

A gift tax can apply even if the property transferred (e.g., a municipal bond) is exempt from federal income tax (or other taxes). However, this all presupposes that the transfer is not supported by adequate and full consideration in money or money's worth. So, to the extent that the recipient (donee) has paid adequate and full consideration in money or money's worth, there is no gift.

For gift tax purposes, the identity of the recipient/donee is largely irrelevant. He/she/it can be an individual, partnership, LLC, corporation, trust, charity, or other legal entity. Usually, a gift to a trust is a gift to its beneficiaries and a transfer to (or from) a business entity is considered a transfer to (or from) its owners. So, if a father gives \$100,000 to a corporation he owns in equal shares with his wife and their two children, he is making four \$25,000 transfers – or a \$25,000 gift to each of the other owners (disregarding the “gift” he made to himself). Similarly, if a corporation makes a transfer to one of its shareholders (or to someone other than a shareholder), the IRS is likely to argue that the transfer is, in reality, made by each of the other shareholders (or by all shareholders) – and may claim that the corporation has made a constructive distribution to them as well. For example, suppose a family-owned corporation sold property worth \$1,000,000 to the daughter of its two shareholders for \$300,000. The IRS will probably tax the transaction first as a \$700,000 constructive dividend to the parents (\$1,000,000 FMV less \$300,000 purchase price); and a second time as a gift of \$350,000 by each parent.

WHY A GIFT TAX?

If a person could freely, and without any tax consequences, transfer income-producing properties such as securities or real estate to family members, it would be simple to lower income taxes by merely shifting property back and forth (at will) among family members in lower income tax brackets.

Likewise, if an extremely wealthy person could give away assets to family members during lifetime with no tax consequences, he or she could make massive gifts – shortly before death – and totally avoid the federal estate tax.

The purpose of the federal gift tax (note that many states have their own gift tax systems) is to reduce the incentive for taxpayers to make such lifetime transfers – or to compensate Treasury for the potential loss of federal income or estate tax revenues when such transfers are made.

WHY DO PEOPLE MAKE GIFTS?

People make gifts for various tax and non-tax reasons. Some of these include:

1. Reduction of probate and administrative costs.
2. Asset protection from the claims of creditors.
3. Vicarious enjoyment via donees' use and enjoyment of the property (and/or its income).
4. Trains donees to handle money, property, business interests.
5. Gives donor opportunity to assess donee's ability to handle money, property, business interests.
6. Helps assure financial security for selected individuals.
7. Helps assure mission accomplishment by charities.
8. Shifts income to family members in lower tax brackets.
9. Utilizes additional (or available) estate tax exemptions of family members.
10. Reduces federal and state death taxes on appreciation of gifted property.

GIFT TAX IS AN EXCISE TAX

An excise tax is not a tax levied on the subject of the property per se, or on the recipient of the gift. Rather, it is imposed on an owner's right to transfer property or an interest in property to another person or entity.

Note that the gift tax is imposed only on transfers from individuals – although certain transfers by entities are "looked through" and treated as if the individuals who own the entity were the transferors. For instance, a gratuitous transfer by a corporation might be considered as an indirect gift by the owners of the business (see examples in "Scope of Gift Tax" above).

GIFT DEFINED

A gift is essentially defined as any voluntary transfer made without consideration. Not all of what is transferred is necessarily a gift. Generally, a working definition of a gift might be: The difference between the value of the property or property interest transferred and any consideration received in return for that transfer. Note that although the donor's mental, emotional, or donative intent is irrelevant for gift tax purposes, among the factors courts will examine are:

- a. the donor's mental competency to make a gift,
- b. the donee's legal and mental capacity to accept the gift,
- c. whether or not the donor irrevocably parted with dominion and control over the transferred property, and
- d. whether or not the donee in fact accepted the gift.

CONSIDERATION DEFINED

In general, if the transferor receives adequate and full consideration equal in value to the property or property interest transferred, any gift tax issue is eliminated. Thus, to the extent the consideration given does not equal the value of the property the donee receives, there will be a gift equal to the difference. So, if Rob Sterling transfers his \$1,000,000 medical building to his sons, Max and Aaron, and they pay their father \$200,000, Rob has made an \$800,000 gift (reduced by any annual exclusions Rob and his wife Charlee may have).

Similarly, consideration is an important factor where one party makes a transfer of property pursuant to a compromise of a bona fide, arm's-length dispute, or under a court order that represents a genuine adversary proceeding. Such transfers are considered to be made for adequate and full consideration. For example, suppose two siblings have been squabbling about a business interest and the argument ended up in litigation. As a result, a compromise payment is made by one sibling to the other in settlement of the dispute. That payment is not considered a gift. Note that in an intra-family situation, there must be clear and convincing evidence of a bona fide, arm's-length adversary proceeding; otherwise, a gift tax will be imposed.

