GIFT TAX 101

Bruce D. Steiner

Kleinberg, Kaplan, Wolff & Cohen, P.C.

I. Benefits of Making Gifts.

A. The taxable transfer is generally limited to the value of at the time of the gift.

B. The future income and growth are generally removed from the estate.

C. The estate tax is on the gross amount, while the gift tax is only on the net amount.

1. Example: decedent has 100, pays estate tax of 45 (or 53.8 in New York), net to beneficiaries 55 (or 46.2 in New York).

2. Example: donor has 100, makes a gift of 69, pays gift tax of 31. The tax has been reduced by 31% (or 42% in New York). The net amount to the beneficiaries has been increased by 25% (or 49% in New York).

D. Some states, such as New York and New Jersey, have an estate tax but no gift tax.

II. Limitations and Tradeoffs of Making Gifts.

A. Assets included in the estate generally receive a basis step-up. Section 1014.

B. Gifts generally take a carryover basis. Section 1015.

C. There is a basis adjustment for gift tax paid on the appreciation. Section 1015(d).

D. Gift tax paid on gifts made within three years of death is included in the estate. Section 2035(b).

E. If the donor retains an interest and dies before the expiration of the retained interest, the property is included in the donor's estate. Section 2036(a)(1). This applies to a grantor retained annuity trust ("GRAT") or a qualified personal residence trust ("QPRT").

F. The gift tax exempt amount is limited to $1 million, even though the estate tax exempt amount is presently $3.5 million. Section 2505(a).

III. The Gift Tax Statute of Limitations.

A. The gift tax statute of limitations is generally three years. Section 6501(a).

B. The statute of limitations is six years if there is an omission of more than 25% of the gifts shown on the return. Section 6501(e)(2).

C. For gifts before August 6, 1997, prior years' gifts could be revalued for purposes of a subsequent gift tax return unless (i) the statute of limitations had run on the prior gift, and (ii) gift tax had been assessed or paid for the prior year. Section 2504; Rev. Rul. 84-11, 1984-1 Cum. Bull. 201.

D. For gifts after August 5, 1997, the value of a prior gift that was adequately disclosed on a gift tax return is final after the statute of limitations expires. Section 2001(f)(2).

E. For gifts after 1996, the statute of limitations remains open unless the gift is adequately disclosed. Treas. Reg. § 301.2501(c)(1).

F. A donor can provide disclosure on an amended gift tax return. Rev. Proc. 2000-34, 2000-2 Cum. Bull. 186.

IV. Gift Tax Statute of Limitations for Estate Tax Purposes.

A. For gifts before August 6, 1997, even if gift tax was paid, the Internal Revenue Service takes the position that gifts can be revalued in determining the adjusted taxable gifts for estate tax purposes. Treas. Reg. § 20.2001-1(e).

B. The Tax Court agreed with the Service, but allowed credit for the gift tax that would have been paid based upon the revalued taxable gift. *Estate of Frederick R. Smith*, 94 T.C. 872 (1990); *acq*., 1990-2 Cum. Bull. 1.

C. For gifts after August 5, 1997, if the gift was adequately disclosed, it cannot be revalued for estate tax purposes. Treas. Reg. § 20.2001-1(b), effective for gift tax returns filed after December 3, 1999.

V. The Generation-Skipping Transfer Tax Statute of Limitations.

A. The gift tax value is used for GST exemption allocations made on timely filed gift tax returns. Section 2642(b)(1).

B. The gift tax value is likewise used for deemed allocations of GST exemption. Section 2642(b)(1).

C. The estate tax value is used for allocations of GST exemption to transfers at death.

D. The inclusion ratio for a direct skip becomes final when the statute of limitations expires as to the GST tax on the direct skip. Treas. Reg. § 26.2642-5(a).

E. With respect to a taxable distribution or taxable termination, the Service takes the position that the inclusion ratio becomes final on the later of the expiration of the statute of limitations for the first GST tax return filed using that inclusion ratio or for the transferor's estate tax return. Treas. Reg. § 26.2642-5(b).

