BLACK LETTER OUTLINES

Federal Wealth Transfer Taxes

FIFTH EDITION

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BLACK LETTER SERIES®

Chapter II

Gift Tax

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A. Introduction

The **gift tax** is designed as a backstop for the federal estate tax. If no tax on lifetime gift transfers existed, individuals could avoid payment of the estate tax simply by gifting away their property any time before death (optimally, for them, the moment before death) to avoid inclusion of assets in their gross estates. Since the gift tax is an excise tax on the donor's act of making a transfer, it encompasses many of those pre-death transfers.

Since 1976, the gift tax and the estate tax are computationally unified. Gifts made during the lifetime of an individual are totaled and used to increase the marginal rate of estate tax paid after death. However, no double taxation (e.g., once during life, again at death) exists since the amount of gift tax due at the present rates on those transfers is subtracted from the tentative estate tax due. [IRC § 2001(b)(2); *see supra* discussion at I. C. 1. (estate tax computation).]

While the gift and estate taxes are unified, there are advantages and disadvantages (discussed in greater detail in the following sections) to making lifetime gifts to one's heirs instead of passing everything in one's estate. One advantage of the gift tax is that the tax is exclusive (one does not have to pay tax on the value of property used to pay the tax). [*See infra* at III. D. 1. d).] Another advantage, provided by IRC § 2503(b), allows for an exclusion from gift tax for transfers under a certain amount (in 2018 that amount is $15,000), and once the property is transferred, it will eliminate any appreciation in value in that property from one's estate.

The primary disadvantage of the gift tax is that an individual must pay the tax shortly after the gift is made, instead of waiting until death. [IRC § 6151.] Another potential disadvantage relates to the transferee's basis in the gifted property. [IRC § 1015(a).] The gifting of appreciated property held by the donor is not completely advantageous under the gift tax, and it may be better to wait until death to make the transfer since the recipient receives a basis in the property at its fair market value at the date of decedent's death. [IRC § 1014(a).] Contrarily, if the donor gifts the appreciated property, the transferee takes the donor's adjusted basis, with a possible increase for a portion of the gift tax paid. [IRC § 1015(a), (d).] This means that, upon the sale or other disposition of the gifted property, the transferee will pay tax on the gain, unless it is excluded by some other Code section (e.g., IRC § 121 Exclusion of gain from the sale of principal residence). However, if property has depreciated in value, waiting until death to transfer the property means all the loss will be eliminated by a fair market value basis under IRC § 1014(a), while some, but not all, of the donor's loss may be maintained if the transfer is by gift. [IRC §§ 1014(a) , 1015(a) (after "except that").]

B. Imposition of Gift Tax [IRC § 2501]

IRC § 2501, found in Chapter 12 of the Internal Revenue Code, imposes the gift tax. Under IRC § 2501(a)(1) the gift tax is imposed on all "*transfers of property by gift*" made during the calendar year, regardless if made by a resident or non-resident of the United States. Therefore, in order to impose the gift tax, there must be 1) a "transfer," 2) "of property," 3) "by gift." These elements will be taken up below.

1. Exceptions

As with most rules in the Code, many exceptions exist to the general rule. Even if there is a "transfer of property by gift," certain transactions are not taxable under Chapter 12.

a) Transfers of Intangibles by Non-Citizens or Non-Residents [IRC § 2501(a)(2)]

Transfers of intangible property (i.e., stocks and bonds) by non-resident, non-citizens of the United States are not subject to the gift tax. [IRC § 2501(a)(2).] This rule encourages foreign investment in United States securities and allows for domestic financial institutions to hold intangible property of non-citizens without it being subject to possible gift taxation. The rule does not apply to individuals who give up their United States citizenship primarily to avoid taxation within ten years from the date of transfer. [IRC § 2501(a)(3)(A).]

b) Transfers to Political Organizations [IRC § 2501(a)(4)]

No gift tax is due on transfers to any party, committee, fund, or other organization that accepts contributions or spends money to influence the election or selection of any individual to any Federal, State, or local public office. Political contributions made directly to an individual are not covered by IRC § 2501(a)(4) and are subject to the gift tax if not excluded under IRC § 2503(b).

c) Transfers to Certain Tax Exempt Organizations [IRC § 2501(a)(6)]

The gift tax does not apply to the transfer of money or other property to an organization described under IRC § 501(c)(4) (civic leagues and social welfare organizations), (c)(5) (labor, agricultural, or horticultural organizations), and (c)(6) (business leagues, chambers of commerce, real estate boards, not organized for profit).

d) Services

Although not expressly stated in the Code, services are excluded from gift taxation. While this can be gleaned from the IRC § 2501(a)(1) application of the gift tax to "transfers of property," in other areas of the Code (like IRC § 102 of the income tax) the term "property" includes both property and services. This is not the case in the gift tax; property means property.

There are two reasons for not taxing services. First, valuation of services is difficult, and it is unclear what services to tax and not tax (how much for babysitting by Grandma?). Second, services do not directly deplete the estate of the service-provider, although they do so indirectly by reducing the time and ability of the donor to create additional wealth for herself.

> ***Example (1):*** Fred fixes his aunt's car. The parts cost $500 and had the repair been done by a mechanic, the labor would have cost $2,000. The cost of parts is treated as a gift under the gift tax, but Fred's labor is not (although both parts and labor are covered by IRC § 102).
>
> ***Example (2):*** Father manages a large mutual fund. On his own time, he manages the stock portfolios of his three adult children. The value of the portfolios has dramatically increased due to Father's expertise. Since Father has provided only services there is no "transfer of property" and no gift tax is due. [*See Commissioner v. Hogle*, 165 F.2d 352 (10th Cir. 1947).]

Example (3): Otto is named executor of his friend's estate, but waives his right to executor fees and provides his services free of charge. If Otto disclaimed the right to fees in a reasonable time after commencing to serve as executor, the fees would be effectively disclaimed and Otto is not considered to be making a gift for the services provided. [*See* Rev. Rul. 66–167.] If services were provided and then disclaimed, there would be income and a gift made. [*See,* Rev. Rul. 64–225.]

Example (4): Stephen, a famous author, helps to edit Thomas' first novel. There are no gift tax consequences. However, if Stephen wrote a novel and gave the copyright to Thomas, this would be a gift of property since the copyright is a property interest.

2. "Property"

The gift tax covers all types of property, tangible and intangible, real and personal. [*See* IRC § 2511(a); Reg. § 25.2511–1(a).] The Senate Report on the 1932 internal revenue revisions states the word "property" should be given a broad interpretation and includes "every species of right or interest protected by law and having an exchangeable value." [S. Rep. No. 665, 72d Cong., 1st Sess. (1931)(1939–1 CB (pt. 2) 496, 524).]

a) Contingent Interests

The property interest can be less than one's entire interest in the property or a contingent interest in property. If the donor transfers a contingent interest in property, the contingency never has to be fulfilled; the gift tax considers the moment of transfer and no further.

Example (1): Peter puts stock in trust, income to Peter for life, remainder to Wendy, an unrelated individual. Peter has made a gift of the remainder interest to Wendy. [*See* Reg. § 25.2511–1(e).] However, if Wendy were related, the gift would include the entire trust corpus under IRC § 2702. [*See infra* the discussion of IRC § 2702, at II. D. 2.]

Example (2): Donald has a contingent remainder interest in a trust. Donald only receives the remainder interest if Yolanda is not alive when the life-estate tenant dies. Donald transfers his contingent interest to Daisy. Later that same year the life-tenant dies, and Yolanda is still alive. Donald must still pay gift tax on his transfer of the contingent remainder to Daisy. [*See Goodwin v. McGowan*, 47 F.Supp. 798 (W.D.N.Y. 1942).]

Example (3): Hurlbut transfers 3,000 shares of X stock with a fair market value of $571,000 into an irrevocable trust. The trust income is to be paid to his wife, Anna Nichol for life. Upon her death the stock will revert back to Hurlbut, if living, but if not then it will pass by Anna's will or, if none, to her intestate successors. The remainder interest is therefore contingent upon Anna Nichol surviving Hurlbut. Even though the remainder is contingent and there is no way to know at the time the stocks are transferred to the trust to whom the remainder interest will pass should it vest, there is a completed gift of the life estate and remainder. This is so since Hurlbut has no economic control over the property except for his reversionary interest. [*See Smith v. Shaughnessy*, 318 U.S. 176, 63 S.Ct. 545, 87 L.Ed. 690 (1943).] Since this was a transfer of an interest in trust to a family member, Hurlbut's interest in property

will be valued under IRC § 2702. [*See infra* the discussion of IRC § 2702 at II. D. 2.]

b) Reversionary Interest Incapable of Being Valued

If the property is subject to a reversionary interest to the donor on the occurrence of a contingency and the contingency cannot be valued, the reversionary interest will be disregarded and the donor will be treated as transferring the entire property interest.

Example: At age 55, Meta transfers property to a trust with the income to her daughter, Elisa, and after her death to Elisa's children after they turn 21 years old. If Elisa dies without children, or should all the children die before their 21st birthday, the property reverts back to Meta. Meta has made a gift of the entire property transferred to the trust, less her reversionary interest. However, since the value of grantor's contingent reversionary interest is unascertainable, it has no computable value and nothing may be deducted from the amount of gift. [*See Robinette v. Helvering*, 318 U.S. 184, 63 S.Ct. 540, 87 L.Ed. 700 (1943); Reg. § 25.2511–1(e)(3rd and 4th sentences).]

3. "Transfer"

The general rule defining a "transfer" for the gift tax is found in IRC § 2511. However, several Code sections included in Chapter 12, and two that are not in Chapter 12, also find a "transfer" in situations where the transferor does not have an interest in the property transferred (e.g., IRC § 2514 for powers of appointment and IRC § 2519 for dispositions of certain life estate interests), in situations where Congress felt a transfer existed (IRC § 7872—below market rate interest loans), or due to the relationship between the donor and donee (IRC § 2702—special valuation rules in case of transfers of interests in trusts).

a) Transfers in General [IRC § 2511]

Except for non-resident, non-citizens, IRC § 2511 encompasses all sorts of transfers. The section applies to transfers that are made directly or indirectly, by trust or otherwise (such as transfers to corporations or partnerships).

The most basic example of a transfer subject to the gift tax is a direct transfer from one person to another (e.g., mother gives her son a baseball glove for his birthday). But other less obvious direct transfers are also covered, such as forgiving a debt, assigning a judgment, or paying benefits from an insurance policy. Transfers made in an indirect manner are also covered by the statute, such as the payment of another's debt (rent, credit card bill, etc.).

A transfer is also found where a donor with donative intent (as opposed to a business reason) intends to transfer an interest in property. However, a donative intent is not required to have the gift tax apply. [*See infra* II. B. 4. a).]

b) "Dominion and Control"

(1) General Rule

If a donor maintains dominion and control over the property there will be no "transfer" for IRC § 2511 to apply. The power of the donor can be either

to change who can take the property (not just solely when) or the express or implied ability to take back the property. [Reg. § 25.2511–2(b).] So long as the donor can manipulate who receives the property, there is no transfer, and if there is no transfer, the gift is not complete. As discussed in more detail below, if the power can only be used in conjunction with another who possesses a "substantial adverse interest," if the donor's control is subject to a fixed and ascertainable standard, or if there is an actual transfer of property, the donor has sufficiently given up control and the gift will be treated as complete.

Example (1): George creates a trust where he will receive the income for life and at his death can appoint the remainder to whomever he wants. Since George has dominion and control over the remainder interest, no gift has been made. Instead, if George irrevocably assigned the remainder interest of the trust to Erwin, an unrelated individual, there would be a completed gift of only the remainder interest. [*See* Reg. § 25.2511–2(b).]

Example (2): Google Corp. has a plan where the survivors of a deceased employee receive benefits equal to three times the employee's regular annual salary. The benefit is not bargained for and can be terminated at any time by either Google or the employee, or if the employee leaves the company for any reason other than death. Anthony dies while an employee of Google and Google pays benefits pursuant to the plan to his surviving spouse, Joan. Anthony has not made a gift to Joan of the policy since he had no property interest and there was no act by Anthony that constituted a "transfer." His participation in the plan was involuntary and he had no power to select the beneficiaries, or to alter the amount, timing, or benefits of the plan. [*See Estate of DiMarco v. Commissioner*, 87 T.C. 653 (1986).]

Example (3): Harriet creates a trust with income payable to David or Ricky, as selected by the independent trustee, and the remainder to Ozzie. If Harriet has no power to choose or replace the trustee she lacks dominion and control over the property, even though the income interest donee is not known at the time the trust is created. There is, therefore, a completed gift of the entire trust corpus.

Example (4): Dorris creates a trust with income payable to Alice and Bertha as Dorris directs, and the remainder payable to Casey. Dorris also has the power to revoke the trust. Dorris maintains dominion and control of the trust and there is no "transfer."

Example (5): At a later time, Dorris gives up the power to revoke the trust, but retains the power to direct the income to either Alice or Bertha. There is a completed gift to Casey of the remainder, but since Dorris has the power to control who receives the income, there is no gift to Alice or Bertha. [*See Burnet v. Guggenheim*, 288 U.S. 280, 53 S.Ct. 369, 77 L.Ed. 748 (1933).] If Casey is related to Dorris the entire trust corpus could be treated as a gift. [*See infra* the discussion of IRC § 2702, at II. D. 2.]

Example (6): If Dorris distributes the yearly income of the trust to Alice, there is a completed transfer in the calendar year of distribution from Dorris to Alice. [Reg. § 25.2511–2(f).]

(2) Control Over Timing Is Not Retained Dominion or Control

A completed gift transfer occurs if the donor merely has the power over *when* an individual may take enjoyment of the property, not *if* they will be able to enjoy the property at all. [Reg. § 25.2511–2(d).]

Example: Dorris creates another trust, this time for the benefit of Emmy. The trust provides for the income of the trust to be distributed to Emmy until she reaches age 40, with the remainder payable to Emmy or her estate. Dorris maintains the right to accumulate the income in the trust instead of distributing it to Emmy. This is a completed gift transfer of the entire trust corpus from Dorris to Emmy since Dorris only has the power to "change the manner or time of enjoyment," not *who* gets the property. [*See* Reg. § 25.2511–2(d).] This transfer is ineligible for the IRC § 2503(b) exclusion since this is not a gift of a present interest. [*See infra* the discussion of IRC § 2503(b), II. E. 1.]

Estate tax crossover: If Dorris dies before Emmy turns 40, the trust corpus will be included in her gross estate under IRC § 2038. [*See supra* discussion of IRC § 2038 at I. A. 2. c).]

(3) Checks

When a donor gives a check as a gift, the transfer does not occur until the check is cashed or negotiated for value to a third person. [Rev. Rul. 67–396.] Since the donor has the ability to stop payment on the check until the check is cashed or negotiated, the donor maintains dominion and control over the check.

Generally, a donor "transfers" a check when the donor has no power to change the disposition of the check under local law. The "transfer" is also complete when the check is deposited or presented for payment if "(1) the check was paid by the drawee bank when first presented to the drawee bank for payment; (2) the donor was alive when the check was paid by the drawee bank; (3) the donor intended to make a gift; (4) delivery of the check by the donor was unconditional; and (5) the check was deposited, cashed, or presented in the calendar year for which completed gift treatment is sought and within a reasonable time of issuance." [Rev. Rul. 96–56.]

Example (1): As a gift, Albert gives John a check from Bank A for $11,000 on December 14, Year 1. On December 31, Year 1, John deposits the check in his own account at Bank B. Bank A honors the check and makes payment to John's account on January 2, Year 2. Under local law a gift of a check is not complete until the check is honored for payment. Since all the requirements of Rev. Rul. 96–56 are met, the $11,000 payment on January 2 relates back to the time when the check was deposited. Albert is deemed to have given John

the money on December 31, Year 1. [*See Metzger v. Commissioner*, 38 F.3d 118 (4th Cir. 1994), Rev. Rul. 96–56.]

Example (2): Same facts as above except that John deposits the check on January 1, Year 2, and the check is honored the next day. Since the check was deposited in Year 2, the transfer is complete in Year 2.

(4) Exceptions

In certain instances a donor may have continued dominion and control over the gifted property, but because that control is not unfettered, the transfer is deemed complete.

(a) Control Exercisable with Another Having Substantial Adverse Interest

If the donor's ability to exercise dominion and control over the property is held in conjunction with a person having a substantial adverse interest to the property's disposition, the donor will be treated as making a completed transfer. [Reg. § 25.2511–2(e).]

Example (1): Douglas creates a trust that pays income to Nancy for her life and the remainder to Bruce. Nancy and Bruce are unrelated to Douglas. Douglas retains the right to change the income beneficiary, but only with the consent of Nancy. Douglas does not maintain the power to change the remainder. Since Nancy has a substantial adverse interest in the exercise of the power to change the income beneficiary, Douglas has made a completed transfer of the income interest. [Reg. § 25.2511–2(e).] Since Douglas has surrendered control of both the income and remainder interests, Douglas has made a completed transfer of the entire trust corpus.

Example (2): Same facts as above, but Douglas can also transfer the remainder interest, subject to Nancy's consent. Since Nancy does not have an interest in the remainder, only the income interest is treated as a completed transfer.

Example (3): Same facts as above, except that Douglas has the right to revoke the trust, but only with Nancy's consent. Nancy's interest should be treated as substantially adverse enough to make this a completed transfer of the entire trust corpus. [*See Camp v. Commissioner*, 195 F.2d 999 (1st Cir. 1952).]

(b) Control Limited by Ascertainable Standard

A transfer will also be treated as complete to the extent the donor's power is limited by a fixed and ascertainable standard. Nevertheless, to the extent the donor's power allows the donor to reclaim the property, then the interest will be treated as an incomplete transfer.

Example (1): Bill creates a trust with income payable to Gail or Elaine and the remainder payable to Harry or Harry's estate. Bill retains the power to allocate the income between Gail and

Elaine, and to add additional income beneficiaries. There is only a completed gift of the remainder. [Reg. § 25.2511–2(c).]

Example (2): Same facts as above except that the income of the trust is payable to Gail for her "education, support, and maintenance," with any remaining income payable to Elaine. Since the income interest is subject to a fixed and ascertainable standard the entire trust corpus will be treated as a completed transfer even if Bill is the trustee.

Example (3): Same facts as above except that the income interest is payable to Gail only but Bill has the power to invade the income interest for his own "reasonable support and comfort." The entire trust corpus, less the amount required for Bill's reasonable support and comfort, will be treated as transferred.

(5) Estate Tax Crossover

If a donor maintains enough dominion and control over the property to render the gift tax inapplicable for want of a transfer, and if the donor dies while still possessing such control over the property, IRC §§ 2036, 2038 or both may apply to include the property into the donor's gross estate. [*See supra* the discussion of IRC §§ 2036 and 2038, at I. A. 2. a) and c).]

c) Other Transfers

Several other Code sections create "transfers" for Chapter 12. These sections are covered *infra* in II. C.]

4. "By Gift"

a) General Rule [IRC § 2512(b)]

IRC § 2501(a)(1) imposes a gift tax on "transfers of property by gift." While the statutory wording is not entirely clear, the Supreme Court has stated IRC § 2512(b) defines the element "by gift." Under IRC § 2512(b) a "gift" occurs when property is transferred for less than "adequate and full consideration in money or money's worth." Congress intended this language to encompass all "protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech." [*Commissioner v. Wemyss*, 324 U.S. 303, 306, 65 S.Ct. 652, 654, 89 L.Ed. 958, 962 (1945).] By primarily considering the adequacy of any consideration received, this test looks at objective facts rather than the more difficult-to-determine subjective motivations of the donor.

Since IRC § 2512(b) does not utilize the subjective motivation of the transferor, donative intent is not required. The Regulations state donative intent is "not an essential element in the application of the gift tax to the transfer." [Reg. § 25.2511–1(g)(1).] However, in order to separate out a transaction that may be in the ordinary course of business, donative intent must be absent. *See infra* discussion II. B. 4. b) (3).

Example (1): Widow Gimee More receives a sizable income from a trust created by her deceased husband's will. However, the trust income ceases if she remarries. Her boyfriend, William, agrees to transfer stock to Widow

More, the value of which would make up for the loss of the trust income. Under the agreement, Widow More promises to marry William and is allowed to keep her marital property and support rights if they divorce. Widow More agrees, William transfers the stock, and they marry. Even if William transfers the stock with no donative intent, he makes a gift to Widow More because the transfer was for less than "adequate and full consideration in money or money's worth," (i.e., the promise of marriage). The fact that the stocks replaced Gimee's trust income does not matter because IRC § 2512(b) requires the consideration to flow directly to the donor (William). [*Commissioner v. Wemyss*, 324 U.S. 303, 65 S.Ct. 652, 89 L.Ed. 958 (1945).]

Example (2): Spencer transfers $30,000 to his brother, Tyler, on the condition that Tyler give $20,000 to their parents. After the transfers are made, Tyler has made no gift under IRC § 2512(b) since the amount he gave to his parents ($20,000) is offset by the $30,000 he received from Spencer. Spencer, however, gave an indirect gift of $20,000 to his parents, and a direct gift of $10,000 to Tyler. [*See* Reg. § 25.2511–1(h)(2).]

(1) Measuring Adequate and Full Consideration

(a) Generally

If the consideration received by the transferor is not capable of being valued in terms of dollars and cents, it is "wholly disregarded" when determining whether a gift occurs under IRC § 2512(b). [Reg. § 25.2512–8.] Even if the consideration would support a contract, unless it can be valued, it may not offset the fair market value of the property transferred.

Example (1): Merrill and Kinta enter into an ante-nuptial agreement which provides that Merrill will transfer to Kinta $300,000 in return for the release of any marital rights Kinta might acquire during the marriage. Kinta keeps her support rights under the agreement. Merrill transfers the cash into an irrevocable trust, and the two get married the next week. Under IRC § 2043(b)(1) of the estate tax, marital rights are not treated as consideration. Since the estate and gift tax need to be interpreted in light of each other, marital rights will not be treated as consideration for Chapter 12. Therefore, there is a $300,000 gift from Merrill to Kinta. [*See Merrill v. Fahs*, 324 U.S. 308, 65 S.Ct. 655, 89 L.Ed. 963 (1945).]

Note: The *Merrill* case was decided before the marital deduction was allowed under IRC § 2523. Under Rev. Rul. 69–347, a transfer under an ante-nuptial agreement becomes complete on the date of the marriage, since before that time the transferor has dominion and control over the property because the terms of the agreement are not yet satisfied. In the above example, the gift is deemed completed at the time of the marriage so Merrill may receive a marital deduction for the transfer of property.

Example (2): Brian promised Carnie $20,000 if she lost 100 pounds. Carnie did so, and Brian paid her the money. Carnie's

losing weight cannot be considered consideration for the $20,000, since it has no ascertainable value to Brian. Consequently, Brian has made a $20,000 gift to Carnie.

Example (3): In Year 1, Father promises Son $10,000 if he graduates from college. Son graduates from college in Year 5 and asks for the money promised by Father. Father does not pay and Son sues for payment. Son wins a judgment against Father for $10,000 in Year 6, which Father pays. While Son's graduation from college is consideration to support a contract between Father and Son, it is not consideration in money or money's worth and will not offset the $10,000 transferred from Father to Son for Father to avoid gift tax consequences. Additionally, since the promise from Father to Son became binding upon Son's graduation from college, the gift of $10,000 is made in Year 5. [*See* Rev. Rul. 79–384.]

(b) Income Tax Crossover

The release of marital rights is treated as consideration to support the sale of property. [*Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947).] In *Farid,* the release of marital rights was the consideration in exchange for property received. The value of the consideration was the amount realized (IRC § 1001(b)) by the transferor to support the sale of the property. Therefore, because this was considered a sale, the property received by the transferee had a fair market value basis (IRC § 1012(a)) and not a transferred basis under IRC § 1015.

(2) Payment of Gift Tax by Donee

The payment of the gift tax by the donee may be treated as offsetting consideration, depending on whether there was an agreement for the donee to pay any gift tax due on a transfer.

(a) Prior Agreement by Donee to Pay Tax

If the donee agreed prior to the transfer to pay the gift tax, such payment is treated as offsetting consideration.

Since the payment of the gift tax would offset the amount of the gift, which in turn would reduce the amount of gift tax, which in turn would change the amount of the gift, and so on, the Service has promulgated a formula to determine the amount of gift tax due in this situation. [Rev. Rul. 75–72.]

(b) No Prior Agreement for Donee to Pay Gift Tax

There is no reduction in the amount of gift where the donee is either forced to pay the gift tax by operation of law, or does so voluntarily with no prior agreement. Under IRC § 6324(b), the donee can be held liable for the payment of any gift tax due by the donor up to the fair market value of any gifts received from the donor. Any payment made under IRC § 6324 does not reduce the amount of the gift from donor

to donee. [*See Affelder v. Commissioner*, 7 T.C. 1190 (1946); *Moore v. Commissioner*, 146 F.2d 824 (2d Cir. 1945).]

(c) Estate Tax Crossover

Under IRC § 2035(b), any gift tax paid on gifts made during the three years prior to the decedent's death is included in the decedent's gross estate. This rule also applies if the donee pays the gift tax. [*See Estate of Sachs v. Commissioner*, 88 T.C. 769 (1987) *aff'd in part and rev'd in part*, 856 F.2d 1158 (8th Cir. 1988).]