Furthermore, not all "consideration" is taken into account for purposes of determining the value "in money or money's worth" received by the transferor/donor. Moral consideration, past consideration, or consideration in the form of a detriment to the donee that does not benefit the donor is not treated as consideration.

For instance, assume Douglas Mellor transferred \$1,000,000 to Mary, a widow, when she promised she would marry him. The impetus for his transfer was to compensate Mary for her forfeiture, upon her remarriage, of a \$1,000,000 interest in the trust established by her late husband. The Supreme Court held in a case with similar facts that Mary's promise to marry Doug was inadequate and not ascertainable in money or money's worth; nor was the forfeiture of her interest in her late husband's trust sufficient consideration (in spite of the fact that she did give up something of considerable value), because the benefit of that value did not go to Doug.

THE TAXABLE GIFT

A person's taxable gift, as noted above, is its fair market value (FMV) determined on the date of the transfer reduced by certain exclusions and deductions. The key exclusion is the annual exclusion (allowable per donee). The key deductions are the marital deduction and the charitable deduction.

THE ANNUAL EXCLUSION

Any person who makes a gift of cash or property to a donee can exclude the first \$11,000 (in 2005 indexed for inflation) from the value of the gift. These so-called annual exclusion gifts can be made to an unlimited number of persons each year. An additional exclusion, unlimited in amount, is available for gifts made for the direct payment of another person's tuition or medical expenses.

The annual exclusion is allowed only for gifts of a "present interest." This means the recipient (donee) must have the immediate, unfettered, and ascertainable right to use, possess, or enjoy the transferred property. No exclusion is allowed for gifts of future interests (e.g., remainders, reversions, and other such interests) which give the donee use, possession, or enjoyment rights only at some future date. Careful planning is often necessary to assure the gift tax annual exclusion, particularly for a gift to a minor, a gift in trust, or for the value of a gift of a life insurance policy made in trust.

GIFT SPLITTING

It is possible for a married couple to double their annual exclusions through what is called "gift-splitting." The law treats a consenting spouse as having made one-half of the gift that is actually made by his or her spouse in a calendar year. The result of gift-splitting is that a couple making gifts in 2005 can exclude as much as \$22,000 (per donee) from current gift tax; the gift tax rate (and the tax liability, if any) for each spouse is calculated separately by reference to his or her own current and prior gifts.

Note: To take advantage of the gift-splitting, the non-contributing spouse must consent to split the gift; and a gift tax return (even if no current tax is due) must be filed. Additionally, if a spouse consents to gift-splitting, all subsequent gifts made in that calendar year are "split."

GIFT TAX MARITAL DEDUCTION

Certain spousal gifts qualify for what is known as the gift tax marital deduction. The purpose of the gift tax marital deduction is to treat a married couple as a single economic unit. The gift tax marital deduction is unlimited.

Essentially, these are outright gifts – or gifts that are tantamount to outright gifts to a U.S. citizen spouse, or a gift to a QTIP (qualified terminable interest property) trust. Similar to its estate tax counterpart, no gift tax marital deduction is allowed for most gifts of terminable interests. No marital deduction is allowed for gifts to non-citizen spouses, but a special "super-annual exclusion" is allowed, and it is currently \$114,000 (indexed for inflation).

GIFT TAX CHARITABLE DEDUCTION

Certain gifts to charity are deductible. Such gifts must meet a number of tests. The charitable recipient must be an entity described in the applicable statutory provision. This includes most, but not all, of the same charities for which deductible income tax contributions may be made.

There is no limit on the amount that can be passed, gift tax free, from a U.S. citizen or resident to a "qualified charity" (essentially a governmental agency, certain religious, scientific, fraternal, and veterans' associations, organizations, or societies).

TRANSFERS NOT TREATED AS GIFTS FOR GIFT TAX PURPOSES

Non-Gifts: Planners often utilize certain shifts of wealth that are not treated as gifts. One example is the rendering of gratuitous services. No matter how valuable the services one person may provide to another, since the gift tax is imposed only on transfers of property or property interests, such services do not fall within the scope of the federal gift tax. So a mother could provide her daughter with investment or business advice, or a grandfather could work for hours in his grandson's business and yet such services are not considered gifts (or transfers of property rights). This suggests a way, if handled properly, to economically benefit a family member without triggering gift tax.

Another such technique, would seem to be the intra-family interest-free loan. Caution is advised here. Although the IRS seldom pursues situations where parents allow their children to use their summer home or car without rent or fees, certainly interest-free and below-market loans of cash are treated as taxable gifts. The IRS will impose a gift tax on the value of the right to use the borrowed money. The interest that the parent could have charged – but did not – or the so-called "forgone interest" will be treated as a gift to the children.