VI. Whether to Disclose a Transaction That May Not Be a Taxable Gift.

A. Disclosure provides finality.

B. The finality extends to other issues such as *Crummey* withdrawal powers.

C. However, disclosure may raise issues that might not otherwise come to light.

D. There is now a question on the estate tax return that asks about transfers to grantor trusts.

VII. Gift-Splitting.

A. A husband and wife can elect to treat gifts to third parties as if made one-half by each of them. Section 2513(c).

B. Whether a gift to a trust in which the spouse is a discretionary beneficiary is eligible for gift-splitting is a complicated issue.

1. Where the trustees had complete discretion as to income and principal, the Service ruled that the value of the spouse's interest could not be determined, so that gift-

splitting was not available. Rev. Rul. 56-439, 1956-2 Cum. Bull. 605.

2. In *William H. Robertson*, 26 T.C. 246 (1956), the Tax Court allowed gift-splitting for the principal where the wife received the income and the trustees could distribute principal to her for her maintenance and support. Given the wife's other assets "and the provisions of the trust agreement which limit the discretion of the corporate trustee to invade the trust principal for the wife's maintenance and support," the Tax Court concluded "that there is no likelihood of the exercise of this power as disclosed by the facts."

3. In *O'Connor v. O'Malley*, 57-1 USTC ¶ 11,690 (D. Neb. 1957), the court allowed gift-splitting as to the principal where the trustees had discretion as to the principal, but the donor testified that she did not intend for any principal to go to her husband, he disclaimed his interest in the principal, and no principal was distributed to him.

4. In *Max Kass*, T.C. Memo 1957-227, the Tax Court did not allow gift-splitting where the trustees could invade for the wife's "general welfare," and the donor "failed to prove sufficient facts by which to measure the probability of the exercise of the power."

5. In *Sands G. Falk*, T.C. Memo 1965-22, the trustees had discretion to distribute the income and principal to the wife if necessary for her "adequate care, comfort, support and maintenance." The Tax Court allowed gift-splitting for the principal but not the income, saying that the possibility of invasion of principal was so remote as to be negligible, but that the possibility of invasion of income was not so remote.

6. In Stanley L. Wang, T.C. Memo 1972-143, the wife received the income, and the trustees could distribute principal to her "for her proper support, care and health, or for any emergency." The Tax Court said that "emergency" was not an ascertainable standard, so that the wife's interest was not severable, so that gift-splitting was not available.

7. In PLR 200422051, the wife received all of the income, and the trustee could distribute principal for her "reasonable support and medical care." The Service held that the wife's right to receive income and principal was susceptible of determination, so that gift-splitting was available for the remaining portion.

8. In PLR 200616022, the wife would receive all of the income of the trust if the husband died within three years. The Service held that the wife's interest was susceptible of determination and severable, so that gift-splitting was available for the remaining portion.

C. Caution: if gift-splitting is elected in the year in which one spouse creates a QPRT, and the donor dies during the QPRT term, so that the residence is included in the donor's estate, the spouse's unified credit used on the gift is not restored.

VIII. The Lifetime QTIP Election.

A. The QTIP election is available for lifetime gifts in which the spouse is entitled to all of the income for life. Section 2523(f).

B. The QTIP election must be made on a timely filed gift tax return. Section 2523(f)(4).

C. This can be a useful technique to take advantage of the poorer spouse's unused estate tax exempt amount if he or she dies first.

1. To the extent of the donee spouse's unused estate tax exempt amount, the trust assets can come back to the donor spouse in the form of a credit shelter trust.

2. The Internal Revenue Service has approved this.

3. Query whether the trust must be established in an asset protection jurisdiction.

IX. The Noncitizen Spouse.

A. There is no marital deduction for gifts to a noncitizen spouse. Section 2323(i)(1).

B. The annual exclusion for gifts to a noncitizen spouse is $125,000 (indexed). Section 2523(i)(2).

C. It is generally desirable to make annual exclusion gifts to the noncitizen spouse to utilize his or her estate tax exempt amount.

