FEDERAL GIFT TAX OVERVIEW

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Tim's practice includes: advising on design and drafting of estate planning documents, including wills, revocable and irrevocable trusts (including charitable trusts), family limited partnerships, shareholder agreements, and intra-family sale agreements; pre-liquidity event tax planning, including leveraged sales of interests in private companies to dynasty trusts, transfers to grantor retained annuity trusts, and pre- and post-sale charitable planning; advising on investment diversification, asset protection, and corporate and family governance issues, including the reorganization of private companies to improve the tax efficiency of those organizations; counseling on the formation and administration of a variety of tax-exempt and charitable entities; transfer situs of trusts to more favorable jurisdictions to take advantage of tax efficiencies and modernized trust laws, and advise clients with respect to state fiduciary income tax issues; structuring and implementing judicial and non-judicial modifications of irrevocable trusts; advising on the structuring and formation of private trust companies in various jurisdictions; preparing and reviewing estate and gift tax returns, including complex reporting and valuation issues; negotiating settlements with the IRS on audited estate and gift tax returns; and advising on litigation disputes between trustees and beneficiaries and in contested trust and tax matters, and consult with fiduciaries in probate and trust administration.

Tim frequently writes and speaks on a variety of tax and estate planning subjects.

I. INTRODUCTION

A. The gift tax is a transfer tax much like the estate tax, but simpler to understand. Whereas the estate tax reaches all residual property that might otherwise escape transfer tax, the gift tax provides for taxation only of specific items that are transferred by gift.

B. The federal taxation of gifts is governed by "Chapter 12": Internal Revenue Code ("IRC") Sections 2501-2524 and accompanying Treasury Regulations. (Estate Tax = "Chapter 11" GST Tax = "Chapter 13").

C. As discussed below, each individual may make $15,000 (indexed for inflation) annual exclusion gifts to as many beneficiaries as he or she desires without gift tax or subsequent estate tax consequences. Also, an individual's unified credit may be used to shelter gifts exceeding the annual exclusion gifts.

D. D. Under the Tax Cuts and Jobs Act of 2017 (the "Act"), the federal estate and gift tax exemption amounts remain unified at $10 million, adjusted for inflation from a base year of 2010, effective for decedents dying and gifts made after 2017 and before 2026. In 2018, the exemption amount is $11.18 million. After December 31, 2025, the exemption amount is scheduled to revert back to the pre-Act amount of $5 million, adjusted for inflation. The gift tax rate remains 40 percent and portability of gift tax exemption between spouses is preserved.

E. A key difference between gift and estate taxes is that gift taxes are imposed on a tax *exclusive* basis (the payment of gift taxes by the donor is not itself subject to gift taxes) while estate taxes are imposed on a tax *inclusive* basis (the assets of the decedent that are used to pay estate taxes are subject to estate tax).

EXAMPLE. D makes a $1 million gift to her son, S. If D has used her full gift tax exemption amount, she will owe $400,000 in federal gift taxes ($1 million x 40 percent). Because it cost D $1.4 million ($1 million gift + $400,000 in taxes) to transfer $1 million to S, D's effective tax rate is 28.6 percent (400,000/1.4 million).

EXAMPLE. At D's death, she leaves a $1 million estate to S. If D has used her full estate tax exemption amount, and assuming D was not domiciled in a state that imposes its own estate tax, D's estate will owe $400,000 in estate taxes ($1 million x 40 percent) and S will receive $600,000. If D leaves a $1.4 million estate to S, D's estate will owe $560,000 in taxes ($1.4 million x 40 percent) and S will receive $840,000. Because the property used to pay estate taxes is subject to tax, in both cases the effective tax rate is 40 percent.

F. Gift tax returns for gifts are to be filed, and gift taxes paid, on annual basis. In general, returns are filed by April 15 of the year following the year of the gifts (a six-month extension of the time to file, but not pay gift taxes, is allowed). For the calendar year in which a donor dies, the return for that year must be filed no later than due date of the donor's estate tax return.

