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The Tax Posture of Gifts in Estate Planning: Dinosaur or Dynasty?

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I. INTRODUCTION

With the advent of the income tax,[1] gifts[2] became a means of minimizing tax liabilities. Subsequently, gift giving took on added tax planning importance when the modern day estate tax was put into effect.[3] Prudent gift giving programs could sharply reduce the amount

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1. U.S. CONST. amend. XIV. It is worth noting that attempts to tax income prior to 1913, although ill-fated, were fashioned in such a way that the current income tax benefits flowing from gifts would also be available, even though gifts were includable in income. *See* Revenue Act of 1894, ch. 349, §§ 27-37, 28 Stat. 509, 553-60; Pollock v. Farmer's Loan & Trust Co., 157 U.S. 429, *reh'g granted*, 158 U.S. 601 (1895) (holding §§ 27-37 of the Revenue Act of 1894 unconstitutional).

2. "Gift" as used in this article refers only to inter vivos transfers and does not encompass testamentary gifts.

3. Revenue Act of 1916, ch. 463, §§ 200-12, 39 Stat. 756, 777-80. The estate tax became a permanent fixture in the tax structure under the 1916 act and has since been revamped and refined to its current status. *See* I.R.C. §§ 2001-2622 (Law. Co-op. 1978 & Supp. 1984). Prior to 1916, Congress had utilized a stamp tax on legacies in 1798 and an inheritance tax that made two short-lived appearances in 1862 and 1898. For a more complete historical treatment of the estate tax, see R. PAUL, FEDERAL ESTATE AND GIFT TAXATION §§ 1.01-.02 (1942); R. PAUL, FEDERAL ESTATE AND GIFT TAXATION 59-78 (1969) [hereinafter cited as FEDERAL ESTATE]; J. LEWIS, THE ESTATE TAX 655-704 (1979).

of property subject to the estate tax and thus decrease its burden.[4] The gift tax was enacted in an effort to seal this potential escape hatch.[5] Its stated purpose and design was to prevent otherwise non-taxed gratuitious tranfers from eroding the estate tax base. The erosion would be prevented through taxing the gifts themselves.[6] Despite the legislative intent, the gift tax structure gave gifts preferential treatment over property transferred at death and continued to provide tax benefits.[7] Recent significant changes in both estate and gift taxes,[8] together with a reduction in the maximum marginal income tax rate,[9] have caused many to speculate whether gifts have lost much, if not all, of their tax appeal.[10] Estate planners must determine the extent