Disclaimers (or Renunciations): If a potential donee refuses to accept a gift he/she does not want, or need, or (for any other reason) declines it, and makes the refusal or renunciation in a timely and proper manner, the gift usually goes to someone else as a result. Although the disclaiming person is in effect making a transfer to the ultimate recipient of the gift, for tax purposes, it is treated as if the disclaiming person were not involved and there is no second gift. In other words, for gift tax purposes, it is as if the gift went directly from the original donor to the ultimate recipient, and the disclaimant is treated as having made no transfer of property. This makes the disclaimer an important tool because it adds great flexibility to planning alternatives.

There are specific requirements for a disclaimer to be effective for tax purposes: (1) it must be in writing; (2) the document must be presented to the transferor (or his/her legal representative or the holder of title) no later than 9 months after the later of (a) the date on which the transfer creating the interest is made, or (b) the date the person disclaiming reaches age 21; (3) the person disclaiming must not have accepted the property or any of its benefits; and (4) because of the refusal, someone other than the person disclaiming must receive the property or interest in property – without influence or direction from the person making the disclaimer.

Inter-spousal transfers: When property is allocated from one spouse to another during the marriage or incident to a divorce or separation agreement, the transfer may not be considered the type of property transfer subject to the gift tax. Specifically, inter-spousal transfers pursuant to a written agreement dividing the property of the spouses and occurring within two years before and one year after a decree of divorce are not treated as taxable gifts – if the spouses' marital rights are settled by the agreement. or it provides for a reasonable allowance for the support of minor children.

Tuition and Medical Care Payments: Amazingly, one person can pay the private school or college or graduate school tuition of another and incur no gift tax. Tuition paid directly to an educational institution for the education or training of another is gift tax exempt – regardless of the amount paid or the relationship of the parties involved. So parents, grandparents, or even friends can make direct payments for tuition without triggering a gift tax. Likewise, any donor can make a direct payment for the medical care expenses of any other individual (e.g. relative or friend) without limit and without incurring a gift tax.

Incomplete Gifts: A gift cannot be subjected to gift tax if it is incomplete. The test of a completed gift is whether or not the donor parted with dominion and control; that is, has the donor irrevocably given up the right to recall the gift? As long as a donor can change the disposition of the gift, alter the identity of the donee, or change how much or when a donee receives his/her gift (or interests/rights), the gift is not complete and no gift tax can be imposed.

GIFT TAX CREDIT

A "unified" credit can be applied against the tax on gifts made either during lifetime or at death (or a part can be applied against each). As noted above, the gift tax credit results in a dollar-for-dollar reduction of the gift tax otherwise due and payable.

Currently, the gift tax credit is capped at \$345,800 and remains level until 2009. Note that the credit, which offsets the tax up to \$1,000,000 of a taxpayer's lifetime taxable gifts, is significantly less than the estate tax credit (\$555,800) which currently offsets the tax on \$1,500,000 of a

decedent's estate assets. And, unlike the gift tax credit, the estate tax credit and the applicable exclusion amount are scheduled for periodic increases through 2009.

COMPUTATION OF GIFT TAX

The computation of a person's gift tax is actually a two-part process. The first part is to compute taxable gifts; the second to calculate the tax payable on those gifts.

Simplified, the process is:

1. COMPUTATION OF TAXABLE GIFTS

Taxable gifts are computed in five steps:

STEP 1: List total gifts for year \$_____

STEP 2: Subtract one-half of gift deemed to be made by donor's spouse (split gifts) \$_____

STEP 3: Subtract allowable annual exclusion(s) \$_____

STEP 4: Subtract marital deduction \$_____

STEP 5: Subtract charitable deduction \$_____

The result is the donor's taxable gifts. A separate and essentially identical process is used to compute the taxable gifts for the spouse of the donor (for split-gifts).

2. COMPUTING GIFT TAX PAYABLE

STEP 1: Compute gift tax on all TAXABLE gifts regardless of when made \$_____

STEP 2: Compute gift tax on all prior taxable gifts \$_____

STEP 3: Subtract Step 2 result from Step 1 result \$_____

STEP 4: Enter any gift tax credit remaining \$_____

STEP 5: Subtract Step 4 result from Step 3 result \$_____

The result is the gift tax actually payable by the donor.

WHAT HAPPENS TO THE GIFT TAX IF THE ESTATE TAX IS REPEALED OR MODIFIED?

