family members, business partners, or other close and reliable associates who employ reciprocal transfers. To illustrate, siblings A and B might each make annual exclusion gifts to their own children and to their nieces and nephews. Thus, sibling A would give the annual exclusion amount to each of A's two children and to each of B's three children, and B would give the same annual exclusion amount to each of sibling B's three children and to each of A's two children. A and B each claim five annual exclusions for gifts to the five children of A and B. Predictably, the government's conclusion is that the "reciprocal trust doctrine" properly applies to regard each sibling as making gifts of twice the annual exclusion amount to each of their own children (which exceed the annual exclusion limits for the year) and none to the sibling's children. In the overall picture, the substance of the reciprocal trust doctrine and its application clearly is correct.

A variation on this theme might entail business partners A, B, and C, who each create a trust for the benefit of their respective children, with each giving the beneficiary a Crummey power of withdrawal and each giving the other two partners a withdrawal power as well. The government would allow the annual exclusion with respect to each partner's own children, but not with respect to each partner's withdrawal powers. As a result, the respective transfers among the partners would net out because the reciprocal withdrawal rights represent gifts to each other partner, matched by the same gifts from those other partners. The effect is that no partner would be deemed to make a gift to any other partner and the amounts not subject to withdrawal by a child would be taxable gifts to the trusts that do not otherwise qualify as present interests for annual exclusion purposes.

A final obvious artifice involved a donor who attempted to manufacture additional gifting opportunities for annual exclusion purposes by giving stock to 29 individuals (many subordinates or employees of the donor), all in amounts sheltered by the annual exclusion. All but two of these donees immediately endorsed the stock they received in blank; those shares subsequently were reissued in the names of various members of the donor's family. According to Heyen v. United States, 945 F.2d 359 (10th Cir. 1991), the 27 purported donees ignorantly believed they were merely participating in stock transfers or they intentionally agreed before receiving the stock that they would endorse the certificates in furtherance of the donor's scheme. Either way, the court agreed with the government's characterization of the transaction as tax fraud and upheld the imposition of a fraud penalty. Obviously, then, as powerful as the annual exclusion is, a more legitimate mechanism than this is needed to take maximum legitimate advantage of the exclusion.

Hanging Powers

Unlike the foregoing approaches, the "hanging" power illustrated with a numerical example in Chapter 9 at pages 53-54 is regarded as an effective method of maximizing the annual exclusion opportunity presented by the use of Crummey withdrawal powers while not exceeding the §2514(e) safe harbor for tax free lapse of these powers. With a proper formulation, contributions may be made excludible in whole by a properly engineered collection of withdrawal rights, without resorting to techniques that are likely to be challenged by the government.

The problem facing many planners is that the per donee annual exclusion is greater than the amount as to which any donee may have a withdrawal power that lapses with no gift tax or subsequent estate tax liability. This is because lapse of a withdrawal power is harmless to the powerholder only to the extent protected by the $5,000 or 5% exception of

§2514(e). Thus, to take maximum advantage of the $11,000 (plus inflation index amount) annual exclusion without causing any gift tax exposure to the beneficiary if the power of withdrawal lapses (which is expected), many planners permit contributions in excess of the five or five exception and rely on a nonlapsing power of withdrawal to preclude immediate wealth transfer taxation to the powerholder.

As an alternative, the power could lapse with respect to the entire contribution amount, but the beneficiary would retain a testamentary power to appoint the amount that exceeds the five or five limitation. That testamentary power would make the lapse an incomplete transfer that avoids gift taxation, but instead there would be estate taxation at the powerholder's death. In whatever format it is used, this hanging power can lapse in subsequent years to the extent those subsequent lapses are tax free under §2514(e). The hope is that all of the hanging power can lapse out before the beneficiary dies. Notwithstanding use of such hanging powers for many years, there appears to be no authority testing the underlying premises or effect of this planning.

Multiple Powers

Also notable in designing a beneficiary's hanging power of withdrawal for Crummey power purposes is Rev. Rul. 85-88, which considered application of the five or five exception in the context of withdrawal rights in multiple trusts, or multiple withdrawal rights in a single trust. For example, a person might possess two separate $5,000 or 5% withdrawal powers created by the same donor in two separate trusts, or two such powers created by contributions to the same trust by two separate donors.