4. For the most part, the estate tax was a levy against property owned or controlled at death. Gifts made prior to death, not recaptured by some gross estate section, would not be part of the tax base. *See* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 1-1 to 1-3 (1974).
5. The first gift tax was promulgated in 1924 with the express purpose of attempting to close the "escape hatch." 65 CONG. REC. 3119-20, 8095-96 (1924). *See infra* note 6. This tax was repealed in 1926. Six years later Congress passed an act which included a tax gift. Revenue Act of 1932, ch. 209, §§ 501-532, 47 Stat. 169, 245-59. The current gift tax provisions are included in I.R.C. §§ 2501-2524 (Law. Co-op. 1978 & Supp. 1984). For a history of the gift tax, see generally R. PAUL, *supra* note 3, at §§ 15.01-.02; FEDERAL ESTATE *supra* note 3, at 70-72.
6. *See House Comm. on Ways and Means, Revenue Bill of 1932*, H.R. Rep. No. 708, 72d Cong., 1st Sess. 27-28; *Senate Comm. on Finance, Revenue Bill of 1932*, S. Rep. No. 665, 72d Cong., 1st Sess. 39. The United States Supreme Court recently stated that its holding was consistent with "one of the major purposes of the federal gift tax statute: protection of the estate and income tax. The legislative history of the gift tax provisions reflects that Congress enacted a tax on gifts to supplement existing estate and income tax laws." Dickman v. Commissioner, 104 S. Ct. 1086, 1091-92 (1984). *See also* Sanford v. Commissioner, 308 U.S. 39, *reh'g denied*, 308 U.S. 637 (1939) (gift tax was to prevent avoidance of death tax through inter vivos gifts). *See generally* Harris, *Legislative History of Federal Estate Taxation*, 18 TAXES 531, 536 (1940); R. PAUL, *supra* note 3, at § 15.04.
7. Primary direct benefits included a gift tax rate schedule that was 25 percent lower than its estate tax counterpart for transfers or similar value. I.R.C. §§ 2502, 2001 (Supp. II 1954). Also each gift could qualify for an annual exclusion (originally $3,000, I.R.C. § 2503(b) (Supp. II 1954), and now $10,000, I.R.C. § 2503(b) (Law. Co-op. 1978 & Supp. 1984)) and each donor was entitled to a lifetime exemption of $30,000 in taxable gifts. I.R.C. § 2521 (Supp. II 1954), *repealed by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(b)(3), 90 Stat. 1520, 1849 [hereinafter cited as TRA].
8. The Tax Reform Act of 1967 entirely revamped the system. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 [hereinafter cited as ERTA], elevated the credits and created an unlimited maritial deduction.
9. Prior to ERTA, *supra* note 8, the maximum marginal income tax was 70 percent. The maximum rate was lowered to 50 percent in an effort to further economic recovery. I.R.C. § 1 (Supp. II 1954), *amended by* ERTA, *supra* note 8, at 176-82. The purpose of this reduction was to provide equitable across the board tax relief and to reduce the distortions, disincentives and inefficiencies that resulted from the higher rates. *See* S. Rep. No. 144, 97th Cong., 1st Sess. 23, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 130.
10. Even before the substantial changes ushered in by ERTA, *supra* note 8, there was

that gifts have been freed from tax bondage. This compels them to reassess the tax planning role of gifts in general. In order to determine if gifts are still capable of effecting tax benefits, it is necessary to analyze the tax status of gifts within the current tax structures. Since from a pure tax perspective the numbers control, the preliminary analysis has a strong mathematical flavor. Once the arithmetic is mastered, the role of gifts in the current tax environment can be defined, and the efficacy of that role evaluated.

II. THE TAXES

A. Income Tax

There is no direct tax benefit conferred by statute to the donor making a gift.[11] The donee receives the legislative benefit in that gifts are excludable from the donee's income.[12] Gifts[13] are essentially received tax-free. A heavy emphasis is placed on the term "received." Although receipt of the gift is not taxable, the donee must account for any income generated by the gifted property during his ownership.[14] Additionally, in all but selected "loss" situations,[15] the donee takes a

much concern over the role of gifts in estate planning. *See* Balmuth, *Is it Still Economical to Make Lifetime Gifts?*, 117 TAX & EST. 165 (1978); Brogan, Jr., *Will Lifetime Gifts Survive?*, 1977 EST., GIFT & TR. J. No. 3, 4 (1977); Officer & Banks, *Estate vs. Gifts in a Period of Inflation*, 58 TAXES 68 (1980); Pennefield, *Alternative Methods of Transferring Property — The Demise of Gifts*, 36 INST. ON FED. TAX'N 329 (1978); Pies & Goldberg, *Estate Planning: Lifetime Gifts — A Quantitative Approach*, 11 TAX ADVISER 83 (1980); Sacher, *Lifetime Gifts Will No Longer Substantially Cut Estate Tax, But Are Still Very Useful*, 4 EST. PLAN. 432 (1977); Shapiro & Brink, *Taking Advantage of the Benefits of Lifetime Transfers Remaining Under the Present Rules*, 5 EST. PLAN. 274 (1978); Solomon, *Gifts in Light of Tax Reform*, 12 INST. ON EST. PLAN. 1700 (1978); O'Sullivan, *Gifting Under the Tax Reform Act of 1976: What's New? What's Left?*, 16 WASHBURN L.J. 275 (1977); Wood, Jr. & Todd, *Gifts Should Still be Made, But Care is Needed in Deciding What to Give, When, and to Whom*, 6 EST. PLAN. 2 (1979).