II. TRANSACTIONS SUBJECT TO GIFT TAX

A. The gift tax applies to any direct or indirect transfer of property. This includes outright gifts or gifts in trust, gifts of real property, and gifts of both tangible and intangible personal property.

1. Types of transactions that may be considered gifts:

- The transfer of cash or securities;
- The creation of a trust;
- The forgiveness of a debt;
- The assignment of a judgment;
- The assignment of the benefits of an insurance policy;
- The transfer of a painting or other work of art; and
- Permitting a child or friend to use a vacation home without paying rent.

2. The amount subject to gift tax is the difference between the fair market value of the property transferred and the value of any consideration received in return.

EXAMPLE. Father transfers $100,000 in cash to Son and receives nothing in return from Son. Father has made a gift of $100,000 to Son.

Example. Father transfers $100,000 in cash to Son to purchase from Son a house with a fair market value of $75,000. As a result of this "bargain sale," Father has made a gift of $25,000 to Son.

B. For property law purposes, a completed gift requires: (1) intent to make a gift; (2) delivery of the gift to the done; and (3) acceptance of the gift.

C. For purposes of federal tax law, neither donative intent nor an identifiable donee is required for a taxable gift to occur. Instead, the following requirements must be met:

1. There must be a completed, irrevocable transfer of property from one person to another (loss of "dominion and control").

a. If the transfer can be revoked by the donor, then no completed gift has occurred.

EXAMPLE. Mother writes a check to Son for $100,000. Because Mother can stop payment on the check, Mother's gift to Son is not complete until Son presents the check for payment at his bank (note that a "relation back" doctrine applies to charitable gifts made in this fashion).

b. Similarly, if the donor has made a transfer but reserved the power to change the disposition of the property (such as through a power of appointment), then no completed gift has occurred. Where a donor transfers property to himself/herself as trustee, the power to make distributions of trust property that is *not* limited by a fixed or ascertainable standard will cause a gift to be incomplete. Conversely, if the donor's power as trustee is limited to a fixed or ascertainable standard, the donor is treated as having made a completed gift.

c. If an individual makes a transfer that is not a taxable gift because at the time of transfer it is not complete and irrevocable, then at such time that the transfer becomes irrevocable a taxable gift occurs. Thus, if an individual establishes a trust for the benefit of his son and retains the right to revoke the trust, no taxable gift has been made. If he subsequently amends the trust to relinquish his power to revoke it, a taxable gift is made at that time, notwithstanding the fact that there is no actual transfer at that time. Note that a transfer that becomes complete as a result of the transferor's death will be subject to estate taxes, not gift taxes.

d. Since a taxable gift does not occur until a transfer is irrevocable, the establishment of a joint bank account is not a taxable gift. When a joint bank account is created, either of the joint tenants has the right to remove all the funds from the account at any time; the transfer is, therefore, incomplete with respect to the person establishing the account. At any time that person can simply withdraw the funds, and no enrichment will have accrued to the benefit of the other joint tenant. On the other hand, at the time the noncontributing joint tenant withdraws funds from the account, the transfer is completed and a taxable gift has occurred. Similar results occur with respect to joint United States savings bonds and to joint brokerage accounts in which the broker holds the securities in street name.

2. The transfer must be for less than full and adequate consideration.

a. Note that an individual must have a beneficial interest in property to make a taxable gift (e.g., transfers by trustees who are not also beneficiaries/settlors of a trust are generally not taxable gifts). Where an individual trustee of a trust is also a beneficiary, a taxable gift may arise if the trustee may make distributions of trust property on a nonascertainable standard.

b. Although an individual may make a taxable gift without being aware of it (such as selling stock in a closely held business to a child for an amount of money that is later determined to be less than the fair market value of the stock), courts have excluded as taxable gifts certain transfers where donative intent is not present.

c. For this reason, involuntary transfers and most bona fide business transactions fall outside the scope of the gift tax. Transfers made according to divorce decrees and arms-length business sales that turn out to be windfalls for the purchaser are not taxable gifts.

