Form 709:
The Gift Tax

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Summary

Oft ignored by the unwitting taxpayer and overlooked by the practitioner, gift tax returns are left unfiled. Find out when these returns are due and how to prepare them. This class will take an in-depth look at a hypothetical client who has made multiple gifts over a period of years, and now seeks your help to comply with all tax reporting requirements.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Introduction

At Christmas time, it sits beneath the decorated tree wrapped in shiny paper that will soon be torn to shreds by an eager child who spent a year begging Santa for the Lego Master Builder Academy, gold Buckycubes, or Rock Star Mickey. At a wedding, it is tastefully and professionally wrapped in gold or silver and will be returned to the store from whence it came to be exchanged for something the bride and groom really wanted.

Whether large or small, packaged in a box or buried beneath tissue paper in a gift bag, discretely hidden in a birthday card or simply given as a card, gifts one and all are fun to give and fun to get! They are offered as tokens of appreciation, to say thanks to a valued employee, as expressions of love and kindness, to assuage guilt or buy gratitude, to say "I care", "I love you."

Whatever the size or motivation, gifts are given, not taken. The giver may hope for reciprocity – he may hope to get something back in exchange, a quid pro quo. He may hope that his gift will be matched with kindness and generosity but, in truth, a gift may go unacknowledged without even a "thank you."

That's the thing about gifts. They are one-way transfers made with nothing more than hope and expectation but without guarantee that anything – tangible or intangible – will be returned. No money, no bigger or better Lego set, no hard work, no obligation or indebtedness, no recognition. Nothing! A gift is *given* but not *taken.*

II. Definition

For tax purposes, gifts are defined as "any transaction in which interest in property is gratuitously passed or conferred upon another."[1]

> *Example*
> *In 2006, Commissioner Mark Everson reminded Oscar winners that they must include the contents of luxury goodie bags received from the Motion Picture Academy on their income tax returns since the items are given to curry favor. They are, therefore, not gifts but rather a form of compensation. Samples of goodies included a $25,000 luxury package for a four-night stay on Waikiki Beach; a gift card entitling the holder to $2,500 of facials and massages; a leather-trimmed cashmere travel blanket valued at $1,495; and an exclusive dinner party at Morton's Steakhouse.[2] If a celebrity accepts and redeems the non-transferable vouchers in a gift bag, he will be taxed on the value of the trip or personal service received.[3]*

> *Example*
> *In contrast, the title to the family home transferred from father to son in exchange for care provided was deemed to be a gift since, under applicable state law, "parents are not required to pay a child,*

[1] Reg. § 25.2511-1(c).

[2] *2006 Oscars and Goodie Bags*, The Prophet Newsletter, March 2006.

[3] As per IRS *Gift Bag Questions and Answers* at http://www.irs.gov/uac/Gift-Bag-Questions-and-Answers [last accessed May 19, 2014].

regardless of age and services performed, when they live with them."[4] *In this case, Dad not only was held liable for unpaid gift taxes but the son, under theory of transferee liability, assumed Dad's previously unpaid income tax debts which had been secured by the IRS when it filed a lien against the home long before the title was transferred.*

A gift is considered complete once the donor parts with dominion or control over the transferred property and no longer has the power to change the disposition of the property for his own benefit or that of others.[5]

Example
You've pushed your plate of food with uneaten morsels across the table and said, "Here, honey, I'm full; you can have the rest of my dinner." With that, you get up from the table to wash the dishes while your honey remains seated and enjoys his extra portion. Just as he savors that extra serving of steaming lasagna, you return to the table to collect dirty dishes. Watching your husband dig into the still-steaming dish of pasta afloat in its creamy béchamel sauce, you suddenly have a craving to have just one more bite and reach over to snatch that mouthful delicacy. Disappointed, your spouse mutters, "Indian giver!"[6]

So when is a gift a "gift"?

In the case of parents making an interest-free loan to their son, the Court determined that they conveyed an economic benefit (the use of money) without consideration (interest payments). They made a gift equal to the value of the interest income they could (should) have earned.[7]

On the other hand, despite donative intent, a gift is not made if the donor does not part with anything of value. In the case where the wife substituted her note for that of her husband's obligation but the bank continued to rely upon the husband's credit-worthiness, the Court held that an agreement to guarantee another's debt did not constitute a completed gift because there was no certainty that payment on the guarantee would be required.[8]

In another case of marital accord, the husband offered to give his fiancé $150,000 if she accepted his marriage proposal but because marriage is not deemed consideration, the Court held that the husband had made a (taxable) gift.[9] Conversely, the transfer of property pursuant to a divorce decree is not a gift since the surrender of marital rights does not occur voluntarily.[10]

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[4] *Rubenstein v. Commissioner*, 134 TC No. 13 as cited in *Father Sells Condo to Son for $10*, NATP TAXPRO Monthly, May 2011.

[5] Reg. § 25.2511-2(b).

[6] *Indian giver* derives from the alleged practice of American Indians of taking back gifts from white settlers. It is more likely that the settlers wrongly interpreted the Indians' loans to them as gifts. This term, which is certainly American, may have been coined to denigrate the native race. [*The Phrase Finder* available at http://www.phrases.org.uk/meanings/202850.html, last accessed May 19, 2014].

[7] *Dickman v. Commissioner*, 465 U.S. 330 (1984).

[8] *Bradford v. Commissioner*, 34 T.C. 1059 (1960).

[9] *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

[10] *Harris v. Commissioner*, 340 U.S. 106 (1950).

A. Elements

The essential elements of a valid gift include:

- Delivery
- Intent
- Acceptance

Delivery may be actual (e.g., Dad parks a new car in the driveway for his teenage son) or implied (e.g., Dad hands his car key to his son), which requires some affirmative act to take place.[11] Delivery may be made directly or indirectly through a third party (e.g., Dad asks Mom to give the car keys to their son) but is considered complete only when the third party has transferred the property.

Donative intent may be expressed clearly and unmistakably or inferred from circumstances, such as the relationship between and the behavior of the parties. The intent must be present at the time of the gift and cannot vaguely indicate the transfer or property at some indeterminate time in the future.

> *Example*
> *Police Officer Peebles discovered that his wife was having an affair with her physician Dr. Hestir. Peebles confronted Hestir and threatened to sue him for $150,000. Two days later, Hestir met Peebles and delivered $25,000 (the most he claimed he could raise). Peebles taped their conversation during the exchange: "Now, Doc, this isn't blackmail money." Hestir replied, "No, I didn't say it was blackmail money; I said I hope it helps you [and your wife]."*
>
> *The following year, Hestir's accountant issued a **1099-MISC** form to Peebles reporting the $25,000 payment. Peebles, however, did not report this income since he considered it to have been a "gift" from Hestir. The Tax Court disagreed, stating that the doctor's payment "was not the result of detached and disinterested generosity or paid out of affection, respect, admiration, or charity. Instead it was paid to avoid a lawsuit, to avoid public and professional embarrassment, and to assuage his own feelings of guilt or moral obligation."*[12]

Lastly, the recipient must unconditionally accept the gift at the time that it is made although he does have the right to reject the gift before the transfer is complete.[13] Once accepted, the donor forfeits all rights to the property and no longer has the power to alter, amend or revoke the gift.

B. Select Types

While hardly an exhaustive or all-inclusive list, some common examples of gifts include:

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[11] Essential Elements of a Gift, USLegal Inc., [available at http://gifts.uslegal.com/essential-elements-of-gift/, last accessed May 19, 2014].

[12] *Peebles v. Commissioner*, TC Summary Opinion 2006-61 as reported in California Enrolled Agent, August 2007.

[13] If a donee makes a qualified disclaimer by irrevocably refusing to accept the proffered gift in writing, the transfer is treated as though it had never been made (IRC § 2518).