(d) Payment of Gift Tax by Donee (Income Tax Crossover)

If the donee pays the gift tax, that amount is included in the amount realized by the donor under IRC § 1001(b). [*See Diedrich v. Commissioner*, 457 U.S. 191, 102 S.Ct. 2414, 72 L.Ed.2d 777 (1982).] This means if the gift tax paid by the donee is greater than the adjusted basis of the donor's transferred property, the donor realizes and recognizes gain. [*See* Reg. § 1.1001–1(e)(1).] Additionally, the donee will have a basis in the property equal to the higher of the gift tax paid or the donor's adjusted basis. [*See* Reg. § 1.1015–4(a).]

(3) "By Gift" (Income Tax Crossover)

Unlike the gift tax, donative intent is required for finding a "gift" for the income tax. [*See* IRC § 102(a); *Commissioner v. Duberstein*, 363 U.S. 278, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960).] To find a "gift" for income tax purposes, the transferor must give it with "detached and disinterested generosity . . . out of affection, respect, admiration, charity, or like impulses." [*Duberstein*, 363 U.S. at 285, 80 S.Ct. at 1197, 4 L.Ed.2d at 1225 (citations omitted).]

(4) Marital Transfers

Marital rights are not treated as consideration for either the gift or estate taxes. [*Merrill v. Fahs*, 324 U.S. 308, 65 S.Ct. 655, 89 L.Ed. 963 (1945).] If property is transferred for the release of marital rights, unless some exception can be found, the transferor spouse will be subject to possible gift tax on the transfer. Fortunately, several exceptions counteract this general rule.

(a) Property Settlements Under IRC § 2516

If the elements of IRC § 2516 are met, the transfer is deemed "made for a full and adequate consideration in money or money's worth." [IRC § 2516.] The transfer must either be in settlement of the spouses' marital or property rights or provide support for the minor children of the marriage. The agreement must be in writing and made within a three-year period of the divorce decree beginning on the date one year before such agreement is entered into.

Example: Brad and Angelina sign an agreement in settlement of their marital property rights on March 28, Year 2. A final divorce

decree must take place between March 28, Year 1 and March 28, Year 4 for IRC § 2516 to apply.

The agreement need not be submitted to the divorce court in order to qualify under IRC § 2516, but only an official final decree of divorce will be accepted by the Service. [Reg. § 25.2516–1(a).] IRC § 2516 shields only those amounts in settlement of spouses' marital or similar property rights or support for the couple's children. Amounts in excess of those minimum amounts constitute a gift. [*Spruance v. Commissioner*, 60 T.C. 141 (1973), *aff'd* 505 F.2d 731 (3d Cir. 1974).]

Example: Preston and Margaret get divorced. Before the divorce was final they signed a written agreement in which Preston would transfer $1 million of marketable securities to a trust from which Margaret would receive the income for life, with the remainder interest passing at her death to their children from the marriage. Unless the children's remainder interest was bargained for by Margaret in exchange for her marital rights, it will be treated as a gift from Preston to the children. The income interest, however, will be treated as being transferred for full consideration under IRC § 2516, meaning Preston makes no gift to Margaret. [*See Spruance*, 60 T.C. at 151.]

(b) Support Rights

Transfers made in exchange for the release of support rights or for the current support of a former spouse or any of the couple's children are treated as made for full consideration. [Rev. Rul. 68–379.] The rationale is that the amounts expended for support during marriage are not treated as a gift, and there is no justification for treating such amounts as gifts solely because the couple is divorced. However, amounts paid in excess of support rights are treated as a gift.

Example: Jimmy gives Roselyn $200,000 in their divorce settlement. The fair market value of Roselyn's support rights is $185,000. The $15,000 transferred over the fair market value of the support rights is not supported by consideration and will be treated as a gift. [*Id.*]

(c) Judicial Decree

Property transferred by judicial decree pursuant to a divorce is not founded on a "promise or agreement" and therefore does not need to be supported by consideration to avoid gift treatment. [*Harris v. Commissioner*, 340 U.S. 106, 71 S.Ct. 181, 95 L.Ed. 111 (1950).] This rule applies to agreements, submitted to the court, made in contemplation of divorce that become part of the judicial decree, assuming the court had the ability to modify the agreement. [Estate of Barrett v. Commissioner, 56 T.C. 1312 (1971).]

b) Exceptions to the General Rule

There are three exceptions to the general rule that a gift is the amount by which the fair market value of the property transferred is greater than any

consideration received by the transferor. The first exception involves transfers made in satisfaction of a support obligation. The second exception exists for "qualified transfers" as defined under IRC § 2503(e). The third exception excludes transfers completed in the "ordinary course of business," even if made for less than adequate consideration.

(1) Transfers Made in Satisfaction of Support Obligations

If payments made by the donor on the behalf of the donee are in satisfaction of the donor's support obligations, those payments are not considered gift transfers. While not expressly stated in the Code or Regulations, the Service agrees with this rule. [*See* Rev. Rul. 68–379.] This rule is consistent with the estate tax. Under IRC § 2053(a)(3), payments of support rights are deductible for estate tax purposes as a claim against the estate. To the extent the gift tax backstops the estate tax, therefore, it makes sense that payments of support during life are not treated as taxable gifts.

Example (1): Michelle and Lee have lived together many years, but never married. Last year they entered into a formal agreement where Michelle released her support rights under state law in exchange for Lee's MGM stock. Since support rights are treated as consideration (unlike marital property rights under IRC § 2043(b)(1)), no gift is made when the value of the support rights equals the amount of property transferred. Therefore Lee does not make a gift when he transfers the stock to Michelle.

Example (2): Fred gives a new car to his daughter, Pebbles, for her sixteenth birthday. Under the general rule of IRC § 2512(b), Fred is treated as giving a gift to Pebbles of the value of the car since he is not receiving anything in return. However, if under state law this would be considered part of Fred's support obligations to his daughter, the transfer would not be treated as a gift.

(2) Qualified Transfers by Donor to Donee [IRC § 2503(e)]

For gift tax purposes, any "qualified transfer" is not treated as a "transfer of property by gift" for the gift tax. There are two types of "qualified transfers": one for the payment of tuition to an educational institution, and the other for medical care payments made directly to a medical provider. The rationale is to favor these types of transfers and exclude payments that may exceed support obligations or exclude payments on behalf of individuals past the age of majority. To qualify, the payments must be made directly to either the educational institution or medical provider. This requirement eliminates the need to trace funds or disentangle combined assets. Both exclusions are allowed regardless of the relationship between the donor and donee.

(a) Education Payments

Tuition payments are treated as a "qualified transfer" only if made directly to the educational institution. Payments for books, supplies, or room and board are not excluded under IRC § 2503(e), and may constitute a gift. [Reg. § 25.2503–6(b)(2).] However, since there is no

degree requirement (e.g., a bachelor's degree), payments for certain travel tours provided by educational institutions may be excludable from the gift tax. Even though payments to qualified tuition programs (i.e., "529 plans" or Coverdell Education Savings Accounts) are for an educational purpose, they are not direct payments of tuition and do not qualify for the exclusion.

> ***Example:*** Son receives a bill of $20,000 for his law school tuition that he gives to Father to pay. Assuming that Son is past the age of majority and Father does not have any support obligations, this payment would, if not for IRC § 2503(e), be treated as a gift from Father to Son.

(b) Medical Payments

Any payments for expenses, not reimbursed by the donee's insurance, resulting from the diagnosis, cure or prevention of disease, as well as for transportation to receive such care constitute a "qualified transfer," as do payments for qualified long-term care services or medical insurance. Any payments made that are reimbursed by insurance are not excluded and may be treated as a transfer of property by gift. [Reg. § 25.2503–6(b)(3).]

> ***Example:*** Good Samaritan (GS) comes across Unlucky, who has just been struck by a hit-and-run driver. GS takes Unlucky to a hospital, where she receives treatment for her wounds. GS pays for all the medical care, which amounts to $15,000. Since GS made the payment directly to the hospital, for the treatment of Unlucky's wound, no gift is made from GS to Unlucky under IRC § 2503(e).

(c) Income Tax Crossover

Because IRC § 2503(e)(1) only applies "for purposes of this chapter" (Chapter 12—Gift Tax), the exclusion does not apply to other areas of the Code. This means that the amounts spent for tuition or medical care can still apply when determining support for dependency under IRC § 152(a), can still qualify for the IRC § 213(a) deduction, and can still be excluded from gross income for the income tax under IRC § 102(a) as a gift.

(3) Transfers Made in "Ordinary Course of Business" [Reg. § 25.2512–8]

Not all exchanges where inadequate consideration is received for the property transferred are treated as "gifts." Transactions completed in the "ordinary course of business" are considered made for adequate and full consideration in money or money's worth. [Reg. § 25.2512–8.] This permits bad bargains, loss leaders, and the like to escape gift taxation. While the Regulations state that the transactions must be made in the ordinary course of business, qualifying transactions need only be "bona fide, at arm's length, and free from any donative intent." [*Id.*] This is why donative intent is important; if it *is* present then the transaction may be subject to the gift tax.

Example (1): As part of a shift of management responsibilities due to Senior Executive's pending retirement, Senior sold stock to Junior Executive for less than fair market value. The agreement was bona fide, at arm's length and due to the particular business interest involved, and the discount was not provided with any donative intent. Even though the stock was sold at less than fair market value, there is no gift since the exchange was in the ordinary course of business. [*Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947).]

Example (2): Bart advertises radios for sale at less than his cost in order to get people to shop at his store, the "Electric Palace." Even though the radios are being transferred to customers at less than full and adequate consideration, since this is part of his ordinary course of business, Bart does not make a gift to his customers of the difference between the fair market value and the price the customers pay.

Example (3): Walter recently purchased a house as his personal residence for $1 million from Estella, but did not get the house inspected before closing. Later, it was determined the house had serious foundation problems which were unknown to either party before the sale and decreased the value of the house by $200,000. Even though this transaction was not in the ordinary course of business (it was for a personal residence), since it was bona fide, made at arm's length and free of donative intent, Walter has not made a gift of $200,000 to Estella.

C. Other "Transfers"

Several Code sections in Chapter 12 (as well as two outside of Chapter 12) either create a transfer where one may not exist or modify the "transfer" requirement in order to determine if the gift tax is applicable on the transaction.

1. Powers of Appointment [IRC § 2514]

The rules governing powers of appointment under the gift tax are very similar to the estate tax rules under IRC § 2041. In fact, the interpretive case law and administrative rulings are interchangeable. [*See* Estate of Sanford v. Commissioner, 308 U.S. 39, 42, 60 S.Ct. 51, 55, 84 L.Ed. 20, 22 (1939); Rev. Rul. 76–547.]

IRC § 2514 covers certain powers of appointment. If the power was created after October 21, 1942, the exercise, release or lapse of the power is treated as a "transfer" of property. IRC § 2514 signals congressional disagreement with the Supreme Court's ruling that powers of appointment are not property interests. Absent IRC § 2514, the holder of a broad power of appointment could effectively exercise complete control over the property subject to the power without gift tax consequences since the power holder would not possess an interest in the underlying property.

Generally, a power of appointment is the right to designate beneficial interests of property, for example who will enjoy the income from a trust. If the power is only over the administrative aspects of the property (such as where to invest trust property), those rights and duties are not considered "powers of appointment." [Reg. § 25.2514–1(b)(1).] Additionally, the term "power of appointment" does not include

powers reserved by a donor to herself (therefore someone other than the donor must hold the powers). [Reg. § 25.2514–1(b)(2).]

Example (1): Phelps creates a trust and names himself as trustee. As trustee, he has the power to distribute the money to anyone he sees fit. By creating the trust Phelps acquired no greater interest in the property than he had before the trust was created, and therefore no power of appointment was created, and IRC § 2514 does not apply. Of course, any transfers of trust income or corpus to any third parties will represent a completed gift by Phelps, but IRC § 2514 is not necessary to make that conclusion.

Example (2): Laurie has the right to income from a trust for life. Laurie has the power to transfer the right to income to Reggie. If Laurie transfers the right to income to Reggie, the general transfer rule of IRC § 2511(a) would apply since Laurie already has a direct interest in the property and IRC § 2514 is not required to create a transfer. [*See* Reg. § 25.2514–3(e)(ex. 1).]

a) Treatment of Post-1942 General Powers of Appointment

Under IRC § 2514(b) general powers of appointment (GPA) are treated as an interest in property. Therefore, the exercise, release, and (sometimes) the lapse of a GPA is deemed a "transfer of property." A transfer by exercise of a GPA is easy to spot, since the property is actually transferred from one person to another. A transfer by release of a GPA is more difficult to spot. A "release" is treated as a transfer because by giving up the GPA, the holder of the GPA effectively transfers the subject property to the default taker. Therefore, a release is treated as if the power holder exercised the power for herself, and then transferred the property to whomever would receive the property in default of the exercise of the GPA.

Example: Ian creates an irrevocable trust naming Ronald as the sole trustee. The trust instrument requires the income and remainder to be payable to Ian's children. Ian also gives Ronald the power to transfer the trust property during the trust term to whomever Ronald chooses, including Ronald. Accordingly, Ronald has a GPA. Unless Ronald makes a proper disclaimer before becoming trustee, a subsequent release of his right to transfer the trust property will be treated as if Ronald transferred the trust corpus to Ian's children. [Reg. § 25.2514–3(e)(ex. 5).]

It is important to note the difference between the estate tax rules for GPAs and the gift tax rules for GPAs. If the estate tax provision on GPAs (IRC § 2041) applies, there is inclusion into the gross estate. *See supra* discussion of IRC § 2041, I. A. 3. c). However, the application of IRC § 2514 merely creates a "transfer of property," not necessarily a gift. Therefore, even after the application of IRC § 2514 one must apply the basic rules discussed above to see if the transfer is taxable under the gift tax. *See supra* discussion of gift transfers, II. B. 3.

Example (1): Same facts as the previous example, except that instead of releasing the GPA, Ronald exercises the power in favor of himself by withdrawing (and keeping) the trust corpus. IRC § 2514 applies to create a transfer since there has been an "exercise" of a general power of appointment; however, one cannot make a gift to oneself, therefore there is no gift tax on the transfer.

Example (2): Same as above, except that Ronald exercises his power and places the property into another trust for his children, with the right to add and subtract beneficiaries at a later date. IRC § 2514 applies to create a "transfer of property" since Ronald has exercised a GPA. However, Ronald maintains "dominion and control" over the trust and no taxable transfer exists under IRC § 2501(a). If at a later date Ronald gives up dominion and control it will be treated as a completed gift at that time, or if he maintains control over the property until his death it will be included in his gross estate under IRC § 2041.

(1) General Powers of Appointment (GPA)

The definition of a GPA in IRC § 2514(c) tracks the estate tax definition in IRC § 2041(b)(1). The primary difference from the estate tax is that the power must be held by the "decedent," while under the gift tax provisions the power must be held by the "possessor." *See supra* discussion of IRC § 2041(b)(1), at I. A. 3. c) (1).

(2) Lapse

A lapse occurs when the power holder fails to exercise the GPA within the time permitted. Since the power holder could have utilized the power to transfer the property, the failure to do so is substantially the same as making a direct transfer to the default taker. Accordingly, under IRC § 2514(e), a lapse of a GPA is treated as a release, and, if the power is a post-1942 power (one created after 1942), the release is treated as a transfer of property. [IRC § 2514(b), (e).]

However, Congress has made allowances for certain lapses in order to help the donors of moderate sized trusts cope with the possibility that the income from the trust will be insufficient for their needs. [S. Rep. No. 382, 83d Cong., 111th Sess. 4, 7 (1951).] To meet this goal, Congress created an exception to the lapse rule for certain situations where the amount which lapses does not exceed a certain threshold. Under this rule, a lapse is treated as a release of that power (and thus as a transfer) only to the extent that the amount subject to withdrawal exceeds the greater of $5,000 or 5% of the value of the assets controlled by the power. This means that a donor may give a donee the right to withdraw at least $5,000 per year without having the withdrawal treated as a transfer by the donee under IRC § 2514. [IRC § 2514(e).] The term "**5 by 5 power**" is used to describe a GPA that can be exercised only to the extent of the greater of $5,000 or 5% of the value of the property subject to the power. Limiting the power holder's interest to a 5 by 5 power ensures that the power holder will not make a gift to the other trust beneficiaries when the power lapses without exercise.

There are two other nuances regarding lapses. First, if the lapse of the power is caused by a legal disability (such as where the donee is a minor or incompetent), the lapse is not treated as a release of the power. [Reg. § 25.2514–3(c)(4).] Second, the 5 by 5 power applies per beneficiary, not per trust. [Rev. Rul. 85–88.]

Example (1): Larry created an irrevocable trust, giving David the income interest in the trust for life, with the remainder to Ethan or

Ethan's estate. David also has the power to withdraw $15,000 from the corpus of the trust each year, but only if the power is exercised in July. If David does not exercise the power, it will lapse to the extent that the amount exceeds the greater of $5,000 or 5% of the value of the trust. If the trust is worth at least $300,000 as of the end of July, the lapse of David's GPA will not be treated as a release of the GPA because the right to withdraw $15,000 does not exceed five percent of the value of the trust (5% of $300,000 is $15,000). If the trust is worth $200,000, the lapse of a $15,000 GPA will be treated as a $5,000 transfer under IRC § 2514 from David to Ethan (5% of $200,000 is $10,000). If the trust is worth $100,000 or less at the time of the lapse, $10,000 will be treated as transferred from David to Ethan. [Reg. § 25.2514–3(c)(4).]

Example (2): Gary created an irrevocable trust with assets less than $100,000, giving Sydney the right to the income of the trust for life, and the remainder to Chris or Chris' estate. Sydney also held the right to withdraw up to $10,000 from any contribution made by Gary to the trust. This withdrawal power would last only for ten days following a contribution by Gary. Gary made a $10,000 contribution on January 1 and a $10,000 contribution on December 1. Sydney did not exercise her right to withdraw in either instance. During the calendar year, therefore, Sydney had the right to withdraw a total of $20,000. Since the right has lapsed, Sydney is treated as transferring $15,000 to Chris, computed by subtracting the greater of 5% of the value of the trust or $5,000 (here, $5,000) from the $20,000 of the lapsed property ($10,000 from the January transfer; $10,000 from the December transfer). [Rev. Rul. 85–88.]

The treatment of lapses over a period of time is not discussed in the gift tax regulations. Since the amount of the property which lapses and is treated as transferred could be greater than the amount of the corpus of the trust at the time when the power is released or the donee dies, it is thought that the treatment should be the same as in the estate taxation. *See supra* discussion of IRC § 2041, at I. A. 3. c).

(3) Exceptions for Disclaimers Under IRC § 2518

While more fully discussed *infra* at II. C. 2., a qualified disclaimer is not treated as a "release" of a power under IRC § 2514. [Reg. § 25.2514–3(c)(5).] The disclaimer does not have to be of all property interests received. Therefore, the donee may disclaim any general power of appointment while accepting other beneficial interests of the trust. [Reg. § 25.2518–3(a)(1)(i).]

b) Treatment of Pre-1942 Powers

For powers of appointment created before October 21, 1942 (a "pre-1942 power"), only the actual exercise of the power (and not the release or lapse of the power) creates a "transfer of property." Furthermore, a pre-1942 power exercisable only in conjunction with another person is *never* treated as a GPA. [IRC § 2514(c)(2); *see generally supra* discussion of IRC § 2041(b)(1), I. A. 3. c) (1) (b).]

c) Treatment of Non-General Powers of Appointment

Powers not exercisable in favor of the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate are not GPAs. They are instead referred to as "non-general" or (somewhat erroneously) "limited" or "special" powers of appointment. Unless the power holder also has an interest in the property, no transfer of property occurs upon the exercise or release of a non-GPA.

This statement does not apply, however, when the power holder has an interest in the property subject to the power. The Service and the Tax Court have held that when such an interest is transferred, it will be treated as a transfer of a property interest under IRC § 2511(a), not IRC § 2514. [*Estate of Regester v. Commissioner*, 83 T.C. 1 (1984); Rev.Rul. 79–327; Reg. § 25.2514–1(b)(2).] However, where a life estate terminates as a result of the exercise of a non-GPA, an old Court of Claims case states no transfer is created at all since IRC § 2514 does not apply to the transfer, and the life estate was not transferred by the donor, but instead was extinguished "by reason of the power and not by a desire on the part of the income beneficiary to give up the life estate irrespective of the power." [*Self v. United States*, 142 F.Supp. 939, 942 (Ct.Cl. 1956).]

> ***Example (1):*** Sam creates a trust that provides income to Alice for life. Alice also has the power to appoint the corpus of the trust to Bill, Charley, or David. Since Alice cannot appoint the property to herself, her estate, her creditors or the creditors of her estate, the power is not a GPA. Later, Alice transfers the corpus of the trust in equal shares to Bill and Charley. Since the power was not a GPA, IRC § 2514 does not apply, and therefore the remainder interest is not transferred. But the Service and the Tax Court would deem the life estate a transfer under IRC § 2511(a), making Alice's exercise a completed gift to Bill and Charley. [*Estate of Regester v. Commissioner*, 83 T.C. 1 (1984); Rev.Rul. 79–327; Reg. § 25.2514–1(b)(2).] However, the Court of Claims would say that there is no taxable transfer under these facts since the transfer is made under a non-GPA and common law would not deem this a transfer. [*Self*, 142 F.Supp. at 942.]

> ***Example (2):*** Same facts as above except that Alice also has the power to dispose the corpus of the trust by her will to anyone, including her estate, if she has not appointed the corpus during her life. If Alice transfers the corpus of the trust during her lifetime, she makes a transfer of the entire corpus of the trust. The transfer of her life estate is a transfer under IRC § 2511, while the transfer of the remainder interest occurs under IRC § 2514 since her GPA is released upon distribution of the property. [Reg. § 25.2514–1(b)(2).]

IRC § 2514(d) is the gift tax counterpart of IRC § 2041(a)(3) and has very limited application. The provision specifies that a transfer occurs when a power (general or non-general) is exercised to create another power, if under local law the new power can be exercised without regard to the creation date of the first power. [IRC § 2514(d); Reg. § 25.2514–3(d).] If not for this rule, property could be passed from generation to generation outside the estate or gift tax and only be possibly subject to the generation-skipping tax of Chapter 13.

2. Disclaimers [IRC § 2518]

IRC § 2518 provides that any person making a "qualified disclaimer" of an interest in property is treated as if the interest was never transferred to that person at all. This section applies to all of subtitle A, which includes the estate, gift, and generation-skipping transfer taxes. In order for a disclaimer to be "qualified," several elements must be met:

1) the disclaimer must be in writing;
2) it must be irrevocable and unqualified;
3) the written disclaimer must be delivered to either the transferor, the legal representative of the transferor, or the legal titleholder of the property interest transferred within nine months of the date of transfer; or in the case of an interest passing to an individual under the age of twenty-one, within nine months after that individual reaches age twenty-one;
4) there has been no acceptance or use of the disclaimed interest; and
5) the interest must pass without the direction of the disclaimant and may only go to the surviving spouse of the decedent or a person other than the individual disclaiming the interest. [IRC § 2518(b).]

In order to provide some certainty to disclaimers, Congress required that the interest be "irrevocable and unqualified" and in writing. If the section allowed for contingent disclaimers ("I disclaim the property only if Jack disclaims his interest"), difficulties might arise in determining when a disclaimer is present. The written disclaimer must also identify the interest being disclaimed and be signed by the disclaimant. [Reg. § 25.2518–2(b)(1).]

The disclaimer must be received by the proper person before the expiration of the nine-month deadline. The regulations allow for the postmark, not the actual delivery, to meet the delivery date deadline. If the last day of the period falls on a Saturday, Sunday, or legal holiday, the date for timely delivery is the following day that is not one of the aforementioned days. [Reg. § 25.2518–2(c)(2).] This nine-month deadline applies not only to the initial recipient of the interest, but also to any individual receiving the property due to a qualified disclaimer.

> ***Example:*** Transferor dies on January 1 leaving an interest in property to Bill. Bill disclaims the interest in the property exactly nine months later and the property passes to Cathy. If Cathy disclaims the property the next day, her disclaimer is untimely since it is not within nine months of the original transfer. [*See* Reg. § 25.2518–2(c)(5)(ex. 3).]

a) The Nine-Month Limitation

The timely delivery rule places a premium on knowing when the period commences, as it begins to run on the date the property interest was acquired, not from the time the recipient obtained knowledge of the acquisition. Generally, unless the interest passes to a minor, the nine-month period starts when the interest to be disclaimed is created. [*See* Reg. § 25.2518–2(c)(3)(i).] For those under twenty-one, the period starts on their twenty-first birthday.

(1) Inter Vivos Gift Transfers

In the case of inter-vivos gifts, the period starts when there is a completed gift for Federal gift tax purposes. [Reg. § 25.2518–2(c)(3)(i).]

> ***Example (1):*** On January 1, Doris creates a trust that pays income to Alice for life and the remainder to Casey. Doris retains the power to revoke the trust. Since Doris has dominion and control over the trust, there is no "transfer." As a result, there is no interest in property for either Alice or Casey to disclaim.
>
> ***Example (2):*** If, on March 1, Doris gives up the power to revoke the trust, there is a completed gift at that time. Alice and Casey have until December 1 (nine months later) to disclaim their respective interests in the property. [Reg. § 25.2518–2(c)(3)(i); *see also* Reg. § 25.2518–2(c)(5)(ex. 6).]