X. Gifts by Nonresident Aliens.

A. A nonresident alien is generally only subject to gift tax on gifts of real or tangible personal property located in the United States. Sections 2501(a)(2) and 2511(a).

B. “Residence” means “domicile” for gift tax purposes. Treas. Reg. § 25.2501-1(b).

C. A nonresident alien does not get the unified credit ($1 million gift tax exempt amount). Section 2505(a).

D. A nonresident alien is not eligible for gift-splitting. Section 2513(a).

E. However, a nonresident alien gets the annual exclusion. Section 2503(b).

XI. Allocating GST Exemption.

A. Direct skips.

1. There is a deemed allocation to a direct skip. Section 2632(b)(1).

2. Example: a transferor gives $100,000 to a grandchild. A $13,000 annual exclusion is available. There is a deemed allocation of $87,000 to the balance of the transfer.

3. A transferor can elect out of the deemed allocation (and pay GST tax). Section 2632(b)(3).

B. Indirect skips.

1. Before 2001, the default rule was no allocation to an indirect skip.

2. Beginning in 2001, there is a default allocation to an indirect skip. Section 2632(c)(1).

3. An indirect skip is a transfer (other than a direct skip) to a GST trust. Section 2632(c)(3)(A).

4. The term “GST trust” is defined in Section 2632(c)(3)(B).

5. The transferor can elect out of the automatic allocation. Section 2632(c)(5).

C. Consider whether it is desirable to allocate GST exemption to a transfer to a trust.

D. Note that for transfers to a trust after March 31, 1988, *Crummey* powers are generally not effective for GST purposes. There is an exception for trusts that do not permit distributions to be made to anyone other than the beneficiary, and that are included in the beneficiary's estate. Section 2642(c).

E. Effective date of allocation.

1. Allocations on a timely filed gift tax return are effective as of the date of the transfer.

2. Late allocations are effective as of the date of allocation.

3. A late allocation can be made effective as of the first day of the month of the allocation. However, in the case of life insurance, the insured must be living at the time of the allocation.

F. Clean up trusts that have an inclusion ratio between zero and one.

G. Estate tax inclusion period ("ETIP") rules.

1. GST exemption cannot be allocated during the transferor's retained term.

2. This affects GRATs and QPRTs.

H. Gift-splitting.

1. If a husband and wife elect gift-splitting for gift tax purposes, the election is effective for GST tax purposes.

2. Unless GST exemption is allocated to all (or no) transfers to a trust, determining the inclusion ratio can be difficult if gift-splitting is elected for some but not all years.

XII. Taking Advantage of Low Interest Rates.

A. Interest rates are at an unusually low level.

B. The applicable Federal rates ("AFRs") for April 2009 (when this outline was prepared) were as follows:

1. The short-term AFR (for terms of up to three years) was 0.83%.

2. The mid-term AFR (for terms of over three years but not over nine years) was 2.13% for monthly or quarterly payments, 2.14% for quarterly or semi-annual payments, and 2.15% for annual payments.

3. The long-term AFR (for terms of over nine years) was 2.92% for monthly payments, 2.94% for quarterly payments, 2.95% for semi-annual payments, and 2.96% for annual payments.

C. The Section 7520 rate for March 2009 was 2.4%.

D. The Section 7520 rate for April 2009 was 2.6%.

E. The Internal Revenue Service announces the AFRs and the Section 7520 rate each month on or about the 20th of the previous month.

F. Some estate planning techniques, such as loans, grantor retained interest trusts ("GRATs"), and sales work better when interest rates are lower. These techniques are discussed below.

XIII. Grantor Retained Annuity Trusts

A. In a GRAT, the grantor retains an annuity interest for a specified term.

B. If the present value of the annuity payments is equal to the value of the property contributed to the GRAT, there is no taxable gift.