In each case a taxable gift will result if the beneficiary allows the multiple withdrawal rights to lapse in a single year unless an appropriate hanging power or testamentary power applies. The taxable gift results because the Ruling appropriately limits to one the number of $5,000 withdrawal rights that can be made available to any one beneficiary. The Ruling did not need to restrict application of the 5% lapse rule under §2514(e) because the 5% test properly is based on the value of total trust assets subject to the withdrawal right at the time of lapse. Thus, if the donee has multiple withdrawal rights in a single trust, the 5% test is based on "the maximum amount subject to the donee's withdrawal power *on the date of lapse of any such power* during the calendar year." As regards multiple withdrawal rights in separate trusts (regardless of their settlor(s)), the 5% test is applied by *aggregating* the amount subject to the power in each trust, determined in the same manner.

As an example that informs the need to know how many trusts (created by the same or different donors) grant the same beneficiary five or five withdrawal rights, the Ruling assumed withdrawal rights in each of two trusts, one of $300,000 and one of $400,000, and determined that the 5% test would be applied against the aggregate value of $700,000. Thus, the 5% exception under §2514(e) would be an aggregate $35,000 for the year.

Generation-Skipping Transfer Tax

Additional tax consequences to the powerholder relate to the generation-skipping transfer tax, and to income taxes. Giving skip persons Crummey withdrawal rights constitutes a direct skip for generation-skipping transfer tax purposes. These contributions are harmless (they qualify for inclusion-ratio-of-zero treatment under §2642(c)) if separate shares are created for each beneficiary. Otherwise they can incur generation-skipping transfer tax even though they qualify for the gift tax annual exclusion. See Chapter 18 at pages 34-35.

The other generation-skipping transfer tax consequence of the lapsing power is that the powerholder becomes the transferor of the trust for subsequent generation-skipping transfer tax purposes to the extent any lapse is gift taxable. New transferor treatment is important because of exemption allocation and generation assignment issues, but it is avoided to the extent lapse is tax free under the five or five provisions of §2514(e). See Treas. Reg. §§26.2601-1(b)(1)(v)(A) (penultimate sentence) and 26.2652-1(a)(5) Example 5.

Pseudo Grantor Trust Status

This new transferor treatment is mirrored and enlarged upon for §678 income tax purposes, which provides that a beneficiary who allows a Crummey power of withdrawal to lapse becomes a grantor of the full lapsed amount in the trust for future income tax purposes. This treatment applies to the entire lapse amount, not just the amount in excess of the §2514(e) five or five exception, and is avoided only to the extent the trust's original settlor retains an interest or power that causes overriding grantor trust income tax liability.

The powerholder is treated as the owner of a portion of the trust in the year the power is exercisable, and lapse of the withdrawal power is tantamount to a release for purposes of §678(a)(2). If the powerholder is entitled to trust income in future years, this release generates grantor trust exposure for the duration of the trust. This means that a portion of trust income is taxable to the powerholder every subsequent year. That often upsets individuals who do not receive the dollars on which they must pay income tax, and this exposure increases every time a withdrawal power lapses. Thus, the government will not treat a new lapse as occurring with respect to the same five or five portion every year. Instead, the increase in the portion subject to grantor trust treatment attributable to a new lapse is computed according to a formula:

$$\text{Increase} = \text{withdrawable amount} \times \frac{\text{trust portion not yet owned}}{\text{total trust corpus}}$$

Subsequent distributions to the powerholder from the trust are deemed to come proportionately from the owned portion and from the balance of the trust.

To illustrate the computation, assume the powerholder may withdraw 5% of the trust corpus every year. In year 1 the owned portion would be $5\% \times 100\% \div 100\% = 5\%$. The year 2 increase would be $5\% \times 95\% \div 100\% = 4.75\%$, and a total of 9.75% would be deemed owned by the powerholder. The year 3 increase would be $5\% \times 90.25\% \div 100\% = 4.5125\%$, and a total of 14.2625% would be deemed owned by the powerholder. The year 4 increase would be 4.286875%, and the owned portion would increase to 18.549375%, and so on. Under this approach, the trust never would become totally owned, no matter how long the withdrawal power existed and lapsed, although the owned portion eventually would approach 100%. The government's computation is equitable but complicated, and underscores the notion that the lapse of a five or five withdrawal power is not harmless for income tax purposes the way it appears to be under §2514(e) for most wealth transfer tax purposes.