- **Below-market loan**: The gift is equal to the interest that should have been charged if the applicable federal rate had been used.[14]
- **Debt forgiveness**: The gift is equal to the unpaid principal balance.
- **Below-market sale**: The gift is equal to the difference between the current fair market value [FMV] and the discounted sales price.
- **Transfer to an irrevocable trust**: The gift is equal to the value of all assets transferred into the trust.
- **Joint and survivor annuity**: The gift is equal to the difference between the premium paid for the joint annuity and the premium paid for a similar single-life annuity.
- **Year-end check**: Although the donor's check may not yet have cleared the donee's bank until the following year, the gift is considered complete if (1) the donor intended to make a gift, (2) the delivery was unconditional, (3) the deposit was made in the year for which completed gift treatment is sought and within a reasonable time of issuance, (4) the donor's bank did not reject the check and (5) the donor was alive when the donor's bank paid it.[15]
- **Corporate dissolution**: The gift is equal to the value of the distribution which exceeds the shareholder's interest in the corporate entity.

In some cases, placing assets into **joint ownership** may be deemed to be a gift when the joint tenancy is created; in other instances, the gift becomes complete only when the assets are withdrawn from the joint account – state law will govern. Generally, transfers of real property, mutual funds, stocks and bonds are considered complete upon re-titling of the assets but transfers of bank and brokerage accounts are complete only when the donee makes a withdrawal from the joint account for his own benefit.[16]

Example
Divorced mom titles her condo in joint tenancy with her son to avoid probate [Gift # 1] but later re-marries and asks her son to quit claim the property back to her [Gift # 2].

Example
Father owns an apartment building worth $1 million and adds his daughter as joint tenant. Because the daughter may at any time sever the joint tenancy and hold title to her 50% share as a tenant-in-common, Father is deemed to have made a gift.[17]

If the property continues to be held in joint tenancy until the donor's death, the property is included in the donor's taxable estate. Thereafter, the donee – once a joint tenant – becomes the owner of the asset which he inherits with a stepped-up basis.[18]

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[14] As per IRC § 7872, the gift is treated as though made on the last day of the calendar year (if demand loan) or on the date the loan was made (if term loan). Gift loans that do not exceed $10,000 are exempt from gift tax.

[15] Rev. Rul. 96-56.

[16] Reg. § 25.2511-1(h)(4).

[17] *The Tax Prophet* (Issue # 104, January 2012) recommends that transferors protect themselves against potential gift tax consequences by drafting a written agreement that states that (i), neither party has the right to sever the joint tenancy without mutual consent, (ii) the joint tenancy is for estate transfer purposes only, and (iii) the original owner will continue as sole owner until he dies or the parties agree to sever the joint tenancy.

[18] IRC § 1014.

Life estate and remainder interests, often used by donors wishing to transfer title to real property while reserving the right to use the property until death, are also governed by state law. Typically, a completed gift is made when the deed is recorded, although the value of the gift may be discounted since the donee does not receive all beneficial rights at the time of transfer.[19]

In some instances, **derivative or partial gifts** may arise as the result of a sale or other transaction which included insufficient consideration for the property transferred or the parties agreed that the donee (rather than the donor) would pay the attendant gift tax. In the instance where the donee pays the donor's tax, the donor may deduct the gift tax from the value of the transferred property (now considered a "net gift")[20] but must then also include the difference between the gift tax and the property's basis in his taxable income.[21]

Example
Taxpayer gifted stock to his children on the condition that they pay the resulting gift tax of $60,000 which exceeded the donor's basis of the stock ($50,000). Since the taxpayer recognized a capital gain of $10,000, he is liable for income tax on this gain.

Generally, a transfer of property to a **Limited Liability Company (LLC)** is treated as a contribution of capital to the contributing member's capital account. Therefore, the transfer does not qualify as a completed gift until such time that the contributing member transfers his ownership units in the LLC to other members.

WHAT IS A "GIFT"?

- **A gratuitous transfer of property from donor to donee**
- **3 elements required: Delivery (actual or implied), Intent (express or inferred), Acceptance (unconditional)**
- **Common examples include family loans, joint accounts, below-market sales**

III. Taxation

In an attempt to tax the transfer of property whether during or after life, the Gift Tax as we know it today was enacted in 1932, about sixteen years after the Estate Tax was put on the books. It is a tax imposed on the donor based on the cumulative value of all gifts made during lifetime, even those which may have been previously taxed.

Like the Estate Tax, the Gift Tax is assessed at graduated rates, but because all of the donor's gifts – past and present – are aggregated, a gift may be taxed at a higher marginal bracket that

[19] Refer to IRC § 7520 for valuation of annuities, life estates, remainders and reversions.

[20] Rev. Rul. 75-72.

[21] *Diedrich v. Commissioner*, 82-1 USTC 9419.

a comparable asset would be taxed if transferred at death. While it is often advantageous to spread the receipt of taxable income over several years to gain the benefit of lower marginal tax brackets, it generally matters not whether one large gift is made in one year or multiple smaller gifts are made over several years since each successive gift is added to those previously made and the total is then subjected to the applicable gift tax rate.

A. Exceptions

Most gratuitous transfers of property ("gifts") are subject to gift tax with certain exceptions:

- Gifts made to IRS-approved charitable organizations are exempt from gift tax. Although there is no limit to this exemption for gift tax purposes, income tax deductions are limited to 50% of the taxpayer's Adjusted Gross Income [AGI] each year. Unused deductions may be carried forward for five years.[22]
- Direct payments to providers for another individual's **medical expenses** are not considered gifts. These payments may cover any type of expense deductible for income tax purposes, including payment of insurance premiums.[23]
- Similarly, direct payments of **tuition** for another person, if paid directly to a qualifying education organization, are not considered gifts.[24] Tuition for full- and part-time students qualifies, but payments for books, school supplies, room and board do not.

Example
Grandpa sent $40,000 directly to Brown University to pay for his grandson's tuition and also sent $13,000 to the teenager to pay for books, supplies and other expenses. Neither payment is reportable for gift tax purposes since the first was a direct payment for tuition and the second was eligible for the annual exclusion.

If Grandpa had instead sent a check for $53,000 to his grandson and directed the teen to pay the tuition bill, Grandpa would have made a gift that while reportable, may still not have been taxable if Grandpa availed himself of his lifetime exclusion [see below].

Interestingly, payments to **Qualified Tuition Programs** [QTPs][25] are not covered by the tuition exemption and are instead treated as taxable gifts. However, QTP contributions are eligible for the annual gift tax exclusion [see below]. In fact, taxpayers may contribute as much as the aggregate of five years' worth of annual exclusions without incurring gift tax consequences. In other words, a donor may elect to exclude up to $70,000 (in 2014), if no other gifts are made to the same donee in this or the next four years.[26] A QTP donor is not subject to gift tax on distributions from these plans unless

[22] IRC § 170.

[23] Reg. 25.2503-6(b)(3).

[24] IRC § 2503(e).

[25] IRC § 529.

[26] The election is made by checking the box on line B of **Form 709**, Schedule A and attaching a statement listing the amounts contributed for each beneficiary and the amounts for which the election is made. Twenty percent of the gift is reported each year for five years; however, if in any of the four years following the election, the taxpayer is not required to file **Form 709** other than

the designated plan beneficiary is changed or the plan is rolled over to a beneficiary who is a generation below (younger than) the original beneficiary.[27]

A parent's **support payments** for the benefit of a minor child are not considered to be gifts if legally required to be made.

Example
Dad contributes to the living expenses of his 25-year old son who lives away from home; amounts in excess of the annual exclusion are deemed to be taxable gifts. On the other hand, if his son were only 17, his payments would be considered to be a part of his legal obligation to support his minor child and not taxable gifts.