(2) Testamentary Transfers

For transfers following the decedent's death, the beginning of the nine-month period depends on whether the transfer was made by the decedent at death or whether the decedent had created an interest in property while alive which is included in his or her gross estate. For transfers made at death (e.g., a bequest of a car pursuant to the will), the nine-month period starts on the date of decedent's death. [Reg. § 25.2518–2(c)(3)(i).] For interests in property created during the decedent's lifetime (i.e., a trust) and later included in the decedent's gross estate, the date of the transfer (i.e., the creation of the trust) is the controlling date, not the decedent's death. [*Id.*]

> ***Example:*** On January 1, Year 1, Doris creates an irrevocable trust with the remainder interest to Casey, but Doris retains the right to income for life. On March 1, Doris dies and the trust corpus is included in Doris' gross estate under IRC § 2036. Casey's remainder interest in the property was created on January 1 and she has nine months from that date to disclaim the interest. The inclusion of the trust corpus into Doris' gross estate has no effect on the time frame for any disclaimer by Casey. [*Id.*]

(3) Powers of Appointment

Powers of appointment are treated as separate interests in property that may be disclaimed independently from other interests in property. [Reg. § 25.2518–3(a)(1)(iii).] The beginning of the nine-month time period depends on whether the power is a general power of appointment (one exercisable in favor of the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate) or a non-general power.

For general powers of appointment, the period starts to run upon receipt of the power. If an interest in property passes by the exercise, release, or lapse of a general power, the individual receiving the property has nine months from the exercise, release or lapse of the power to disclaim the property. [Reg. § 25.2518–2(c)(3)(i).]

Example: On May 13, Year 1, Alex creates an irrevocable trust with the income payable to Bob for life. Bob is given a general power of appointment exercisable at his death over the trust corpus. If Bob fails to exercise the power the corpus will pass to Esther or Esther's estate. Bob dies on June 17, Year 4 and exercises his power in favor of Charlie. If Charlie is twenty-one years or older at the time, Charlie has nine months from June 17, Year 4 to disclaim the trust corpus. [Reg. § 25.2518–2(c)(5)(ex. 2).]

For non-general powers of appointment the power holder and all other possible power holders must disclaim within nine months of the original transfer that created the power.

Example: Same facts as above except Bob's power is a non-general power of appointment to appoint the property to either Chuck or Dan at Bob's death. Assuming they are all age twenty-one or over, if Bob, Chuck, Dan, or Esther want to disclaim an interest in the property they must do so within nine months of May 13, Year 1. [Reg. § 25.2518–2(c)(5)(ex. 1).]

(4) Joint Interests in Property

Joint interests in property are treated as transferred in two parts. One-half of the property transfers at the time of the initial transfer and one-half of the property transfers when the joint tenant dies. [Reg. § 25.2518–2(c)(4)(i).]

Example: On February 1, Year 1, Allen purchased a piece of property with his own funds and named Beatrice as a joint tenant. On January 1, Year 9, Allen dies. Beatrice can disclaim one-half of the property interest within nine months of February 1, Year 1 (the creation of the joint tenancy) and can disclaim the other one-half within nine months of January 1, Year 9 (the date of Allen's death). It does not matter if the property is held as a tenancy by the entirety or that Allen supplied all the consideration for the purchase. [Reg. § 25.2518–2(c)(5)(ex. 7).]

Joint bank accounts receive different treatment since the transferor has the right to take back the account's funds, thereby revoking the transfer. Since the transfer is not complete at the creation of the joint bank account, the nine-month period begins when the co-tenant dies. [Reg. § 25.2518–2(c)(4)(iii).]

b) No Acceptance of Benefits

In order to have an effective disclaimer, the disclaimant cannot accept any of the property nor any benefits from the interest in the property. Acceptance is defined as "an affirmative act which is consistent with ownership of the interest in property." [Reg. § 25.2518–2(d)(1).] Examples are accepting dividends, rent or interest from the property or directing others over the management of the property. It does not include taking mere delivery of title without other acts consistent with ownership.

If the property is capable of being divided into separate distinct portions, a disclaimant may disclaim all of the interest or only a portion of the interest in

the property transferred. For this purpose powers are treated as separate interests in property. [IRC § 2518(c)(2).]

Example (1): Gerald gifts Holly 100 shares of Widget Corporation stock. Holly accepts five shares, but sends a written disclaimer to Gerald for the remaining 95 shares within nine months of the transfer. Holly has made an effective disclaimer of the 95 shares. [Reg. § 25.2518–3(a)(1)(ii).]

Example (2): Same facts as above, except that Holly disclaims the income interest in the shares, but retains the remainder interest. Since Holly has not disclaimed an undivided portion of the Widget stock, this is an invalid disclaimer. [Reg. § 25.2518–3(d)(ex. 2).] However, if Holly had received both the income and remainder interests of a trust, it would be a qualified disclaimer if she disclaimed either or both of the interests received. [Reg. § 25.2518–3(d)(ex. 8).]

Example (3): Gilbert receives an income interest from a trust and a testamentary general power of appointment over the trust's corpus. Since powers are treated as separate interests, Gilbert may keep the income interest and disclaim the power over the corpus. [Reg. § 25.2518–3(d)(ex. 21).] Gilbert may also disclaim a portion of the general power (e.g., retain the power to appoint only 1/3 of the trust corpus), but could not validly disclaim the right to appoint to himself only.

3. Dispositions of Certain Life Estates [IRC § 2519]

IRC § 2519 is the gift tax complement to IRC § 2044 in the estate tax and one or the other, but not both, will apply to all qualifying income interests for which an election was made. IRC § 2519 provides that if the donee spouse disposes of any portion of a qualifying income interest, a constructive transfer of all the interests in property (normally the remainder of a trust) other than the income interest occurs. [IRC § 2519(a).]

This means that on the transfer of a qualifying income interest by the donee-spouse, two transfers are present. First, there is a transfer of the income interest under normal gift tax rules. [i.e., IRC § 2511.] Second, the remaining interests in property, other than the qualifying income interest, are constructively transferred under IRC § 2519. Both transfers must be separately analyzed to determine whether the gift tax will apply. It is important to note that even if the donee spouse disposes of only a fraction of the qualifying income interest, the entire remainder interest will be transferred, not just a corresponding fraction. The transfer of only a fraction of the qualifying income interest may also trigger other Code sections like IRC § 2702 (used to determine the amount transferred) and IRC § 2036 (since IRC § 2519 creates a transfer for purposes of "*this chapter and chapter 11*") to determine the estate tax consequences of the transfer.

Example (1): A testamentary trust created under Donald's will holds Trump stock. The income from the trust is payable at least annually to Donald's wife, Melania, for life. After Melania's death the trust corpus is to pass in equal shares to Donald's children. Donald's executor elects to treat the property as qualified terminable interest property ("QTIP") and the estate receives a marital deduction for the full fair market value of the property under IRC § 2056(a). Several years later when the value of the property is $300,000, and the value of the life estate is $100,000, Melania transfers her income interest in the trust to Carl, her tennis pro. Under IRC § 2511(a), Melania makes a gift

of $100,000 (the value of her life estate interest) to Carl. Additionally, IRC § 2519 creates a constructive transfer of the remainder ($200,000, computed by taking the excess of the $300,000 fair market value of the trust less the qualifying income interest of $100,000) that also will be treated as a gift to Donald's children. While an IRC § 2503(b) annual exclusion is allowed for the transfer of the life estate, none is permitted for the remainder interest since it is a future interest in property. [Reg. § 25.2519–1(g)(ex. 1).]

Example (2): Same facts as above except that Melania sells her life estate to Carl for $100,000. Since the income interest was transferred for full consideration, no gift is made of the transfer of the qualifying life estate interest. [IRC § 2512(b).] However, under IRC § 2519 there is still a transfer of the $200,000 remainder interest that is treated as a gift with no IRC § 2503(b) annual exclusion permitted. [Reg. § 25.2519–1(g)(ex. 2); IRC § 2503(b) discussed *infra* at II. E. 1.]

Example (3): Before Melania transferred the life estate, as an investment decision and as permitted by the trust documents, the trustee of the trust sells the Trump stock and purchases other stock. Selling the stock is not a "disposition" of the qualified income interest for IRC § 2519 purposes, so there is no constructive transfer of the remainder interest. [Reg. § 25.2519–1(f).]

Example (4): Same facts as in the first example, except that instead of making a transfer to her tennis pro, Melania transfers 30% of her life estate to her daughter, Marla. Under general gift tax principles, Melania made a gift transfer to Marla of $30,000 (30% of the $100,000 qualifying income interest). There is also a constructive transfer of the remainder interest under IRC § 2519. Furthermore, since Melania has transferred an interest in trust (her income interest) to a family member (Marla) and retained an interest (the 70% remaining income interest), IRC § 2702 applies. Under IRC § 2702 the value of Melania's remaining income interest is zero, and the total transfer under IRC § 2519 becomes $270,000 (the $300,000 fair market value of the trust less the $30,000 qualifying income interest transferred to Marla). Finally, if Melania does not transfer the rest of her income interest before she dies there will be estate tax consequences under IRC § 2036. Estate tax consequences exist because IRC § 2519 also creates a "transfer" for purposes of chapter 11 (the estate tax) and Melania has the right to the stock for life. The application of IRC § 2036 means that 70% of the trust corpus (the remaining percentage she owns of the life estate) will be included in her gross estate at death (the amount constructively transferred at her death). [Reg. § 25.2519–1(g)(ex. 4).]

IRC § 2207A(b) allows for the donor to recover from the donee any additional gift tax paid due to the application of IRC § 2519. The recoverable amount is equal to the total amount of gift tax payable for the year less the amount due if IRC § 2519 did not apply. [IRC § 2207A(b).]

4. Gifts by a Spouse to a Third Party [IRC § 2513]

IRC § 2513 was enacted in 1948 to reduce the tax disparities between married individuals giving gifts in community property states as opposed to separate property states. In community property states a gift made by either spouse of community property is treated as a gift of a one-half interest by each spouse. IRC § 2513 allows for the same result on transfers by spouses in separate property states if they so elect to "split gifts."

The gift-splitting provision has three requirements. First, the gift must be made during the couple's marriage. Any gift made before marriage cannot be split. If the gift is made while the couple is married, but they divorce (or one spouse later dies in the same calendar year), the gift may be split only if neither spouse (or the surviving spouse) remarries before the end of the calendar year in which the gift occurred. [IRC § 2513(a)(1).] Second, each spouse must be either a citizen or resident of the United States at the time of the gift. [*Id.*; Reg. § 25.2513–1(b)(2).] Finally, both spouses must consent to the election to split gifts. [IRC § 2513(a)(2).]

There are several benefits to gift splitting. First, the IRC § 2503(b) annual exclusion of both spouses can be used, thereby increasing the amount transferred without gift tax liability to $20,000 ($30,000 in 2018 adjusted for inflation) per donee. [IRC § 2503(b).] Second, the IRC § 2505 unified credit of both spouses can be used by each spouse. Finally, since the gift tax rate is imposed on lifetime gifts made by a donor, the lower brackets can be utilized by both spouses. Note, however, that these benefits come at a cost: if the gift is split under IRC § 2513, joint and several liability exists for any gift tax due by either spouse. [IRC § 2513(d).]

> ***Example:*** Britney and Kevin are married and citizens of the United States. During the current year, Britney gives a gift of $20,000 to Rachel, and Kevin gives a gift of $40,000 to Mike. If Britney and Kevin so consent, the transfers are deemed to be made one-half by each spouse under IRC § 2513(a). Therefore, Britney makes a gift to Rachel of $10,000 and a gift to Mike of $20,000. Likewise, Kevin makes a gift to Rachel of $10,000 and a gift to Mike of $20,000. After the application of the IRC § 2503(b) annual exclusion of $10,000 (unadjusted for inflation), neither Britney nor Kevin makes a taxable gift to Rachel, and each makes only a $10,000 gift to Mike. Britney and Kevin may also use their remaining individual unified credits (if any) under IRC § 2505 to reduce the amount of gift tax due on the gift to Mike.

a) Spousal Consent

Both spouses must consent to the election each year they decide to split gifts. Once they do decide to consent, the consent applies to all gifts made by either spouse during the entire year. The couple cannot specify which transfers they want to split. [IRC § 2513(a)(2).]

The consent must be provided on a gift tax return filed by each spouse. [IRC § 2513(b); Reg. § 25.2513–2(a)(1).] If only one spouse is required to file a return, both spouses may consent on that single gift tax return. [Reg. § 25.2513–2(a)(1).] The consent must be given by the earlier of either: 1) April 15th of the following year, if a timely gift tax return is filed; 2) the time when the gift tax return is filed if no gift tax return was timely filed and it is after April 15th of the following year; or 3) before a notice of deficiency is sent out for the year in question, if no gift tax return is filed. [IRC § 2513(b)(2).]

A revocation of consent may only be made up until April 15th of the year following the transfer. [IRC § 2513(c)(1).] Any consent to split gifts for the prior year given after that date may not be revoked. [IRC § 2513(c)(2).]

b) Exceptions

(1) Interests Incapable of Valuation

If the gift is made in trust and the corpus may be invaded by one of the spouses making it impossible to determine the value of the remainder, the gift may not be split.

Example: Tony transfers $54,000 to an irrevocable trust giving his wife, Maria, the income for her life, remainder to their son, Bernardo. An unrelated trustee also has the power to invade the corpus of the trust for Maria in the trustee's absolute discretion. Normally, the remainder interest given to Bernardo could be split between husband and wife under IRC § 2513. However, since the trustee has absolute discretion to invade the corpus, the various interests of the trust cannot be valued and the gift may not be split as between Tony and his wife. Here, Tony has made a $54,000 total gift to Maria (of the income interest) and to Bernardo (of the remainder). Additionally, since the gift is a terminable interest, no marital deduction is allowed under IRC § 2523 unless the proper elections are made. [*Kass v. Commissioner*, 16 T.C.M. (CCH) 1035 (1957).]

(2) Spouse Granted a General Power of Appointment

If the donor spouse transfers a piece of property but grants the non-donor spouse a general power of appointment over such property, the gift may not be split. [IRC § 2513(a)(1)(penultimate sentence).] Some commentators believe this exception is not required since the GPA would create valuation problems, which would prohibit splitting the gift.

c) Estate Tax Crossover

IRC § 2513 states that gifts are split "for purposes of this chapter" [Chapter 12—Gift Tax]. This means that couples cannot split gifts for purposes of the estate tax, which is in Chapter 11 of the Code. The entire amount of any gift transfer (not just one-half) will go into computing the estate tax (part of the "adjusted taxable gifts" made during the decedent's life time) even if the gifts were split for purposes of the gift tax when the gift was made.

5. Payments of Generation-Skipping Transfer Tax on Direct Skips [IRC § 2515]

The generation-skipping tax ("GST") is imposed on certain transfers that pass over (or "skip") intervening generations. [*See infra* Chapter III. covering the Generation-Skipping Transfer Tax.] It is imposed on top of any estate or gift tax due on the transfer. When a transfer of an interest is made directly to a skip person that is subject to the gift tax (called "direct skips" in Chapter 13), the transferor is responsible to pay the gift tax. [IRC § 2603(a)(3).] The additional tax liability paid by the transferor due to the GST results in an additional gift. [IRC § 2515.] Therefore, the transferor is essentially treated as giving two gifts, one for the initial transfer and another for the payment of the GST. This makes the transfer tax inclusive (a tax on the amount used to pay the tax) and treats the transaction the same as testamentary direct skips.

Example: T gifts GC, T's grandchild, Blackacre when the property is worth $2 million. T's transfer will be subject to both the gift tax and GST (since this is a direct skip). Assuming an applicable gift and GST tax rate of 40%, the generation-skipping tax is $800,000 (40% of $2 million). The total amount of gifts to GC will be $2.8 million ($2 million for Blackacre, $800,000 from the payment of the GST under IRC § 2515). T's gift tax liability will be $1,120,000. The total amount of transfer taxes for T from the transfer is $1,920,000, or about 96% of the value of the property transferred.

6. Below-Market Gift Loans [IRC § 7872]

In certain circumstances the interest free use of money is considered a transfer of property. [IRC § 7872.] Two transfers are created under IRC § 7872. First, an imputed amount is transferred from the lender to the borrower. [IRC § 7872(a)(1)(A), (b)(1).] Second, an interest payment is imputed passing from the borrower to the lender. [IRC § 7872(a)(1)(B).] Therefore, IRC § 7872 treats the use of money the same as the use of other property (e.g., the rent free use of a house or boat). This was not always the case. [*See, J. Simpson Dean v. Commissioner*, 35 T.C. 1083 (1961) holding the foregone interest was not income to the lender.] The change occurred after the Supreme Court in *Dickman v. Commissioner*, 465 U.S. 330, 104 S.Ct. 1086, 79 L.Ed.2d 343 (1984) held that an interest free loan to a family member resulted in a taxable gift of the unpaid interest. Congress followed up *Dickman* by creating IRC § 7872 statutorily creating a "transfer." IRC § 7872 potentially applies to many different situations, but only gift tax implications will be considered here.

Section 7872 applies to (1) "**below market loans**," (2) "to which this section applies." [IRC § 7872(a)(1), (b)(1).] Both elements are defined below. IRC § 7872 dictates only the amount of transfer, with other Code sections used to determine the tax treatment of each imputed payment.

a) Elements of IRC § 7872

(1) "Below Market Loan"

To determine whether a loan is "below market," there is first a determination of whether it is a demand or term loan. [IRC § 7872(e)(1).] **Demand loans** are either "payable in full at any time on the demand of the lender" or are non-transferable and conditioned on the performance of substantial future services by an individual. [IRC § 7872(f)(5).] A **term loan** is a default described as "any loan that is not a demand loan." [IRC § 7872(f)(6).]

Example: On February 1, Year 1, Mother loans Son $20,000 payable in one year. The loan is a term loan since it is not due on the demand of the lender (Mother). [IRC § 7872(f)(6).]

Demand loans qualify as below market loans if the interest rate is less than the applicable federal rate. [IRC § 7872(e)(1)(A).] The applicable federal rate is the Federal short-term rate for the year in question. [IRC § 7872(f)(2)(B).] The Federal short-term rate is the average market yield on outstanding government obligations with three years or less to maturity. [IRC § 1274(d)(1)(A), (C)(i).] Therefore, a comparison of the

loan's interest rate to the Federal short-term rate determines whether a demand loan is "below market."

Term loans are considered below market if the amount loaned exceeds the **present value** of all payments due under the loan. [IRC § 7872(e)(1)(B).] The amount loaned is "the amount received by the borrower." [IRC § 7872(f)(4).] The present value of payments is computed by using the appropriate Federal rate for the term of the loan determined under IRC § 1274(d). [IRC § 7872(f)(1).]

> ***Example:*** On January 1, Mother loans Son $20,000 payable in one year. Son owes $500 of interest at the end of the term when the applicable Federal rate is 10%. The loan qualifies as a term loan since it is not due on the demand of the lender (Mother). [IRC § 7872(f)(6).] The amount loaned is $20,000 (the amount received by Son). [IRC § 7872(f)(4).] The discounted present value of all payments due under the loan ($20,500 due in one year) is $18,594 for a one-year period using the applicable 10% discount rate compounded semi-annually. This loan is considered a "below market loan" since the amount loaned ($20,000) exceeds the present value of all payments due under the loan ($18,594). [IRC § 7872(e)(1)(B).]

(2) "To Which This Section Applies"

In order for IRC § 7872 to apply, the below-market loan must be one "to which this section [IRC § 7872] applies." [IRC § 7872(a)(1), (b)(1).] "Gift loans" are included in the types of loans to which IRC § 7872 applies. [IRC § 7872(c)(1)(A).] A gift loan is any loan where the "foregoing of interest is in the nature of a gift." [IRC § 7872(f)(3).] Therefore, if a lender forgives the interest on a loan out of detached and disinterested generosity, IRC § 7872 will apply, unless an exception applies.

IRC § 7872 will not apply if the total amount of gift loans from one individual to another is less than $10,000 and, therefore, no interest is imputed between the parties. [IRC § 7872(c)(2)(A).] This exclusion is separate from the one under IRC § 2503(b). However, this section does not allow for spouses to each transfer up to the $10,000 limit, since a married couple is treated as one person and, as such, the amount loaned is aggregated for both. [IRC § 7872(f)(7).] Moreover, the $10,000 de minimis exception does not apply if the borrower purchases income-producing assets like stocks, bonds, or rental property. [IRC § 7872(c)(2)(B).]

b) Gift Tax Consequences of the Application of IRC § 7872

The imputed transfer amount for below-market gift loans depends on whether the loan is a demand or term loan. However, regardless of the amount, the tax treatment remains the same for the amount deemed transferred from lender to borrower; that amount constitutes a gift. The lender treats the imputed transfers as a gift to the borrower; the borrower is allowed to exclude the imputed amount as a gift under IRC § 102(a). For the borrower, the tax treatment of the imputed interest expense amount from borrower to lender depends on the use of the funds. For example, if the funds were used to purchase a house, the imputed amount may be deductible under IRC § 163.

[IRC § 163(a), .] The lender treats the imputed amount as interest income. [IRC § 61(a)(4).]

(1) Gift Demand Loans

For gift demand loans, the transfer from lender to borrower and borrower to lender is the same and is the amount of "foregone interest." [IRC § 7872(a)(1).] The time of the transfer occurs on the last day of the calendar year. [IRC § 7872(a)(2).] The foregone interest is the amount of interest due using the applicable Federal rate less any interest payable on the loan. [IRC § 7872(e)(2).] Basically, the amount of foregone interest is what Congress feels should have been paid in interest less the interest due under the agreement.

> ***Example:*** On January 1, with donative intent, Mother lends $1,000,000 to Son. The loan is payable at the discretion of Mother. The loan has 5% interest (compounded annually) due each year the loan is outstanding. Assume the applicable Federal rate is 10%, compounded semi-annually. IRC § 7872 applies since this is a below-market demand gift loan. [IRC § 7872(a)(1), (e)(1)(A), (f)(5).] The amount of foregone interest for each year the loan is outstanding is $52,500. The forgone interest is determined by first computing the amount of interest due using the applicable Federal rate of 10% compounded semi-annually ($102,500), then subtracting the amount of interest payable ($50,000). The $52,500 represents the amount of gift transfer from Mother to Son. [IRC § 7872(a)(1)(A).] It also represents the deemed interest payment from Son to Mother. [IRC § 7872(a)(1)(B).] The tax implications for Son depend on his utilization of the loan funds.

Unless a tax avoidance purpose exists, the imputed transfer amount from borrower to lender for gift loans of $100,000 or less is limited to the amount of the borrower's net investment income. [IRC § 7872(d)(1)(A), (B).] The net investment income is the excess of the income received on the borrower's investment less the expenses to create that income. [IRC §§ 7872(d)(1)(E)(i), 163(d)(4)(A).] If the borrower's net investment income does not exceed $1,000, it is treated as zero. [IRC § 7872(d)(1)(E)(ii).] This rule does not limit the imputed transfer from lender to borrower, and therefore, does not affect the amount deemed a gift.

(2) Gift Term Loans

(a) Imputed Gift Transfer

The amount of the deemed gift from lender to borrower for below market gift term loans is determined using IRC § 7872(b)(1) as a result of IRC § 7872(d)(2). [IRC § 7872(d)(2).] Under IRC § 7872(b)(1), the deemed gift transfer equals the amount loaned less the present value of all payments required under the loan. [IRC § 7872(b)(1).] The gift occurs on the later of the date the loan was made or the first day when IRC § 7872 applies (e.g., when the amount loaned exceeds the $10,000 exception). [IRC § 7872(b)(2).]

Example: With donative intent, Father lends $50,000 to Son for a term of ten years at 0% interest. If the applicable Federal rate is 10% compounded semi-annually, the present value of the loan payments ($50,000 to be paid in ten years) is $18,844. [IRC § 7872(f)(1).] The loan qualifies as a "below-market loan" since the amount loaned ($50,000) exceeds the present value of all payments due under the loan ($18,844). [IRC § 7872(e)(1)(B), (f)(4).] Moreover, the loan is one "to which this section applies," since Father's donative intent in foregoing the payment of interest is "in the nature of a gift." [IRC § 7872(c)(1)(A), (f)(3).] Father's deemed gift transfer is determined under IRC § 7872(b)(1), since the loan is a term loan. [IRC § 7872(d)(2), (f)(6).] The deemed gift totals $31,156: the amount loaned ($50,000) less the present value of all payments due under the loan ($18,844). [IRC § 7872(b)(1).] Father is deemed to have transferred $31,156 of the $50,000 loan as a transfer of property by gift. Additionally, under IRC § 102(a) Son does not include any of the deemed transfer in his gross income.

(b) Imputed Interest Payment

Just as for gift demand loans, the amount of foregone interest is the deemed interest payment from borrower to lender. [IRC § 7872(a)(1)(B).] The net investment income limitation also applies to limit the deemed transfer to the borrower's net investment income. [IRC § 7872(d)(1).]

Example: Same facts as above, with the additional fact that Son has $3,000 of net investment income. Generally, the amount of imputed interest from Son (borrower) to Father (lender) is the foregone interest. [IRC § 7872(a)(1).] The foregone interest for the year on $50,000 at 10% interest compounded semi-annually is $5,125. However, unless avoidance of the Federal tax is one of the principal purposes of the loan, the amount of the imputed interest payment is limited to the Son's net investment interest ($3,000). [IRC § 7872(d)(1)(A).] Father will include the $3,000 in his gross income. Son's tax treatment of the $3,000 deemed interest payment depends on his use of the $50,000. [*See, e.g.,* IRC § 163(a).]