11. Gifts are not tax deductible. Moreover unlike some other taxes, any gift tax paid by the donor is not deductible. I.R.C. § 275(a)(3) (Law. Co-op. 1974 & Supp. 1984). Gift tax paid, however, may be added to the donee's basis in the property transferred. *Id.* § 1015(d). This "bump" in basis is limited to the amount of the gift tax attributable to the appreciation of the property during the donor's ownership. For examples of how the "bump" works, see Treas. Reg. § 1.1015-5, T.D. 6693, 1963-2 C.B. 326, 328-32, *amended by* T.D. 7238, 1973-1 C.B. 544, 544-46; T.D. 7910, 1983-2 C.B. 161, 162.
12. I.R.C. § 102(a) (Law. Co-op. 1974 & Supp. 1984).
13. Although § 102(a), *id.*, excludes gifts from gross income and § 2501, *id.*, imposes a tax on gifts, the statute does not define the term "gift."
14. As with any other property, the owner is charged with the income tax burden. *See* J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 17 (Rev. Vol. 1982).
15. I.R.C. § 1015(a) (Law. Co-op. 1974). In cases where the donor's adjusted basis is greater than the fair market value of the property at the date of gift, the donee will take as his basis the fair market value rather than the donor's adjusted basis for the purpose of determining loss. For situations where the taxpayer takes the

"carry-over" basis in the gifted property, and upon his taxable disposition[16] is responsible for all of the appreciation occurring during both his ownership and that of his donor.[17] This effectively limits the original exclusion from income to the donor's adjusted basis in the gifted property alone. Although the carry-over basis rule may dull the luster of the tax-free receipt, this is partially offset by the donee's ability to tack the donor's holding period onto his own,[18] which allows easier access to potentially favorable capital gains treatment.[19] In all, the statutory framework does little to diminish the joy of receiving.

Although not directly favored, the donor can derive some income tax relief from his munificence. Two notable benefits are the consequences of the tax treatment adversely affecting donees through the donee's tax accountability for subsequently earned income and the carry-over basis rule. The impact of these rules can be compelling enough to tip the scales in favor of giving gifts.

First, consider that a donor can effectively shift the income of productive property away from himself by transferring the property to a donee—keeping in mind that the donee would usually have a lower marginal tax rate. Second, disposing of property by gift is not a taxable event to the donor.[20] This allows appreciation to be passed to donees, where, again, it will most probably be subjected to lower tax rates than that of the donor. It is worth noting that the donor may pass on the appreciation accrued during his ownership, along with any

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property and suffers neither gain nor loss by utilizing either the fair market value or the donor's adjusted basis, see Treas. Reg. § 1.1015-1(a)(2)(example)(1956).

16. Of course this is only true if the donee makes a taxable disposition of the property. Conceivably, the donee could transfer the property in a manner that would not trigger a tax accounting, i.e., by gift (*but see infra* note 20), and thus not bear the tax cost for any appreciation on the property.
17. If the donor acquired the property with a carry-over basis, the donee who is selling the property would have to account for all the appreciation on the property which accrued during his ownership, that of his donor, and that of the donor's donor.
18. I.R.C. § 1223(2) (Law. Co-op. 1974 & Supp. 1984).
19. Section 1202(a), *id.*, permits 60 percent of an individual's net capital gain to be deducted from gross income. "Net capital gain" is defined in § 1222(11), *id.*, as the excess of net long term capital gain over net short term capital loss. For net long term capital gain see Tax Reform Act of 1984, Pub. L. No. 98-369, § 1222(3),(4),(7), 98 Stat. 494, 1011 (as amended by § 1001(a)(1) reducing the holding period from one year to six months) [hereinafter cited as TRA 84]. For net short term capital gain see *id.* § 1222(1),(2),(6) (as amended by § 1001(a)(2).
20. *See* Campell v. Prothro, 209 F.2d 331 (5th Cir. 1954); S.C. Johnson & Son v. Commissioner, 63 T.C. 778 (1975); Sorelle v. Commissioner, 22 T.C. 459 (1954). *But see* Diedrich v. Commissioner, 457 U.S. 191 (1982) (where the donor had to recognize gain to the extent that the donee's payment of the donor's gift tax liability on the transfer exceeded the donor's adjusted basis in the gifted property). *See generally* TRA 84, *supra* note 19, § 1026 ("grandfathering" pre-March 4, 1981, net gifts from the adverse income tax exposure. This non-code section rule was recently applied in Davis v. Commissioner, 84-2 U.S. TAX CAS. (CCH) ¶ 9877 (1984)).

