Gifting in 2010 Part One – understanding the environment

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It appears unlikely that Congress will pass any transfer tax reform in 2010. As a result, 2010 could be the best of times for gifting by affluent clients. Part I of this article considers the multiple factors that surround gifts in 2010. Part II covers select gift planning opportunities available this year.

Consider the following factors that encourage gifts in 2010:

- Historically low applicable federal rates that encourage certain gifting strategies,
- Low asset values, particularly in real estate and family businesses,
- Intra-family transfer discounts could be curtailed by Congress or the IRS in the near future,
- A gift tax rate of 35% for 2010,
- Because the gift tax is a tax-exclusion tax, the effective tax rate for gifts in 2010 (when the donor survives the gift by three years) is only 25.93% (see Part II for details),
- The increasing probability of restoration of the 2001 transfer tax rules in 2011, with the estate tax exemption going to $1.0 million and the transfer tax rate at 41-60%, and
- The benefit of "income shifting," given the likely significant increases in state and federal income tax rates in the coming years and the resulting spread in income tax rates at the upper and lower ends of taxation.

Tax exclusion planning. Payment of gift taxes can have a significant advantage over the payment of estate taxes. The principal reason is that gift tax is calculated on a tax-exclusive basis (on the value of the property transferred), while the estate tax is calculated on a tax-inclusive basis (on the value of property transferred plus any amount used to pay the estate tax). If the donor pays the gift tax, the donor effectively transfers $1.35 of value for each dollar gifted (when compared to the estate tax), but is only subject to transfer tax on one dollar.

> *Planning example:* Assume a client has $4,000,000 available to make a transfer to heirs and pay the resulting transfer tax. Assume further that the full amount of the transfer is taxable and that a 55% estate tax rate (assuming death occurs after 2010) and 35% gift tax rate applies. The client can make a $2,962,963 gift in 2010 and pay the resulting gift tax liability of $1,037,037 ($2,962,963 x 35%). If, on the other hand, the client bequeathed the entire $4,000,000 after 2010, then the client could only transfer $1,800,000 ($4,000,000 less a 55% tax). The net result is that the gift transferred an additional $1,162,963 ($2,962,963-$1,800,000).

The gross-up rule. However, the gift tax can become a tax-inclusive tax if the donor/payor of the gift tax fails to survive the gift by three years. Code Sec. 2035(b) provides: *"The amount of the gross estate . . . shall be increased by the amount of any tax paid under [the gift tax rules] by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death."* Note that the date of the gift, not the date of the payment of the gift tax, begins the three year statute. If gift splitting is elected, the inclusion applies to the spouse who actually paid the gift tax, not necessarily the spouse who made the taxable gift. Rev Rul 81-302, 1981-2 CB 170 , provides that state gift taxes are not pulled back into the taxable estate.

Basis issues. In general, Code Sec. 1015(a) provides that the donee of a gifted asset takes over the tax basis of the donor. However, if the donor's basis in the asset exceeds its fair market value, the rules get a little more complicated for the donee. If the donee subsequently sells the asset for a gain, the donee uses the donor's basis in the property. If the donee sells the asset for a loss, the fair market value of the donated assets is used as the basis. Thus, if the donee sells the asset for a price between the fair market value and the donor's basis, neither a loss nor a gain is incurred.

Code Sec. 1015(d)(6) provides: *"In the case of any gift made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as (i) the net appreciation in value of the gift, bears to (ii) the amount of the gift. Net appreciation in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift."* (emphasis added). Pursuant to Reg. § 1.1015-5(c)(2) , the denominator of the ratio (i.e., "amount of the gift") is reduced by any applicable annual exclusion gifts.

GST taxes. As Howard Zaritsky noted in Weekly Alert ¶ 10 04/08/2010 : "Serious planning for generation skipping transfers is virtually impossible in 2010. The only thing we know is that outright generation-skipping transfers in 2010 are not taxable...." With the uncertainty over the GST tax treatment of post-2010 distributions from GST trusts, clients should consider:

- Making such gifts directly (as opposed to using GST trusts) to grandchildren and other skip persons.
- Using FLPs and LLCs or non-voting stock, if they want to reduce the control of the donee.