D. Special Valuation Rules

1. Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships

a) Introduction

Even after a careful reading of IRC § 2701, its purpose and effect can remain elusive. To understand the problem IRC § 2701 addresses, one must first understand the mechanics of the classic preferred interest estate freeze technique. Suppose a taxpayer owns all of the stock in a closely held corporation. The taxpayer wants to transfer a substantial portion of the stock to the taxpayer's child, but there are three obstacles to an outright gift

transfer. First, the taxpayer does not want to lose control of the corporation. Second, the taxpayer does not want to lose a substantial portion of the dividend stream flowing from the corporation. And finally, such a large gift would likely result in liability for federal gift tax.

Prior to the enactment of IRC § 2701, a common solution to these obstacles was to effect an income tax-free recapitalization of the stock into two classes: voting preferred stock and non-voting common stock. [IRC § 368(a)(1)(E).] In addition to carrying all of the voting rights, the preferred stock would feature a fixed liquidation preference equal to the pre-recapitalization value of the corporation's stock and a fixed dividend preference equal to the corporation's pre-recapitalization income stream. The common stock would lack voting rights, but because the preferred stock's rights at liquidation and distribution are frozen, the common stock would receive all future appreciation in the value of the corporation.

Following this recapitalization, the taxpayer would transfer the non-voting common stock to the child and retain the voting preferred stock. This technique solved the problems of the outright gift: the taxpayer kept control over the corporation by holding all of the voting shares, the fixed dividend preference ensured that the taxpayer would continue to enjoy an income stream at the same level, and the gifted common shares could be transferred at very little value because they lacked voting rights and no present rights to dividends or liquidation proceeds. Meanwhile, all future growth in the corporation was allocated to the common shares. At the taxpayer's death, the gross estate would include only the preferred shares, and that value would be fixed because of the limited and preferred distribution and liquidation rights. All of the post-gift appreciation in the corporation's value was allocable to the common shares that were in the hands of the child.

Despite challenges from the Service, the preferred interest freeze technique worked. Additionally, it worked not only for corporations, but for partnerships as well. It took IRC § 2701 to render the technique ineffective. Where applicable, IRC § 2701 requires that the computation of the value of the gifted common interest be determined by valuing the retained preferred interest at zero (the "zero-value rule"). [IRC § 2701(a)(3)(A); Reg. § 25.2701–1(a)(2).] In effect, then, a gift of the common interest is valued as though it were a gift of both the common and preferred interests. If IRC § 2701 does not apply, the gift transfer is valued under the normal valuation rules.

> ***Example:*** Robert, an individual, holds all the outstanding common stock of Baratheon Corporation, with a total fair market value of $1 million. In a tax-free reorganization, Robert transfers his Baratheon common stock for 900 shares of preferred stock and 100 shares of common stock. The preferred stock has an annual non-cumulative dividend of $100 per share, and a right to sell the stock back to the corporation (a "put") for $1,000 per share. Assume that the fair market value of the preferred stock is $900,000. Robert transfers the 100 shares of common stock to his daughter, Myrcella. Several years later, Robert dies when the total value of Baratheon is $2.5 million.

Without IRC § 2701, the gift and estate tax treatment would be as follows. On the transfer of the common stock to Myrcella, Robert would have a taxable gift of $100,000 ($1 million less the $900,000 fair market value of the preferred

stock). On his death, Robert would include the $900,000 of preferred stock in his gross estate under IRC § 2033. The $1.5 million increase in value (which could have been due in part to the corporation never authorizing any dividends to the preferred stock) is not taxed, and therefore, the value is "frozen" at the time of transfer with all the appreciation going to the common stock.

With IRC § 2701 the outcome is very different. Robert's preferred stock (an "applicable retained interest") is valued at zero. Thus, the transfer to Myrcella results in a $1 million taxable gift. On Robert's death, $900,000 is still included in his gross estate, but the estate will receive some relief since the preferred stock has already been taxed under Chapter 12. [IRC § 2701(e)(6); Reg. § 25.2701–5; *see infra.* at II D. 1. i).]

IRC § 2701 is best approached in three steps. First, see if IRC § 2701 applies to the facts. Next, see if any exceptions exist to the application of the rule. Finally, if no exceptions exist, value the property under IRC § 2701.

IRC § 2701 applies when two conditions are met. Under the introductory language of IRC § 2701(a), the taxpayer must transfer an interest (formally, a "subordinate interest") in a partnership or corporation to or for the benefit of a statutorily defined member of the taxpayer's family in a younger generation. [IRC § 2701(a)(1); Reg. § 25.2701–3(a)(2)(iii).] Second, immediately after the transfer, the taxpayer or an applicable family member (a member of the taxpayer's family in an older generation) must hold an "applicable retained interest." [IRC § 2701(a)(1)(B), (b)(1).] IRC § 2701 does not apply when market quotations are available for either the retained or transferred interest, if the transferor's retained interest is the same class as the transferred interest, and if the interests are given proportionally. The exceptions are covered in greater detail *infra* at II. D. 1. d). [IRC § 2701(a)(1)(flush), (a)(2).]

b) [Step 1] First Requirement for the Application of IRC § 2701(a): Transfer of Subordinate Equity Interest to a Member of Transferor's Family

(1) "Transfer" Requirement

In order for IRC § 2701 to apply, there must be a "transfer" made by the taxpayer. The transfer may be direct or indirect.

(a) Direct Transfers

The transferor must give up dominion and control of the property to satisfy the transfer requirement. [*See supra*, II. B. 3. b).] Even transfers not considered gift transfers, due to the fact that full and adequate consideration is paid under IRC § 2512(b) for the transferred interest, can still be treated as a "transfer" for IRC § 2701, effectively changing a sale into a gift. [Reg. § 25.2701–1(b)(1).] This prevents avoidance of the zero-value rule by making payments, since the value of the interest given can be nominal.

***Example (1)*:** Parent has both preferred and common stock in Corporation X. Parent transfers the common stock outright to Child, while retaining the preferred stock. This is a transfer that is covered by IRC § 2701.

Example (2): Parent has both preferred and common stock in Corporation X with fair market values of $96,000 and $4,000, respectively. Parent sells the common stock to Child for $4,000, while retaining the preferred stock. Although Child paid consideration for the common stock, the sale will be treated as a "transfer" for IRC § 2701. If the zero valuation rules apply, Parent will be treated as making a $96,000 gift to Child ($100,000 transferred less the $4,000 consideration paid). [IRC § 2701(a)(3)(A); Reg. § 25.2701–1(b)(1), –3(b)(4)(iv).]

The exercise, release, or lapse of a power is treated as a "transfer" under IRC § 2701 only when they are treated as transfers under IRC § 2514. [Reg. § 25.2701–1(b)(3)(iii).] Therefore, the exercise, release, or lapse of a post-1942 general power of appointment is treated as a transfer for IRC § 2701.

Example: Parent creates a trust by transferring the common stock from Corporation X discussed above. Parent gives Spouse a non-general power to transfer the common stock to Child. If Spouse exercises the power and transfers the common stock to Child, no transfer will occur for IRC § 2701(a). If instead, Spouse had a general power of appointment, the exercise of the power would be treated as a transfer covered under IRC § 2701.

The disclaimant does not treat any shift of rights occurring due to a qualified disclaimer under IRC § 2518 as a transfer. However, depending on who ultimately receives the interest, IRC § 2701 may apply when valuing the interest from the original transferor. [Reg. § 25.2701–1(b)(3)(ii).]

Example: Grandfather owns all the preferred and common stock of Corporation Y. He transfers the common stock to Parent, while retaining all the preferred stock. Parent makes a qualified disclaimer of the common stock, and as a result the stock goes to Child. Parent is not treated as making a transfer to Child, but IRC § 2701 may apply to value the transfers created by the disclaimer going from Grandfather to Child.

(b) Indirect Transfers

IRC § 2701 also covers indirect transfers, various transactions where the younger generation receives an interest in the corporation or partnership. Examples of indirect transfers are transfers completed by the application of the attribution rules, and certain contributions to capital or other changes in the capital structure of the corporation or partnership.

i) Attribution Rules

Equity interests held indirectly through a corporation, partnership, estate, trust, or other entity are attributed to an individual. [IRC § 2701(e)(3).] An individual is treated as owning the stock held by the corporation in proportion to the fair market value of the stock owned by the individual to the total fair

market value of all the stock of the corporation. Partnership interests have similar attribution, but the proportion used is the individual's interest in the profits or capital interests in the partnership to the total partnership fair market value of such interests. [Reg. § 25.2701–6(a).]

> ***Example:*** Parent owns all the common stock of X Corporation (X). Y Corporation (Y) has two classes of stock, preferred and common, both of which are owned by X. Parent has X transfer all the common stock of Y to Child. Since the ownership interests of X are attributed to Parent, the transfer is treated as a transfer by Parent to Child.

ii) Transfers Under IRC § 2701(e)(5)

In order to find a transfer under IRC § 2701(e)(5), three elements must be met. First, there must be a contribution to capital, redemption, recapitalization, or other change in the capital structure of a corporation or partnership. Second, the transferor or an applicable family member must receive an applicable retained interest (defined *infra* at II. D. 1. c) (2)) in such entity or, due to the transfer, their interests are increased. Finally, there is no transfer for IRC § 2701 if the transfer leaves the transferor, applicable family members, and members of the transferor's family in substantially identical positions after the transaction. [IRC § 2701(e)(5).]

(1) Contributions to Capital, Redemptions, and Other Changes in the Capital Structure

Neither the Code nor Regulations define a contribution to capital for IRC 2701(e)(5). However, it is thought to include any transfer of money or other property to a corporation or partnership in return for an equity interest in the entity. [STEPHENS, ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 19.02[2][a][i] (9th ed. 2013).] A redemption is a transaction between the entity and shareholder/partner in which the equity interest is surrendered for either cash or property.

> ***Example (1)*:** Parent and Child decide to form X Corporation (X). Parent and Child both transfer cash to X, for which Parent receives preferred stock and Child receives common stock. This is a contribution to capital and is treated as a transfer of common stock from Parent to Child. As discussed above, the consideration paid by Child will not prevent the application of IRC § 2701.

> ***Example (2)*:** Corporation Y (Y) has a total of 1,000 shares outstanding, which are owned 75% by Alice and 25% by Boris, Alice's child. Alice transfers 250 shares of her common stock to Y in exchange for 300 shares of preferred stock, which, due to the nature of the attached rights, is treated as an applicable retained

interest. This is a capital structure transaction, and since Alice retains an applicable retained interest, is treated as a transfer of common stock from Alice to Boris. [Reg. § 25.2701–3(d)(ex. 4).]

(2) Qualifying Outcomes to Transferor or Applicable Family Member

Not all contributions to capital or changes to the capital structure are treated as transfers under IRC § 2701(e)(5); the transfer must be one of three specific types of transfers specified in the Regulations. The first type of transfer is what one might expect; as a result of the transaction, the transferor or an applicable family member receives an applicable retained interest in the capital structure transaction. [IRC § 2701(e)(5)(A); Reg. § 25.2701–1(b)(2)(i)(B)(1).] Applicable retained interests are defined in *infra.* at II. D. 1. c) (2), but the examples below will consist of preferred stock with non-cumulative dividend rights.

Example: The Alice and Boris hypothetical, immediately above, is an example of a transfer where the transferor receives an applicable retained interest in the capital structure transaction. Alice gave up common stock for preferred stock, which was an applicable retained interest. [Reg. § 25.2701–3(d)(ex. 4).]

The second transfer that is treated as indirect is one in which the transferor or an applicable family member holds an applicable retained interest before the capital structure transaction, subsequently surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest"), and receives property other than an applicable retained interest in return. [IRC § 2701(e)(5)(B); Reg. § 25.2701–1(b)(2)(i)(B)(2).] This is treated as a transfer since after the termination the subordinate interests are increased by the taxpayer's actions.

Example: Corporation Z has two shareholders, Parent and Child. Parent holds both preferred and common stock, while Child holds only common stock. If Parent redeems her common stock for cash, the transaction will be treated as a transfer of stock under IRC § 2701 from Parent to Child. [Reg. § 25.2701–1(b)(2)(i)(B)(2).] After the transaction, Child's interest in Corporation Z increases since there is less stock outstanding after the redemption.

The third type of transfer treated as indirect is one in which the transferor or an applicable family member holds an applicable retained interest before the capital structure transaction, later surrenders an equity interest in the entity (other than a subordinate interest), and the fair market

value of the applicable retained interest is increased. [Reg. § 25.2701–1(b)(2)(i)(B)(3).]

> ***Example:*** Parent holds two different classes of preferred stock, Class A and B, in a corporation. Child holds common stock in the same corporation. Assume that both the Class A and B are applicable retained interests under IRC § 2701(b)(1)(A). If Parent redeems the Class A stock for cash, this will be treated as a transfer from Parent to Child.

(3) "Substantially Identical" Transfer Exception

There is no indirect transfer created in the case of a capital structure transaction if the interests held by the transferor, the transferor's applicable family members, and members of the transferor's family are substantially identical before and after the transaction. [IRC § 2701(e)(5); Reg. § 25.2701–1(b)(3)(i).] Voting rights are disregarded in determining if the interests are substantially identical. [Reg. § 25.2701–1(b)(3)(i).] The exception for substantially identical interests does not apply to contributions of capital made by the transferor. [IRC § 2701(e)(5).]

> ***Example:*** Parent holds all the preferred stock in Corporation Alpha, with Child holding all the common stock. In a recapitalization transaction, the preferred stock of the corporation is changed from voting to non-voting stock, but otherwise remains the same. Since the voting rights are disregarded, the holdings of Parent and Child are substantially identical both before and after the recapitalization and no transfer has occurred for IRC § 2701(e)(5).

(2) Interest in Corporation or Partnership

The interest that is transferred (either directly or indirectly) must be an equity interest that possesses a right to the income or capital in either a corporation or partnership. An equity interest is stock in a corporation or any interest as a partner in a partnership. [IRC § 2701(a)(4)(B)(ii).] The transferred interest must be subordinate to other interests (called "senior equity interests") of the entity. [Reg. § 25.2701–3(a)(2)(iii).]

(3) "Member of the Transferor's Family"

In order for IRC § 2701(a) to apply, there must be a "transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family." The term "member of the transferor's family" includes only the transferor's spouse, any descendant of the transferor or transferor's spouse, and the spouse of such descendants. [IRC § 2701(e)(1).] In determining such persons, relationships by adoption are treated the same as those by blood. [IRC § 2701(e)(4).] The definition, therefore, includes the transferor's spouse, children, grandchildren, etc., but excludes brothers, sisters, nieces and nephews.

c) [Step 2] Second Requirement for the Application of IRC § 2701(a): After the Transfer, the Taxpayer or Applicable Family Member Holds an Applicable Retained Interest

As stated earlier, the application of IRC § 2701 has two elements. The first, "transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family" is discussed above. The second requirement is that the transferor or "applicable family member" must hold an "applicable retained interest" immediately after transfer. Both "applicable family member" and "applicable retained interest" are defined below.

(1) "Applicable Family Member"

For IRC § 2701(a), the term "applicable family member" includes the transferor's spouse, any ancestor of the transferor or transferor's spouse, and the spouse of such ancestor. [IRC § 2701(e)(2).] In determining such persons, relationships by adoption are treated the same as those by blood. [IRC § 2701(e)(4).] The definition, therefore, includes the transferor's spouse, parents, grandparents, etc., but excludes brothers, sisters, uncles, and aunts. Note that the transferor's spouse can be both a "member of the family" and an "applicable family member."

Example: Widget Corporation has three shareholders, Grandfather, Parent (Grandfather's child) and Grandchild (Parent's adopted child). Grandfather holds all the preferred stock in Widget, while Parent and Grandchild hold the common stock. Parent transfers her common stock to Grandchild. Grandfather is a direct ancestor of Parent and therefore is an "applicable family member." IRC § 2701 will apply to value Parent's common stock since it was made to member of Parent's family (Grandchild) and an applicable family member (Grandfather) had an applicable retained interest (the preferred stock) after the transfer.

(2) "Applicable Retained Interest"

The heart of IRC § 2701 is contained in the definition of what is treated as an "applicable retained interest." Generally, the reason different items are treated as an applicable retained interest is that they are discretionary rights that can be controlled by the transferor or an applicable family member. The Code assumes that this control will be used to maximize the value of the junior equity interest, thereby passing money to a lower generation at no estate tax cost.

An applicable retained interest is any interest in an entity that is either: 1) a distribution right from a controlled entity, or 2) any liquidation, put, call, or conversion right (collectively called "extraordinary payment rights" in the Regulations). [IRC § 2701(b)(1); Reg. § 25.2701–2(b).] It is important to distinguish the two types of applicable retained interests, since the manner in which they are valued is different. [*See* IRC § 2701(a)(3)(A)–(C).]

(a) Distribution Rights in a Controlled Entity

Generally a distribution right is the right to distributions from an entity with respect to the ownership (equity) interest therein. For a corporation, the right to distributions must be with respect to its stock (i.e., a dividend), and for a partnership, the right to distribution must be made with respect to a partner's interest in the partnership. [IRC § 2701(c)(1)(A).] However, the following are not treated as distribution rights: (1) if the right to distribution is the same or subordinate to the transferred interest, (2) extraordinary payment rights, and (3) guaranteed partnership payments under IRC § 707(c). [IRC § 2701(c)(1)(B).]

***Example (1)*:** Frederick owns two classes of stock in Oreo Corporation (Oreo), preferred stock that has a non-cumulative right to dividends and common stock. Frederick transfers the common stock to his son, Greg. If Oreo is a controlled corporation, Frederick's preferred stock is an applicable retained interest.

***Example (2)*:** Same as above except the preferred stock is subordinate to the rights of the common stock. Frederick's rights will not be treated as a distribution right since they are secondary to the rights of the common stock transferred by Frederick to Greg.

i) Control

If the transferor does not have the ability to dictate, either alone or with family members, whether the distribution rights of the stock will be satisfied, there is limited freeze possibility and IRC § 2701 will not apply. In finding whether control exists, the ownership interests considered are both the ancestors of the transferor and transferor's spouse ***and*** any lineal descendants of the parent of the transferor or transferor's spouse. This includes a wide range of people including grandparents, parents, brothers, sisters, nieces and nephews. [IRC § 2701(b)(2)(C); Reg. § 25.2701–2(b)(5)(i).]

For a corporation, control is holding 50 percent or more of the total voting power or the total value of the equity interests in the corporation. Stock that is only allowed to vote on extraordinary measures (liquidations, mergers, etc.) or is subject to a contingency outside the power of the shareholder that has not occurred is not considered in determining control. [IRC § 2701(b)(2)(A); Reg. § 25.2701–2(b)(5)(ii).] Partnerships are "controlled" if either: (1) a partner holds 50 percent or more of the capital or profit interest in the partnership, or (2) any general partner in a limited partnership. [IRC § 2701(b)(2)(B); Reg. § 25.2701–2(b)(5)(iii).]

Example: Corporation P is owned equally by three unrelated shareholders; A, B, and C. The ownership share consists of both preferred and common stock. Since none of

the shareholders have 50 percent or greater vote or value of the corporation, the zero-value rule will not apply to any gift transfers they make of their stock.

(b) Extraordinary Payment Rights

Applicable retained interests also include extraordinary payment rights. Extraordinary payment rights include the right to compel the liquidation of the entity, and any put, call, or conversion right, if the exercise or non-exercise affects the value of the transferred subordinate equity interest. However, if the liquidation right, put, call, or conversion right falls into one of two classes, it is not treated as an applicable retained interest. First, rights which are non-discretionary and must be exercised at a specific time and for a specific amount (called "mandatory payment rights" in the Regulations) are not applicable retained interests. [IRC § 2701(c)(2)(A), (B); Reg. § 25.2701–2(b)(4).] Neither are nonlapsing rights to convert stock or partnership interests into a fixed number or percentage in the same class as the transferred interest. [IRC § 2701(c)(2)(C); Reg. § 25.2701–2(b)(4)(iv).] The extraordinary payment rights under IRC § 2701 will be treated as if they will not be exercised and valued at zero unless paired with a distribution right. [IRC § 2701(a)(3).]

(c) Liquidation, Put, Call, or Conversion Right

Liquidation Right: The right to compel the liquidation of the entity is an extraordinary payment right. This is more than the right just to participate in any liquidation, which would lack the discretionary element required to force valuation under IRC § 2701. [Reg. § 25.2701–2(b)(4)(ii).] However, if the transferor has sufficient voting power to compel liquidation, the right to participate in liquidation is treated as an extraordinary payment right. [Reg. § 25.2701–2(d)(ex. 3).]

> ***Example (1):*** Along with applicable family members, Percy owns 60 percent of the voting right in Corporation X. In order to compel liquidation, 80 percent of the vote is required. Percy's right to participate in liquidation of Corporation X is not considered an extraordinary payment right and therefore is not an applicable retained interest. [Reg. § 25.2701–2(d)(ex. 4).]
>
> ***Example (2):*** Same as above, except only 60 percent of the vote is required to compel liquidation. Percy's right to participate in liquidation is now an extraordinary payment right, and is an applicable retained interest. [Reg. § 25.2701–2(d)(ex. 3).]

Put: The right of a shareholder to sell his or her interest back to the corporation at a set price (e.g., Class A shares can be sold back to the corporation for $10 minimum). The right may be tied to a specific period of time. A put is given to protect a shareholder from a decrease in the value of the stock.

Call: The right of a shareholder to purchase stock from a corporation at a set price (e.g., the corporation will sell Class A shares to shareholder for $10 maximum). The right may be tied to a specific period of time. Calls include warrants, options, or other rights to acquire additional equity interests. [Reg. § 25.2701–2(b)(2).]

Conversion Right: The right to convert one interest into another interest.

d) [Step 3] Exceptions to IRC § 2701(a)

Situations that lack the discretionary control over the various aspects of the value of an equity interest are excluded from the valuation rules of IRC § 2701(a). Therefore, the zero-value rule does not apply to interests for which market quotations are readily available, if the applicable retained interest is the same class as the transferred interest, and to proportionate transfers, such as where the transferor gifts a portion of his or her common interest and the same portion of his or her preferred interest. [IRC § 2701(a)(2).]

(1) Market Quotations

Since IRC § 2701 was created to value interests that are difficult to value, if either the transferred or applicable retained interest can be valued on an established securities market (e.g., the New York Stock Exchange), IRC § 2701 does not apply. [IRC § 2701(a)(1)(flush), (a)(2)(A); Reg. § 25.2701–1(c)(1), (2).]

(2) Same Class of Stock

Section 2701 does not apply if the applicable retained interest and the transferred interest are identical (or proportional) in rights, disregarding any non-lapsing differences in voting rights. [IRC § 2701(a)(2)(B); Reg. § 25.2701–1(c)(3).]

Example (1): Frederick owns all the preferred and common stock in Oreo Corporation. Frederick transfers 50 percent of his preferred stock to his son Greg. Since the transferred and applicable retained interest are the same class, IRC § 2701 does not apply. [IRC § 2701(a)(2)(B).] There is no estate freezing potential here since Frederick and Greg have the same interests in property.

Example (2): Same as above, except the preferred stock transferred to Greg does not have any voting rights. The voting rights are disregarded and stock is therefore identical and IRC § 2701 does not apply. [Reg. § 25.2701–1(c)(3).]

(3) Proportional Transfers

If the transferor transfers interests in such a way that there is a proportionate reduction in the transferor's interests, the zero-valuation rule does not apply. In computing whether a proportionate reduction is made, the holdings of the transferor and all applicable family members are considered both before and after the transfer. [IRC § 2701(a)(2)(C); Reg. § 25.2701–1(c)(4).] Since the transfer is proportional, there is no

potential for freezing the retained interest while passing on the growth in the retained interest and the special valuations rules are not necessary.

> ***Example***: Father gives 20% of his interest in the non-voting common stock of Family Corporation (FC) to Daughter. In the same transaction, Father gives Daughter 20% of his interest in the voting preferred stock in FC. The zero-value rule does not apply to these gifts even though the formal requirements for the application of IRC § 2701 are present; Father has given Daughter a proportionate share of both a subordinate equity interest (the common shares) and a senior equity interest (the preferred shares).

e) [Step 4] Valuation of Applicable Retained Interests

If all the elements are met for the application of IRC § 2701, the next step in the analysis is to value the applicable retained interests and transferred interest. Generally, applicable retained interests are valued at zero. This is because the statute assumes the distributions will not be made or the extraordinary rights will not be exercised. The zero valuation rule does not apply where the distribution rights are "qualified payments" and, therefore, outside of the control of the transferor or applicable family member. [IRC § 2701(a)(3)(A), (B).] Regardless, if the zero-value rule applies, the transferred interest has a minimum value of 10 percent of the total value of the entity, plus any debt owed to the transferor by the entity. [IRC § 2701(a)(4).]

> ***Example:*** Mother transfers all of the non-voting common stock in Family Corporation (FC) to Son, retaining all of the voting preferred stock in FC. An appraisal of the FC shares conducted immediately prior to the gift indicates that the total combined value of the FC stock is $10 million. Because the common stock lacks voting rights and the preferred stock holds substantial distribution and liquidation preferences, the value of the non-voting common stock is $100,000, and the value of the voting preferred stock is $9,900,000. Since Mother transfers a subordinate equity interest to a member of the family and has an applicable retained interest, IRC § 2701 applies to value the transaction. Assuming the distribution rights are not qualified, Mother will be considered to have made a gift of $10 million to Son, since the preferred shares retained by Mother will be valued at zero.