Even if the estate and generation-skipping transfer taxes are repealed or modified, there will be a gift tax. Why? Because Congress specifically retained a gift tax in order to protect federal income tax revenues. The objective, as I noted above, was to discourage taxpayers from making gifts of income-generating or appreciated assets to family members who are in lower income tax brackets, and/or to those who have offsetting losses. The rationale is that if a donor could transfer a highly appreciated asset without incurring gift tax, he or she could transfer the asset to a family member

(presumably in a lower tax bracket) and, in turn, the donee could sell the asset and pay a lower capital gains tax than the donor. Subsequently, if there were no gift tax, the donee could gift or bequeath the sales proceeds back to the original owner/donor.

STEP-UP IN BASIS AND CARRYOVER BASIS

Step-Up in Basis: Under current law (now through 2009, and scheduled to resume in 2011), a **step-up in basis** regime applies to assets transferred at death. This means that at a person's death, the cost basis of an asset is re-set to the value of the asset as of the decedent's date of death (or an alternate valuation date, if elected). If and when the asset is later sold during the recipient's lifetime, his/her capital gain is the difference between the sales price and the stepped-up basis (rather than the decedent's adjusted basis). That is, under current law, the heirs' basis is artificially established rather than being carried over from the decedent's cost basis. The effect of a step-up in basis system is the permanent elimination of the increase in value of the asset (the capital gain) that occurred during the time the decedent held the property.

Modified Carryover Basis: An often overlooked cost (and aggravation) estate tax repeal is the change from the current step-up-in-basis system to a modified carryover basis system for assets transferred at death. This means all individuals will be forced to keep permanent records of acquisition and improvement costs on assets or properties they own, and make them available indefinitely for future generations, if necessary.

In general, the basis of a person acquiring property from a decedent in 2010 will be equal to the lesser of (a) the adjusted basis of the decedent (i.e., carried over to the recipient from the decedent), or (b) the fair market value of the property at the date of death of the decedent.

There are two exceptions to the carryover of basis:

1. A total per-decedent step-up of up to \$1.3 million and \$60,000 for nonresident aliens (indexed for inflation), for transfers to anyone other than the surviving spouse.
2. An additional step-up of up to \$3 million (indexed for inflation) is permitted for assets transferred to a surviving spouse.

Note that these are dependent on an allocation by the estate's executor who must apply the step-up allowance to specific assets and that the figures apply to the net increase in value of the assets rather than the gross value. Thus, the \$1.3 million step-up might cover all the gains in a gross estate valued at \$2 to \$3 million or more. The spousal step-up of \$3 million alone could cover the gains in an estate with a gross value of \$4 million to \$5 million. So it is possible that these two exceptions will provide what equates to a step-up in basis for smaller estates.

CARRYOVER BASIS FAILED IN THE PAST

Carryover basis has proved unworkable in the past because people have serious trouble determining and keeping records of the historical cost basis of an inherited asset. The Tax Reform Act of 1976 enacted a carryover basis regime but it was postponed by three years by the Revenue Act of 1978 and then repealed by the Crude Oil Windfall Profit Tax Act of 1980 before it ever took effect.

MODIFIED CARRYOVER BASIS AND LIFETIME GIFTS

If estate tax repeal becomes permanent, wealth transfer planning for high net-worth clients will be much, much more complex and challenging. First and foremost, for larger estates, how would the executor determine which assets to apply the step-up in basis? What would be his/her liability if the wrong decision is made?

For some clients, their decision whether to make lifetime gifts would not be simplified merely because there would be no estate or generation-skipping transfer taxes – instead it would be complicated by the modified carryover basis regime. In addition to other factors, they would have to consider the income tax effect on the gain should their heirs find it necessary to dispose of not only the gift but also bequests during their lifetime. Imagine the nightmare the required record keeping and basis tracking would cause in the event transfers are made for several generations into the future!

CONCLUSION

Gifts – and gift taxes – are here to stay. Gift giving is an important estate planning tool but it must be integrated into a well-planned and carefully coordinated estate and wealth transfer planning effort. In deciding whether or not to make a gift and, if so, the right type of property to give, consider the following:

1. Give property likely to appreciate in value to remove both the property and the appreciation on that property from the donor's estate.
2. Give property with a "leverage factor," i.e., property with a low cost to give and a high growth potential. For instance, the gift of life insurance has a relatively low cost but removes a substantial amount from the donor's estate.
3. Give property that is – or will become – income producing. Give that property to lower income-bracket family members.
4. Be wary of gifts of property subject to debt. If debt on a property exceeds the cost basis, the donor may trigger a capital gain on the excess of the debt over the donor's cost. For instance, suppose a person has a basis in a building of \$100,000. She borrows \$700,000 using the building as collateral, and then gives it to an adult child when it is worth \$1,000,000. The gift triggers a taxable event for income tax purposes. She will have to report the \$600,000 of gain at the date of the gift.
5. Match the gift to the needs and abilities of the recipient as well as to the objectives of the donor.

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