he may have acquired with the property.[21] Also, since making a gift is not a taxable disposition, the donor is afforded the opportunity to divest himself on a tax-free basis of certain assets carrying an ordinary income "taint."[22]

In a negative vein, there is a high non-tax cost which is paid in order to reap these tax benefits: the donor must completely divest himself of all interest in the property before any tax rewards can be obtained. Thus, an overall evaluation of an individual's particular situation must be made before it can be determined whether making the gift is justified. The tax consequences of gift-giving are forced to share center stage with other non-tax considerations[23] in the determination of the appropriate course of action. Although the tax ramifications should always be considered, as the following examples illustrate, standing alone they are probably insufficient to justify the decision to make the gift.

Consider each of the following situations in which the donor is in a fifty percent marginal income tax bracket; the donee is in a twenty percent marginal income tax bracket; both the donor and donee are cash-basis, calendar-year taxpayers; there is no gift tax due on any of the transfers; all of the gifts are made on the first day of the year; and any sales of the property are made at the year's end.

Situation I. Donor makes a gift of $5,000 cash to his son.

Situation II. Donor makes a gift of a piece of vacant land worth $20,000 in which he has a $12,000 adjusted basis to his daughter, who then sells the property.

Situation III. Donor makes a gift of stock worth $10,000 in which he has a $4,000 adjusted basis to his brother. The stock pays $1,000 cash

21. *See supra* note 16.

22. Generally, the disposition, other than a redemption, of § 306 stock will give rise to ordinary income treatment to the extent of "earnings and profits" at the time of distribution of the stock itself. I.R.C. § 306(a)-(b) (Law. Co-op. 1974 & Supp. 1984). Section 306(e) specifically exempts gifts of § 306 stock from triggering the ordinary income accounting. *Id.* § 306(e). The donee does, however, acquire the "taint." *Id.* § 306(c)(1)(C). For the special rule treating the redemption of § 306 stock as a § 301 distribution, see *id.* § 306(a)(2).

In addition to § 306 stock, the recapture provisions of § 1245 and § 1250 are not triggered by the gifts. *Id.* §§ 1245(b)(1), 1250(d)(1). However, a gift will cause a recapture of the investment tax credit. *Id.* § 47(a)(1).

23. The non-tax reasons for making gifts are as varied as the donors themselves. The donor may be looking to minimize future estate settlement costs by using joint tenancy or a trust as the devolutionary device. Perhaps the prime objective is to avoid having to manage the assets or see a loved one enjoy the use of the property now. Gifts can also help support an elderly relative or provide a child funds to purchase a house or seize a business opportunity. And maybe the most important non-tax reason of all, donors make gifts purely as a way of showing love and affection for the donees. The reasons cited are not intended to be exhaustive. They are merely illustrations of the numerous qualitative concerns of the estate planner.

dividend at the middle of each year. The brother sells the stock.

In Situation I, if Donor had retained the money and earned eight percent interest on it, at the end of the year he would have had $5,200. This amount is computed as follows: the original $5,000 plus $400 of interest ($5,000 at eight percent) minus the $200 tax liability ($400 at fifty percent). By making the gift, Donor avoids the $200 tax liability, but has parted with $5,000 plus the $200 after-tax interest he would have earned. In all, he has saved $200 at a cost of $5,200.