(1) Qualified Payments

Qualified payments are basically mandatory distribution rights of the shareholder. Since the distributions are non-discretionary, the zero-valuation does not apply. [IRC § 2701(a)(3)(C).] A right to a **qualified payment** is a right to a cumulative dividend on preferred stock payable on a periodic basis to the extent the amount of the dividend is determined at a fixed rate or bears a fixed relationship to a specified market rate. [IRC § 2701(c)(3); Reg. § 25.2701–2(b)(6).] Thus, if the entity pays a market-rate dividend on the preferred interest, Congress will forego application of the zero-value rule because there is assurance that dividends will be paid to the transferor and thus become part of the transferor's gross estate to the extent not consumed before death. If the rate bears a set relationship to a specified market rate interest (e.g., "6

percent above the prime rate"), this will be treated as a fixed rate even though it fluctuates. [IRC § 2701(c)(3)(B).] As discussed in more detail below, a transferor or applicable family member may elect in or out of the treatment of the distribution as a qualified payment. [IRC § 2701(c)(3)(C).]

Example (1): Peter holds all the stock of Dino Corporation (DC). Peter transfers all his non-voting common stock to his daughter, Gabrilla, retaining the DC voting preferred stock that has a cumulative annual dividend of $10. Since Peter controls DC, the right to dividends is an applicable retained interest. [IRC § 2701(b)(1).] However, since the dividend right is cumulative and at a fixed amount, it is a "qualified right" and the preferred stock will not have a zero value. [IRC § 2701(a)(3)(C), (c)(3)(A); Reg. § 25.2701–2(d) (ex. 1).]

Example (2): Same facts as above except that the right to dividends on Peter's preferred stock is non-cumulative. The distribution right is still an applicable retained interest, but is no longer a "qualified right" and will be valued at zero. [IRC § 2701(a)(3)(A), (c)(3)(A).] Note, that if in either example Peter did not control DC, the distribution right would not be an applicable retained interest and the preferred stock would be valued at its fair market value. [IRC § 2701(b)(1)(A); Reg. § 25.2701–2(d)(ex. 2).]

(a) Elections

The transferor or applicable family member may elect to treat distribution rights as qualifying or non-qualifying. [IRC § 2701(c)(3)(C).] The transferor may treat all or a portion of the distribution rights as nonqualifying, although the rights meet the requirements to be considered qualifying payments. [IRC § 2701(c)(3)(C)(i); Reg. § 25.2701–2(c).] This is done primarily to avoid the tax consequences of IRC § 2701(d) (the "lookback" rule discussed *infra* at II. D. 1. h)), which can increase the amount of taxable gifts or taxable estates for payments that were due but not made. It is also possible for the transferor and applicable family members to treat the payments as qualifying payments, regardless of whether they meet the requirements. [IRC § 2701(c)(3)(C)(ii).] Once the election is made, it is irrevocable. [IRC § 2701(c)(3)(iii).]

Example: Same facts as above where Peter's preferred stock had non-cumulative dividend rights. While the stock is non-qualifying, if Peter elects to treat the stock as qualifying, it will not be valued at zero. However, the stock will be subject to the look-back rule of IRC § 2701(d).

(b) Valuation of Qualifying Payments

i) Solely Distributions Rights

Equity interests with qualifying payment rights not connected to extraordinary payment rights are valued without regard to IRC § 2701. [IRC § 2701(a)(3)(C).]

Example (1): Parker holds all the stock of Xerxes Corporation (XC) worth a total of $1.5 million. XC is recapitalized, so that there is both preferred and common stock. After the recapitalization, Parker has 1,000 shares of preferred stock with a par value of $1,000 and an annual cumulative dividend of $100 per share, and 1,000 shares of common stock. Assume that the value of the preferred stock is $1 million. Later, Parker transfers all the common stock to his daughter. Since Parker transfers a subordinate equity interest to a member of his family and retains an applicable retained interest, IRC § 2701 applies. However, since the applicable retained interest (the preferred stock) has a cumulative fixed dividend right, it is a qualifying payment. Therefore, the preferred stock is valued at $1 million, and the gift to Parker's daughter is $500,000. [Reg. § 25.2701–1(e)(ex. 1).]

Example (2): If Parker's right to dividends were non-cumulative, the right would not be a qualifying right and valued at zero. This means Parker is treated as transferring $1,500,000 to his daughter. Parker may elect to treat all or a portion of the preferred stock as subject to a qualifying payment to avoid the application of the zero-value rule. [Reg. § 25.2701–1(e)(ex. 2).]

ii) Qualifying Distribution Rights and Extraordinary Payment Rights

If the transferor's applicable retained interest consists of a distribution right with qualified payments and one or more extraordinary payment rights, the "lower of" rule applies. The extraordinary payment rights are valued as if they were exercised in such a manner that results in the lowest value for all the attached rights. [IRC § 2701(a)(3)(C).]

Example: Xylong Corporation (X) has a total equity value of $1.5 million and has two classes of stock outstanding, all owned by Peggy. One class consists of 1,000 shares of preferred stock with an annual cumulative dividend right of $100 per share, and a right to sell the stock to X (a "put") for $900 per share. Assume that the value of the cumulative annual dividend is $1 million. The other class consists of 1,000 shares of non-voting common stock. Peggy transfers all the common stock to her daughter, Emmy. Here IRC § 2701 applies since Peggy has transferred a junior equity interest to a member of her family and keeps an applicable retained interest. Since the distribution right is cumulative and at a fixed rate, it is a qualifying payment right. Here, the "lower of" rule applies since the preferred stock confers both a qualifying distribution right and an extraordinary payment right (the put). The value of the preferred stock is $900,000 since if Peggy exercised the put it would result in the lowest value ($900,000 v. $1 million). Therefore, the

amount of gift to Emmy is $600,000. [Reg. § 25.2701–2(a)(5)(ex.).] If the annual cumulative dividend right was valued at $800,000, the put would be treated as not being exercised and the value of the preferred stock would be $800,000 (the lower of $800,000 or $900,000).

f) Subtraction Method of Valuation

The amount of the gift is computed by using the "subtraction method of valuation." [Reg. § 25.2701–3(a)(1).] Generally, this is done by taking the total fair market value before the transfer of all family-held interest and reducing it by the family-held senior equity interests (which include the applicable retained interests valued under IRC § 2701). The difference is then allocated between the transferred interests and other family-held subordinate equity interests. Finally, any discounts and other appropriate reductions are applied to determine the final value of the gift. The specific steps, covered in a summary fashion, are as follows.

Step 1 (Reg. § 25.2701–3(b)(1)): Value the entire amount of family-held interests. Family-held interests are all those owned by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse. [Reg. § 25.2701–2(b)(5)(i).]

Step 2 (Reg. § 25.2701–3(b)(2)): After finding the total value, the senior equity interests and applicable retained interests held by the transferor and applicable family members are determined after the application of IRC § 2701. In subtracting the value of the senior equity interests from the family-held interests, the Regulations isolate the value of the junior interests held by T, applicable family members and members of T's family.

Step 3 (Reg. § 25.2701–3(b)(3)): The remaining value is allocated among the transferred interest, and other subordinate interests held by T, and T's applicable family members.

Step 4 (Reg. § 25.2701–3(b)(4)): Reduce the transferred amount for any minority or similar discount, reductions under IRC § 2702, and any consideration received by the transferor.

g) Minimum Valuation [IRC § 2701(a)(4)]

The transferred interest is subject to a minimum value, and therefore, cannot be treated as zero. All "junior equity interests" have a minimum value of 10 percent of the sum of the total value of all the entities equity interests and the total amount of indebtedness owed by the entity to the transferor and applicable family member. [IRC § 2701(a)(4)(A).] The transferred interest is then given a proportional amount of such minimum value. The rule has limited application, since the applicable retained value is generally zero, which leads to a greater value of the transferred interest than would exist under the minimum valuation rule.

Example: Kermit holds all the stock of Piggy Corporation (PC) worth a total of $1.5 million. PC is recapitalized, creating both preferred and common stock. After the recapitalization, Kermit has 1,000 shares of preferred stock with a par value of $1,500 and an annual cumulative dividend computed at a fixed rate, and 1,000 shares of common stock.

Assume that the value of the preferred stock is $1.5 million. Here, IRC § 2701 applies, but the applicable retained interest (the preferred stock) has a cumulative fixed dividend right, so it is a qualifying payment. Instead of valuing the transfer at zero, the minimum valuation rule applies to value the transferred amount at $150,000, 10 percent of the $1.5 million total value of PC.

h) Lookback Rule [IRC § 2701(d)]

Generally applicable retained interests are valued at zero under IRC § 2701. This is not the case for distribution rights (e.g., dividends) that are subject to any qualified payments. In this case, the interest is valued at its fair market value, since the payments are cumulative and at a fixed amount or percentage, thereby taking away any discretion about whether the payments will be made or not. Even though there is a set definition of what is a qualified payment, the transferor and applicable family members may elect in, or out, of treating such rights as qualified.

The lookback rule of IRC § 2701(d) is the statutory check to make sure the promised payments are actually made. If the payments are not made, the Code attempts to approximate the value of the payments plus interest and adds that to either the taxable estate (if computed at the transferor's death) or taxable gift (if computed before transferor's death). In this way, the transferor and applicable family members are kept to the corporate or partnerships obligations of paying off the qualified payments.

i) Adjustments to Estate and Gift Tax [IRC § 2701(e)(6)]

If IRC § 2701 applies to value an interest, unless there is a distribution right with qualified payments, the applicable retained interest is valued at zero. Since the applicable retained interest remains with the transferor, the possibility of the interest being taxed twice is present: once at the time of transfer and again at the transferor's death or subsequent transfer of the interest. Foreseeing this problem, Congress included IRC § 2701(e)(6) to mitigate the possibility of double tax on the same interest.

The relief provision applies when: (1) there is a subsequent transfer or inclusion in the gross estate of the transferor, (2) of an applicable retained interest valued under IRC § 2701(a). In such cases the Code states that the Regulations should provide for "appropriate adjustments" to be made for the estate, gift, and generation-skipping transfer taxes "to reflect the increase in the amount of any prior taxable gift made by the transferor or decedent by such valuation." [IRC § 2701(e)(6).]

The Regulations provide that the amount on which the estate or gift tentative tax is computed is reduced by the "amount of the reduction." The amount of the reduction is the *lesser of*: (1) the amount by which the taxable gifts were increased due to IRC § 2701 on the initial transfers of the subordinate interest to the member of the family, or (2) the "duplicated amount." The duplicated amount is the amount by which the current gift or estate tax value of the applicable retained interest involved in the subsequent transfer exceeds the § 2701 value of the interest at the time of the initial transfer. [Reg. § 25.2701–5(a), (b), (c).]

Example: Petunia holds all the outstanding shares of X Corporation (XC) that consists of both preferred and common stock. There are 1,500 preferred shares which have a $1,000 par value, non-cumulative dividend right of $100 per share, and a put to XC at the demand of the shareholder for par value. There are 1,000 common shares with a fair market value of $500,000. The total value of XC is $2 million.

In Year 1, Petunia transfers the 1,000 shares of common stock to her child, Melissa. Since Melissa is a "member of the family" and transferred a junior interest, while Petunia kept an applicable retained interest, the valuation rules of IRC § 2701(a) apply. [IRC § 2701(a)(1).] Since the preferred stock's distribution rights are not qualified payments, assuming that Petunia does not elect to treat them as such, the preferred stock will have a zero value. [IRC § 2701(a)(3)(A).] Using the subtraction method, the amount treated as transferred to Melissa is $2 million ($2 million family-held interest less zero) and Petunia treats that amount as a taxable gift.

Example (Gift Transfer of Applicable Retained Interest): Assume that in Year 4, when the value of the preferred stock is $1.4 million, Petunia transfers all 1,500 shares to Melissa. Without any relief, the preferred stock value would be taxed twice, once in Year 1 due to the zero valuation under IRC § 2701, and again in Year 4. Here, IRC § 2701(e)(6) applies since there is a subsequent transfer of the applicable retained interest valued under IRC § 2701(a) (Petunia's preferred stock). Under the Regulations the $1.4 million taxable gift will be reduced by the lesser of: (1) the amount the applicable retained interest was increased under IRC § 2701 (here $1.5 million), or (2) the duplicated amount ($1.4 million). The duplicated amount is the amount of the gift tax value on the transfer of the preferred stock in Year 4 ($1.4 million) less the value of the preferred stock in Year 1 (zero). After applying the reduction, the gift tax on Petunia's transfer will be zero. [Reg. § 25.2701–5(d)(ex. 1).]

Example (Transfer of Applicable Retained Interest at Death): Instead of making the transfer of preferred stock above, assume that Petunia dies in Year 4 when the value of the preferred stock is $1.5 million. Without any relief, the preferred stock value would be taxed twice, once in Year 1 due to the zero valuation under IRC § 2701, and again in Year 4 since the stock would be included in her gross estate under IRC § 2033. Here, IRC § 2701(e)(6) applies since the applicable retained interest valued under IRC § 2701(a) (Petunia's preferred stock) is included in Petunia's gross estate. Under the Regulations, the $1.5 million increase in Petunia's taxable estate is reduced by $1.5 million. [Reg. § 25.2701–5(d)(ex. 2).]

2. Transfers of Interests in Trust to Family Members [IRC § 2702]

a) Background

IRC § 2702, located in Chapter 14 (Special Valuation Rules) of Subtitle B (Estate and Gift taxes), does more than just value interests, despite its title and placement. If applicable, IRC § 2702 determines whether any transfer

made to a member of the transferor's family will be treated as a "gift" or not. It can also give a zero value to any retained interests of the transferor in order to increase the amount of any gift transfer.

IRC § 2702 is a response to several "estate freezing" techniques that would allow individuals with substantial estates to pass assets likely to appreciate significantly in value at little or no transfer tax cost. One common freeze technique was the so-called grantor-retained income trust (GRIT), where the grantor would transfer assets to an irrevocable trust, retaining the right to income for a term of years. The value of the gift would be the present value of the right to the remainder interest, which was often much less than the value of the property contributed to the trust.

> ***Example:*** Father transfers $100,000 in property to an irrevocable trust he creates for himself and Daughter. He keeps a fifteen-year income interest, with the remainder going to Daughter. If the applicable interest rate for valuation under IRC § 7520 equaled 10%, the gift of the remainder interest to Daughter would be valued at only $23,939. If Father lives fifteen years, Daughter will take the entire trust (valued at over $400,000 provided that there were no withdrawals and the trust assets appreciated at a 10% annual rate) with no further gift (when Father's term of years expires there is no transfer to daughter) or estate (no one died) tax consequences. If Father dies before the fifteen-year term expires, the fair market value of the trust at the time of his death would be included in his gross estate under IRC § 2036. Therefore, without IRC § 2702 Father could transfer appreciating assets eventually worth $400,000, with only gift tax consequences on a $23,939 taxable gift. IRC § 2702 thwarts the estate freeze by valuing the retained interest at zero. So here, Father's retained fifteen-year income interest would be valued at zero, meaning the amount of taxable gift from Father to Daughter would be the full $100,000 transferred in trust.

b) Application of IRC § 2702

The analysis for IRC § 2702 is typical of many sections of the Code. First, see if IRC § 2702 applies to the facts. Next, see if any exceptions exist to the application of the rule. Finally, if no exceptions exist, apply the rule and value the property under IRC § 2702. For the application of IRC § 2702, there must be: 1) a "*transfer*" in trust, 2) of an "*interest*," 3) to a "*member of the transferor's family*," 4) by "*gift*," and 5) an interest in the trust must be "*retained by the transferor*" or "*any applicable family member*." [IRC § 2702(a)(1).]

(1) Specific Elements

(a) Transfers in Trust

As used in IRC § 2702, the word "transfer" includes transfers to either new or existing trusts and assignments of an interest in an existing trust. [Reg. § 25.2702–2(a)(2).] A transfer may also be imputed where two or more family members make a joint purchase of term interests in property. [IRC § 2702(c)(2) (see below).] However, the exercise, release or lapse of a non-general power of appointment or a qualified

disclaimer under IRC § 2518 of an interest is not considered a "transfer" for purposes of IRC § 2702. [Reg. § 25.2702–2(a)(2)(i), (ii).]

Example: Grandparent holds the income interest to a trust, with Parent, Grandparent's child, holding the remainder interest. Parent transfers his remainder interest to Son. Since Parent assigned an interest in an existing trust, this is a transfer that can trigger application of IRC § 2702. [Reg. § 25.2702–2(a)(2).]

i) Imputed Transfers in Trust [IRC § 2702(c)]

Another estate freezing technique involves a joint purchase of successive interests in property (e.g., life estates and remainders) between two family members. This accomplishes approximately the same goal as the example at the beginning of this section: no gift exists since the family member purchased the interest in property, albeit at a much lower price, and no estate tax consequences occur because no estate tax provisions provide for inclusion in the transferor's gross estate.

IRC § 2702(c)(2) provides that if two or more family members make a joint purchase of term interests, the individual(s) acquiring the term interests are treated as having acquired the entire property and subsequently transferred the non-term interests to the other person(s). This applies to purchases made in either a single transaction or a series of transactions. [IRC § 2702(c)(2).]

"Term interests" include life interests or interests in property for a term of years. [IRC § 2702(c)(3).] Any series of successive interests in property will be treated as term interests. Term interests do not include fee interests in property (e.g., tenants in common, tenants by the entirety, or joint tenancies). [Reg. § 25.2702–4(a).] Additionally, leasehold interests in property transferred for full and adequate consideration are not treated as "term interests." [Reg. § 25.2702–4(b).]

When IRC § 2702(c)(1) and (c)(2) are applied together, they work to create the requisite "transfer of an interest in trust" required for the application of IRC § 2702(a)(1). IRC § 2702(c)(2) creates a transfer between family members when term interests are purchased. Then IRC § 2702(c)(1) treats those interests as being transferred to a trust.

Example (1): Homer and his child, Bart, make a joint purchase of an apartment building with Homer purchasing a twenty-year term interest in the property, while Bart buys the remainder interest. Since Homer purchased a term interest in property with a family member, under IRC § 2702 he is treated as acquiring the entire property and transferring the remainder interest in trust to Bart for full consideration. Although not yet discussed in this section, Homer's term interest will be valued at zero and the entire

value of the building (less Bart's payment) will be treated as a gift to Bart. [Reg. § 25.2702–4(d)(ex. 1).]

Example (2): Marge and her child, Maggie, make a joint purchase of an office building, with each acquiring a 50% undivided interest as tenants in common. Even though this is a joint purchase, made between family members, the interests purchased are not considered term interests and IRC § 2702(c) (and therefore IRC § 2702) does not apply. [Reg. § 25.2702–4(d)(ex. 3).]

(b) "Interest"

i) General Rule

For IRC § 2702, to apply the transferor must make a transfer of an "interest." Generally, "interests" are interest in property, but the term also includes powers over trust property that would cause the transfer to be an incomplete gift under Chapter 12. [Reg. § 25.2702–2(a)(4).]

Example: Tim transfers property to an irrevocable trust, with the income payable at his discretion to either Julie or Jane for ten years and the remainder to Tim's son, Ronald. Since Tim maintains dominion and control over the ten-year income interest, that portion is an incomplete gift. [Reg. § 25.2511–2(c).] However, under IRC § 2702, Tim's power is treated as an "interest" that he has retained over the property. [Reg. § 25.2702–2(a)(4).] This results in the application of IRC § 2702 to the income interest which is subsequently valued at zero. Tim is thus considered to have made a gift to his son of the entire value of the property contributed to the trust. Similarly, if Tim maintained a power to switch the beneficiary of the remainder interest (but not the income interest), the remainder interest would be valued at zero.

ii) Treatment of Transfers of a Portion in Trust [IRC § 2702(d)]

If a specified portion of the income or remainder interest is transferred in trust, only such portion will be taken into account when applying IRC § 2702. [IRC § 2702(d).]

Example (1): Father transferred property to an irrevocable trust, retaining the income interest for life and designating 2/3 of the remainder interest payable to his daughter and the remaining 1/3 to his nephew. Under IRC § 2702(d), the transfer will be treated as creating two different trusts, with the IRC § 2702 zero-value rule applying only to the 2/3 portion of the trust for the benefit of his daughter. IRC § 2702 does not apply to the 1/3 portion for the benefit of his nephew since the nephew is not considered a member of

Father's family for the purposes of that section. [IRC §§ 2702(e), 2704(c)(2).]

Example (2): Adam creates a trust in which he retains the income interest for his life. The remainder is payable to his son, subject to Adam's retained power to give 1/4 of the remainder interest to his daughter. IRC § 2702 will apply only to the 3/4 remainder interest that is a completed gift. [Reg. § 25.2702–2(d)(ex. 5).]

(c) To a "Member of the Transferor's Family"

"Members of transferor's family" (not to be confused with "applicable family member," defined *infra* at II. D. 2. b) (1) (f)) includes the transferor's spouse, ancestors and lineal descendants of transferor or transferor's spouse, brothers and sisters, and the spouses of any of these individuals. [IRC §§ 2702(e), 2704(c)(2)(A)–(D).] It does not include more remote relationships, such as the transferor's aunts, uncles, nieces or nephews. For IRC § 2702 to apply, only one of the interests need be simultaneously transferred to a member of the transferor's family, not all interests.

Example: Grantor transfers property in trust. The trustee is required to pay the income to Grantor for ten years, then to Grantor's sister for ten years, and then to Grantor's nephew for his life. Grantor's nephew is not a "member of the transferor's family" for the application of IRC § 2702. However, since Grantor's sister is a member of the transferor's family, Grantor's retained income interest may be valued at zero if the other elements of IRC § 2702 apply.

(d) Transfer Is "By Gift"

The transfer must be a completed gift. *See supra* discussion of when a gift is complete, II. B. 3. b).

(e) "Retained by" the Transferor or Applicable Family Member

Under IRC § 2702 "retained by" has substantially the same meaning as its common usage: the same individual must hold an interest both before and after the transfer in trust. A wrinkle occurs for purchased term interests (e.g., life estates). Even though the transferor did not hold the interest before transfer (since it was newly purchased), it is treated as "retained by" the transferor if the transferor holds the term interest after the transfer. [Reg. § 25.2702–2(a)(3).]

Since the Regulations define "retained by" with reference to the same individual holding an interest in trust both before and after the transfer, it seems at first as if the phrase "or applicable family member" is superfluous. However, this language applies to transfers of interests from established trusts where an "applicable family member" maintains an interest in the trust both before and after a transfer.

Example (1): Gus holds the income interest in a trust, with Peter, Gus's child, holding the remainder interest. Neither Gus nor Peter created the trust. Peter transfers his remainder interest to his child, Mary. Gus here is an "applicable family member" under IRC § 2701(e)(2)(B) who "retains" an interest both before and after Peter's transfer. IRC § 2702 applies to the transfer and Peter is treated as transferring the full value of the corpus to Mary since under IRC § 2702 Gus' interest is valued at zero.

Example (2): Darrin transfers his separate property to an irrevocable trust. The trust is to pay income to Darrin's spouse, Marta, for her life, with the remainder passing to Darrin's child, Scott. Here there is a transfer of an interest in trust made to members of the transferor family as required under IRC § 2702(a)(1). However, since neither Darrin nor an applicable family member retained an interest (Marta did not have an interest in the property before transfer), IRC § 2702 does not apply. [Reg. § 25.2702–2(d)(ex. 3).]

(f) "Applicable Family Member"

An "applicable family member" is different than a "member of the transferor's family" as defined above. **Applicable family member**, defined under IRC § 2701(e)(2), includes only the transferor's spouse as well as the ancestors and their spouses of either the transferor or the transferor's spouse. The lineal descendants of the transferor or the transferor's spouse are not included.

Example: John Walton's parents are Zeb and Esther. John and his wife, Olivia, have several children, John Jr. ("John-Boy"), Mary-Ellen, and Jason. John has one brother, Ben. If John Sr. is the transferor, the "applicable family members" include only Olivia (John's wife) and Zeb and Esther (John's ancestors). Neither John's brother Ben nor John Sr.'s children are included. [IRC §§ 2702(a)(1), 2701(e)(2).]

(2) Exceptions

(a) Incomplete Gifts [IRC § 2702(a)(3)(A)(i)]

If no portion of the gift is complete to an applicable family member, IRC § 2702 will not apply to the transfer. [IRC § 2702(a)(3)(A)(i).] Consideration received by the transferor is not considered in determining whether a gift is incomplete. [IRC § 2702(a)(3)(B).]

Example (1): Byron creates an irrevocable trust reserving the right to income for ten years, followed by the remainder passing to his daughter, Cheri. Byron also retains the right to substitute any of his grandchildren for Cheri as the remainder beneficiary. Since Byron has dominion and control over the remainder interest, no portion of the transfer is a completed gift and IRC § 2702 does not apply. [*See* IRC § 2702(a)(3)(A)(i); Reg. § 25.2702–2(d)(ex. 4).]

Example (2): Jo transfers property to an irrevocable trust, retaining the right to receive income for fifteen years. After fifteen years, the income of the property is to be paid to her spouse, Friedrich, for five years. After that five-year period ends, the trust terminates and the corpus of the trust at the time of termination is to be transferred to Jo's child, Teddy. Jo retains the right to revoke Friedrich's five-year income interest. There is a completed gift of the remainder interest to Teddy, and an incomplete gift of the five-year income interest to Friedrich, since Jo maintains dominion and control (the right to revoke). [Reg. § 25.2511–2(c).] Since the gift transfer is not wholly incomplete, IRC § 2702 applies. Jo's power over the five-year income interest will be treated as a retained interest (therefore valued at zero), and the entire value of the corpus of the trust will be treated as a gift to Teddy.