B. Annual Exclusion

Each year, a donor may exclude the first $14,000 given to each donee. Husband and wife may join together and gift up to $28,000.[28] Gift-splitting, allows a married couple to treat gifts made by one spouse as though one-half had been made by each spouse. As a result, spouses are able to maximize their annual exclusions, sheltering gifts made from the assets of only one spouse and which would otherwise not be fully excluded by that individual's annual exclusion. To qualify, spouses must (1) be U.S. citizens or residents at the time of the gift, (2) be married at the time of the gift, and (3) remain unmarried at the end of the calendar year if they have separated during the year of the gift.[29]

Example
Husband (H) and Wife (W) agreed to split the following gifts: H gave his nephew $21,000; W gave her niece $18,000. H's gift to nephew is treated as one-half ($10,500) from H and one-half ($10,500) from W. W's gift to niece is also treated as one-half ($9,000) from W and one-half ($9,000) from H.

Each donee is then viewed separately to determine if the amount gifted exceeds the annual exclusion. Although no taxable gifts have been made, each donor is required to file a gift tax return to report the gift-splitting.

To qualify for the annual exclusion, the donor must gift a present interest and grant the donee an immediate right to use and possess the property.[30] Generally, gifts in trusts do not constitute present interests unless the donee has a right to the income from the property and has the right to sell his interest in the property. However, gifts to a minor's

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to report that year's portion of the election, the taxpayer does not need to file or otherwise report that year's portion. Any amount in excess of $65,000 must be reported in the year the gift is made [IRC §529(c)(2)].

[27] IRC § 529(c)(5).

[28] These limits are those currently in effect for 2014. The exclusion is indexed for inflation but will not be increased until the inflation-adjusted amount reaches the next multiple of $1,000 [IRC § 2503(b)(2)].

[29] The election is made on lines 12 through 17 of Part 1 on **Form 709**. Each spouse must consent by signing line 18 of the other spouse's **Form 709**. The returns should be mailed to the IRS in the same envelope.

[30] The gift of publicly-traded stock is considered a gift of present interest, but gifts of restricted stock, family limited partnerships, and shares of a limited liability company have been deemed to be gifts of future interest since the donee could not freely transfer his interest. [*Hackl v. Commissioner*, 335 F.3d 664 (2003)].

trust[31] – such as those made under the Uniform Transfer to Minors Act (UTMA) – qualify as present interests if (1) the funds can be used immediately for the minor's benefit, (2) the minor will receive the property by age 21 and (3) the property will pass to the minor's estate if the minor dies before reaching the age of majority.[32]

Gifts of future interest given in trust may be "converted" to present interest with the insertion of a Crummey power granting trust beneficiaries to withdraw principal from the trust for a limited period of time. For example, Dad establishes an irrevocable life insurance trust [ILIT] to ensure that the eventual estate taxes due upon his death can be paid without compounding the tax liability by including the insurance policy in his taxable estate. He funds the ILIT annually with just enough to cover the insurance premiums. His children, the beneficiaries of the trust, are notified each year of their right to withdraw the annual contribution. Wisely, they choose to leave the ILIT funds untouched and allow the trustee to make the scheduled premium payment but because they have the right – even only temporarily – to possess the gifted amount, Dad's contribution becomes a present interest eligible for the annual gift tax exclusion.

A gift to a corporation is a gift to its shareholders but because title of the transferred property is held in the corporation's name, shareholders do not receive an immediate right to use, possess, or enjoy the donated property or the income from the property.[33] Of course, the gifted property increases the value of the underlying shares of the corporation but the shareholders cannot benefit from this increase until the company is liquidated or the shareholders are able to dispose of their stock holdings. Thus, gifts to a corporate entity have been deemed to be gifts of future interest and are not eligible for the annual gift tax exclusion .[34]

However, a gift to a corporation with a single shareholder could potentially be deemed to be a gift of a present interest since the sole shareholder could liquidate his corporation at will. Similarly, a gift to a partnership, LLC or other pass-through entity is considered to be a gift allocated to the individual partners or members proportionate to the partners' or members' respective capital accounts[35] as long as the donee partners or members have the unrestricted right to withdraw their capital.[36]

C. Lifetime Exclusion (Applicable Credit)

In addition to the annual exclusion, each donor is entitled to a lifetime exclusion of $5,340,000 ($10,680,000 for married couples)[37], which is *not* indexed for inflation. This

[31] Beware of the Kiddie Tax that may apply the parents' tax rate to the investment income of children under age 19.

[32] IRC § 2503(c).

[33] *Hollingsworth v. Comm.*, 86 T.C. 91 (1986) and Rev. Ruling 71-443.

[34] *Chanin v. U.S.*, 393 F. 2d 972.

[35] *Shepherd v. Comm.*, 115 T.C. 376 (2000).

[36] *Wooley v. U.S.*, 736 F. Supp. 1506 (1990)].

[37] Applicable limits in 2014.

exclusion translates to a gift tax credit of $2,081,800 (based on current applicable tax rates). If an individual makes taxable gifts in excess of the annual exclusion amount, he must report them on **Form 709** when made, but need not pay any tax until his current or subsequent taxable gifts cumulatively exceed the lifetime exclusion. Accumulated gifts excluded by the lifetime gift exclusion serve to reduce the applicable exclusion available to the decedent on his estate tax return.

Example
Taxpayer gives $25,000 to her daughter in 2014. The first $14,000 of the gift is not subject to gift tax because of the annual exclusion. The remaining $11,000 is a taxable gift but may be exempt from taxation under the lifetime exclusion. Nevertheless, a gift tax return must be filed for the year of the gift.

Example
In 2012,[38] Taxpayer (who has not previously made any gifts) gifted the following:

- *$8,000 Car to Son (no other gift was given to Son during the year)*
- *$25,000 Cash for Daughter's down-payment on a house*
- *$15,000 Paid college tuition of Nephew*

Taxpayer must apply the exclusions in the following order:

1. *Apply the educational (medical or charitable) exclusion: Gift to Nephew is exempt.*
2. *Apply the annual exclusion: Entire gift to Son and first $13,000 of gift to Daughter are exempt.*
3. *Apply the lifetime exclusion: Remaining $12,000 of gift to Daughter is taxable. The tax thereon totals $4,200 which will reduce Taxpayer's available Unified Credit to $1,768,600.*

*Taxpayer does not owe gift tax in the current year but must file **Form 709**.*

Form 709 must be filed whenever a donor makes a reportable gift, whether or not he anticipates that his cumulative gifts will be exempt under the lifetime exclusion or that his estate will ultimately be too small and not subject to the estate tax.

The lifetime exclusion is applicable to both gift and estate taxes and, in fact, has been unified under the Tax Reform Act of 1976 and renamed the "Applicable Credit Amount". While the effect is the same, the exclusion is used to reduce the amount of taxable gifts; whereas the credit is used to reduce the amount of tax due. Therefore, when properly computing the gift tax liability on **Form 709**, the taxpayer begins by reporting all taxable gifts and calculating the tax on the *full* amount of these gifts. Only after the tax is calculated, may the taxpayer then subtract the applicable credit to determine the actual tax due.

D. Applicable Individuals

The gift tax applies to donors who are U.S. citizens and residents, regardless of where the gifted property is situated.[39] Non-residents are subject to gift tax only if the gifted property is U.S.-sited real or tangible personal property.

[38] The applicable annual exclusion was $13,000 in 2012; the gift tax credit was $1,772,800 and the applicable tax rate was 35%.

[39] IRC § 2501(a).

Example
A Mexican citizen owns real property in Arizona which she gifts to her son (also a Mexican citizen). She is liable for U.S. gift tax.[40]

Example
A U.S. citizen owns real property in Mexico which he gifts to his daughter. He is liable for gift tax, whether or not his daughter is a U.S. or Mexican citizen.