In Situation II had Donor retained the land and sold it himself he would have realized an $8,000 gain. If the asset qualified for favorable capital gain treatment,[24] the net effect would have been a $3,200 increase to his taxable income,[25] and a concomitant $1,600 tax liability. At year's end he would have had $18,400.[26] By making the gift, Donor avoided the $1,600 tax liability, but at a cost of $18,400. If the net capital gain deduction was not available, then the $8,000 gain would have generated a $4,000 tax liability.[27] This would have resulted in a $16,000 transfer being made to avoid a $4,000 tax exposure.

In Situation III, retention of the stock would have meant $1,000 in dividend income plus $2,400 of includable gain from the sale after applying the net capital gain deduction. This $3,400 of additional income would have resulted in another $1,700 of tax for Donor. He then would have had $9,300.[28] Instead, by making the gift he has avoided a $1,700 tax liability at a cost of $9,300 in lost capital. If the net capital gain deduction was not available, the tax saving escalates to $3,500 and the lost capital is reduced to only $7,500.[29]

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24. Generally, § 1221 considers all property held by a taxpayer to be a capital asset except for items specifically excluded by subsections (1) through (5). I.R.C. § 1221 (Law. Co-op. 1974 & Supp. 1984). For purposes of the example, as long as the land is not inventory, held primarily for sale to customers, or used in a trade or business by the donee, it will be a capital asset in his hands. Even if the land is used in a trade or business, it may be treated as a capital asset. *See id.* § 1231(a). The taxpayer must have a net capital gain to obtain favorable treatment. *See supra* note 19.
25. The $3200 is the result of the recognized gain of $8000 (amount realized of $20,000 in excess of the $12,000 adjusted basis; *see* I.R.C. § 1001(a) (Law. Co-op. 1974 & Supp. 1984)) minus the § 1202 capital gain deduction of $4800 (48000 – .6).
26. This figure reflects the deduction of the $1600 tax liability from the $20,000 in proceeds received on the sale of the land.
27. Without the § 1202 deduction the full $8000 gain would be subjected to the 50 percent marginal tax rate and create the $4000 figure.
28. The sale proceeds of $10,000 added to the dividends of $1000 ($11,000 income) minus the $1700 tax cost equals $9300.
29. Again the § 1202 deduction is instrumental. I.R.C. § 1202 (Law Co-op. 1974 & Supp. 1984). Without the deduction the taxable gain is the full $6000 ($10,000 amount realized in excess of $4000 adjusted basis; *see id.* § 1001(a)). The donor's taxable income is $7000 ($6000 plus the $1000 dividend income) which at a marginal tax rate of 50 percent generates a $3500 liability. Since the tax liability would

One need not be an astute estate planner nor a sophisticated mathematician to conclude that the pure income tax numbers by themselves do not justify gift giving. Donors, however, make gifts for a myriad of reasons and not just to minimize taxes.[30] Although the tax numbers may not justify the gift, tax factors can be added to other considerations to assist in the overall "give or keep" decision. Once a donor has decided to make the gift, the tax savings can serve to reduce the cost of implementing that decision. Viewing the three hypothetical situations from the donees' perspectives, and comparing them with the "donor-retention" results, demonstrates the worthiness of tax incentives for gift giving.

In Situation I, upon receiving the $5,000, the son incurs no adverse income tax exposure.[31] The $400 of interest generated that year is, of course, required to be included in his income. Utilizing the donee's twenty percent marginal tax bracket, there is an $80 tax liability, and the donee will have $5,320 of after-tax dollars at year's end. The bottom line shows that a $5,320 benefit (post-tax dollar's on hand) was conferred upon the son at a net capital cost of $5,200 to the donor. The $120 difference is absorbed by the unintended "donor" in the transaction—the government. Although, in this instance, the government's "gift" is relatively small, with higher rates of return and lower donee tax brackets, better results through increased government participation can be obtained.