Qualified Minor's Trusts

Some transfers, typically in trust, that otherwise would not meet the annual exclusion present interest requirement nevertheless qualify for the annual exclusion because of a special exception for "qualified minor's trusts" in §2503(c). This tool is important because gifts to minors that take advantage of the gift tax annual exclusion may be a significant component of any comprehensive estate plan. And the dollar amounts involved may exceed the amount the donor (or the donee's parents) would want the minor to control at a tender age.

The subject matter of an annual exclusion gift may be transferred directly to a minor and qualify for the annual exclusion notwithstanding that the minor does not have legal capacity to deal with the transferred property and even if no legal guardian has been appointed. Legal incapacity has certain implicit protections against loss or mismanagement by the minor, but Congress recognized that the inherent disadvantages of transferring property outright to a minor make this an undesirable mechanism to take advantage of the annual exclusion. So Congress enacted §2503(c), which deems that a transfer creates a present interest in a minor beneficiary if the principal and income[16] of the gifted property may be expended by or for the benefit of a beneficiary who has not attained 21 years of age.

also, §509 please See p. 24

In addition, any unexpended principal and accumulated income must be subject to the beneficiary's control when the beneficiary attains age 21, or it must be distributed to the beneficiary's estate or be subject to the beneficiary's general power of appointment if the beneficiary dies before reaching that age. In many cases the power of appointment is the preferable alternative. This will be true especially if the donor is a potential heir of the beneficiary. In such a case, trust property that is payable to the beneficiary's estate if the beneficiary dies before reaching 21 years of age

16. Unlike the annual exclusion present interest requirement, there is no §2503(c) requirement that the trust property be income producing.

may pass back to the donor, who typically does not want to receive by inheritance any of the property the donor was seeking to remove from the donor's estate through annual exclusion gifts.

Because the beneficiary cannot make a will in most states until reaching a certain age, this possible inheritance is not avoidable if the trust provides for payment to the beneficiary's estate and the beneficiary dies before reaching that age. For this reason, it typically is preferable to provide that the trust property will pass as the beneficiary appoints pursuant to a general inter vivos or testamentary power of appointment.[17] This trust will qualify under §2503(c) notwithstanding that the beneficiary also may be unable due to age to exercise the power of appointment (and, thus, that the property will pass to designated default beneficiaries other than the donor).[18]

An income interest or other less than fee simple interest in such a trust also may qualify for the §2503(c) annual exclusion. For example, imagine a trust to pay income to a minor beneficiary for life, perhaps granting the trustee discretion to distribute trust corpus to the beneficiary, but reserving the remainder after the minor's death for other designated beneficiaries. Just the value of the life estate in such a trust standing alone qualifies for the annual exclusion. As another alternative, it is permissible to provide the beneficiary with a limited window of opportunity to withdraw the trust corpus upon reaching the age of 21 and, to the extent the power of withdrawal is not exercised, to provide after the time window has closed that the trust will continue until a later date.[19] As with a lapsed Crummey power of withdrawal, the trust will be regarded as the beneficiary's property for income and wealth transfer tax purposes following the lapse of such a power, and it too will qualify for the annual exclusion.

In lieu of drafting and administering separate trusts for minor beneficiaries (or a single trust with separate shares), a donor may wish to take advantage of the fact that every American jurisdiction has enacted custodianship legislation, usually modeled after the Uniform Gifts to

17. Under Treas. Reg. §25.2503-4(b) the general power may be exercisable by deed or by will or by either. It may be advisable to require its execution with all the formalities of a will to limit the possibility of inadvertent exercise by inter vivos document.

18. Treas. Reg. §25.2503-4(b) requires that there be no substantial restrictions on exercise of the power by the beneficiary but provides that restrictions under controlling local law that preclude the beneficiary from exercising the power do not prevent the power from satisfying this requirement.