An unlimited marital deduction is allowed for gifts (not including Qualified Terminable Interest Property [QTIP][41]) passing between citizen spouses. Gifts to non-citizen spouses are limited to an inflation-adjusted amount on transfers of present interests.[42]

E. Special Rules for Non-resident Aliens

Non-resident aliens are eligible for the annual gift exclusion ($14,000 in 2014) but not the lifetime exclusion ($5.34 million in 2014). Instead, the estate of a non-resident alien receives a credit of only $13,000 against the federal estate tax (the equivalent of a $60,000 exemption), an exemption level that has remained unchanged since 1988.[43]

BEWARE: An individual who is otherwise non-resident may be considered to be a "resident" for gift and estate tax purposes – the determination will hinge not on residency but rather on the taxpayer's domicile. Thus, if an alien enters the US even only briefly but has no definitive intent to depart, he will be considered to be a US resident subject to the gift and estate regimes. If US tax authorities are unable to collect gift or estate tax liabilities accrued to the alien, the liability will likely be transferred to and collected from the US beneficiary of the gift or inheritance.

While non-resident aliens are subject to federal estate tax on all US-sited tangible and intangible property, they are subject to gift tax only on lifetime transfers of US-sited tangible property.[44] In general, aliens may not claim a credit for death taxes paid to a foreign government even if the tax results from double taxation of the same property here and abroad. (Certain countries have entered into tax treaties that modify the general rules applicable to estate and gift taxes.)

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[40] Example given in Lockwood, *The Taxation of Gifts*, National Public Accountant, Nbr. 2003, June 2003.

[41] A QTIP is a trust in which the surviving spouse receives lifetime income from the trust's assets but the trust's corpus is left to an alternate beneficiary, such as the couple's child. A QTIP qualifies for the annual gift tax exclusion if the donee spouse receives income payments for life and no one retains a power of appointment to substitute the donee spouse as beneficiary. If the gift tax exclusion is claimed on the QTIP, the property must be included in the donee spouse's estate [IRC § 2523]. Gift taxes paid by donee spouse on transfers made by the donee spouse within three years prior to the donee spouse's death, are includible in the donee spouse's estate [*Estate of Morgens*, 109 AFTR 2d 2012-736].

[42] The exclusion is set to $145,000 in 2014.

[43] *Estate Planning Tools for Nonresident Aliens* [available at https://www.lexisnexis.com/community/lexishub/blogs/practiceareacommentary/archive/2011/02/11/estate-planning-tools-for-nonresident-aliens.aspx, last accessed May 20, 2014].

[44] In a strange twist of logic, cash – in the form of bills and coins – is considered tangible property (subject to gift tax) but transfers by check are considered intangible and exempt for gift tax (PLR 8210055).

Aliens seeking to avoid US gift tax may consider gifting intangible assets (such as investments held at a brokerage account) or transferring US-sited real property to a business entity, thereby converting a tangible asset into an intangible which can then be transferred gift-tax free to a beneficiary.[45] To minimize or avoid estate taxation, aliens should not hold any US-sited assets at death.

Surprisingly, aliens are entitled to claim up to $1 million GST exemption for lifetime transfers and up to $5.34 million (in 2014) exemption for generation-skipping transfers at death (just like US residents).

It is the donor, of course, who is liable for filing **Form 709** but it should be noted that US recipients of "foreign" gifts may be subject to reporting requirements as well. If the aggregate value of gifts received from a non-resident alien individual or foreign estate exceeds $100,000 per year,[46] the US beneficiary must attach **Form 3520** Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts to a timely filed individual income tax return (or estate tax return if the recipient has died).[47]

F. Expatriates

US citizens and residents who receive gifts or bequests on or after June 17, 2008 from covered expatriates[48] may be subject to a transfer tax (imposed on the recipient rather than the donor).[49] The tax is assessed at the then in-effect top estate and gift tax rate (40% in 2014).

WHAT IS TAXED?

- **All gifts except direct transfers for the payment of another's tuition and medical expenses.**
- **Only gifts in excess of $14,000 per year per donee (in 2014).**
- **Spouses may use gift-splitting.**
- **Unlimited marital deduction between citizen spouses; limited to $145,000 (in 2014) for transfer to non-citizen spouse.**
- **Non-resident aliens may gift up to $14,000 per year per donee (in 2014) but may not avail themselves of the lifetime exclusion.**
- **US taxpayers who receive gifts or inheritances from former US citizens may by subject to a new transfer tax.**

[45] It is suggested that at least a year pass between the dates of property transfer to the corporation or partnership and the eventual transfer to an individual recipient.

[46] For gifts from foreign corporations and partnerships, the reporting threshold is $15,102 (in 2014).

[47] Penalties for failure to file **Form 3520** equal the greater of $10,000 or 35% of the value of property transferred to or distributions received from a foreign trust.

[48] "Covered" expatriates are US citizens or long-term residents who meet certain income and net worth threshold amounts and who have (in)voluntarily relinquished their citizenship or green card status (IRC § 877A).

[49] IRC § 2801.

IV. Tax Return Specifics

All gifts in excess of the annual exclusion are reportable on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return**. Gift tax returns cannot be filed jointly since each spouse has a separate annual exclusion attributable only to him, even when gift-splitting is elected.

A. Filing Requirement

Gift tax returns must be filed for all taxable transfers of property for which inadequate consideration was received and must be filed in the following situations, even if no tax is due with the return:

- A taxpayer gave gifts in excess of the annual exclusion amount to someone other than his spouse.
- A taxpayer made a gift in excess of the annual limit to a non-citizen spouse.
- A taxpayer made a gift of a future interest of any amount since it is not exempted by the annual exclusion amount.
- A married couple elects to split gifts (regardless of amount) or one spouse makes a gift of jointly-held or community property.
- If the individual is a beneficiary, partner, or shareholder of a trust, estate, partnership, or corporation that has made a gift.
- If the donor has died prior to filing a gift tax return, the executor must do so on his behalf.
- If the donor has not paid the gift tax and the liability transfers to the donee.

No return is due for gifts that do not exceed the allowable annual exclusion to each donee, donations of the donor's full interest in the donated property, transfers to political organizations,[50] or payments that qualify for educational and medical exclusions.

Even when **Form 709** is required, not all gifts need to be reported since each donee is considered separately. If all gifts to one donee can be excluded by the annual exclusion, no gifts to that donee are reported; however, if gifts to a second donee exceed the exclusion, then those gifts must be reported.

B. Filing Deadline

Gift tax returns must be filed by April 15th of the year following the calendar year in which the gratuitous transfer was made, unless an extension for filing the taxpayer's income tax return has been requested using **Form 4868 Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.** If **Form 4868** has not been filed, **Form 8892 Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax** may be used instead to obtain an automatic six-month extension.

[50] IRC § 527(e)(1).

If reporting gifts made by an individual who has died since making the gift, the filing deadline is the earlier of April 15th or the deadline (with extensions) for the estate tax return. While extensions extend the time for filing, they do not extend the time for payment which, if late, is subject to penalties and interest.[51]

C. Tax Rates (in 2014)

The applicable gift tax rates are the same as those applied to the estate tax.

Taxable Amount ($)	Marginal Tax Rate (%)
0 – 10,000	18
10,001 – 20,000	20
20,001 – 40,000	22
40,001 – 60,000	24
60,001 – 80,000	26
80,001 – 100,000	28
100,001 – 150,000	30
150,001 – 250,000	32
250,001 – 500,000	34
500,001 – 750,000	37
750,001 – 1,000,000	39
1,000,001 and over	40

D. The Gift Tax Calculation

(Taxable Gifts during lifetime * Applicable Tax Rate)
– (Taxable Gifts in prior years * Applicable Tax Rate)
= Tentative Tax
– Applicable Credit Amount
= Tax Due

Calculated at *cumulative* graduated rate

Example
Facts: In 2003, taxpayer made taxable gifts (after the annual exclusion) totaling $500,000. In 2006 – prior to his death – taxpayer made additional taxable gifts totaling $600,000. The value of taxpayer's estate at death was $2.9 million.