D. Powers of Appointment. If an individual possesses a general power of appointment with respect to property and exercises that power of appointment in favor of someone other than himself, he has made a taxable gift to that person. Similarly, a release or lapse of the power may be a taxable gift (note the "5 and 5" exception of IRC Section 2514(e)).

E. Certain below-market interest rate loans constitute gifts to the borrower of the use of loan proceeds. See IRC §7872.

F. Gift of Insurance.

1. Individuals frequently view insurance as an ideal asset to transfer by gift. People are not concerned with losing control of life insurance because it is an asset which they do not generally view as having great value during their lives (especially term policies). To the extent that the policies have little lifetime value, little or no gift tax is incurred on the transfer of the policies. Finally, since the beneficiary of the life insurance policy normally will receive the proceeds without income tax consequences, no

step-up in basis is lost with respect to a gift of life insurance.

2. A gift of life insurance is valued for gift tax purposes at its fair market value on the date the gift is made (usually based on the "interpolated terminal reserve" of the policy).

3. An individual must survive three years after transferring a life insurance policy in order to avoid having the proceeds taxed in his or her estate.

4. To avoid the three-year inclusion rule above, an individual can sell a policy on his or her life to a trust that is treated as a grantor trust as to him/her for federal income tax purposes. Note that other sales may trigger the "transfer-for-value" rules and cause the proceeds of the policy to be subject to income taxes on the death of the insured.

III. ANNUAL EXCLUSION (IRC SECTION 2503)

A. A. Under current law, any individual is entitled to make a gift to any other individual of an amount up to $15,000 in any calendar year without incurring any gift tax liability. The number of donees who can be given the $15,000 gifts is unlimited, and the donees need not be related to the donor in any way. Such tax-free gifts can be made on an annual basis to each donee; however, if the gift is not made in any year, the ability to make the exclusionary gift is not carried forward. Thus, an individual is free to give his or her child $15,000 without gift tax consequences every year; however, if the individual fails to make a gift in any calendar year, he or she cannot make a $30,000 tax-free gift in a subsequent year.

B. The annual exclusion is only available for gifts of present interests. Gifts of future interests, i.e., gifts in which the donee's right to enjoyment of the property is deferred until some future time, do not qualify. This means that many gifts in trust will not qualify for the annual exclusion.

1. **EXAMPLE.** An individual sets up a trust for his 25-year-old child which provides that the trustee has the discretionary power to distribute income and principal to the child for five years, and at the end of the five years the property will be distributed outright to the child. The gift is a future interest since the child's right to beneficial enjoyment of the property is deferred for five years. This transfer in trust would not be eligible for the annual exclusion.

2. This future interest rule has an important exception that governs certain transfers in trust for the benefit of minors. IRC Section 2503(c). The exception provides that in the case of property left in trust for a minor, if the principal and income of the trust are available to be expended for the benefit of the minor and, to the extent that they are not so expended, will pass to the minor upon his or her 21st birthday (or, if the minor dies before reaching 21, will pass to his or her estate or to whomever he or she designates in his or her will), then the property so transferred will qualify for the annual exclusion.

3. In addition to the exception for a minor's trusts, a beneficiary's right to withdraw property contributed to a trust, even for a limited time, can convert the beneficiary's interest into a present interest so that the contribution qualifies for the annual exclusion. This is true even though the beneficiary does not exercise the power and otherwise will not be entitled to receive the property until much later. This withdrawal right is known as a "Crummey Power." (Note, however, that there are separate, more stringent rules that determine whether there is a present interest for GST purposes).

C. A donor may make up to five years' worth of annual exclusion gifts in a given year to a donee if the transfer is to a Section 529 plan for the benefit of that donee (although this will reduce/eliminate the amount of annual exclusion gifts that the donee can receive over the balance of the five-year period).

D. In addition to the annual exclusion gifts, an individual may make unlimited gifts to pay for certain educational or medical expenses of a donee without gift tax liability. These gifts must be paid directly to the school or medical care provider.