19. See Rev. Rul. 74-43:

> a gift to a minor in trust, with provision that the beneficiary has, upon reaching age 21, either (1) a continuing right to compel immediate distribution of the trust corpus by giving written notice to the trustee, or to permit the trust to continue by its own terms, or (2) a right during a limited period to compel immediate distribution of the trust corpus by giving written notice to the trustee which if not exercised will permit the trust to continue by its own terms, will not be considered to be the gift of a future interest as the gift satisfies the requirements of section 2503(c) of the Code, and the exclusion provided for in section 2503(b) is allowable.

Parameters such as those informing the validity of Crummey withdrawal powers probably are adequate.

Minors Act or its more recent replacement, the Uniform Transfers to Minors Act. These custodial arrangements qualify under §2503(c) and permit a donor to transfer property to a custodian for the benefit of a minor. That account usually is retained until the custodianship must terminate, typically at the beneficiary's age of 18 or 21 years (or the minor's death), at which time the property is distributable to the minor (or to the minor's estate).

Custodianships offer a convenient and inexpensive mechanism for making gifts to minors that qualify under §2503(c) and, until termination, protect against the hazards of an outright transfer. Nevertheless, certain cautions must be exercised. For example, the statutory provisions governing the account cannot be changed. Thus, a distribution to the beneficiary's estate and potential distribution back to the donor cannot be prevented.

More importantly, the government asserts that the value of custodianship property is includible in a donor's gross estate under §2038 if the donor dies while serving as the custodian, because the donor's powers are deemed to be retained powers over the gifted property.[20] Unfortunately, this estate tax exposure cannot easily be avoided by a donor who wants to maintain control over the gift. For example, the reciprocal transfers doctrine prevents avoidance of this exposure by merely employing reciprocal transfers by which one parent acts as fiduciary of accounts created by the other and vice versa.[21]

Similarly, the government has asserted §2036(a)(1) indirect retained beneficial ownership and §2041(a)(2) general power of appointment inclusion with respect to any donor or any third party acting as trustee or custodian over assets held for their own dependents. In each case the government's theory is that the donor or the fiduciary is the indirect beneficiary of funds that may be used to support or maintain a person the donor or the fiduciary is legally obligated to support or maintain.[22] As discussed in Chapter 5 at page 26, this discharge of obligation of support theory is significantly misunderstood and not supportable under the law of most states, but it never has been challenged.

20. Treas. Reg. §20.2038-1(a); Rev. Rul. 59-357, and Rev. Rul. 57-366, based on Lober v. United States, 346 U.S. 335 (1953).

21. See Exchange Bank & Trust Co. v. United States, 82-1 U.S. Tax Cas. (CCH) ¶13,444 (Ct. Cl. 1981), aff'd, 694 F.2d 1261, 1269 (Fed. Cir. 1982), in which spouses each transferred assets under custodianships for their children. To the extent the husband was the donor the wife was named as custodian, and to the extent the wife was the donor the husband was named as custodian. The husband died while several of the children were under 21 years of age, and the court held that assets held by the husband as custodian, which were transferred by his wife, were includible in the husband's gross estate as they would have been if he had been the transferor, under an application of the reciprocal trust doctrine: "The fact that the focus in this case is upon crossed custodianships rather than crossed trusts offers no basis for denying the application of the reciprocal trust doctrine." The court on appeal concluded "that the reciprocal trust doctrine should be applied to uncross the custodianships because the transfers were interrelated, and because the arrangements left the donors in the same economic positions as they would have been in had they retained the property as custodians under the Florida Gifts to Minors Act."

22. See Treas. Reg. §§20.2036-1(b)(2), 20.2041-1(c)(1).

Although the theory upon which the government's discharge theory rests is wrong, and trust or custodianship assets should not be included in the parent's gross estate, naming a parent as fiduciary in these cases may be begging for a controversy that it would be better to avoid. Alternatively, a provision precluding the use of assets in a way that may discharge a support obligation is wise drafting to guard against either §2036 or §2041 exposure (but note that Uniform Act accounts cannot be amended to make such a change).