Gift Tax Calculation:

$ 500K in '03 → Tax = $155,800 (but $0 paid since < $345,800 lifetime credit available)
600K in '06
$ 1.1M cumulative gifts → Tax = $386,800 tentative tax on total gifts made in both years

$ 386,800	*Tentative tax*
– 155,800	*Tax liability on '03 gift*
$ 231,000	*Tax attributable to '06 gift*
– 190,000	*Credit remaining after '03 gift (= $345,800 – 155,800 used in '03)*
$ 41,000	*Tax due in '06*

[51] IRC § 6651(a)(1).

Estate Tax Calculation:

$ 2.90M	*Value of estate in '06*
+ 1.10M	*Prior taxable gifts [see above] added back to estate*
$ 4.00M	*Tax base used to compute estate tax*
$ 1,700,800	*Tentative tax on $4 million tax base*
– 41,000	*Tax previously paid on gifts [see above]*
$ 1,659,800	*Estate tax liability*
– 780,800	*Unified credit (based on $2M in '06)*
$ 879,000	*Estate tax due in '06*

E. Responsibility for the Tax

While the donor is principally liable for the gift tax, the liability may shift to the donee if the donor fails to meet his obligation. Assessment against the donee may be made up to one year after the expiration of the assessment statute against the donor expires.[52] The IRS may file a lien against the transferred property for a period of ten years from the date of the gift.

The personal representative of a donor's estate may become personally liable for unpaid gift taxes, although he may request release from personal liability by submitting a written application.[53]

F. Penalties

Taxpayers may be subject to penalties ranging from late filing and late payment assessments[54] to penalties arising from valuation misstatements for which they will be assessed 20% of any underpayment caused by a substantial over- or understatement of value.[55]

Persons – including lawyers, appraisers, and tax practitioners – who knowingly aid and abet the understatement of another's tax liability may also be penalized.[56] In 2007, preparer penalties for understatement of a taxpayer's income tax liability were extended to include preparers of estate and gift tax returns.[57]

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[52] IRC § 6901(c)(1).

[53] IRC § 2204.

[54] IRC §§ 6651(a)(1) and (2).

[55] IRC § 6662 defines "substantial" misstatements as those that are 65% or less of the determined value and cause a tax understatement of more than $5,000. The penalty is increased to 40% for "gross" valuation misstatements which are 40% or less of the determined value.

[56] IRC § 6701.

[57] IRC § 6694.

G. Statute of Limitations

For the purpose of giving taxpayers certainty that the government cannot pursue them for unpaid taxes after a certain period of time, the statute on gift tax returns is limited to three years (six years if the amount of unreported items exceeds 25% of the amount of the reported items).[58] However, prior to the enactment of The Taxpayer Relief Act [TRA] of 1997, even gift valuations reported on properly filed gift tax returns could be challenged and changed by the IRS after the donor's death![59]

Under TRA 1997, in order to revalue a gift that has been adequately disclosed on a gift tax return, the Service must issue a final notice of redetermination of value within the statute of limitations applicable to the gift for gift tax purposes.[60] As a result, "there is now an added incentive for a taxpayer to file a gift tax return that includes details about the nature of the transfers made. This will ensure the taxpayer has met the adequate disclosure standard and will curtail the IRS's ability to challenge the valuation of gifts."[61]

To meet the adequate disclosure standard, gift tax returns should include a detailed description of the transaction – whether transferred or retained interests – as well as the identity of and relationship between donor and donee, and a detailed explanation of the method used to value the transferred property (less applicable discounts). Taxpayers today may wish to disclose even non-reportable gifts to establish valuation methods and preclude potential revaluation should they later make similar (taxable) transfers.

> *Example*
> *Taxpayer owns all of Company's outstanding 100 shares, valued at $2 million. He gifts one share to his daughter and values that share at $10,000 by applying a 50% minority and marketability discount ($2,000,000/100 × 50%). Based on this value, the taxpayer's gift is less than the annual exclusion and therefore not reportable. However, by filing Form 709, the taxpayer can explain how he determined the value and prevent the IRS from challenging his valuation after the statute of limitations expires should he wish to gift additional shares or leave them for his heirs to inherit.*

> *Example*
> *Zuckerberg (of Facebook fame) placed some of his pre-IPO stock into a special trust – a grantor retained annuity trust [GRAT] – in the hopes that the value of that trust would increase exponentially when the company went public. Forbes magazine conservatively estimated that this transfer would successfully (and legally) shelter roughly $185 million from gift tax when the stock eventually passed to the trust's beneficiaries.*[62]

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[58] The statute of limitations does not apply to unfiled returns or to those returns that, while filed, did not provide adequate information regarding the nature of the gift, its value, the valuation methodology used, or discounts applied.

[59] *Smith v. Commissioner*, 94 T.C. 872 (1990).

[60] Department of the Treasury, Internal Revenue Service, Office of Chief Counsel, Notice N (35) 000-151, February 27, 1998.

[61] Soled, *New Gift Tax Considerations*, Journal of Accountancy, October 1998 [available at TaxProf Blog, http://www.journalofaccountancy.com/Issues/1998/Oct/soled.htm, last accessed May 20, 2014].

[62] Jacobs, *Facebook Billionaires Shifted More Than $200 Million Gift-Tax Free*, Forbes [available at http://www.forbes.com/sites/deborahljacobs/2012/03/07/facebook-billionaires-shifted-more-than-200-million-gift-tax-free/, last accessed May 20, 2014].

FILING THE GIFT TAX RETURN

- **Form 709 must be filed to report all transfers made for inadequate consideration unless the gifted amount to each donee is less than the annual exclusion or is otherwise excludable.**
- **The filing deadline for Form 709 is April 15th of the year following the completed transfer or, if the gift was made in the year of death, Form 709 must be filed along with the estate tax return.**
- **The maximum marginal tax rate is 40% (in 2014) and is applied to the aggregate total of all lifetime gifts made.**
- **Each donor is entitled to a $5.34 million lifetime exclusion (in 2014).**
- **Taxpayers and preparers are subject to penalties for misstatements.**
- **The statute of limitations on a gift tax return adequately disclosing all reportable gifts is generally three years.**

V. Valuation

Gifted property must be valued at FMV[63] at the time that the transfer from donor to donee is completed. Certain gifts, such as gifts of partial interest, may be eligible for valuation discounts unavailable to testamentary transfers that can lessen the gift tax bite. On the other hand, transfers by bequest but not gift generally receive a stepped-up basis which may serve to lessen a future capital gains tax.

FMV can be determined for assets, such as publicly-traded stocks and bonds that trade on an established market; but the valuation of other assets may become more challenging and may require valuation by a competent and professional appraiser. The IRS requires "qualified" appraisals to be prepared by "qualified" appraisers who must provide reports that contain information regarding the appraiser's background; a description of his fee arrangement with the taxpayer; the method, basis, and justification of the valuation used; in addition, of course, to the established value.[64]

Nevertheless, even valuations of gifts appraised in this manner may be disputed by the IRS which typically favors high rather than low valuations to boost tax collections. Taxpayers, on the other hand, obviously prefer the reverse and often seek to justify valuation discounts based on the lack of marketability, income, or control of the gifted property.