Example (3): Father creates a trust, retaining the right to income for ten years, followed by the outright distribution of the remainder to Child. Child pays Father full and adequate cash consideration for the remainder interest. IRC § 2702 applies to this transfer since the gift is not incomplete without regard to the consideration paid. [IRC § 2702(a)(3)(B).]

(b) Personal Residence Trusts

If the proper requirements are followed, an individual may retain a term interest in a personal residence while giving the remainder interest to a member of the transferor's family without triggering IRC § 2702. [IRC § 2702(a)(3)(A)(ii).] Congress probably excludes certain transfers of interests in personal residences because there is less likelihood of manipulation in the transfer of a personal residence as compared to other forms of property.

There are two types of personal residence trusts: a basic personal residence trust and a qualified personal residence trust. The basic personal residence trust is the much more restrictive of the two due to the limits on the type of property the trust may contain. Consequently, most estate planners prefer the qualified personal residence trust.

i) Basic Personal Residence Trusts

The corpus of a basic personal residence trust must consist only of the personal residence of the term interest holder, and only the transferor, transferor's spouse, or transferor's dependents may occupy the residence during the trust term. Up to two residences of the transferor may qualify for inclusion in a personal residence trust. The most restrictive aspect of a basic personal residence trust relates to eligible trust assets: only the personal residence itself can be owned by the trust, not any of the household furnishings. The trust can hold cash only if the money was received for the damage, destruction, or involuntary conversion of the residence, and the money must be reinvested

back into the property within two years. The trust documents must also prohibit the sale or transfer of the residence for the duration of the term interest. [Reg. § 25.2702–5(b).]

ii) Qualified Personal Residence Trust

A qualified personal residence trust (QPRT) is also restricted to the personal residence of the transferor and has the same restrictions on who may live in the home. However, a QPRT may also hold cash in the amount necessary to pay expenses, mortgages, or improvements to be incurred within the next six months. The residence may also be sold, so long as the proceeds are reinvested into another residence within two years of the sale. [Reg. § 25.2702–5(c).]

(c) Regulatory Exceptions

IRC § 2702(a)(3)(A)(iii) states that exceptions may be made to the application of IRC § 2702 "to the extent that regulations provide that such transfer is not inconsistent with the purposes of this section." The purpose of IRC § 2702 is to make sure that a transferor cannot artificially reduce the value of a remainder interest gift to a member of the transferor's family by retaining certain trust interests in the trust that reduce the future value of the remainder interest.

i) Charitable Transfers [Reg. § 25.2702–1(c)(3), (4), (5)]

The Regulations exclude charitable remainder trusts, pooled income funds, and charitable lead trusts from the application of IRC § 2702. [Reg. § 25.2702–1(c)(3), (4), (5); *see supra* discussion at I. B. 3. b) (2) (b)–(d) for the requirements of these types of trusts.]

> ***Example:*** Grantor transfers property to a pooled income fund, with Grantor retaining an income interest for ten years, then to his child for the child's life, with the remainder to a charity. Under the Regulations, IRC § 2702 does not apply and the amount of the gift is reduced by Grantor's retained term interest. Without the aid of the regulations, Grantor's retained term interest would be valued at zero. Grantor can also receive a charitable deduction for the remainder interest. *See infra* discussion of gift tax charitable deductions [IRC § 2522], II. E. 2. a).

ii) Retained Interest Under the Control of an Independent Trustee [Reg. § 25.2702–1(c)(6)]

IRC § 2702 does not apply if the interest retained by the transferor or applicable family member is the receipt of trust income under the sole discretion of an independent trustee. [Reg. § 25.2702–1(c)(6).]

> ***Example:*** Greg transfers funds to an irrevocable trust with the income payable to Son for his life, remainder to

Daughter. The trust has an independent trustee who has the right to give all or any portion of the income to Greg for the shorter of Greg's or Son's life. If Daughter transfers the remainder interest to her spouse, without any administrative intervention the transfer would be subject to IRC § 2702 since Greg "retains" an interest and Daughter transfers an interest in trust to a member of her family. However, under Reg. § 25.2702–1(c)(6) Greg's interest in the trust is disregarded and IRC § 2702 does not apply.

iii) Certain Transfers Made Pursuant to IRC § 2516

Under the Regulations, so long as the transferor's spouse holds all the remaining interests in the trust, IRC § 2702 will not apply to any transfers subject to IRC § 2516 made before a divorce is final. [Reg. § 25.2702–1(c)(7); *see supra* discussion of IRC § 2516, II. B. 4. a) (4) (a).] The Regulations effectively treat the soon to be ex-spouse as a former spouse, making him or her a non-family member.

Example: One year before the divorce is final and pursuant to an agreement, Tom creates a trust with income to Lynette for life. The trust corpus reverts to Tom at her death. Assuming the agreement meets the other requirements of IRC § 2516, then even though this is a transfer to a member of Tom's family (a spouse) and Tom retains an interest in the transferred property, this transfer is outside the application of IRC § 2702. Effectively, Lynette is treated as an ex-spouse even though they are married at the time of transfer.

iv) Certain Transfers of Property in a Qualified Domestic Trust (QDOT) [Reg. § 25.2702–1(c)(8)]

The regulations provide IRC § 2702 does not apply when a non-citizen surviving spouse transfers an interest in a qualified domestic trust (QDOT) under IRC § 2056A. This means the deceased spouse remains the transferor of the property retained by the surviving spouse.

(3) Valuation

If no exceptions exist, IRC § 2702(a)(2) values a retained interest if there is a transfer of an interest in trust by gift to a member of the transferor's family and part of the interest in the trust is retained by the transferor. Valuation under IRC § 2702 depends on the type of interest being valued. "Qualified interests" are valued under the normal valuation rules for the gift tax under IRC § 7520. [IRC § 2702(a)(2)(B).] Non-qualified interests are valued at zero. [IRC § 2702(a)(2)(A).] The rationale behind such valuation is that qualified interests can be properly valued, and therefore normal valuation methods can be used.

(a) Qualified Interests Under IRC § 2702(b)

There are three types of "qualified interests": a qualified annuity interest, a qualified unitrust interest, and a qualified remainder interest.

i) Qualified Annuity Interests [IRC § 2702(b)(1)]

A qualified annuity interest arises in the context of a popular estate planning technique commonly known as a GRAT (**grantor-retained annuity trust**). A GRAT is an irrevocable trust where the grantor retains the right to receive not less than once per year either a stated dollar amount or a fixed percentage of the initial fair market value of the property transferred to the trust. The payments may increase by no more than 120% per year. If the trust's income exceeds the stated annuity amount, the excess may be distributed to the grantor; however, those additional amounts will not be taken into account in valuing the qualified interest. Additionally, the trust documents must prohibit prepayment of the annuity interest to the grantor. [Reg. § 25.2702–3(b), (d)(5).]

Example (1): Alex transfers property to an irrevocable trust maintaining the right to receive income from the trust for ten years. After the ten-year term has expired, the trust will terminate and the trust corpus will be paid to Charles, Alex's son. If, however, Alex dies within the ten-year period the trust corpus is to be paid to Alex's estate. Since Alex transferred an interest in trust to a member of his family and retained an interest, IRC § 2702 applies. Both Alex's income interest and the contingent reversion are valued at zero because they are non-qualified interests. If, however, the trust allowed for a distribution of the greater of $10,000 or the trust income, the ten-year term interest would be a qualified annuity interest. In that situation, the income interest would receive its present value, but the contingent reversion would not. The amount of the gift to Charles would be the value of the trust corpus less the present value of the ten-year term interest. [Reg. § 25.2702–3(e)(ex. 1).]

Example (2): Urkle transfers property to an irrevocable trust, keeping the right to receive $10,000 for years 1 through 3, $12,000 for years 4 through 6, and $15,000 for years 7 through 10. After 10 years the trust will terminate, and the corpus will be distributed to Urkle's daughter, Karen. The basic elements of IRC § 2702 are met since Urkle transferred an interest in trust to a family member and also retained an interest therein. Since a qualified interest may only increase 120% from the previous year, Urkle has a qualified annuity interest for $10,000 in years 1 to 3, $12,000 in years 4 to 6, $14,600 in year 7, and $15,000 in years 8 to 10. [Reg. § 25.2702–3(e)(ex. 2).] The excess

transfer amount in year 7 ($200) is not used in determining the value of the annuity.

The GRAT is an effective tool for achieving an "estate freeze" that will not trigger application of IRC § 7520's zero-value rule. Grantor usually sets the annuity amount below the amount of expected growth (the sum of the income from the trust assets plus the appreciation in value of those assets during the annuity period). That way, the grantor shifts more value to the remainder beneficiary than what the applicable valuation rule in IRC § 7520 assumes.

Example: Ernie transfers $100,000 in investment assets to an irrevocable trust, retaining the right to receive $5,000 annually from the trust for a term of ten years. Upon the end of the ten-year term, the trust will terminate and the remainder will be paid to Bert (Ernie's son) or Bert's estate. If Ernie dies during the ten-year term, payments will continue to be made to Ernie's estate. Ernie's retained right to the annual payment of $5,000 is a qualified income interest, so the value of the gift to Bert will be determined under IRC § 7520. Neither Ernie nor Bert pays additional tax of any kind when the trust terminates. Suppose the value of the gift to Bert is $70,000. If the trust assets grow in value by ten percent each year during Ernie's term interest, the annual growth will exceed the $5,000 annuity payable to Ernie each year. In fact, under these assumptions, the value of the remainder interest passing to Bert at the end of Ernie's term interest would be approximately $174,000. Thus, by reporting a $70,000 gift to Bert at the formation of the trust, Ernie is able to pass $174,000 of value to Bert upon the conclusion of the trust term.

ii) Qualified Unitrust Interests

A qualified unitrust interest arises when the grantor maintains a fixed percentage of the fair market value of the trust determined annually (instead of a fixed dollar amount or a fixed percentage of the initial value with the qualified annuity interest). [Reg. § 25.2702–3(c)(1)(i).]

iii) Qualified Remainder Interests

A qualified remainder interest is another interest that may be treated as a qualified interest. A qualified remainder interest is a non-contingent remainder interest where all of the term interests are either qualified annuity interests or qualified unitrust interests. Unlike either of the other qualified term interests, the governing instrument must prohibit the payment of income in excess of the annuity or unitrust amounts in order for the remainder to be a qualified remainder interest. [Reg. § 25.2702–3(f)(1)(i)–(iv).]

Example (1): David creates an irrevocable trust with income to his child, Chris, for ten years, after which time the trust property will revert back to David or David's estate. Since David transferred an interest in trust to a member of his family and retained an interest, IRC § 2702 applies. Chris' ten-year income interest is neither a qualified annuity interest nor a qualified unitrust interest so David's reversion does not qualify as a qualified remainder interest. David will be treated as giving the entire trust corpus to Chris as a gift since his retained reversion will be valued at zero. [Reg. § 25.2702–3(f)(3)(ex. 1).]

Example (2): Same facts as above, except that Chris is to receive $100 per year from the trust for ten years, regardless of the trust's income. Now Chris' interest is a qualified annuity interest and there is also a non-contingent remainder interest; therefore, David's reversion is a qualified remainder interest. While IRC § 2702 applies, the reversion is valued under the normal rules for the gift tax and will not be included in the taxable gift to Chris.

(4) Reduction in Taxable Gifts of Subsequent Transfer of a Retained Interest

Unless a qualified interest is retained by the transferor, IRC § 2702 assigns a zero value to the transferor's retained interest, thereby subjecting it to the gift tax even though it is retained by the transferor. If the retained interest is later transferred, it will be subject to a second round of taxation under the estate or gift tax. While relief from double gift taxation is not covered by the Code, the Regulations do allow for some relief. [Reg. § 25.2702–6(a)(1).]

The amount of taxable gifts is reduced by the lesser of: 1) the amount of increase in the taxable gifts due to the application of IRC § 2702 on the initial transfer, or 2) the increase in the amount of taxable gifts (or gross estate) due to the subsequent transfer of the interest. [Reg. § 25.2702–6(b)(1).]

Example: Xavier transfers property to an irrevocable trust, maintaining a ten-year income interest in the property. After ten years, the trust will terminate and the trust corpus will be distributed to Xavier's child, Dawn. The ten-year income interest has a value under IRC § 7520 of $40,000. Xavier is treated as making a taxable gift of the entire trust corpus to Dawn, and IRC § 2702 applies to value Xavier's retained interest at $0. If Xavier makes a gift of his ten-year income interest to a third party when it is valued at $31,000, he will be entitled to a reduction in his taxable gifts for the year in the amount of $21,000. $21,000 is the lesser of the amount of increase due to the application of IRC § 2702 on the initial transfer ($40,000) or the increase in the amount of taxable gift due to the subsequent transfer of the interest ($31,000 less $10,000 (the IRC § 2503(b) annual exclusion unadjusted for inflation) or $21,000). [Reg. § 25.2702–6(c)(ex. 1).]

(5) Application of IRC § 2702 to Chapter 13 (Generation-Skipping Tax)

IRC § 2702 does not apply to the generation-skipping tax of Chapter 13. [PS–92–90, 1991–1 C.B. 998, 1001–02.]

3. Treatment of Certain Lapsing Rights and Restrictions [IRC § 2704]

IRC § 2704 contains two sets of rules for measuring the value of transferred interests in a corporation or partnership. The first set of rules considers the effect of lapsing rights, and the second set of rules pertains to the effect of certain restrictions on liquidation of the entity.

Certain lapses in voting, liquidation, or similar rights in a corporation or partnership are treated as transfers of those rights by the holder. [IRC § 2704(a)(1).] If the lapse occurs while the holder of the right is alive, the transfer will be treated as a gift. If the lapse occurs upon the death of the holder of the right, the transfer is deemed to occur at death and included in the decedent's gross estate. [Reg. § 25.2704–1(a)(1).] The amount of the transfer (or the amount included in the gross estate, as the case may be) is the excess of the value of all interests in the entity held by the holder immediately before the lapse (determined as if the lapsed rights were non-lapsing) over the value of such interests immediately after the lapse. [IRC § 2704(a)(2).]

There are two elements to the application of IRC § 2704(a)(1). First, there must be a lapse of voting or liquidation right in a corporation or partnership. [IRC § 2704(a)(1)(A).] Second, the holder of the lapsed right and members of his or her family must control the entity both before and after the lapse. [IRC § 2704(a)(1)(B).] These elements work to ensure that the deemed transfer will only apply to those lapsed rights that were intended to drive down the transfer tax value of the holder's interest in the entity.

> ***Example:*** George was a partner in a limited partnership. At his death, George held both a general partner interest and a limited partner interest. The general partner interest carried with it the right to liquidate the partnership. The limited partner interest had no such power to compel liquidation. Accordingly, the value of the limited partner interest was $59 million if it was held jointly with the general partner interest but only $33 million if it was held alone. A buy-sell agreement between George and his son, William Henry, required George's estate to sell the general partner interest to William Henry for $750,000. Absent IRC § 2704(a), the value of the limited partner interest included in George's estate was $33 million, for the right to liquidate the partnership lapsed at death due to the obligation to sell the general partner interest to William Henry. [*Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987).] But IRC § 2704(a) applies, assuming George and members of his family (including William Henry) controlled the partnership before and after George's death. Accordingly, George is treated as having made a transfer of $26 million (the excess of the $59 million value of the limited partner interest assuming the liquidation right was non-lapsing over the $33 million value of the limited partner interest after the lapse) at death that is also included in his gross estate.

IRC § 2704(b) relates to restrictions imposed on a power to liquidate a corporation or partnership. If three requirements are met, then any "applicable restrictions" are to be disregarded when valuing a transferred interest in the entity. [IRC § 2704(b)(1).] These requirements are (1) a transfer of an interest in a corporation or partnership, (2) to or for the benefit of a member of the transferor's family, and (3) where the transferor and the members of the transferor's family control the entity immediately before the transfer. [IRC § 2704(b)(1)(A)–(B).] An **applicable restriction** is any limitation on the entity's ability to liquidate that either lapses to any extent after the transfer or can be removed after the transfer by the transferor or any member of the transferor's family. [IRC § 2704(b)(2).]

> ***Example:*** Wendy and Peter, a married couple, own general partner and limited partner interests in a limited partnership. Under their partnership agreement, Wendy and Peter have agreed that the partnership can be liquidated only with the written consent of all partners, though this restriction on liquidation may be removed by a unanimous vote of the partners. Wendy transfers her limited partner interest to her son, Michael. All of the requirements for IRC § 2704(b)(1) are met, for Wendy has transferred to her son an interest in the partnership controlled by Wendy and her husband. Consequently, the value of the limited partner interest transferred to Michael shall be valued without regard to the restriction that the partnership may be liquidated only with the consent of all partners, because this restriction can be removed upon the vote of Wendy, Peter, and Michael, all members of the same family.

Certain restrictions on liquidation are not disregarded even though the elements of IRC § 2704(b)(1) are met. Commercially reasonable restrictions on liquidation arising from a financing transaction with an unrelated party are not subject to IRC § 2704. [IRC § 2704(b)(3)(A).] In addition, restrictions on liquidation imposed by state or federal law do not trigger IRC § 2704(b). [IRC § 2704(b)(3)(B).] In effect, then, only those liquidation restrictions that are more stringent than those under applicable law or those found in commercially reasonable financing transactions will be disregarded. [Reg. § 25.2704–2(b).]

E. "Taxable Gifts" [IRC § 2503(a)]

IRC § 2503(a) defines the term "**taxable gifts**" as the total amount of gifts made during the taxable year minus any gift tax deductions allowable. The amount of "taxable gifts" is one of the primary factors used to compute the gift tax under IRC § 2502(a) for the current year (the other being the amount of taxable gifts for all preceding years).

1. The Annual Exclusion [IRC § 2503(b)]

Unless excluded, the gift tax applies to all transfers of property by gift. [*See* IRC § 2501(a)(1).] "Gift" is defined by IRC § 2512(b) as the fair market value of property transferred less any consideration received. This definition includes such things as birthday, holiday, and graduation presents. However, since the commencement of the current gift tax in 1932, Congress has allowed a yearly per-donee exclusion to "obviate the necessity of keeping an account of and reporting numerous small gifts." [S. Rep. No. 665, 72d Cong., 1st Sess. (1932), *reprinted in* 1939–1 (Part 2) CB 496, 525.]

Under IRC § 2503(b)(1) the first $10,000 of gifts (except for gifts of future interests) are excluded from "taxable gifts" under IRC § 2503(a). After 1998, the $10,000

exclusion amount is indexed for inflation using the 1997 Consumer Price Index as the base. However, the increase is only in $1,000 increments. [IRC § 2503(b)(2).] The first increase occurred in 2002 and as of 2018 the exclusion amount is $15,000. [Rev. Proc. 2017–58.]

The exclusion is mandatory and is as generous as it sounds. A donor may give up to $10,000 every year (before the adjustment for inflation) to any donee without incurring any gift tax liability, which is why it is called the **annual exclusion**. Presently, this means that if a donor had 20 grandchildren he or she could transfer up to $200,000 per year tax free ($10,000 to each grandchild). Additionally, if the donor is married and the couple chooses to use IRC § 2513 to split the gifts between the spouses, the amount transferred free of gift tax is doubled to $400,000. However, the exclusion does not carry-over to any other year, so any unused portion is lost. Moreover, the exclusion applies to transfers to unrelated donees as well.

> ***Example:*** Gary gives several gifts to his niece during the year and makes no other gift transfers. He gives her a car (fair market value of $5,000) for her birthday, a necklace (fair market value of $4,000) for her graduation and cash of $4,000 for Christmas. The total gifts during the year amount to $13,000. However, after the IRC § 2503(b) exclusion is applied (before the adjustment for inflation), Gary's "taxable gifts" amount to only $3,000.

a) Application of IRC § 2503(b)

Before applying the IRC § 2503(b) exclusion, several issues need to be addressed, including the identification of the donee, whether the gift is of a present or future interest, and the application of the future interest rule to minors.

(1) Identification of the Donee

IRC § 2503(b) allows an exclusion for "gifts . . . made to any person by the donor." Under IRC § 7701(a)(1), "person" includes people, trusts, estates, partnerships, and corporations. This means gifts to entities may qualify for the exclusion, but note that the courts have made it difficult to receive an exclusion for such transfers.

(a) Trusts

The Regulations provide that in a gift transfer of property through a trust, the donees are the beneficiaries of the trust and not the trustee or trust itself. [Reg. § 25.2503–2(a); *see also Helvering v. Hutchings*, 312 U.S. 393, 61 S.Ct. 653, 85 L.Ed. 909 (1941).] Accordingly, a gift of $20,000 to a trust with two beneficiaries is treated as a gift of $10,000 to each beneficiary.

(b) Partnerships

On gift transfers to partnerships, the donees are the individual partners. However, this does not automatically mean that the donor may take an exclusion amount for each partner. An exclusion amount may only be taken if the transfer is made to a general partnership (as opposed to a limited partnership) where the partners have unlimited access to their capital accounts. If the transfer is to a limited

partnership, the transfer is treated as a future interest and no exclusion is allowed. [*Wooley v. United States*, 736 F.Supp. 1506 (S.D. Ind. 1990).] *See infra* the discussion of the rule prohibiting application of the annual exclusion to future interests, at II. E. 1. b) (1).

(c) Joint Interests in Property

Each joint tenant is a donee when a donor gifts property as a joint tenancy. This rule applies no matter whether the gift is made as tenants in common, joint tenants with rights of survivorship, or tenants by the entirety.

(d) Corporations

The individual shareholders are the donees on gift transfers to corporations. [Reg. § 25.2511–1(h)(1).] However, the donor may not take any IRC § 2503(b) annual exclusion for a transfer to a corporation because it is treated as the transfer of a future interest since the shareholders do not have present individual control over the gift property.

> ***Example:*** Lavonna transfers a parcel of land to a corporation in exchange for a corporate note. Each year Lavonna discharges $10,000 of debt to the corporation with the intent to make a gift to the shareholders, each of which is her child or grandchild. Even though Lavonna makes a gift to each individual shareholder, she cannot take an IRC § 2503(b) annual exclusion since she did not transfer a present interest in property. [*See Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000).]

(e) Charities, Public or Political Organizations

Transfers to other organizations are generally treated as a gift to the entity as a whole since there are no easily identifiable beneficiaries, shareholders, or partners. [Reg. § 25.2511–1(h)(1); *see also* Reg. § 25.2502–1(d)(ex. 3).] These gifts also might not qualify for the annual exclusion under IRC § 2503(b) since they are gifts of future (as opposed to present) interests in property.

b) Present and Future Interests

(1) Future Interests

IRC § 2503(b) allows for an exclusion of gifts "other than gifts of future interests in property." The exclusion is denied for transfers of **future interests** due to the "difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts." [S. Rep. No. 665, 72nd Cong., 1st Sess. (1932), reprinted in 1939–1 (Part 2) CB 496, 526.]

The Regulations define a future interest as any interest in property "limited to commence in use, possession, or enjoyment at some future date or time." [Reg. § 25.2503–3(a).] This means the exclusion is denied where

the benefits of the gifted property cannot be immediately enjoyed. Examples of future interests are remainder interests in trust (vested or contingent), a trustee's unfettered discretion to distribute income from a trust (since the property may never be distributed, creating valuation difficulties), and other instances where circumstances prevent the income of the trust from being valued.

> ***Example (1):*** Bob creates an irrevocable trust with income to Allen for Allen's life, remainder to Chris. Since Chris does not come into immediate possession of the property, his remainder interest is considered a future interest and does not qualify for the exclusion. Bob will receive an annual exclusion for the income interest transferred to Allen. The annual exclusion amount, before the adjustment for inflation, will be the lesser of the fair market value of Allen's life estate interest or $10,000.

> ***Example (2):*** Louise transfers one-twentieth of her mineral royalty interest in a parcel of real property to each of her ten children in trust on October 2, Year 1. The trust documents provide that the royalty payments will begin from mineral production starting after January 1, Year 2. Since the beneficiaries cannot immediately enjoy the benefits of the property transferred, the IRC § 2503(b) annual exclusion is denied. The fact that the trust could have been created or funded after the first of the year is inconsequential to the result. [*See Jardell v. Commissioner*, 24 T.C. 652 (1955).]

> ***Example (3):*** Elgin creates a trust whose terms provide that the income from the trust be distributed to his three children in whatever manner the independent trustee deems advisable, with no ascertainable standard provided for the distribution. Although all the income must be distributed, since the distributions are in total control of the trustee, the children's interest cannot be valued and no IRC § 2503(b) annual exclusions are allowed. [Reg. § 25.2503–3(c)(ex. 3); *see, e.g., Maryland Nat'l Bank v. United States*, 609 F.2d 1078 (4th Cir. 1979).]

> ***Example (4):*** Taxpayer creates an irrevocable trust for his three children. The trust documents provide that the income of the trust is to be paid annually in equal parts to each child until age thirty, after which a child may terminate his or her portion of the trust and receive a share of the corpus. To fund the trust, Taxpayer transferred stock from his closely held corporation that has never paid dividends. Since the stock is not publicly traded and no dividends have ever been paid, the income interest is unproductive and cannot be valued. As a result, no IRC § 2503(b) exclusion is permissible. [*See Stark v. United States*, 477 F.2d 131 (8th Cir. 1973).] An exclusion for "unproductive property" is disallowed only for gifts made in trust and not for direct gifts. Some scholars have challenged this rule by pointing to the lack of distinction between non-productive property and other assets which are allowed the exclusion but provide very little current income (e.g., growth stocks). [STEPHENS, ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 9.04[1][c][iii] (9th ed. 2013).]