The addition of language to a §2503(c) trust prohibiting distributions that might be deemed to discharge or satisfy any person's legal obligation to support or maintain a minor beneficiary will not cause the trust to fail the Treas. Reg. §25.2503-4(b)(1) requirement that there be no substantial restriction on the provision of benefits in a §2503(c) account for the minor beneficiary. Such a prohibition, sometimes referred to as an "Upjohn" clause,[23] "does not in any way impair but, rather, insulates the minor beneficiaries' present interest in the trust contributions. The trustee is empowered to distribute all or any part of these funds for any purpose and toward any end not already provided by law."

The government suggested that the restriction might be substantial if the settlors were not financially able to fulfill their legal obligations to the beneficiary. The *Upjohn* court rejected this notion because the settlors' financial condition made this possibility remote. In addition, under state law, the settlors' legal obligation would decline with any diminution in their financial resources, which would release the trustee from the restriction against expending funds for the beneficiary.

Although not articulated by the court, no distribution made by the trust would run afoul of the prohibition if state law provides that a parent's legal obligation is not discharged or satisfied by trust distributions. In that respect, the proscription on the trustee is meaningful only in that it blocks the government's improper discharge of obligation argument and does not impair the fiduciary or violate the substantial restriction prohibition.

Ed/Med Exclusion

In addition to the §2503(b) annual exclusion and §2503(c) qualified minor's trust version of it, §2503(e) allows an unlimited exclusion for amounts properly paid for the education or medical expenses of any person.[24] Qualified transfers include amounts paid for tuition of full or part time students (but not for ancillary expenses such as room and board, books, and fees. Treas. Reg. §25.2503-6(a)(2)). Medical expenses are more

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23. So named after Upjohn v. United States, 72-2 U.S. Tax Cas. (CCH) ¶12,888 at 86,077-86,078 (W.D. Mich. 1972) (provision that "no income or principal shall be paid, distributed or applied for support or maintenance which the settlors or either of them are legally obligated to provide a beneficiary, nor to defray any legal obligation of the settlors or either of them" did not preclude §2503(c) qualification).

24. As with §2503(b), payments meeting the §2503(e) requirements may be shielded from generation-skipping transfer taxation by §2642(c)(3)(B) if its requirements are met.

broadly defined to include costs for "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." Treas. Reg. §25.2503-6(a)(3). Not covered, however, are amounts paid for expenses that are reimbursed by insurance or amounts paid for medical insurance for any individual.

Both the education and medical expense payments must be made directly to the education or medical service provider. Payments that reimburse the donee do *not* qualify. §2503(e)(2); Treas. Reg. §25.2503-6(c) Examples (2) and (4). For example, a deposit in a student's checking account to cover a check from the student to the university for tuition will not qualify; the donor must pay that amount directly to the university bursar. Similarly regarding medical expenses, any items paid by the donee for which the donor provided reimbursement also would be subject to gift tax. Further, a transfer to a trust for the ultimate payment of tuition charged by an educational institution is not a qualified tuition payment that would be excluded from the gift tax under §2503(e), because the qualifying transfer must be directly to a qualifying educational organization. Treas. Reg. §25.2503-6(c) Example (2).

Donors who do not want to transfer funds directly to an educational institution but who are considering a gift designed to further the education of a donee may wish to consult §529, which provides an income tax exemption for qualified state tuition programs. For gift tax purposes, §§529(c)(2), 529(c)(4), and 529(c)(5) provide that contributions to these programs are completed gifts for gift tax purposes, with present interest §2503(b) gift tax and §2642(c) generation-skipping transfer tax annual exclusion (but not §2503(e) ed/med exclusion) qualification. There is even a special five year ratable carry forward provision if the contribution exceeds the donor's annual exclusion limitation for the year of contribution.[25] Most importantly, distributions from the plan may be used for §529(e)(3)(A) qualified higher education expenses, which are more than just tuition and fees (such as for room, board, books, and other required expenses), and they are not gifts to the beneficiary (nor is a change of beneficiary usually taxable). These trusts provide a convenient form of transfer, with no income tax to the designated beneficiary and automatic qualification for the §2503(b) gift tax annual exclusion.

Other options include gift to minors act accounts and prepaid tuition plans.[26] The list of available options is rapidly changing and advisors can only help to evaluate various criteria that may be useful or important to a

25. With estate tax inclusion to the donor under §529(c)(4)(C) to "recapture" any outstanding carry forward amount if death occurs within the five year carry forward period.