Lack of Marketability

Restricted stock (unregistered shares of publicly-traded companies), shares of closely-held or privately owned companies, limited and family partnerships, amongst others share a common trait – the inability to be readily converted to cash. Studies, which have compared the price of publicly-traded, unrestricted shares of companies to the price of restricted shares of the same

[63] The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of the relevant facts [Reg. §25.2512-1].

[64] Reg. § 301.6501(c)-1(f)(3).

companies sold in the private market, have found pricing differences ranging from 13% to 45%.[65]

Lack of Control

When minority shares are gifted, the donee often owns an asset but cannot meaningfully participate in the management of the entity or determine its destiny by voting. In the past, "[t]he IRS contended that a 'unity of ownership' theory espoused under Revenue Ruling 81-253 1981-2 CB 187 prohibited a minority discount for shares that a donor gives to relatives. The revenue ruling concluded that, absent family discord, no minority discount is allowed for transfers of a corporation's shares among a family's members if the family controls the corporation at the time of the transfer. However, courts have consistently rejected the IRS' position and ruled in favor of granting a minority discount to taxpayers who transfer shares of a closely-held corporation to family members. *Charles W. Ward,* 87 TC 78 (1986); *Estate of Samuel I. Newhouse,* 94 TC 193 (1990). Finally, the IRS announced recognition of minority discounts for intra-family transfers of closely held stock. Rev. Rul. 93-12, 1993-1 CB 202"[66]

Built-in Gains

In some cases, property is gifted that includes built-in gains on assets held long before the donee acquired his ownership. These gains will eventually be taxed – presumably to the donee – creating a tax liability for gains that never truly belonged to him but for which, by virtue of the gift, he is now responsible. "While the courts and the IRS have agreed that built-in gains tax on a corporation's appreciated assets should be taken into account in valuing its stock using the net asset valuation method, they have not agreed on the proper method for quantifying the discount."[67]

Discounted valuations almost inevitably are disputed by the IRS and often must be settled in court where a battle of experts is waged.

VALUING THE GIFT

- **Gifts must generally be valued at FMV.**
- **When FMV is not readily determinable, qualified appraisers should be used to establish value.**
- **Certain gifts may be eligible for valuation discounts based on a lack of marketability or control.**
- **Valuations – especially discounted values – are hotly contested by taxpayers and the IRS.**

[65] Ransome and Satchit, *Valuation Discounts for Estate and Gift Taxes*, Journal of Accountancy, July 2009 [available at http://www.journalofaccountancy.com/Issues/2009/Jul/20091463, last accessed May 20, 2014].

[66] Trott and Sutton, *Federal Gift Tax (and the Generation-Skipping Transfer Tax)*, page 21.

[67] Ransome and Satchit, *Valuation Discounts for Estate and Gift Taxes*.

VI. Basis & Holding Period

The donee's basis and holding period of property transferred by gift generally equals the donor's basis and holding period.[68] The donee's basis may be increased by the amount of gift tax attributable to the accumulated appreciation, if actually paid.

Example
Donee received a gift with a basis of $100,000 and a FMV of $120,000. Donor paid the $5,000 gift tax. Donee later sold the gift item for $150,000.

Donee's basis is calculated as follows:

Donor's Basis	*100,000*
*Allocated Gift Tax Paid {(120,000 – 100,000) ÷ 100,000} * 5,000*	*1,000*
Donee's Basis	*101,000*

However, if the donee sells the gifted property for less than what the FMV was at the time of the gift, his basis is the lower of the donor's basis or the FMV of the property at the time of the gift. The chart below summarizes the rules governing the donee's basis depending upon whether the donee later sells the gifted property at a price more than, less than, or equal to the FMV at the time of the gift:

	Sell < FMV	Sell btw FMV & D's Basis	Sell > FMV
Donor's Basis	100	100	100
FMV at the time of gift	90	90	90
Donee's Sales Price	80	95	120
➔ Donee's Basis	90	90 or 100	100
Donee's Capital Gain (Loss)	(10) = 80 - 90	0	20 = 120 - 100
Donee's Basis equals…	The lower of FMV or Donor's Basis	Basis for gain is 100, but no gain; basis for loss is 90, but no loss	Donor's basis [GENERAL rule]

Part Sale / Part Gift

If an owner sells his property for less than its FMV, the transaction is deemed to be part sale/part gift. The buyer's basis is the greater of the amount paid for the property or the seller's basis increased for any gift tax paid attributable to the appreciation. However, the basis for loss cannot exceed FMV at the time of the gift. The seller's capital gain is the difference between the amount realized from the sale and the adjusted basis. (His loss, if realized, is not deductible).[69]

[68] IRC §§ 1015 and 1223(2).
[69] Reg. § 1.1001-1(e).

	Donee sells at gain	Donee sells at loss
Donor's Basis	12	40
FMV at the time of the gift	35	35
Donor sells to Donee for…	20	20
Donor's reportable gift	35 – 20 = 15	35 – 20 = 15
Donor's Capital Gain (Loss)	20 – 12 = 8	20 – 40 = (20) BUT Donor can't deduct loss
➔ Donee's Basis	20 Greater of amt. Donee pd. or Donor's basis	35 Greater of amt. Donee pd. or Donor's basis, BUT never more than FMV
Donee sells for…	50	15
Donee's Capital Gain (Loss)	50 – 20 = 30	15 – 35 = (20)

BASIS AND HOLDING PERIOD

- **Carry-over Basis: Generally, donee assumes donor's basis and holding period.**
- **However, if the gifted property is later sold at a loss, donee's basis is limited to the lesser of the FMV at the time of the gift or donor's basis.**
- **Donee's basis may be increased by an allocable portion of gift tax paid.**
- **Property sold at less than FMV results in part sale/part gift treatment.**

VII. Generation-skipping Tax (GST)

The GST is imposed on a direct transfer of property to a grandchild which would otherwise be subject to two levels of estate (or gift) taxation if first taxed as part of the parent's estate, then transferred from parent to child, taxed as part of the child's estate, and finally transferred to the grandchild.[70] Because the GST rate equals the top bracket of the estate tax rate currently in effect, this tax usually exceeds that which would have otherwise been incurred at graduated rates if the property had been transferred and taxed at each successive generation.

GST is imposed on the following transfers:

- A transfer of property, subject to gift or estate tax, made to a skip person.
- A termination of a trust interest that passes property to a skip person.
- Any other trust distribution to a skip person.

[70] GST is imposed on direct skips, taxable terminations, and taxable distributions made to a skip person defined as a relative who is at least two generations below the transferor. Spouses, former spouses, tax-exempt organizations and charitable trusts are non-skip persons. If the transferor's child is deceased, the grandchildren by that child are not considered skip persons [IRC § 2612]. If the transferor has no lineal descendants and a niece or nephew of the transferor is deceased, the children of the deceased niece or nephew are not skip persons [IRC § 2651].

A. Exclusions

Each transferor has a $5.34 million exemption (in 2014).[71] The tax is not applied to outright gifts that are excluded by the annual gift tax exclusion or qualified transfers for medical and tuition payments. However, a gift to a trust which qualifies for the gift tax annual exclusion must meet additional requirements to qualify for the GST tax exclusion – for example, Crummey Trusts qualify for the annual gift tax but not the GST exclusion.