C. For this purpose, the value of the annuity payments is determined based upon the Section 7520 rate.

D. The annuity payments can be level, or can increase by up to 20% each year.

E. For example, if you created a GRAT in April 2009, with level payments of 35.08155% per year of the initial contribution for three years, or 26.64605% per year of the initial contribution for five years, the value of the annuity payments is equal to the value of the initial contribution, so that there is no gift.

F. Advantages of the GRAT compared to other techniques:

1. It is specifically permitted by statute. Section 2702.

2. There can be little or no taxable gift.

3. If the value of the contribution is increased on audit, there is no corresponding increase in the gift. Instead, the annuity payments are increased.

4. It is essentially “heads you win, tails you break even.”

5. The GRAT is particularly useful for volatile assets.

6. You can create a series of GRATs. Each time you receive an annuity payment, you can contribute it to a new GRAT.

7. After the annuity term ends, the trust can continue as an intentionally defective grantor trust (“IDGT”), as discussed below.

G. Disadvantages of the GRAT compared to other techniques.

1. Under the estate tax inclusion period (“ETIP”) rules, a transferor cannot allocate GST exemption to the GRAT until the annuity term expires. Section 2642(f).

2. The Section 7520 rate is 120% of the mid-term AFR, rounded to the nearest 0.2%, so it is by definition higher than the mid-term AFR, and generally higher than the short-term AFR.

3. If the grantor dies before the expiration of the annuity term, then the capitalized value of the annuity payments (or the entire value of the GRAT, if less) is included in the grantor’s estate.

4. There is some cost and complexity to doing a series of GRATs.

XIV. Gifts, Loans or Sales to Intentionally Defective Grantor Trusts

A. An IDGT is a trust that is intentionally a grantor trust for income tax purposes, but is a completed gift for gift tax purposes and is not included in the grantor’s estate for estate tax purposes.

B. The grantor is taxable on the income of the IDGT for income tax purposes.

C. By paying the income tax on the trust income, the grantor is effectively making additional nontaxable gifts.

D. In Rev. Rul. 2004-64, the Service conceded that the grantor’s payment of the income tax on the income and gains of an intentionally defective grantor trust does not constitute an additional gift for gift tax purposes.

E. The benefit of the IDGT can be leveraged by lending money or selling assets to the trust. For this purpose, the interest rate must be at least equal to the AFR (or else interest will be imputed).

F. Most practitioners believe that the IDGT should have at least 10% equity, or, in other words that the debt/equity ratio should not be more than 9:1.

G. Advantages of the sale or loan to an IDGT compared to other techniques:

1. The transferor can allocate GST exemption at inception.

2. The mid-term AFR is lower than the Section 7520 rate, and the short-term AFR is generally lower than the Section 7520 rate. The long-term AFR is sometimes lower than the Section 7520 rate.

3. If the seller or lender dies before the note is repaid, only the balance due on the note should be included in his or her estate.

H. Disadvantages of the sale to an IDGT compared to other techniques:

1. There is no statutory authorization for a sale to an IDGT.

2. While the 10% equity rule is common practice, there is no assurance that 10% equity is sufficient.

3. If the donor makes a gift equal to 10% of the total assets (in other words, a gift of 10% and a sale of 90% of the assets transferred to the IDGT), the gift is wasted if the value of the assets declines such that the payments on the note exhaust the trust.

4. If the seller dies before the note is fully paid, the income tax treatment of the gain portion of the remaining note payments is uncertain.

XV. Loans to Individuals.

A. Instead of lending money to an IDGT, the lender can lend money to his or her children or other borrowers.

B. This is simpler than creating a trust, but does not provide the benefit of the lender paying the income tax on the IDGT's income and gains.

XVI. Charitable Lead Trusts

A. A charitable lead trust ("CLT") provides an annuity ("CLAT"), or unitrust ("CLUT") interest to charity for a period of time, followed by a remainder to or in trust for noncharitable beneficiaries.