26. Another potential income tax opportunity is §135, which permits the payment of qualified higher education expenses with United States savings bonds without recognition of any unrealized income in the bond. Unlike §529, there is a graduated reduction in the amount of income that may be excluded under §135, based on the taxpayer's adjusted gross income.

family, including questions of age limitations for contributions and withdrawals, contribution maximums, qualified expenditures, client control over account investments and distributions, spendthrift protections, and both state and federal income, estate, gift, and generation-skipping taxation.

Unified Credit

Any gift tax incurred on a taxable gift exceeding the allowable annual exclusion or the ed/med exclusion may be offset by the unified credit and therefore may not actually be payable. The unified credit is not elective and cannot be reserved for future use. Instead, it is automatic and offsets the tax on the first taxable transfers made by citizens and residents of the United States,[27] up to the gift tax applicable exclusion amount. To the extent it is not used during life, the unified credit remains available at death. There is no need to use it to avoid losing it. Nevertheless, as illustrated at page 8, because the unified credit is a fixed entitlement, the most benefit is garnered the sooner the unified credit is used to transfer property that is expected to appreciate in value in the future.

Gift Splitting

Married United States citizen or resident taxpayers may double the benefit of the unified credit, generation-skipping transfer exemption, or gift tax exclusions available to either of them alone. Authorized by §2513 are gifts made by one spouse that are treated as split equally and made half by each, just by executing the §2513(b) consent. Thus, for example, if a donor has substantial wealth but the donor's spouse has little, one way to take advantage of the spouse's tax benefits would be for the donor to make a taxable gift to third parties and for the spouse to consent to it for gift-splitting purposes. In this manner the donor can transfer double the amount of the transfers either could make alone and can generate effectively the same result as if the donor made a gift to the spouse tax free under the §2523 marital deduction and then each spouse made their own transfers to take advantage of their own benefits.

The advantage of gift splitting is that it does not give control to the donor's spouse or subject the gifted property to creditors of the donor's spouse. In many cases, however, an outright gift to the spouse followed by separate gifts by each may be preferable because gift splitting is an all-or-nothing endeavor. The spouses must make the §2513 election with respect to all gifts made by either of them during any part of the taxable period; spouses cannot elect split gift treatment for only selected gifts during the taxable period. §2513(a)(2); Treas. Reg. §25.2513-1(b)(5). Indeed, gift splitting is effective even with respect to inadvertent or unintended gifts made by either spouse during the election period.

27. Unlike §2101(c), which simply limits the unified credit at death with respect to nonresidents who are not citizens, §2505(a) does not allow the credit at all with respect to United States taxable inter vivos gifts made by nonresidents who are not citizens.

In addition, gift splitting is available only for gifts to donees other than the consenting spouse. Thus, a different approach is required if any portion of a gift benefits the consenting spouse and the value of that interest is not ascertainable (and therefore cannot be evaluated separately or severed). For example, if a donor wishes to establish an inter vivos trust to provide income and principal in the discretion of a disinterested trustee among a group consisting of the consenting spouse and the donor's descendants, no part of that gift could be split by the spouses unless the portion for the donor's spouse could be valued separately from the other interests given. In such a case a separate marital deduction trust for the donor's spouse and another separate trust for the descendants (as to which the spouse could make the gift-splitting election) might be a more appropriate technique. A similar separation might be required if the donor spouse wanted the consenting spouse to have control over the gifted property in the form of a power of appointment.[28]

Finally, you should consider conflict of interest and adequate representation issues when advising the consenting spouse regarding gift splitting. It may be that the §2513 consent is harmless or desirable in a given situation, but consider whether you would give the same advice to consent to split gifts if the donor was represented by someone else. For example, imagine that the marriage was not the first for either and the consenting spouse had natural objects of the bounty who differ from those of the donor spouse. Would you advise the consenting spouse that the donor spouse should compensate the consenting spouse for the use of the consenting spouse's unified credit or generation-skipping transfer exemption (which both are one-time benefits that cannot be replaced after they are used)? Annual exclusion gifts to objects of just the donor's bounty would be different, because the consenting spouse loses nothing by agreeing to split gifts that the consenting spouse otherwise would not make to those individuals. These are renewable and unlimited opportunities. But use of the consenting spouse's unified credit or generation-skipping transfer exemption to shelter gifts to the donor's beneficiaries denies the opportunity to use those benefits for transfers to the consenting spouse's own beneficiaries.