(2) Present Interests

The Regulations define a **present interest** in property as the "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." [Reg. § 25.2503–3(b).] The focus is on the immediate enjoyment or benefits from the property, not on title or vesting. [*Fondren v. Commissioner*, 324 U.S. 18, 20, 65 S.Ct. 499, 501, 89 L.Ed. 668, 674 (1945).] When a present interest is transferred, the actuarial value of the interest can be excluded up to the maximum provided under IRC § 2503(b) ($15,000 in 2018). [Rev. Proc. 2017–58.]

The existence of a spendthrift clause or other condition that the property provide its primary benefits at a later point in time is not important, so long as the donee has access to the property at the time of transfer. For example, the Regulations provide that the transfer of a life insurance policy or promissory note, each of which would provide payments at some point in the future are transfers of present interests. This is because the property has immediate benefits, such as the possibility that it can be sold or used as security for a loan. [Reg. § 25.2503–3(a).]

> ***Example (1):*** Larry transferred his life insurance policy to Mary when it had a fair market value of $50,000. Even though the benefits of the policy will not fully mature until Larry dies, it is treated as the transfer of a present interest in property. [Reg. § 25.2503–3(a).]
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> ***Example (2):*** Larry pays the premiums on a life insurance policy covering his life each year. Mary is in possession of all incidents of ownership in the policy. Larry's premium payments are treated as an indirect gift of a present interest in property to Mary and qualify for the exclusion. [Reg. § 25.2503–3(c)(ex. 6).]
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> ***Example (3):*** Payton creates an irrevocable trust with a five-year income interest going to Marvin and the remainder to Brandon. He funds the trust with $20,000 and the income interest is valued at $5,000, leaving the remainder to be valued at $15,000. The trust instrument has a spendthrift clause prohibiting Marvin from alienating, assigning or otherwise anticipating such income. Payton is still allowed an IRC § 2503(b) annual exclusion of $5,000 since the spendthrift provision does not make the income interest uncertain or postpone its immediate enjoyment. [Rev. Rul. 54–344.] After the application of the exclusion, Payton will have no taxable gifts to Marvin and a $15,000 taxable gift to Brandon.
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> ***Example (4):*** Payton transfers $10,000 to a qualified tuition plan (i.e., a "529 plan") for his brother Eli. The gift is a present interest and qualifies for the IRC § 2503(b) annual exclusion.

(a) Exceptions

i) Power to Invade Corpus for the Income Interest Holder [IRC § 2503(b)(1) (second sentence)]

One wrinkle in the present interest rule is for transfers in trust where the trustee has the power to give the corpus of the trust

only to the income beneficiary. Since the trustee could terminate the income interest at any time, the interest is incapable of being valued absent some special rule. However, since in this instance the property may only go to the holder of the income interest, there is no harm in allowing the exclusion. The second sentence of IRC § 2503(b)(1) provides that the trustee's power in these situations is disregarded, allowing for the interest to be valued and the exclusion applied.

> ***Example:*** Donor creates a trust which provides for payment of the net income of the trust to Frank for his life, with the remainder to Greg. A third-party trustee has the power to give the corpus of the trust to Frank at any time before Frank's death. Generally, the trustee's right to invade the corpus of the trust makes valuing the income interest impossible and no exclusion would be available. However, since the corpus may only be transferred to Frank, the holder of the income interest, the power is disregarded in valuing Frank's income interest. The power could not be disregarded if the trustee had the power to give the corpus to anyone else but Frank. [Reg. § 25.2503–3(c)(ex. 4).]

ii) Lump Sum Payments to Qualified Tuition Plans

Gift transfers to qualified tuition programs, popularly known as "529 plans," are treated as present interests in property even though the property is used to pay future education expenses. [IRC § 529(c)(2)(A)(i).] The amounts can only be excluded under IRC § 2503(b) since they are not qualified transfers for IRC § 2503(e). [IRC § 529(c)(2)(A)(ii).]

IRC § 529(c)(2)(B) allows a donor to elect to prorate contributions in excess of the IRC § 2503(b) annual exclusion amount over a period of five years to a state sponsored qualified savings plan for higher education. In this way, before the adjustment for inflation, a lump sum gift of $50,000 can be excluded from the gift tax under IRC § 2503(b) over a five-year period. However, in this example, all other gifts made by the donor to that donee during the same five-year period are included in the taxpayer's taxable gifts, unless the exclusion amount increases. This election can be made for each donee's 529 plan to which the donor contributes.

> ***Example:*** In Year 1, Dorothy Gale transfers $55,000 to the Kansas qualified tuition program for the benefit of her son. Dorothy elects to treat $50,000 (five years of present IRC § 2503(b) exclusions) ratably over a five-year period. Dorothy's total gifts in Year 1 are $15,000 ($10,000 from the IRC § 529(c)(2)(B) election plus the $5,000 remainder not covered by the election). The IRC § 2503(b) exclusion, before the adjustment for inflation, excludes $10,000 and taxable gifts for Year 1 are $5,000. [IRC § 2503(a), (b)(1).] In Year 2 Dorothy will start with $10,000 of gifts to her son. Dorothy

may still contribute amounts over $10,000 to qualified tuition programs for other individuals and use the IRC § 529(c)(2)(B) election to spread those contributions over a five-year period.

(b) *Crummey* Powers

If the beneficiaries of a trust do not have a present interest in the property transferred to the trust, an IRC § 2503(b) annual exclusion is not available to the donor. However, a general power of appointment given to the beneficiaries creates a present interest up to the amount the beneficiaries can appoint. In this way, gifts to trusts *can* qualify for the IRC § 2503(b) annual exclusion. Practitioners refer to the general power of appointment given to trust beneficiaries as "***Crummey*** **powers**," after the Ninth Circuit case that upheld their validity, *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968). The basic premise is that the possibility of possession (the right to withdraw) is equal to immediate possession and enjoyment of the property. *Crummey* powers are not limited to transfers in trusts, but they are used primarily in that capacity. *Crummey* powers are also used in partnerships where the gift transfer would not be treated as a present interest in property. [Priv. Ltr. Rul. 9710021 (Dec. 6, 1996).]

> ***Example:*** Clifford transfers property into an irrevocable trust for his four minor children. The trust provides that the income of the trust is to accumulate until the children are 21, then any income from the trust is to be distributed from the ages of 21 to 35, and once they turn 35, the trustee has the discretion to distribute the income or accumulate it as he or she may see fit. The trust also allows each child the non-cumulative right to withdraw $10,000 each year. Under local law, a guardian is required to withdraw the money, but no guardian has been appointed for any of the children. Clifford transfers $40,000 to the trust in Year 1. Since the income is to be accumulated until the children are 21, without the power to withdraw funds, the children only have a future interest in the trust and no exclusions would be available. However, the right to withdraw funds is treated as a present right of possession for $10,000 and creates a present interest, even though there are no guardians for the children, and under local law they lack the capacity to file for the appointment of a guardian and could not demand the money without the help of their parents. Accordingly, Clifford can claim four annual exclusions and exclude the entire amount contributed to the trust from his taxable gifts for Year 1. [*Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).]

The Tax Court has held that beneficiaries with only contingent remainder interests can possess valid *Crummey* powers. [*Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991).] By utilizing contingent beneficiaries, the number of IRC § 2503(b) annual exclusions increases without decreasing the amounts received by the vested primary beneficiaries. However, the Service maintains its

position that it is improper to permit annual exclusions for transfers to trusts where the power holders have only contingent remainders or no interest in the trust at all. [*Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), *action on dec.*, 1992–09 (Mar. 23, 1992).]

> ***Example:*** Marie creates an irrevocable trust, with the income going to her two children, Frank and Lillian. At Marie's death, the trust will terminate and be equally divided between her surviving children. Marie's grandchildren take only if either Frank or Lillian dies before Marie. Upon the creation of the trust, Frank has two children and Lillian has three. All the beneficiaries of the trust (Frank, Lillian, and the five grandchildren) have the right to withdraw $10,000 from the trust up to fifteen days after any contributions to the trust are made. Frank and Lillian have vested interests, and the five grandchildren possess contingent remainders since they only take if their parents pre-decease Marie. Since the grandchildren possess the right to withdraw funds, Marie is allowed a total of seven IRC § 2503(b) annual exclusions when she contributes property to the trust, even though the grandchildren are contingent beneficiaries and might never receive any property from the trust. [*Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991) (the Service agreed not to appeal this case but said it will litigate this issue anywhere outside the Ninth Circuit).]

The Service has challenged the right to use the exclusion in those trusts where the power holder lacks knowledge or time to make a demand, or where there exists a prearranged understanding that the withdrawal rights will not be exercised. [Rev. Rul. 81–7.] In the above situations, the Service feels the withdrawal power is illusory and therefore does not create a present interest in property. However, to date the Service has not successfully litigated this point in court.

> ***Example (1):*** Gus created an irrevocable trust on December 29, Year 1, by contributing $5,000 to the trust. The trust instrument gave the right to income to Al for life, remainder to Ben. Under the terms of the trust Al has the non-cumulative right to withdraw $5,000 each calendar year, but that right was never communicated to him. Even though Al had the right to withdraw $5,000 Gus is not permitted to take any portion of the IRC § 2503(b) annual exclusion due to Al's lack of knowledge and because the two-day period (December 30 and 31) makes the demand right illusory and effectively deprives the donee of the power. [Rev. Rul. 81–7.]

> ***Example (2):*** Lieselotte transfers a commercial building worth $180,000 to an irrevocable trust. Lieselotte's two children receive the income interest, with the remainder going to whichever of her sixteen grandchildren they select. All eighteen persons with an interest in the trust are given *Crummey* powers to withdraw up to $10,000 following any transfer of property into the trust. After Lieselotte transfers the building the beneficiaries were notified of their withdrawal rights. However, none of the

beneficiaries exercised their right. Since no evidence exists that the beneficiaries would be penalized for exercising their demand rights, or that the trustees purposefully withheld information from the beneficiaries, there is no implied agreement from the behavior of the beneficiaries. Thus, Lieselotte is entitled to eighteen IRC § 2503(b) annual exclusions. [*Estate of Kohlsaat v. Commissioner*, 73 T.C.M. (CCH) 2732 (1997).]

i) Crossover Issues

The characterization of a *Crummey* power as a general power of appointment is an important planning issue to consider when using them in trusts. *Crummey* powers may have both estate and gift tax consequences to the holder of the power.

(1) Gift Tax Consequences

Under IRC § 2514(e), a "lapse" of a general power of appointment will be treated as a "release" to the extent the lapsed *Crummey* power exceeds the greater of $5,000 or 5% of the value of the assets from which the power could be satisfied. *See supra* discussion of IRC § 2514, at II. C. 1. If the withdrawal right pertains to the contribution only, the 5% will be computed from the contribution amount (not the trust corpus) since those are the proceeds from which the "lapsed powers could be satisfied." [IRC § 2514(e)(2).] If the withdrawal right is from the trust corpus, the corpus (including the new contribution) is used to compute the 5% amount.

The amount treated as "lapsed" is deemed a transfer to the beneficiaries of the trust. [IRC § 2514(b).] The consequence of the lapse is that a gift is made to the remaining beneficiaries of the trust, and those beneficiaries will probably not be allowed an exclusion since they do not have present interests in the trust. Furthermore, IRC § 2702 could apply if the other beneficiaries are family members of the power holder.

(2) Estate Tax Consequences

IRC § 2041 may also apply to the *Crummey* withdrawal power. This section definitely applies if the power holder dies while possessing the right to withdraw funds. [IRC § 2041(a)(2).] The amount of property over which the power holder had a power at death is included in his or her gross estate. Even if the power holder does not die, there could still be inclusion in the gross estate. If there is a lapse, the amount treated as lapsed (if the power holder receives an income interest in the trust) would constitute a release of a power and such property would be includable in the power holder's gross estate under IRC § 2036. The amount to be

included would be the percentage of corpus that has lapsed, which would accumulate over time.

> ***Example:*** Clara has a *Crummey* power to withdraw $5,000 from a trust. On Clara's death, IRC § 2041 will include $5,000 in her gross estate.

(3) Avoidance of Gift and Estate Tax Consequences

To avoid these results, *Crummey* powers can be limited to the greater of $5,000 or 5% of the trust corpus, even though the maximum annual exclusion amount under IRC § 2503(b) is $10,000 before the adjustment for inflation. Such a limitation prevents any amounts from lapsing and being included in the power holder's gross estate under IRC § 2041, or being a gift transfer under IRC § 2514.

Another way to avoid these results is to use a **"hanging" *Crummey* power**. A "hanging" *Crummey* power exists when the trust instrument states that the withdrawal power remains with the power holder for that amount in excess of the greater of $5,000 or 5% of the funds from which the exercise of the lapsed power could be satisfied. In this manner there will be no gift tax consequences upon the lapse of a *Crummey* power, though there will still be estate tax consequences if the power holder dies during the year since nothing has "lapsed."

c) Transfers to Minors

Parents or grandparents who want the IRC § 2503(b) exclusion but do not want to give the child or grandchild the money directly can use IRC § 2503(c) to create a present interest in property. IRC § 2503(c) applies when the property and income from the property (1) may be expended by, or for the benefit of, the donee before reaching age 21, and (2) the amount not distributed will either pass to the donee upon reaching 21 or, should the donee die before, be distributed to the donee's estate or by a general power of appointment of the donee. [IRC § 2503(c).]

IRC § 2503(c) provides yet another way to create a present interest in a transfer to trust for a minor, besides the use of a *Crummey* power. Because the donee of an IRC § 2503(c) trust does not hold a power to withdraw trust property, IRC § 2503(c) also avoids the problem of having the *Crummey* power lapse, triggering gift or estate tax consequences.

The decision of whether to distribute funds from the trust may be left to the complete discretion of the trustee, so long as there are no substantial restrictions on the exercise of the trustee's discretion. Thus, the donee is not required to have any authority over distribution of income; only the right to the income is important and not the likelihood of distribution from the trust.

The trust income may be distributed before the donee reaches age 21 and still satisfy IRC § 2503(c). [Rev. Rul. 73–287.] In addition, after the donee reaches the age of 21, the donee can possess the right to extend the terms of the trust. [Reg. § 25.2503–4(b)(2).]

A trust may also qualify under IRC § 2503(c) if only the accumulated income interest is distributed upon the donee reaching 21, and not the entire trust corpus. [*Commissioner v. Herr*, 303 F.2d 780 (3d Cir. 1962).] However, if this type of clause is present, only the income interest of the trust will qualify for the exclusion. [*Commissioner v. Thebaut*, 361 F.2d 428, 430–31 (5th Cir. 1966).]

Example (1): Pop creates an irrevocable trust for the benefit of Pop's children. The trustee is authorized to spend trust funds only for the beneficiaries' education. Regardless of whether the other trust provisions satisfy IRC § 2503(c), the subsection does not apply since there are "substantial restrictions" on when the income may be distributed. [Reg. § 25.2503–4(b).] The trust may, however, still qualify for the IRC § 2503(b) annual exclusion to the extent the beneficiaries have present interests in the trust. [Reg. § 25.2503–4(c).]

Example (2): Allene creates a trust for her minor grandchild, Ronald. The terms of the trust dictate that the trust income may be distributed as the trustee dictates until Ronald reaches the age of 21. At that point, any undistributed income is to be paid to Ronald. Thereafter, until Ronald reaches age 30, the trust will accumulate the income and then distribute the entire trust corpus, principal and income, to Ronald upon his reaching age 30. If Ronald dies before age 21, the accumulated trust income is to be paid to his estate. Even though only the accumulated income, and not the trust corpus, is distributed to Ronald at 21, this trust qualifies for IRC § 2503(c). The income from the trust is "property" for purposes of IRC § 2503(c), and the income may be separated from the corpus of the trust. Allene may only receive a IRC § 2503(b) annual exclusion (before the adjustment for inflation) for the fair market value of income interest of the trust up to $10,000. [*Commissioner v. Herr*, 303 F.2d 780 (3d Cir. 1962); Rev. Rul. 68–670.]

Example (3): Same facts as above, except that the trustee is required to distribute the income from the trust to Ronald from the ages of 21 through 30. The income interest from 21 to 30 is a separate and distinct interest and cannot be combined with the income interest qualifying for IRC § 2503(c). Therefore, it is a future interest and will not qualify for an IRC § 2503(b) annual exclusion. [*Estate of Levine v. Commissioner*, 526 F.2d 717 (2d Cir. 1975).]

d) Other Issues

(1) Application to the Generation-Skipping Tax (Chapter 13)

Gifts under the IRC § 2503(b) amount are given a zero inclusion ratio for the generation-skipping transfer tax. [IRC § 2642(c).] *See infra* discussion of the zero inclusion ratio under IRC § 2642(c), at III. D. 2. b) (1) (a).

(2) Gift Tax Returns

No gift tax return is required to be filed if all gifts made are under the IRC § 2503(b) annual exclusion amount. [IRC § 6019(1).] If a married couple consent to split gifts, however, a gift tax return is required by at least one

spouse even if, after splitting gifts, neither spouse makes a gift in excess of the IRC § 2503(b) annual exclusion amount.

2. Deductions

a) Gift Tax Deduction for Charitable and Similar Gifts [IRC § 2522]

The charitable deduction is very similar under both the estate and gift tax. The primary difference is that inter vivos gifts made to charities may also be deducted for purposes of the donor's Federal income tax liability, while this is not allowed for testamentary gifts of the same nature.

IRC § 2522(a) provides for a charitable deduction for citizens and residents of the United States in an unlimited amount for gifts made to listed organizations. The types of charities included on the list are substantially similar to the types of organizations that are allowed deductions under both the estate [IRC § 2055(a)] and income tax [IRC § 170(a)]. The gift does not have to be made to a domestic entity in order to qualify for the gift tax deduction. [Reg. § 25.2522(a)–1(a)(flush).]

A deduction is also allowed for gifts by non-citizen, non-residents of the United States made to qualifying charities. The transfer, however, must be made only to domestic corporations or other organizations if used in the United States. [IRC § 2522(b)(3)–(4).]

The deduction is not allowed if the gift is subject to a condition unless "the possibility that the charitable transfer will not become effective is so remote as to be negligible." [Reg. § 25.2522(c)–3(b)(1).] This could create a situation where the transfer to a charity may be a complete gift, but is not deductible since the standard for when a gift is complete is less stringent than the standard for when a charitable gift is deductible.

> ***Example:*** Charlie transfers land to City government for use as a public park. The gift is conditional so that if the land is ever used for a purpose other than a public park, the land will revert back to Charlie or his heirs. If the possibility that City will fail to use the land for a public park is not so remote as to be negligible, the gift is probably complete, but Charlie will not receive a gift tax deduction due to the condition placed on the gift. [*See* Reg. § 25.2522(c)–3(b)(2)(ex. 2).]

The charitable deduction is allowed in the year the gift is complete. *See supra* discussion at II. B. 3.

(1) Disallowance of Deductions [IRC § 2522(c)]

(a) Gifts to Disallowed Organizations or Trusts [IRC § 2522(c)(1)]

Gifts to certain organizations or trusts are disallowed a charitable deduction. For example, under certain circumstances, this includes gifts to an organization subject to tax under IRC § 507(c) (applying to formerly tax-exempt private foundations). [IRC § 508(d)(1).] In addition, gifts to private foundations or IRC § 4947 trusts are also disallowed a deduction under certain circumstances. [IRC

§ 508(d)(2).] Gifts to foreign organizations which engage in certain prohibited transactions or which are not taxable during the taxable year are also not allowed a charitable deduction. [IRC § 4948(c)(4).]

(b) Split Interest Gifts [IRC § 2522(c)(2)]

Gift transfers divided in time between charities and non-charities are either restricted in amount or disallowed under IRC § 2522(c)(2). Because these restrictions are similar to those present in the charitable estate tax deduction, they are covered in detail in I. B. 3. b).

Example: Neptune transfers property to an irrevocable trust, giving a life estate to Muriel with the remainder going to Atlantis University (A.U.). If the transfer does not meet the requirements of split interests gifts under IRC § 2522(c), the gift to A.U. will not qualify for a charitable deduction. Additionally, the transfer to A.U. does not qualify for the annual exclusion under IRC § 2503(b) since it is a transfer of a future interest.

(c) Fractional Gifts

Unless permitted by an exception, no deduction is allowed for contributions of fractional interests of tangible personal property. A charitable deduction is allowed if the taxpayer, or the taxpayer and the donee, hold all interests in the property. Also, a deduction may be allowed under situations provided for in the regulations (which to date have not been enacted) for proportional contributions made by co-owners of property. [IRC § 2522(e)(1).]

Example (1): Mr. Diesel owns several pieces of rare artwork. He transfers a one-third interest in one painting to a museum, which entitles it to possess the painting four months a year. While Mr. Diesel transferred a fractional interest in tangible personal property, he may take a deduction since he owned all the interests in the property before the transfer.

Example (2): The next year Mr. Diesel transfers another one-third interest in the painting to the museum. He may still take a deduction since the interests are held by the taxpayer (Mr. Diesel) and the donee (the museum).

Example (3): The transferred painting is owned equally by Mr. Diesel and Mr. Fairmont. Unless provided for in the regulations (which to date have not been enacted), Mr. Diesel cannot take a charitable deduction if he transfers less than 100% of his interest in the painting.

Even if a deduction is allowed it may be recaptured (plus interest and a 10% penalty) if the remaining interest is not transferred to the donee at the earlier of either: 1) 10 years from the date of the initial fractional contribution, or 2) the death of the donor. Even if the property is transferred within the required time period, a recapture will occur if the donee has not had “substantial physical possession” of

the property and used the property in a way that is related to the organization's tax-exempt status. [IRC § 2522(e)(2).]

Example: In the above examples, if the painting is used as an art exhibit sponsored by the museum and transferred within ten years, or if Mr. Diesel dies earlier, at his death, there should be no recapture of the deduction. If not, then all the deductions received by Mr. Diesel for the contribution of the painting plus interest and a ten percent penalty will be recaptured.

(2) Amount of Deduction

If a full interest in property is transferred to a qualifying charity, a deduction is allowed for the full fair market value of the property transferred. If a partial interest in property is transferred, and the requirements of IRC § 2522(c) are met, the partial interest is valued under IRC § 7520.

The deduction is reduced by any consideration received by the donor. [IRC § 2512(b).] Therefore, any amounts received by the donor from the charity serve to reduce the amount of the deduction allowed.

(3) Filing of Gift Tax Return

No gift tax return is required to be filed if the donor's only gifts consist of gifts made to charities that are fully deductible. [IRC § 6019(3).]

b) Gifts to Spouses [IRC § 2523]

Originally enacted in 1948 to alleviate the disparity in estate and gift tax treatment in separate property and community property states, the marital deduction was made limitless in 1981 to reflect Congress' belief that a married couple should be treated as one economic unit. Now, transfers of fee interests in property during the marriage are fully deductible and not subject to the gift tax.

Under IRC § 2523(a), a deduction is allowed for the full value of gift transfers made to donor's spouse, unless the interest transferred is disqualified "terminable interest property" under IRC § 2523(b). In order to take the marital deduction, the donor and donee must be married at the time of transfer, since the section is inapplicable to transfers made either before marriage or after divorce.

The gift tax marital deduction under IRC § 2523 and the estate tax marital deduction under IRC § 2056 are very similar in language and scope. *See supra* discussion at I. B. 4., for extensive coverage of the estate tax marital deduction. Accordingly, this section only covers those areas where the gift tax marital deduction differs from the estate tax marital deduction.

(1) Terminable Interests [IRC § 2523(b)]

If all the interests in property are not transferred to the donee spouse, the transfer may not be deductible. When a portion of the transferred property passes to any person other than the donee spouse (including the donor) after the donee spouse's interest, or when the donor retains the power to appoint such an interest, no marital deduction is allowed unless an

exception applies. The terminable interest rule in effect restricts the marital deduction only to those situations where the property will be subject to estate taxation at the donee spouse's death, or gift taxation if the property is transferred outside the marriage.

If the transferred property can be satisfied from a group of assets, the Code assumes the transferred assets do not qualify for the marital deduction. This is provided for in IRC § 2523(c), which is the gift tax counterpart to IRC § 2056(b)(2). If such an assumption is made, it serves to reduce the amount of marital deduction allowed.

> ***Example:*** Harold creates a trust, with income to Harold for ten years. At the end of the ten-year period, the trustee is to transfer $100,000 to Harold's wife Maude, with any remainder going to their son. The trust has two assets. Asset 1 is corporate stock. Asset 2 is property that Harold previously transferred to Uncle Moe, retaining a twenty-year income interest in the property. Asset 2 is a terminable interest since Uncle Moe takes the property after the income interest terminates. [IRC § 2523(b)(1).] Therefore, the asset does not qualify for the marital deduction. [*Id.*] Assuming that the income interest in Asset 2 is worth $30,000 at the end of ten years, the marital deduction is the present value of $70,000 due in ten years. The transfer to Maude at the end of the ten-year period is assumed to include the disqualified income interest regardless of the value of the corporate stock. [IRC § 2523(c); Reg. § 25.2523(c)–1(c)(ex.).]