In Situation II, the daughter receives the land tax free and takes a $12,000 carry-over basis in it.[32] Since the land is vacant, there are no annual earnings to account for. Upon selling the land, the daughter will realize an $8,000 gain and, assuming she can qualify for the net capital gain deduction, will essentially include only $3,200 in her taxable income.[33]

At the daughter's marginal tax rate the sale will generate a $640 tax liability, leaving her with $19,360: the $20,000 gross receipt minus the $640 tax cost. This provides a $19,360 benefit received at a cost of only $18,400 to the Donor. The government effectively added $960 to the Donor's gift. If the capital gain deduction were unavailable, she would be forced to account for the full $8,000. This would result in a

have been $3500, had the donor retained the property, his after tax amount would be $7500 ($11,000 gross receipts minus the $3500 tax cost).

30. A major aspect of estate planning is devoid of tax considerations and is concerned principally with the devolution of property. To this end the income tax consequences are of little importance. *See supra* note 23 for discussion and rationale of this argument.

31. I.R.C. § 102(a) (Law. Co-op. 1974 & Supp. 1984).

32. *Id.* §§ 102(a), 1015(a). As previously discussed these two sections are the operating rules for donees. *See supra* notes 11-15.

33. As was the case with the donor, the 60 percent § 1202 deduction will reduce the $8000 gain by $4800 to $3200. *See supra* note 25.

$1,600 tax liability, leaving Donor with only $18,400 after-tax dollars. In this instance, the government's part of the gift would be increased to $2,400.[34] The government's largesse is becoming impressive.

Not surprisingly, Situation III yields a combination of results obtained in the previous two examples. Again, the brother receives the value of the stock tax free but takes a $4,000 carry-over basis, and must report the $1,000 dividend income as his own. Upon disposition of the stock, a $6,000 gain is realized which will, assuming the availability of the net capital gains deduction, increase taxable income by $2,400. The $43,400 of income to the donee will result in a $680 tax liability, and reduce his after-tax receipt to $10,320 ($11,000 minus $680). If the net capital gain deduction is not available, the tax liability would be $1,400, leaving the brother with $9,600 after taxes. The comparative results are as expected. With favorable long term capital gain treatment, the Donor confers a $10,320 benefit at a $9,300 cost to himself. Without it, the benefit is $9,600 at a cost of $7,500.

The examples clearly demonstrate that, although there are income tax benefits associated with gift, such benefits are insufficient to be the sole motivating force to compel a transfer. There can be government participation in the gift, which in certain circumstances can be quite substantial. But even in the best of situations the tax savings cannot overcome the loss of capital. Moreover, this conclusion is not altered by the mere fact that assets generating ordinary income provide greater tax benefits as opposed to net capital gain. Some assets will produce greater "value received to value relinquished" ratios. However, the ratio bears primarily on the choice of asset to be given, and not on the actual decision of whether or not to make the gift.

Despite the inability to generate sufficient tax benefits to justify making gifts, there is mathematical support which indicates that there are some tax rewards for donors. In the proper circumstances, donors can save tax dollars and maximize transferred values at the government's expense. Thus, even though recent changes to tax rates have minimized the rate spread, and consequently reduced the government's particpation in the gift, income tax advantages can be obtained by making gifts.

A simple analysis of the numbers in the illustrations evince that the donor's only tax saving is on the income element that is transferred; and then, only at the donor's marginal tax bracket. The government's "gift" equals the income element multiplied by the spread between the donor's and the donee's marginal tax bracket. When the

34. Even though the daughter has less in her pocket after taxes than she did when favorable capital gains treatment was available, this is more than offset by the fact that the donor's capital cost is less. Without the § 1202 deduction, the donor parted with $16,000; thus, the daughter's $18,400 exceeds the donor's cost by the $2,400.

income element represents a relatively small percent of the value of the gift, large values are transferred with the receipt of only minor tax benefits and little governmental largesse. Not surprisingly, this sometimes small savings-to-value ratio has prompted a variety of attempts to shift only the income element without the concomitant loss of ownership and control of the property. These assignment of income techniques generally have met with little success.