Those tax benefits may not be worth much to a consenting spouse who has little wealth currently, but people inherit, win the lottery, accumulate earnings, and find other ways to acquire wealth. Against that possibility, a separate advisor for the consenting spouse might suggest that the donor should compensate the consenting spouse for the use of the consenting spouse's nonrenewable entitlements. The challenging issue is: What are they worth? For example, should the unified credit be measured in terms of the actual tax offset by a gift taxed at the bottom estate or gift tax brackets, or

28. The express language of §2513(a)(1) denies gift splitting if the consenting spouse has a general power to appoint the gifted property. Apparently a nongeneral power in either spouse will not preclude gift splitting, although the power might cause the gift attributable to the powerholder to be incomplete.

should the cost to the consenting spouse of splitting a gift be measured by the tax that might be incurred at the top marginal brackets that could apply to wealth transfers by the consenting spouse during life or at death? How should the likelihood of acquiring sufficient wealth to take advantage of these tax benefits be factored into the equation? And would a demand for compensation cause such a rift between the donor and consenting spouses that the possibility should not be broached?

These ethical and practical concerns are in addition to several technical flaws in the operation of the gift splitting provision in the context of transfers that are brought back into the donor's gross estate at death. Together they ought to give pause to any advisor who is planning with spouses who make inter vivos transfers. Annual exclusion split gifts are relatively easy and potentially harmless; others gifts raise more significant concerns. Unfortunately, it is not yet known whether a separate marital deduction transfer to the spouse, followed by separate gifts by both spouses, will be respected by the government as a viable alternative to gift splitting. As a consequence, if the latter alternative is considered safer or more desirable, it should be pursued with some caution, the dollar amounts should not be identical to a split gift alternative, and some time might be inserted between the marital deduction transfer and the spouse's separate gift. Independence should be guaranteed, and even the appearance of an implied understanding or coerced planning should be avoided.

Inter Vivos Marital Deduction

The unlimited inter vivos marital deduction provides an opportunity for spouses to engage in asset reallocations for tax minimization or any other purpose. Planners should be cautious regarding planning in lieu of gift splitting, however, to avoid a marital deduction gift made by a donor spouse to what otherwise would be a consenting spouse, who the government then alleges by prearrangement thereafter made a gift to objects of the donor spouse's bounty. The concern is that the government will treat the gift as a transfer of all the property by the donor spouse to those objects directly, as to which neither the marital deduction nor gift splitting would apply (the latter because it was not elected and the former because of the agreement to pass the property along to the ultimate donees).

In addition, planning close to the end of a donee spouse's life should beware of inadvertent application of §1014(e), which would deny a new basis at death to any appreciated property transferred to a dying spouse who directly or indirectly transfers the property back to the donor spouse. Otherwise, by virtue of the unlimited lifetime marital deduction in §2523 and the nearly unlimited lifetime income tax free interspousal transfer rule in §1041, inter vivos interspousal property transfers are virtually ignored for income and wealth transfer tax purposes, as if the spouses were a single economic unit for all tax purposes.

One notable exception to this treatment applies if the donee spouse is not a citizen or resident of the United States, in which case the special rules in §§1041(d) and 2523(i) may deny tax free status for either income or wealth transfer tax purposes. A useful gift tax alternative in §2523(i)(2), however, authorizes a $114,000 (in 2004, plus an inflation index amount in later years) annual exclusion for transfers to the noncitizen, nonresident spouse.

One form of inter vivos planning may be particularly attractive to spouses with significant but disparate wealth. Assume, for example, that spouses D and S seek estate planning and that the initial interview discloses that S (whom you expect to be the surviving spouse, based on age, lifestyle, and physical characteristics) has more wealth than the maximum amount that can pass free of tax under the applicable exclusion amount of the unified credit. More importantly, assume that D has little independent wealth. In such a case one very obvious planning suggestion would be to encourage S to give D enough wealth to shelter D's tax benefits if D does die first. This might include an amount equal to D's unused estate tax applicable exclusion amount and generation-skipping exemption, and perhaps even enough wealth to run through the less than maximum estate tax brackets in D's gross estate.