B. By providing a charitable annuity interest equal to 100% of the value of the trust, any balance remaining at the end of the annuity term can pass to the donor's family free of estate or gift tax.

C. For this purpose, the value of the annuity payments is determined based upon the Section 7520 rate. However, a donor can elect to use the Section 7520 rate for the month of the transfer, or either of the two preceding months.

D. Based upon the 2.4% Section 7520 rate in effect in March 2009, an annuity of 8.017382% for 15 years or 6.354290% per year for 20 years will result in no taxable gift.

1. If the CLAT earns more than the annuity payments, the value of the CLAT will increase.

2. If the earnings of the CLAT are exactly equal to the annuity payments, the value of the CLAT will remain constant.

3. If the CLAT earns more than the Section 7520 rate but less than the annuity payments, the value of the CLAT will decline.

4. If the earnings of the CLAT are exactly equal to the Section 7520 rate, then the last annuity payment will exhaust the CLAT.

E. The CLAT can be a grantor trust for income tax purposes.

1. The donor will get an income tax deduction for the value of the charity's interest, subject to the limitations on the charitable deduction.

2. The donor will be taxable on the income and gains of the CLAT, with no further charitable deduction for the annuity payments to charity.

F. Alternatively, the CLAT can be set up so that it is not a grantor trust.

1. The grantor will not get an income tax deduction for the value of the charity's interest.

2. The trust will pay its own income tax, and will get a charitable deduction for the annuity payments to charity.

Bruce D. Steiner is an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York City, and is a member of the New York, New Jersey and Florida Bars.

Mr. Steiner has thirty years of experience in the areas of taxation, estate planning, business succession and wealth transfer planning, and estate and trust administration.

Mr. Steiner has lectured for the American Bar Association, the New York State Bar Association, the New York City Bar Association, the New Jersey Institute for Continuing Legal Education, BNA Tax Management, the Rockland, Essex and Middlesex County Bar Associations, the New York and New Jersey State CPA Societies, the New York City, the Rockland County, the Hudson Valley, the Western Connecticut, the Northern New Jersey, the Middlesex-Somerset, the Central New Jersey, and the Greater New Jersey Estate Planning Councils, the Financial Planning Association, the New York University and Baruch College Schools of Continuing Education, the C.W. Post Tax Institute, the Farleigh Dickinson Tax Institute, the New York City, the Greater Newark and the Fairfield County CLU Chapters, JP Morgan Chase Bank, Bank of America, Wachovia Bank, Hudson Valley Bank, Merrill Lynch, Metropolitan Life, Cornell University, Consumers Union, Lawline, and many other professional and community groups.

Mr. Steiner has written articles for *Estate Planning*, *BNA Tax Management, Trusts & Estates*, the *Journal of Taxation*, the *CPA Journal*, *Probate & Property*, *TAXES*, the *Journal of Corporate Taxation*, the *CLU Journal*, and other professional journals.

Mr. Steiner writes a column for the *CCH Journal of Retirement Planning*, and is a commentator for Leimberg Information Services, Inc., a technical advisor for *Ed Slott's IRA Advisor*, a member of the editorial advisory board of *Trusts & Estates*, and a deputy editor of the *Bergen Barrister*. He has served as a director of the Estate Planning Council of New York City, and on the professional advisory boards of several major charitable organizations.

Mr. Steiner has been quoted in various publications including *Forbes*, the *New York Times*, *Lawyers Weekly, Bloomberg's Wealth Manager, Financial Planning, Kiplinger's Retirement Report, Medical Economics, Newsday*, the *New York Post*, the *Naples Daily News, Individual Investor*, TheStreet.com, and Dow Jones (formerly CBS) Market Watch.

Mr. Steiner received an A.B. from Cornell University, a J.D. from the State University of New York at Buffalo, and an LL.M. in taxation from New York University, where he was a Gerald L. Wallace scholar.

551 Fifth Avenue
New York, New York 10176
Telephone: (212) 986-6000
Facsimile: (212) 986-8866
E-mail: bsteiner@kkwc.com