(a) Donor Retains Interest or Third-Party Acquires Interest [IRC § 2523(b)(1)]

The terminable interest rule under IRC § 2523(b)(1) is substantially similar to its estate tax counterpart at IRC § 2056(b)(1). The primary coverage for this area is contained in the estate tax portion in I. B. 4. a) and only the differences are highlighted here. The most significant difference under the gift tax provision is that a donor's retained interest in the property can be a terminable interest. This is not present in the estate tax provision, since that provision covers transfers from a decedent rather than a donor. [IRC § 2523(b)(1).]

Another difference between the estate and gift tax marital deductions is found in the first sentence of the flush language (the penultimate sentence) of IRC § 2523(b). The rule provides that the exercise or release of a non-general power is treated as a transfer for the creation of a terminable interest. This means that a donor's spousal transfer of an interest originally created by someone outside the marriage may not qualify for the marital deduction.

> ***Example:*** Raymond receives a ten-year income interest in trust, as well as the power to appoint the remainder to any of his children at his discretion. In default of any appointment, the remainder will go to Raymond's spouse. Raymond exercises the power and appoints the remainder to his son Seth. Raymond then transfers his income interest to his spouse. Since the power was a non-general power, IRC § 2514 does not apply to create a transfer. However, under the penultimate sentence of IRC

§ 2523(b), Raymond made a "transfer" to Seth creating a terminable interest. Since Raymond has transferred the remainder to a person other than his spouse and Seth may take the property after the ten-year period ends, it is a terminable interest and Raymond cannot claim a marital deduction for the gift of the income interest to his spouse.

The last difference between the gift tax's terminable interest rule and the estate tax's terminable interest rule is found in the last sentence of the flush language to IRC § 2523(b). This rule states that unless the donee has a life estate with a power of appointment that qualifies under IRC § 2523(e), an interest in property that can pass to either the donee spouse or some other person is treated as being transferable only to the other person. This means a transfer is treated as a terminable interest if it is not clear that the property interest can only pass to the donee spouse.

Example: Husband transfers property to an irrevocable trust giving his wife the right to the trust's income for ten years. After ten years, the corpus of the trust is to be distributed between the wife and the couple's three children in such a manner as the trustee determines. Even though some or all of the property may pass to the donor's spouse, after the application of the last sentence of IRC § 2523(b), for the purposes of determining if Husband transferred a terminable interest, the remainder interest will be treated as being completely transferred to a "person other than the donee spouse." [Reg. § 25.2523(b)–1(b)(3)(ex. 1).]

(b) Retained Powers of the Donor [IRC § 2523(b)(2)]

Under IRC § 2523(b)(2), a terminable interest is created if the donor retains a power to appoint the property after the complete termination of the donee spouse's interest. The donor does not actually have to own the property for this exception to apply, but if not, the donor must have a general power of appointment over the property, or no transfer will exist under IRC § 2514. For purposes of the application of IRC § 2523(b)(2), the fact that the power cannot be exercised until after the passage of time or the occurrence or non-occurrence of an event or contingency is disregarded.

Example (1): A.J. gives Bart a general power of appointment (GPA) over some property owned by A.J. Bart exercises the GPA giving a life estate to his wife, Lisa, and retaining the power to appoint the remainder. Bart's power to transfer the property after Lisa's property interest terminates creates a terminable interest under IRC § 2523(b)(2). Bart receives no marital deduction for the transfer. [Reg. § 25.2523(b)–1(d)(3)(ex.).]

Example (2): A.J. also gives Bart a life estate in the income interest of a trust, with the power to name the remainder beneficiary if Bart survives A.J. Bart gives the life estate interest to his spouse, but retains the right to appoint the remainder. The contingency is disregarded and Bart is treated as having the

power to appoint the remainder. Bart receives no marital deduction for the transfer, since his spouse received a terminable interest under IRC § 2523(b)(2).

(c) Exceptions to the Terminable Interest Rule

There are several exceptions to the terminable interest rule. If an exception is found, a marital deduction from the taxable gifts may still be allowed even though the interest transferred to the donee spouse is a terminable interest. Most of the exceptions presented mirror the estate tax marital deductions and are covered more fully in that section. *See supra* the discussion of the estate tax marital deduction, I. B. 4. a) (2).

i) Life Estate with Power of Appointment in Donee Spouse [IRC § 2523(e)]

This non-elective exception is permitted when the donee spouse has a life estate interest in the property and has the sole power to transfer the interest to whomever the donee spouse should choose. This provision is similar to IRC § 2056(b)(5) for the estate tax marital deduction.

ii) Transfer of Qualified Terminable Interest Property (QTIP) [IRC § 2523(f)]

One of the most important and most utilized exceptions to the terminable interest rule is the exception for qualified terminable interest property (QTIP) found in IRC § 2523(f) and its estate tax counterpart at IRC § 2056(b)(7). For this exception to apply to the property 1) the donor spouse must transfer property, 2) the donee spouse must possess a qualifying income interest for life in the property, and 3) the donor must elect to have the exception apply. [IRC § 2523(f)(2).] The primary difference between the gift and estate tax QTIP exceptions is that the donor must elect to have the gift tax section apply, whereas the executor makes the election for estate tax purposes.

If the donee spouse transfers any portion of the qualified income interest, it will lead to the constructive transfer of all the remaining interests. *See supra* discussion at II. C. 3., for the application of IRC § 2519 to a transfer of a QTIP interest. If the donee spouse never transfers any portion of the interest at death, the entire interest will be included in the donee spouses' gross estate under IRC § 2044. *See supra* discussion at I. A. 3. e), for the application of IRC § 2044 where the spouse holds a QTIP interest at death.

If the other interests in the trust besides the donee spouse's interest qualify as a charitable remainder trust, a marital deduction is allowed even though a terminable interest is transferred. IRC § 2523(g) is the gift tax counterpart to IRC § 2056(b)(8). For the specific requirements of IRC § 2056(b)(8), *see supra* discussion at I. B. 4. a) (2) (c).

iii) Joint Interests Held Between Donor and Donee Spouse [IRC § 2523(d)]

If a donor spouse transfers a piece of property to the donee spouse as a joint tenant, the interest is a terminable interest under IRC § 2523(b)(1). The rationale is that if the donor spouse lives longer than the donee spouse, the donor takes the entire property. The survivorship right means 1) the donor has retained an interest in property and 2) by reason of that interest may enjoy the property after the completion of the donee spouse's interest. Therefore, without an exception, all transfers made in joint tenancy or tenancy by the entirety are not allowed a gift tax deduction.

IRC § 2523(d) avoids this result. It has no counterpart in the estate tax, as this situation cannot occur under the estate tax since the transferring spouse is deceased when the transfer is made. The exception disregards both the survivorship rights and the possibility of a severed interest for the purposes of applying the terminable interest rule. After the application of IRC § 2523(d) the donor spouse no longer retains any interest in the property, and the interest is not considered a terminable interest.

> ***Example:*** With his separate property, Husband purchases $200,000 of stock and places it in joint tenancy with right of survivorship with his wife. The fact that Husband may take back all of the property after his wife's death is disregarded and, for the application of the terminable interest rule, no interest may return to Husband after his wife dies. Husband has given his wife a $100,000 gift that qualifies for both the IRC § 2503(b) annual exclusion and the marital deduction of IRC § 2523(a), resulting in zero taxable gifts.

(2) Spouse Not a U.S. Citizen [IRC § 2523(i)]

No marital deduction is allowed when the donor's spouse is not a citizen of the United States. While the deduction is disallowed, the IRC § 2503(b) annual exclusion is increased from a base of $10,000 to $100,000 for transfers to the non-citizen spouse, an amount that is adjusted for inflation. [IRC § 2523(i).] For 2018, the inflation adjusted amount is $152,000. [Rev. Proc. 2017–58.]

(3) Gift Tax Return [IRC § 6019(2)]

A gift tax return is not required to be filed for any gift receiving a marital deduction, unless an election is made during the year to pass qualified terminable interest property under IRC § 2523(f). In that case, the election must be present on a gift tax return filed for the year. [Reg. § 25.2523(f)–1(b)(4).]

c) Extent of Deductions [IRC § 2524]

IRC § 2524 limits any gift tax deductions to the amount of gifts made after any exclusions. This prohibits the improper offset of deductions against gifts that do not qualify for either the charitable or marital deduction. After the application of IRC § 2524, the gift tax deductions can only create a zero net deduction.

Example: Adama gives a gift of $25,000 to Galactica University (G.U.) and a $22,000 gift to his son, Apollo. After using the $10,000 exclusion under IRC § 2503(b)(not adjusted for inflation), Adama will have a $15,000 gift to G.U. and a $12,000 gift to Apollo. IRC § 2524 limits the amount of the gift tax charitable deduction under IRC § 2522(a) to $15,000, the amount of the gift to G.U. after the application of IRC § 2503(b). Adama cannot claim a $25,000 gift tax charitable deduction in addition to the annual exclusion because that would effectively reduce the taxable gift to Apollo for which no gift tax deduction should be allowed. The amount of Adama's income tax charitable deduction is still $25,000. [IRC § 170(a).]

F. Computation of the Gift Tax [IRC § 2502]

The gift tax is computed on the amount of taxable gifts given during each calendar year. Taxable gifts are the base used for taxation, comparable to the "taxable estate" in the estate tax or "taxable income" in the income tax.

Since 1976, the gift tax and estate tax rates have been "unified," meaning a single rate schedule is used to compute both taxes. This rate schedule is located in IRC § 2001(c). The tax rate for the gift tax is computed based on progressive rates which increase based on the total amount of taxable gifts made during the donor's lifetime.

Computing the gift tax is a two-step process. First, a "tentative tax" is computed on all taxable gifts made by the donor after June 6, 1932, including those taxable gifts made during the current year. [IRC § 2502(a)(1).] Next, a "tentative tax" is computed using taxable gifts made after June 6, 1932, but does not include gifts made during the current year (called taxable gifts made during "preceding calendar periods"). [IRC § 2502(a)(2).] This amount is then subtracted from the first tentative tax (which includes the amount of gifts in the current year) to arrive at the gift tax liability for the current year. In this manner, only the current year's taxable gifts incur any tax liability and the taxable gifts made during prior years are used only to increase the marginal rate of taxation on the current year's taxable gifts. To arrive at the gift tax due, the donor's unified credit is applied against the computed gift tax liability. [IRC § 2505.]

Example (1): Norm makes $6 million of taxable gifts during Year 1. Year 1 is the first year in which Norm has made any gifts over the annual exclusion amount [IRC § 2503(b).] to a single donee. To determine Norm's gift tax liability a tentative tax is first computed on the total amount of taxable gifts made by Norm after June 6, 1932. In this example the tentative tax is computed on $6 million using the tax rates found at IRC § 2001(c). Using the table the amount of tentative tax is $2,345,800, with a marginal rate of 40%. The second tentative tax is computed using only those taxable gifts made before the current year, here $0. Therefore Norm's gift tax liability is $2,345,800. However, to arrive at the amount of gift tax due, Norm must deduct his unified credit amount. [IRC § 2505.]

Example (2): In Year 2, Norm makes another $6 million of taxable gifts. Now a tentative tax is first computed on $12 million, the sum of $6 million of taxable gifts made in the current year and the $3 million of taxable gifts made in Year 1. The tentative tax on $12 million under IRC § 2001(c) is $4,745,800. Next, a tentative tax is computed on all gifts made prior to Year 2 (the $3 million in gifts made in Year 1). As determined in the first example, the amount of gift tax on $6 million is $2,345,800. To find Norm's gift tax liability for Year 2 we take the excess of the first tentative tax ($4,745,800) less the second tentative tax ($2,345,800), leaving $2,400,000 in gift tax liability. As in the first example, Norm needs to utilize the unified credit (if any) to determine the amount of gift tax due. [IRC § 2505.]

Note: The taxable gifts made in Year 1 were only used to place the taxable gifts made in Year 2 in the correct tax bracket on the progressive rate schedule of IRC § 2001(c).

1. "Taxable Gifts for Preceding Calendar Periods" [IRC § 2504]

To determine the current year's gift tax liability, "taxable gifts for preceding calendar periods" are used to calculate the rate of taxation. IRC § 2502(b) defines "preceding calendar periods" and the term includes all the years from June 6, 1932. [IRC § 2502(b)(flush).] "Periods" is used in the statute instead of "years," since between 1971 and March 3, 1982 the gift tax was computed quarterly. At all other times the gift tax was computed on a calendar year basis.

The amount of taxable gifts for preceding calendar periods is figured using the law as it existed at that time. This means that items that are not taxable under current law, but were taxable at an earlier time, are still included, and vice-versa. Also, if a transfer should have been included in the previous years' taxable gifts but was omitted on the gift tax return, that transfer must be included in computing the taxable gifts for preceding calendar periods. It does not matter if the statute of limitations has passed. It is important to note that the omitted amounts are not subject to the gift tax, but they merely increase the rate at which the current year's gifts are taxed.

Deductions and exemptions allowable in previous years, with one exception, are also utilized in determining the amount of taxable gifts for preceding calendar periods. [IRC § 2504(a)(2), (b).] The one exception is the application of former IRC § 2521, the specific exemption which was allowed in varying amounts between $30,000 and $50,000 before 1977, and was replaced with the unified credit of IRC § 2505. The now defunct IRC § 2521 exemption is used to reduce taxable gifts made before 1977 by $30,000, regardless of whether the taxpayer actually utilized the exemption. [IRC § 2504(a)(3).]

The valuation of different assets transferred in previous calendar years presents a problem. To alleviate the administrative burden and add some certainty, Congress enacted IRC § 2504(c). IRC § 2504(c) provides that after the statute of limitations has expired under IRC § 6501 (normally three years), the value of gifts made after August 5, 1997 cannot be changed for the purposes of computing the gift tax. IRC § 6501 provides that for the statute of limitations to expire so that no additional gift tax may be assessed or collected, and the value of the gift to be final, the item must be listed on the gift tax return in such a manner to give notice to the Secretary. [IRC § 6501(c)(9).] Therefore if no gift tax return is filed, or was filed but did not include the item, IRC § 2504(c) will not apply and the item may be revalued. Before the enactment of IRC § 2504(c), for a valuation to be final, the gift tax had to be

assessed or paid on the transfer. Therefore, in cases where no tax was due because of the unified credit, valuation remained an open question.

2. Unified Credit Against Gift Tax [IRC § 2505]

After 1976, citizens and residents of the United States have a credit against any gift tax imposed. The amount of the gift tax credit is the applicable credit amount under IRC § 2010(c). [*See supra* discussion of IRC § 2010(c) at I. C. 2. a).] The applicable credit is the sum of the basic exclusion amount and the deceased spousal unused exclusion amount. For gifts made in 2018 through 2025 the basic exclusion amount is the tentative tax under IRC § 2001(c) on $10 million, or $3,945,800. The basic exclusion amount is adjusted for inflation after 2010. [IRC §§ 2505(a)(1); 2010(c)(3).] As of 2018, the applicable exclusion amount is $11.18 million, resulting in a $4,417,800 tax credit. [Rev. Proc. 2018–18.] The result of this credit is that until a donor's total amount of lifetime taxable gifts exceeds $11.18 million there is no tax liability. The amount of the credit is reduced by the amount of credit utilized in any preceding calendar period. [IRC § 2505(a)(2).] In order to compute the amount of credit used in preceding calendar periods the current rates under IRC § 2502(a)(2) are used. [IRC § 2505(a)(flush).] The amount of credit utilized under IRC § 2505 does not reduce the credit allowed under the estate tax under IRC § 2010.

> ***Example:*** In the earlier example, Norm had a gift tax liability in Year 1 of $2,345,800. After application of the IRC § 2505(a) credit (unadjusted for inflation, so $3,945,800) of the same amount, Norm's gift tax due is zero. In Year 2, Norm would owe $800,000 in gift tax since the $12 million in gifts has fully exhausted his gift tax unified credit of $10 million.

The credit is mandatory and a donor may not elect when to utilize the credit. If a donor fails to utilize the credit it will still reduce the amount of available credit in later years.

> ***Example:*** Gilbert transfers $1 million to his son Albert as a gift. Gilbert has not made any previous taxable gifts. Albert agrees to pay the gift tax due on the transfer, so Gilbert will not have to use his IRC § 2505 unified credit. Even if Gilbert files a gift tax return and does not utilize his IRC § 2505 credit, the statute provides that the available credit is reduced by the amount of "allowable" credits in preceding years, and Gilbert would have to reduce his available credit by $1 million. [Rev. Rul. 79–398.]

G. Procedural Rules

1. Who Must File

A gift tax return must be filed each calendar year an individual makes "any transfer by gift" unless the transfer falls into one of three categories. [IRC § 6019(intro.).] First, no return is required for transfers excluded under IRC § 2503(b) ["Exclusions from gifts" *see supra* II. E. 1. discussing the exclusion] or IRC § 2503(e) [exclusions from gifts for certain transfers for medical or educational expenses *see supra* II. B. 4. b) (2) discussing the exclusion]. [IRC § 6019(1).] Second, transfers deductible under the gift tax marital deduction [IRC § 2523] do not need to be reported. [IRC § 6019(2).] Third, no return is required for deductible charitable contributions under IRC § 2522, so long as the donor's entire interest in the property is transferred (only of present interests in property) or it was a qualified conservation contribution of an easement. [IRC § 6019(3).] Therefore, if all

the individual's transfers for a given year do not fall into one of the three exceptions, a return is required regardless of whether gift tax is due or not. [Reg. § 25.6019–1(a), (f).] For example, a gift tax return is still required even if there is no gift tax liability due to the application of the unified credit under IRC § 2505. [Reg. § 25.6019–1(f).]

Non-gift transfers do not require a return. Non-gift transfers includes transfers of services, transfers in the ordinary course of business, transfers made for full and adequate consideration in money or money's worth, transfers made in satisfaction of support obligations, or transfers to political organizations, etc. [*See supra* II. B. 1. b) and II. B. 4. covering the exceptions to the gift tax and the general rule of when something is a "gift."]

A gift tax return is required from each individual making a qualifying transfer of property by gift. For married couples, each spouse must file their own gift tax return, since no provision allows for joint gift tax returns.

Death or incompetence does not terminate the obligation to file a return. If the donor dies before filing a gift tax return, the executor of the will or administrator of the estate is required to file the gift tax return. [Reg. § 25.6019–1(g).] If the donor becomes legally incompetent, the donor's guardian is required to file the return. [*Id.*]

2. Filing Date

A gift tax return may be filed as early as January 1, but no later than April 15, of the year following the transfer. [IRC § 6075(b)(1); 2017 IRS Instructions to Form 709, p. 4.] An extension may be automatically granted for taxpayers who obtain an income tax extension under IRC § 6019. [IRC § 6075(b)(2).] Any extension is limited to six months, unless the taxpayer is abroad. [IRC § 6081(a).] If the taxpayer dies before filing, the gift tax return is due at the same time as the estate tax return, including any extensions. [IRC § 6075(b)(3).]

3. Payment of Gift Tax and Liens

Generally, payment of the gift tax by the donor occurs when the gift tax return is due "without regard to any extension of time for filing the return." [IRC § 6151(a).] An extension of time to pay the gift tax may be granted, but not for more than six months, unless the taxpayer is abroad. [IRC § 6161(a)(1).]

The donor assumes primary liability for any gift tax imposed. [IRC § 2502(c).] If spouses split any gifts during the year under IRC § 2513, the entire gift tax of each spouse is joint and several liability of the other, regardless of whether the gift tax due is from a split gift. [IRC § 2513(d); Reg. §§ 25.2502–2, 25.2513–4.] If the donor dies before the payment of the gift tax, the executor or administrator must pay the debt from the donor's estate. [Reg. § 25.2502–2.] If the donor does not pay the gift tax due on the gift, the donee is responsible for its payment up to the fair market value of the gift. [IRC § 6324(b)(second sentence).] The donee's liability does not depend on whether the donee's gift was under the IRC § 2503(b) exclusion amount or received a gift tax deduction (marital or charitable). [*Baur v. Commissioner*, 145 F.2d 338, 339 (3d Cir. 1944); *La Fortune v. Commissioner*, 263 F.2d 186, 194 (10th Cir. 1958).]

If the gift tax is not paid, there is ten-year lien starting on the date the gifts were made on all property subject to the gift tax for such calendar year. [IRC § 6324(b)(first sentence).] The lien is terminated at the earlier of ten years, when

the gift tax is paid, or when it “becomes unenforceable by reason of lapse of time.” [*Id.*]

H. Review Questions

1. Bill gives $1 million to the Green Party. Is that amount a gift?
2. Jason owes Laura $15,000. Without any business purpose, Laura forgives the debt. Has Laura made a gift to Jason?
3. By contract Jack owes Jill $10,000 which is due on April 15, Year 1. The payment date passes with no payment. Jill does not seek payment and lets the statute of limitations run out on the collection of the debt. Has Jill made a transfer of property to Jack?
4. Bill transfers to Steve several state bonds that are exempt from taxation under IRC § 103. Has Bill made a gift to Steve that can be subject to the gift tax?
5. Douglas creates a trust that pays income to Nancy for her life and the remainder to Bruce. Nancy and Bruce are unrelated to Douglas. Douglas retains the right to change the remainder interest, but only with the consent of Nancy. Douglas does not maintain the power to change the income interest. Is there a completed transfer of any interest in property?
6. David’s father promises to pay David $20,000 if he stops chewing tobacco. David quits and receives $20,000. Has a gift transfer been made?
7. Kitty pays for ice-skating lessons and rink time for her minor daughter at a cost of $20,000 per year. Has Kitty made a gift?
8. Kitty transfers $20,000 to Whatsamatta University Law School for her 35-year-old son’s law school tuition. State law provides Kitty does not have any support obligations to her son. Has Kitty made a gift?
9. Wally has a general power of appointment over $20,000 per year from a trust created by Theodore. The trust provides income to Wally, and the remainder interest to Wally’s son, Beaver. If Wally does not exercise the power it will lapse. What are the gift tax consequences, if any, if Wally fails to exercise the power in a year when the trust corpus is $300,000?
10. In the current year, Donor gives Mary an income interest in a trust for life, with the right to demand the corpus of the trust after 10 years. Donor’s initial transfer to the trust is $20,000 and Mary’s life estate interest, disregarding the right to demand the corpus, has a value of $17,280. What is the amount of taxable gifts from Donor to Mary from this transfer assuming the annual exclusion under IRC § 2503(b) is $10,000?
11. Using his separate property, Husband purchases a $100,000 annuity for his wife. The annuity provides annual payments to Wife for her life. If the total amounts of payments made before Wife’s death are less than $100,000, additional payments are to be made to Son. Does the transfer of the annuity from Husband to Wife qualify for the marital deduction under IRC § 2523(a)?
12. Husband transfers an apartment building to Alan, an unrelated third-party, reserving a right to the rental income from the property for the next 10 years. The next year, Husband transfers his remaining income interest in the property to Wife for no consideration. What are the tax consequences of the transfer to Wife?

13. Generally, under which of the following circumstances (if any) is a gift tax return required to be filed? Assume the IRC § 2503(b) annual exclusion amount is $10,000.

    A. A donor gives gifts to someone (other than a spouse) totaling more than $10,000.

    B. A donor gives a gift of a future interest in property less than $10,000.

    C. A donor gives a gift to an individual and splits the gift with donor's spouse.

    D. All of the above.

14. Tom gifts a vase with a fair market value of $50,000 to his friend, Katie. Tom's adjusted basis in the vase is $10,000. What is the gross amount of the gift to Katie (without any reduction from IRC § 2503(b))?

    A. $10,000

    B. $29,000

    C. $40,000

    D. $50,000

15. True or false: All gifts over $10,000 to an unrelated individual 38 years younger than the donor are subject to both the gift and generation-skipping tax. Assume the IRC § 2503(b) annual exclusion amount is $10,000.

16. Bill transferred the following gifts to individuals during the current year. Which, if any, are "taxable gifts"?

    I. $15,000 transferred to Bill's mother to offset medical expenses.

    II. A $20,000 state bond exempt from Federal taxation under IRC § 103.

    III. 500 shares of Macrohard stock transferred to Bill's sister, Tina. The stock had a basis of $3,000 and a fair market value of $20,000.

    IV. $17,000 paid to Whatsamatta University (a qualified educational organization) for his son's room and board.

        A. All of the above

        B. II and III only

        C. II, III, IV, but not I

        D. I, II and III, but not IV

17. Jimmy transfers several assets in the current year.

    - Transfer of his business to his son for $50,000. The fair market value of the business at the time of transfer was $125,000.
    - Transfer of $20,000 to the Republican National Committee.
    - Transfer of stock worth $20,000 to the University of Florida, where he got his LL.M. in taxation. The basis of the stock was $3,000.
    - Payment directly to the school of $17,000 for the college tuition of his niece.

    What is the total amount of taxable gift transfers, before any IRC § 2503(b) or unified credits, given by Jimmy?

    A. $50,000

    B. $75,000

C. $95,000

D. $132,000

E. None of the above

18. Dennis transfers a life insurance policy on his life valued at $100,000 to a trust. After Dennis dies, the insurance proceeds are to be held in trust with the income going to Steve, remainder to Trevor, Steve's son. Dennis transfers $10,000 to the trust each year to pay the premiums on the insurance policy. Steve has the non-cumulative yearly right to withdraw $10,000 from the corpus of the trust. What are the estate and gift tax results of the $10,000 yearly transfer? What are some ways to avoid any negative consequences? Assume the IRC § 2503(b) exclusion amount is $10,000.