IV. GIFT SPLITTING (IRC SECTION 2513)

A. The spouse of an individual, for gift tax purposes, may elect to be treated as the donor of one-half the value of the gifts the individual makes from his separate funds. Thus, the gift tax liability can be split between two spouses, even though only one spouse has wealth.

EXAMPLE. A wishes to make a $20,000 gift to his child in 2018. If A were to make this gift by himself (and his spouse did not consent to the gift-splitting election), the gift would exceed A's annual exclusion, and either he would have to use a portion of his unified credit or, if that had been exhausted previously, he would be subject to tax on $5,000 of the gift. On the other hand, if A's spouse consents to treat half the gift as having been made by her, then even though the gift was made from A's funds, each spouse is deemed to have made a $10,000 gift to the child for gift tax purposes. In this case, both gifts are absorbed completely by the annual exclusions.

B. As a result of gift splitting, a couple can join in giving any number of individuals up to $30,000 per year without incurring gift tax liability, regardless of the fact that the funds that were actually the subject of the gift were the property of one spouse only.

Example. If a married couple with two married children and four grandchildren elect to split gifts, they can give each of these six blood relatives up to $30,000 per year without incurring any transfer tax. If they decide to include the spouses of their children in their gift program, they increase their group of donees to eight and can give each of these eight donees up to $30,000 per year. Thus, they can make gifts of up to $240,000 per year, each and every year, without incurring any transfer tax liability and without using any portion of their unified credit.

C. Note that the election to split gifts is not effective with respect to a transfer by one spouse to a trust in which the other spouse has a beneficial interest, unless the other spouse's interest is ascertainable (i.e., severable) at the time of the gift.

Example A. Husband makes a gift to a trust for the benefit of Wife and descendants, to whom the trustee may distribute trust property for their respective support, health, education, best interests and welfare. Because Wife could, potentially, receive a distribution of all trust property, the election to split gifts will not be effective as to the gift to the trust.

EXAMPLE B. Husband makes a gift to a trust for the benefit of his descendants. Wife is given a withdrawal power over $5,000 of the gift but has no other beneficial interest in the trust. Because Wife's interest in the transferred property is clearly ascertainable and can be severed from the balance of the transfer, Husband and Wife may not split $5,000 of the gift to the trust, but may split the balance of the transfer.

V. DISCLAIMERS (IRC SECTION 2518)

A. A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. If a disclaimer satisfies the requirements of Section 2518, the individual making the disclaimer is not treated as having made a taxable gift.

B. A disclaimer that fails to satisfy one or more of the requirements of Section 2518 is treated as a gift for federal gift tax purposes, even if the disclaimer still meets the requirements of a valid disclaimer under applicable state law. In other words, it is possible to have a transfer that is treated as a gift for federal tax purposes but not for purposes of state property law.

VI. MARITAL DEDUCTION (IRC SECTION 2523)

A. The marital deduction for gift tax purposes is essentially the same as for the estate tax. ERTA (the Economic Recovery Tax Act of 1981) eliminated monetary limitations on the amount of the marital deduction and greatly simplified this area of the law. Currently, unlimited transfers may be made from husband to wife and vice versa without gift tax. These tax-free transfers can be: (a) outright; (b) by the creation of joint tenancies; or (c) by the creation of certain qualifying interests in trusts. The rules governing the qualification of trust interests are comparable to those discussed in connection with the estate tax marital deduction.

B. With respect to gifts to non-citizen spouses, non-taxable gifts of $152,000 per year (as of 2018, but indexed for inflation) are permitted as "annual exclusion" gifts, without the need to use a Qualified Domestic Trust ("QDOT").

VII. CHARITABLE DEDUCTION (IRC SECTION 2522)

A. This is available solely for transfers for charity. There is a gift tax return filing requirement for charitable transfers in excess of $15,000.

B. Transfers for charitable and private purposes. The rules governing the availability of the charitable deduction for lifetime transfers to charitable remainder trusts, charitable lead trusts, or pooled income funds are comparable to those in connection with the estate tax charitable deduction.