> *Example*
> *A taxpayer, who for years has made annual gifts to his three grandchildren to take advantage of the annual gift tax exclusion, has now created a trust for the benefit of all three children and made one lump-sum gift to the trust equal to three times the annual gift tax exclusion. This gift, while eligible for the gift exclusion does not qualify for the GST exclusion.*

Gifts to trusts must first satisfy the annual exclusion for all gifts ($14,000 in 2014) and then two additional requirements: (1) the trust must be for the benefit of a *single* skip person[72] and (2) the trust must be includible in the skip person's gross estate if the trust does not terminate before that person's death.[73]

The GST exemption is not an exemption in the customary sense but serves instead to reduce the applicable rate of tax on the GST transfer [see computation below]. Any portion of an individual's GST exclusion that is not used during a calendar year is automatically allocated to lifetime transfers that are not direct skips but are indirect skips to GST trusts. If the GST tax exemption is not allocated by the due date of **Form 706**, the remaining exemption is automatically allocated, first to direct skips occurring at death, and next to all transfers to GST trusts for which the decedent is the most recent transferor. Transferors can elect not to have the automatic rules apply.[74]

B. Computation

The GST Tax is calculated using the maximum estate tax rate currently in effect; it is not a graduated tax but simply the product of all GST transfers during the year multiplied by the maximum estate tax rate (40% in 2014) times an inclusion ratio which is used to convert an allocated portion of the GST exemption into a tax rate deduction. Thus, in 2010, when the estate tax rate was temporarily at zero, there was no GST.

> *Example*
> *Taxpayer transfers $2 million to a trust for her son and grandson which permits the trustee to make discretionary distributions to either or both beneficiaries. Taxpayer allocates $500,000 of her GST exemption to the transfer. When the son dies in 2014, there is a taxable termination. With the value of the trust now at $3 million, the tax will be calculated as follows:*
>
> *3,000,000 * 40% * [1 – (500,000 ÷ 2,000,000)] = 3,000,000 * 30% = 900,000*

[71] Unlike the estate tax exclusion which is portable between husband and wife, the unused portion of the GST exclusion is not transferable.

[72] IRC § 2613(a).

[73] IRC § 2642(c)(2).

[74] IRC § 2632(b) and (c).

C. Reporting

Direct skip transfers made during lifetime are reported on **Form 709** on Schedule A, Part 2;[75] direct skips made at death are reported on **Form 706** on Schedule R.

Liability for the GST is assigned to the transferor for direct skips, to the trustee for taxable terminations, and to the transferee for tax distributions from trusts.

GENERATION-SKIPPING TAX

- **GST is assessed based on the value of property transferred to a skip person.**
- **The GST exemption is currently set at $5.34 million (in 2014).**
- **In general, GST transfers are eligible for the annual gift exclusion but GST transfers to trusts must satisfy additional requirements.**
- **The GST tax rate equals the maximum current estate tax rate times an inclusion ratio.**
- **GST transfers are reported on Form 709 if made during life; on Form 706 if made at death.**

VIII. Gift Tax in Concert with the Estate Tax

When the Estate Tax was enacted in 1916, it did not take long for clever taxpayers to circumvent the tax which gave the government the ability to share in the transfer of wealth at death. While some taxpayers mulishly announced, "I just won't die!" others simply chose to transfer their wealth while still alive and avoid what is often called the "Death Tax".

And so, the Gift Tax was first enacted in 1924, repealed in 1926, overhauled and reintroduced in 1932 as a protective measure to minimize estate and income tax avoidance. Later, the Economic Growth and Tax Relief Reconciliation Act [EGTRRA] of 2001 began to phase out the Estate Tax,[76] but maintained the Gift Tax precisely for the same reasons it was originally enacted.[77]

To ensure that all transfers – whether during life or after death – are similarly taxed, estates and gifts are subject to a common rate schedule. Additionally, cumulative taxable gifts made during life are added back to the taxable estate, thereby bumping the taxable estate into a higher tax bracket and increasing the resulting tax due from which taxpayers may then subtract the amount of gift tax actually paid in prior years. This convoluted calculation has the effect of eliminating double taxation but ensures that all gifts are ultimately taxed at the highest applicable tax bracket based on their cumulative value at death.

[75] The tax is computed on Schedule C.

[76] Many of EGTRRA's provisions were scheduled to sunset at the end of 2010 but were extended through December 31, 2012 by TRA 2010.

[77] Joulfaian, *The Federal Gift Tax: History, Law, and Economics*, U.S. Department of Treasury, OTA Paper 100, November 2007.

The Gift Tax is said to be tax-exclusive since the tax is assessed only on moneys that are actually transferred, while the Estate Tax is tax-inclusive since taxpayers are required to pay tax on moneys that will be transferred as well as moneys that will be used to pay the tax due. As a result, the Estate Tax is more onerous than the Gift Tax.

Example
Assume that the tax rate on both estates and gifts is a flat 50% and that all of the unified credit has been used: If Taxpayer gave a $2 million gift; he would pay $1 million tax from moneys that he retained and did not transfer to the donee. He has just "spent" $3 million of which the donee pocketed ⅔.

But if Taxpayer has a net worth of $3 million at the time of death, the estate tax would consume $1.5 million, leaving the heirs with only ½.

It is important to note that any unified credit that is used up to reduce the gift tax, no longer remains available to offset the estate tax.

Deathbed Transfers

Often, proactive taxpayers attempting to prevent the inclusion of assets at death, "quickly" transfer assets before passing away. While the appreciation on these last-minute transfers[78] between the date of transfer and death is never included in the estate, the value (at the time of the gift) of certain gifted property[79] – along with the gift tax previously paid – is added back to the gross estate and subject to estate tax.[80]

Example
Dad gifted his personal residence valued at $5,263,000 to Son in 2011, retaining the right to live in the home rent-free. After excluding $13,000, the tentative gift tax totals $1,818,300; subtract the credit attributable to Dad's previously unused lifetime exclusion and the gift tax equals $87,500 which Dad paid.

Dad dies in 2012. Both the value of the gift and the gift tax paid are added back to Dad's estate which is now taxed on an additional $5,350,500 even though the property transferred before death. After computing the estate tax tentatively due, the tax will be reduced by the amount of gift tax previously paid.

To prevent the deathbed transfer of assets from a healthy spouse to one who is ill, a one-year waiting period is imposed on the basis step-up rule – if during that year a transferred asset is returned to the donor-spouse, the donor will not be entitled to a basis step-up.[81]

The value of life insurance policies gifted within three years of the transferor's death will be included in the decedent's estate.[82]

[78] The IRS imposes a three-year look-back period.

[79] Affected gifts include retained life estates (§ 2036), transfers affective at death (§ 2037), revocable transfers (§ 2038), and life insurance proceeds (§ 2042).

[80] IRC § 2035(b) – known as the "Gross-up Rule".

[81] IRC § 1014(e).

[82] IRC § 2035(a).

Capital Gains

Recall that the basis and holding periods of assets transferred by gift differ from those transferred by bequest:

- Gifted assets generally retain the donor's basis and holding period.
- Inherited assets receive a stepped-up basis and always have a long-term holding period.

As a result, heirs get a fresh start, whereas donees become liable for any gains accumulated during the transferor's tenure. To ensure that these accrued gains are not subjected to both gift and income taxes, the asset's basis is increased for gift taxes paid that are allocable to the gains.[83]

ESTATE VERSUS GIFT TAX

- **The value of all taxable gifts made during life are added back to the decedent's estate, ensuring that gifts and bequest are always taxed at the highest applicable marginal rate.**
- **An executor may claim a credit against the estate tax liability for gift taxes previously paid.**
- **Gift Tax is tax-exclusive; Estate Tax is tax-inclusive.**
- **The Three-year Rule is intended to discourage deathbed transfers.**
- **The donor's accumulated appreciation will be taxed to the donee.**

IX. Comprehensive Example

Facts:
Single taxpayer made the following cash gifts in 2011:

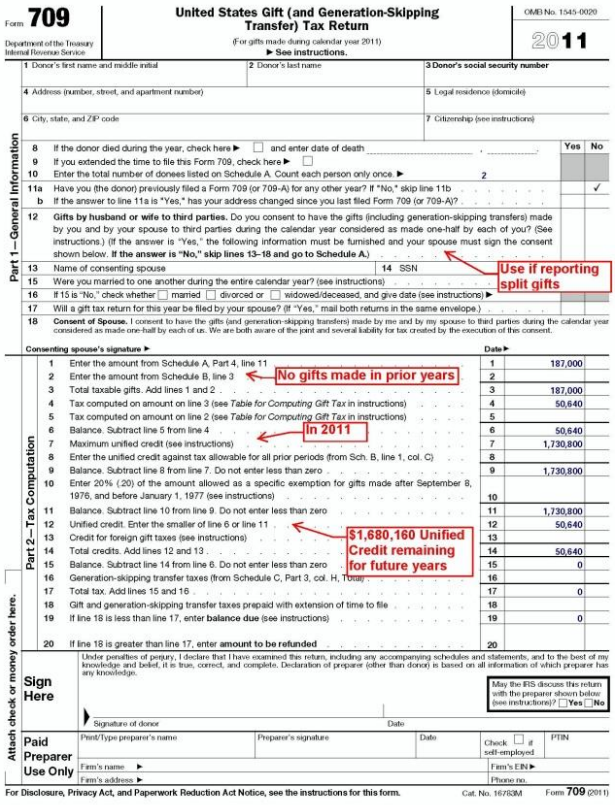
- $200,000 Cash to son Bob
- $100,000 Church donations
- $13,000 ea. Checks 5 grandkids

Step 1: Use Schedule A, Part 1 to report gifts to Son and Church – report gifted amounts in full (and provide as much detail as possible).

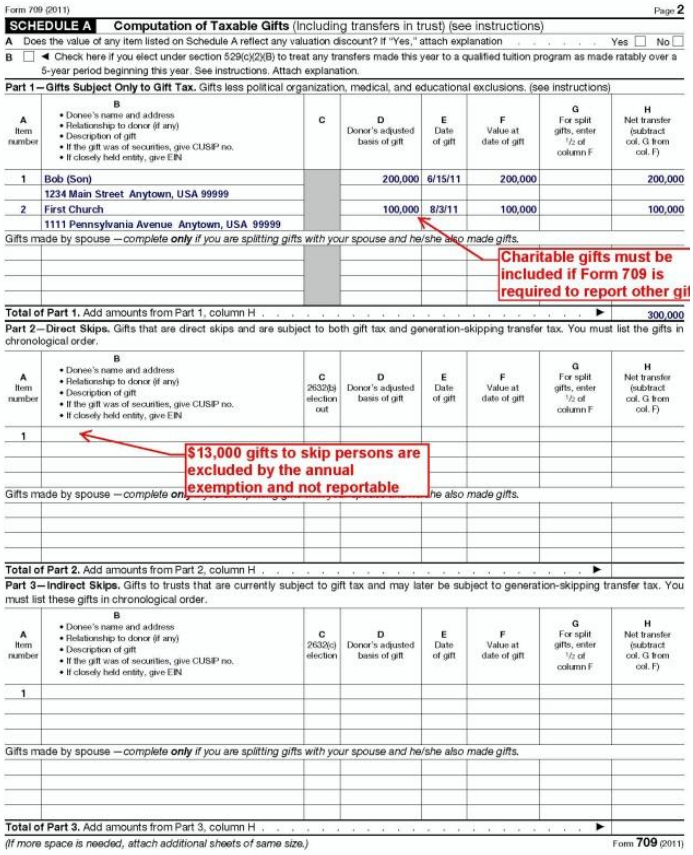
Step 2: Do not report gifts to grandchildren in Part 2 or 3 since they are exempt under the annual exclusion.

Step 3: Carry totals from Part 1 to Part 4 (on Page 3) – deduct annual exclusion and non-taxable charitable deduction (net of its exclusion) to determine taxable gifts.

Step 4: Carry total of taxable gifts on Line 11 of Schedule A, Part 4 to Line of **Form 709,** Page 1 and complete tax computation using tax rate schedule provided with **Form 709** Instructions; then subtract available Unified Credit to determine tax due.



[83] IRC § 1015(d)(2).



X. Conclusion

"Supporters of the estate and gift tax argue that it provides progressivity in the federal tax system, provides a backstop to the individual income tax and appropriately targets assets that are bestowed on heirs rather than assets earned through their hard work and effort."[84] Critics on the other hand, claim that these taxes stifle and even discourage savings and economic growth, that it unfairly burdens small businesses and family farms, and that it is assessed at an inopportune time when families should devote energies to the grieving process rather than tax compliance. Whatever the pros and cons, gift and estate taxes are expected to generate only 1.2% of total federal revenues during the current decade.[85] This sobering statistic may argue in favor of eliminating these transfer taxes altogether due to their ineffectualness or argue in favor of expanding legislation to foster a potentially lucrative source of revenue.[86]

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[84] Gravelle, *Economic Issues Surrounding the Estate and Gift Tax: A Brief Summary*, CRS Report for Congress, The Library of Congress, Order Code RS20609, April 24, 2007.

[85] As estimated by the Congressional Budget Office, *Economic Budget and Issue Brief*, December 18, 2009 [available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10841/12-18-estate_gifttax_brief.pdf, last accessed May 20, 2014].

[86] *The Tax Prophet* (Issue # 104, January 2012) reports that the IRS has received judicial permission and "is trolling in California for gift taxes" by reviewing state records in search of family transfers of real property between 2005 and 2010. Although the lifetime gift tax exclusion is currently over $5 million, it was limited to $1 million in earlier years.

Tax Law – Old and New

We have until recently been operating under gift and estate law enacted with the Unemployment Insurance Reauthorization and Job Creation Act of 2010, which extended (and modified) provisions originally introduced with the enactment of EGTRRA 2001 and that were scheduled to expire at the end of 2010. The 2010 law was also temporary, requiring extension or replacement of provisions after December 31, 2012. The American Taxpayer Relief Act of 2012 (ATRA)[87] did just that.

Under ATRA, the Gift and Estate Tax exemption has been permanently set to $5 million, indexed for inflation – thus, the exemption amount for 2014 is $5.34 million. The top marginal bracket has been set to 40%.

Other relevant adjustments include:

- The lifetime estate tax exclusion continues to be portable between spouses and allows the surviving spouse to use any unused portion of the decedent spouse's exclusion. This provision was originally in effect only in 2011 and 2012 and has now been permanently enacted into law. As a result, the combined exemption for a couple in 2014 is $10.68 million.[88]
- The annual gift tax exclusion has been permanently indexed for inflation and is scheduled to rise in increments of $1,000 whenever inflation adjustments are sufficient. For 2014 the exclusion is set at $14,000.

The Year of the Big Gift

Fearing changes that would have been less taxpayer-friendly prior to the enactment of ATRA, wealthy taxpayers had previously been advised to take advantage of a planning opportunity by making large gifts in 2012. Expecting the lifetime exclusion to revert back to pre-EGTRRA levels, tax advisors suggested that sufficient property be transferred to benefit from the $5.12 million exclusion then in effect to shelter as many assets as possible before the scheduled reversion to $1 million occurred on January 1, 2013. By making transfers in the 2012, planners hoped that their clients would lock in the exclusion and shelter large portions of their wealth from gift tax in current and future years.

While the dreaded change did not in fact occur, many taxpayers acted on the advice unsure of what might come. Although no detriment enured, tax practitioners should note that taxpayers who gifted amounts in 2012 (or other years) may have already exhausted much, if not all of their lifetime exclusion and may be entitled to claim only a small remainder in the eventual year of death.

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[87] Public Law 112-240, enacted January 2, 2013.

[88] A surviving spouse may apply the unused portion of the pre-deceased spouse's estate tax exemption against any future estate or gift tax liability of the survivor as long as the deceased spouse was the most recent spouse of the survivor. [IRC §§ 2010, 2501 and 2502].