Holding period. Code Sec. 1223(2) provides that the donee's holding period is tacked to the holding period of the donor. Therefore, the donee can more easily qualify for long term capital gain treatment.

Timing. Generally, advisors should consider putting the plan in place and then waiting to complete the gift until the end of 2010, because:

- If the client dies before the end of 2010, not only would the gift have created an unnecessary transfer tax, but the partial step up in basis (of up to $4.3 million) provided in Code Sec. 1022 would also be lost.
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- Congress might still act before the end of 2010 to change the transfer tax rules. Retroactive changes could sabotage the plan. Other legislative changes might create new and unexpected planning opportunities or traps.
- Other family changes might occur that reduce the benefit of the proposed plan (e.g., divorce of a child).
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Clients could complete the entire process and then place all the documents and appraisals in escrow with an independent party who is directed to deliver the relevant documents to the donees by Dec. 31, 2010, if none of the above conditions have occurred. To assure that the gifts are deemed completed gifts, the escrow release date should leave sufficient time for actual delivery to the donees or their designated agents. The escrow agent may need to know where the recipients are vacationing at year-end to make sure delivery occurs.

Hoarding cash. One of the reasons that planning should start now is the need for many clients to start accumulating cash (e.g., selling or mortgaging assets) to pay for the gift taxes which will be due by Apr. 15, 2011. The amount of cash the client can accumulate by Apr. 15, 2011 will directly determine how much can be gifted by Dec. 31, 2010.

> **Caution:** In considering a taxable gift to a non-spouse, one of the considerations should be the impact of the donee dying within a few years of the transfer. While Code Sec. 2013 provides an estate tax credit for estate taxes paid by a previous decedent/owner, there is no comparable benefit for gift taxes paid. Potentially, the combination of the gift tax on the initial gift coupled with the estate tax liability upon the donee's death could eliminate the tax benefits of gifting in 2010. If there are no GST issues, it may make sense to gift to a trust in lieu of a direct gift (particularly for an heir with significant health issues) and give the intended initial donee a lifetime interest in the trust. The trust could provide potential estate tax savings to the remaindermen and asset protection to the donee.
> **Caution:** Be wary of gifting assets with secured debt. Assume a real estate lot is worth $1,000,000 with a $900,000 mortgage and a $700,000 basis. The gift of the real estate could create $200,000 in tax recognition to the donor.

Gifting in 2010 Part Two – a few planning examples

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Select gift planning opportunities available this year include the following.

Inter-vivos trusts. The timing of gifts is a critical issue in starting the three year statute of limitations for inclusion of any gift tax in the donor's taxable estate. The statute is triggered by the completion of the gift, not the payment of the gift tax. Therefore, the earlier the gift, the less gift-tax-inclusion risk that is absorbed by the decedent's estate. One approach is the creation of a lifetime QTIP trust. The donor can create the trust now, but defer the decision on electing QTIP status until the gift tax return is filed—up until Oct. 17, 2011 if the return is extended. But if the decision creates a taxable gift (i.e., deciding not to elect QTIP status), the decision should be made no later than Apr. 15, 2011 in order to avoid penalties and interest on the gift tax.

One concern with a lifetime QTIP trust is that even if the donor does not elect to treat a part of the QTIP trust as a marital deduction trust, the sole beneficiary of the trust is the donor's spouse. To get around this issue, the trust instrument could provide that if the spouse disclaimed all or any portion of the trust, it passes to a By-Pass type trust or to designated individuals (e.g., GST "skip" persons). The spouse would have nine months after the funding of the trust to make the decision to disclaim. Such disclaimers are permitted for estate tax purposes pursuant to Reg. § 20.2056(b)-7(d)(3) —the so called "Clayton" regulation. However, the limits of the estate tax "Clayton regulation" for gift tax marital deduction purposes are not entirely clear because there is no similar gift tax regulation.