In a typical situation S might balk at this advice until it is made clear that an inter vivos qualified terminable interest property trust may be employed to protect the wealth against predators who might attempt to reach those assets in D's hands. For example, a not unlikely scenario would entail D as the less wealthy spouse because of a failed business venture, with creditor problems that linger. The spendthrift nature of the inter vivos qualified terminable interest property trust for D's benefit, created by S, can provide protection against claims that might be respected if the property were transferred to D outright. Other reasons (such as denial of control) also might recommend use of the inter vivos qualified terminable interest property trust for D. With sufficient protection, S might be willing to engage in this form of inter vivos planning designed to shelter D's tax benefits. But a stumbling block might be S's desire to continue to enjoy the income from the trust property after D's death, if events turn out as this planning anticipates.

The planning issue is whether S may retain a secondary life estate following the qualified terminable interest property income interest in D for the balance of D's life. Under §2523(f)(5)(A) a donor spouse *may* retain such a secondary life estate and the trust property will not be includible in the donor's gross estate (under §2036(a)(1) or any other estate tax inclusion section). Nor will a subsequent transfer of the retained secondary life estate by the donor spouse generate any gift tax consequences. According to Treas. Reg. §25.2523(f)-1(f) Example 11, §2044 inclusion to D effectively cleanses the trust, meaning that S's secondary income interest is treated as if D created the trust.

As a result, it is relatively easy for a donor spouse to shift wealth to a donee spouse by inter vivos transfer with the only potential risk being that, if they divorce, the income interest for the balance of the donee spouse's life will be lost to the donor spouse. In addition, under §§672(e) and 677(a), that income will be taxed to the donor spouse even after the divorce. Depending on state law, that income interest may count in the divorce property settlement action and offset any obligation that otherwise might be imposed on the donor spouse anyway. And the income tax obligation similarly might be factored into any ongoing alimony, support, or property settlement negotiation.

Inter Vivos Charitable Deduction

Like the §2523 unlimited lifetime marital deduction, §2522 offers an unlimited gift tax charitable deduction for qualifying transfers made inter vivos. In addition, §2501(a)(5) allows a gift tax political contribution exclusion for transfers to a §527(e)(1) political organization.

Like gifts in general, a §2522 deductible inter vivos charitable gift can be more valuable than one made at death, for many of the same reasons. Most obvious are those that apply if the transfer has both taxable and deductible components: in that case shifting income and growth out of the donor's estate, paying any gift tax attributable to the transfer to avoid paying estate tax on the gift tax dollars themselves, and generating valuation opportunities all can be important. And the exclusion under §2501(a)(5) for inter vivos transfers to a political organization is preferable to a testamentary transfer to the same organization because there is no estate tax exclusion or deduction available for political contributions.

There is an additional reason to favor accelerating charitable transfers into lifetime planning, even in cases involving a 100% deductible charitable gift (as to which a charitable deduction at death is as effective as a charitable deduction inter vivos, regardless of the size of the transferred property). This advantage, unique to inter vivos charitable planning, is the §170 income tax charitable deduction, which has no counterpart for other gift planning and is not available at death. This deduction generates an income tax saving attributable to the inter vivos charitable gift, which can finance other planning that also may be attractive.

For example, a donor may choose to transfer the income tax dollars saved with an inter vivos charitable contribution to a donee who will use the money to help finance life insurance on the donor's life (or other investments) to compensate for the dollars contributed to charity. The transaction has many of the advantages of inter vivos giving in general, to the extent this replacement wealth is excluded from the donor's gross estate at death (in this case financed in part by the tax savings produced by the income tax deduction).

Just as gifts made inter vivos are more attractive for wealth transfer tax purposes than those at death, this income tax advantage makes the inter vivos charitable gift a better plan *if* the donor was going to make the charitable transfer in all events. The income tax deduction also recommends planning that relies on the estate tax marital deduction. If the decedent failed to provide for charity inter vivos, a desirable alternative is to leave property