In *Lucas v. Earl*,[35] the grandfather of the assignment of income cases, Justice Holmes declared that skillfully "devised contracts . . . by which the fruits are attributed to a different tree from that on which they grew,"[36] would not be recognized for tax purposes. Similarly, in *Helvering v. Horst*,[37] the Court stated in essence that the same theory applied to ownership of property. For tax purposes, an owner could not "gift" away the income generated by the asset while retaining ownership of the rest of the property. The issue of how much dominion and control one could retain and not be taxed on the income was tested in *Helvering v. Clifford*.[38] The *Clifford* Court concluded that transferring away beneficial ownership for a short time span (five years), but retaining substantial control over the property as trustee, was insufficient to shift the tax consequences away from the donor-trustee. Subsequently, Congress enacted the grantor-trust provisions.[39] The primary function of these provisions is to identify those situations in which tax consequences will be attributed to the grantor of a trust even though the trust (or its beneficiaries) would seem to be the appropriate taxpayer(s).[40] In setting out the parameters of control which will cause the attribution of income tax consequences to the grantor, a substantial exception was made for the

35. 281 U.S. 111 (1930).
36. *Id.* at 115.
37. 311 U.S. 112, 120 (1940).
38. 309 U.S. 331, 335-36 (1940).
39. With the enactment of the Internal Revenue Code of 1954, Congress included §§ 671-78 which are commonly referred to as the grantor trust provisions. In reference to these provisions, the House of Representatives report explained that "[t]he effect of this provision is to insure that the taxability of *Clifford* type trusts shall be governed solely by this subpart," and that the provisions would follow the *Clifford* analysis. *House Comm. on Ways and Means, Internal Revenue Code of 1954*, H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A212, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4025, 4351-52.
40. I.R.C. Subchapter J §§ 641-83 (Law. Co-op. 1974 & Supp. 1984), provides the complex and sometimes arcane rules of trust and trust beneficiary taxation. The basic rules, however, recognize the trust as a separate entity, with tax consequences relating to trust transactions accountable by the trust and not the grantor. In the simple trust setting where all of the trust income is required to be paid out, beneficiaries will probably ultimately bear the full tax consequences. In complex trusts where accumulations are permitted, the trust itself may well bear the tax burden. The taxation of trusts is well beyond the scope of this work. For a complete discussion of trust taxation, see J. MERTENS, *supra* note 14, at § 36.

"short term" or "Clifford Trust."[41] The exception permits the grantor to retain an otherwise fatal tax reversionary interest in the corpus of a trust provided that it will not take effect within ten years from the creation of the trust.[42] Thus, a trust providing for a reversion of corpus ten years and one day from creation will, providing it does not run afoul of other grantor-trust provisions, permit the income during that period to be shifted away from the grantor and on to the beneficiary. A trust with an interest reverting to the settlor upon the death of an income beneficiary also avoids grantor-trust treatment, even if the life expectancy of the income beneficiary is less than ten years.[43] It is worth noting, however, that to the extent these trusts can shift income tax consequences to beneficiary-donees, the donor must part with dominion and control over the property for the operational period in order to obtain any tax benefits.[44]

Even if one is willing to part with dominion and control, a shifting of the income cannot always be assured.[45] The government will question the donors' timing, motives and genuineness of transfer when it believes income is improperly moving away from the transferor. The