Net gifts. A "net gift" is a gift in which the donor, as a condition of the gift, requires the donee to pay the resulting gift tax. The gift's value is reduced by the gift tax to be paid by the donee because the donee's payment of the gift tax is considered a partial sale, not a gift, by the donor. According to Rev Rul 75-72, 1975-1 CB 310 , the amount of the gift tax (and the resulting reduction in the value of the gift) is determined by the following formula: the tentative gift tax divided by the sum of one plus the rate of tax. In Rev Rul 80-111, 1980-1 CB 208 , the IRS noted that any state gift taxes which were assumed by the donee can also be taken into account to reduce the gift. In Rev Rul 81-223, 1981-2 CB 189 , the IRS provided that the donor cannot elect to withhold the use of his or her gift exemption and have the donee pay a higher gift tax.

> *Planning example:* Assume the donor makes a $1.0 million net gift in 2010. The donor has no gift tax exemption or annual exclusion available and the gift is fully subject to a 35% gift tax. The result of the net gift:

- According to the above formula, the gift tax on the "net gift" is $259,259—an effective transfer tax rate of 25.93% on the $1.0 million transfer,
- The sale portion of the transfer is $259,259, and
- The gift portion of the transfer is $740,741.

Because part of the net gift transaction is treated as a sale transaction, the donor may recognize taxable income from the sale portion of the transaction. What taxable income does the donor recognize from the sale? Reg. § 1.1001-1(e)(1) provides that "Where a transfer of property is part a sale and in part a gift, the transferor has gain to the extent that the amount realized by him exceeds his adjusted basis in the property." As confirmed by the examples in the above regulation, the entire basis (not a just an amount proportionate to the sale part of the transaction) is used to compute the donor's gain, effectively reducing the gain to zero, unless the gift taxes paid by the donee exceed the donor's total adjusted basis in the property. See also: Diedrich (1982, S Ct) 50 AFTR 2d 82-5054 .

There are a number of other issues with net gifts, including:

- The income is taxable to the donor in the year the gift tax is paid, not in the year the gift was made. Thus, any taxable income from the net gift will ordinarily occur in the year following the gift. This could be problematic for gifts in 2010 because of the expected increase in ordinary income and capital gain tax rates in 2011.
- The Eighth Circuit ruled in Estate of Sachs, 62 AFTR 2d 88-6000 , 856 F2d 1158 (8th Cir. 1988) that if the donor dies within three years of the net gift, the gift taxes paid by the donee are still includable in the donor's taxable estate.

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- Advisors need to make sure that the obligation of the donee to pay the gift tax is not a conditional or speculative obligation. A written net gift agreement should clearly state that the donee is obligated to pay the gift tax shown on the filed gift tax return. A related issue is whether that indemnity should extend to higher gift taxes after an audit and/or any additional estate tax from the inclusion of gift taxes in the donor's taxable estate pursuant to the "gross-up" rule. If the donee takes on such obligations, the issue then becomes whether the obligations by the donee and expectations of payment are sufficient to further reduce the gift tax value of the taxable gift. For more detail on this issue, see: Armstrong, Frank Jr Est v. U.S., (2002, CA4) 89 AFTR 2d 2002-513 , aff'g Armstrong, Frank Jr, Est v. U.S., 2001 (DC VA) 87 AFTR 2d 2001-707 ; Estate of Armstrong, 119 TC 220 (2002); McCord, Charles T. Jr. v. Com., (2006, CA5) 98 AFTR 2d 2006-6147 and Arlein & Frazier, "The Net, Net Gift," Trusts and Estates, August 2008.
- Pursuant to Code Sec. 677(a)(1) and Reg. § 1.677(a)-1(d) , if a trust is the donee of a net gift, income earned by the trust from the date of contribution to the date the grantor's gift tax liability is satisfied may be taxable to the grantor under the grantor trust rules (i.e., the trust is satisfying the legal obligation of the grantor). Income from trust assets should be minimized during this period.

Discounting family debt. Many clients have created significant intra-family debt (e.g., an installment sale of a family business interest to an income defective trust). Rather than leaving the debt in the estate of the holder of the note, clients should consider a forgiveness of the debt on a net gift basis—effectively treating a net gift arrangement as a discounted pay-off of the note. Here's the basic question to ask the reticent client: "If you could satisfy a debt for 26% of its face value, while eliminating an estate tax of up to 55% of the debt, why would you NOT act?"

> *Planning example:* Assume a client has completed a sale of real estate using a $10 million note from an income defective trust for his children. The client agrees to forgive the note if the trust will pay the resulting gift tax. Assuming the client has used all of his gift exemption (e.g., to fund the seed money for the transaction), the gift tax on the net gift value would be roughly $2.6 million. The trusts could borrow the funds to pay the taxes by obtaining a bank loan against the real estate before the Apr. 15, 2011 due date of the gift tax.
> But what if the above trust is a GST trust? Because of the uncertainties surrounding gifts to GST trusts in 2010, the client's advisors may not want to make a significant gift to a GST trust. However, the client could make the net gift of the note to his heirs. The trust could obtain a loan from a commercial lender and prepay $2.6 million of the note to the donee/family members who then pay the gift tax. Note that even though the $10 million dollar note has been removed from the client's taxable estate, the amount of trust's debt has not increased, because the gift tax liability obligation funded by the commercial loan effectively reduced the principal of the note.
> **Caution:** Pursuant to Code Sec. 453B , the gift of an installment sale note can create the immediate recognition of any taxable gain in the note.

Discounting values. Clients who are considering gifts in 2010 should consider adopting methods designed to reduce the taxable value of the gift. Thus, the use of FLPS, minority interests, charitable lead trusts and similar discounting approaches should be strongly considered. For example, assume a charitably inclined client wants to make a gift to family members, but would prefer to defer the gift for several years, until the family members are older. Assume a client survives a 2010 gift by three years and creates a charitable lead trust which effectively discounts the value of the gift by 60%. The effective tax rate for such a gift could be as low as 10.37% (i.e., 25.93% times 40%)—well below the capital gain tax rate.

Gifts from existing marital trusts. While estate tax deferral almost always makes sense, 2010 has turned many of our planning perspectives on their heads. What happens if a spouse died before 2010 and created a marital trust for the surviving spouse? Pursuant to Code Sec. 2044 the marital trust assets may be subject to estate tax at the death of the surviving spouse at an effective transfer tax rate of up to 55% after 2010 versus a 35% gift tax rate (or lower) in 2010.

Clients who have marital trusts should consider:

- Taking a principal distribution from the trust and then gifting the assets to heirs at the low 2010 gift tax rate, or
- Purchases or gifts of lifetime or remainder interests in the marital trust. The merger of lifetime and remainder interests in a marital trust is normally treated as a gift transaction, generally as a "net gift" transaction. See: Rev Rul 98-8, 1998-1 CB 541 ; Reg. § 20.2207A-1(a)(2) , Reg. § 20.2207A-1(b) , Reg. § 25.2519-1(c)(1) , Reg. § 25.2519-1(C)(4) , Reg. § 25.2519-1(G) .

  Planning example: Assume a client's deceased spouse created a QTIP trust which holds $10 million growing at 5% per year. The surviving spouse is financially comfortable and is willing to make a net gift of $6.0 million to her heirs and the trust permits discretionary principal distributions. Assuming the surviving spouse has used all of her gift exemption, the net gift tax is approximately $1.5 million, making a net passage to heirs of $4.5 million. If the client dies in five years, the $6.0 million asset would have been worth approximately $7.66 million and the estate tax (at 55%) would have been up to $4.2 million—a net after-tax bequest of $3.4 million. However, if the client made the net gift five years earlier, after appreciation, the heirs would own an asset that has appreciated to $5.7 million—a transfer tax savings of up to $2.3 million.