41. I.R.C. § 673 (Law. Co-op. 1974 & Supp. 1984).
42. The code provides that a grantor "shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom" if the interest begins within 10 years of the transfer of date of that part of the trust. *Id.* § 673(a). *See also* Treas. Reg. § 1.673(a)-1 (1960) (reversionary interests).
43. I.R.C. § 673(c) (Law. Co-op. 1974 & Supp. 1984). *See also* Treas. Reg. § 1.673(a)-1(b) (1960) (discussing § 673(c)).
44. A review of the grantor trust provisions may be helpful at this point. Section 671 provides that the "owner" of a trust account for all of the income tax consequences of the trust. Section 673 explains that a grantor who retains a reversionary interest in the trust is the owner of the trust, but carves out an exception if such interest will not take effect for at least ten years and one day or until the death of the income beneficiary. Section 674 explains that the grantor may be considered the owner of a trust if he (or a nonadverse party. *See infra* note 59) has the power to determine who can receive the income from the trust. Section 675 speaks to problems arising when the grantor or nonadverse parties hold merely administrative powers over the corpus of the trust. Section 676 attributes the trust's tax consequences to the grantor if he or a non-adverse party can revoke the trust. Section 677 provides that the grantor can be the owner of the trust even if he does *not* receive its income directly. Finally, § 678 permits ownership to be attributed to a third person who is not the grantor and who may not be a beneficiary if (1) this third party has the power to obtain trust income for his own benefit, and (2) the grantor is not considered the owner. *See generally* B. BITTKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 80 (1981); J. MERTENS, *supra* note 14, at § 37.
45. *See, e.g.,* Salvatore v. Commissioner, 29 T.C.M. (CCH) 89 (1970) (addressing the problem of "ripe" fruit for which taxpayers must take account despite outright transfers and the independent integrity of such transfers); Rev. Rul. 69-102, 1969-1 C.B. 32. *See generally* Eustice, *Contract Rights, Capital Gains and Assignments of Income*, 20 TEX. L. REV. 1 (1964); Lyon & Eustice, *Assignment of Income; Fruit and Tree as Irrigation by P.G. Lake*, 17 TAX L. REV. 293 (1962).

recent spate of cases challenging the income deflecting efficacy of "family estate trusts" is the latest round in the government's effort to prevent gratuitous transfers from generating unwarranted income tax benefits.

Although there are variations, the central theme of the "family estate trust" is to have the trust tax account for income putatively earned by the trust through the grantor's efforts. Then, the trust pays the grantor's personal living expenses and deducts them from its income. The grantor assigns beneficial interests in the trust to different family members so that any tax accountability for distributed trust income can be spread over more than one taxpayer. Theoretically, such a procedure reduces the grantor's tax liability through the effective deductibility of otherwise non-deductible items[46] and the deflection of income to close family members.[47] However, the government has attacked the income shifting efficacy of this type of trust on three theories: anticipatory assignment of income;[48] application of grantor-trust provisions;[49] and lack of economic reality, i.e., a sham transaction.[50] These theories are not mutually exclusive, and the government freely argues any combination of the three.[51] Revenue Ruling 75-257[52] provides a clear view of the government's approach.

In Revenue Ruling 75-257, the grantor transferred into a "Family Estate Trust" his personal residence, apartment building, and income producing securities. The grantor also executed an exclusive "lifetime services" contract entitling the trust to all future income earned by him regardless of its source. Despite this contract, the grantor's employer continued to remit salary to the grantor, who in turn endorsed the paychecks over to the trust. The grantor received certificates representing beneficial ownership of the trust. The grantor, his wife and a third party were made trustees with broad powers includng the abil-

46. The trust deducts as business expenses under § 162, I.R.C. § 162 (Law. Co-op. 1974 & Supp. 1984), items which § 262 would prohibit the grantor from deducting on his own return.

47. Generally, by spreading the income among family members one can cause the income to be taxed in lower marginal tax brackets and, perhaps, through the use of otherwise unused zero bracket amounts eliminate the tax entirely.

48. *See, e.g.*, Loeffler v. Commissioner, 46 T.C.M. (CCH) 1153 (1983); Belshaw v. Commissioner, 45 T.C.M. (CCH) 1062 (1983); Clifton v. Commissioner, 45 T.C.M. (CCH) 999 (1983).

49. *See, e.g.*, Schultz v. Commissioner, 686 F.2d 490 (7th Cir. 1982); Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980); Kirst v. Commissioner, 45 T.C.M. (CCH) 1053 (1983).

50. *See, e.g.*, Holman v. United States, 728 F.2d 462 (10th Cir. 1984); Landsberger v. Commissioner, 692 F.2d 501 (8th Cir. 1983); Patsey v. United States, 84-1 TAX CT. REP. DEC. (P-H) ¶ 9304 (1984); Kelley v. Commissioner 46 T.C.M. (CCH) 380 (1983); Swayze v. Commissioner, 45 T.C.M. (CCH) 1104 (1983).

51. *See, e.g.*, Bensen v. Commissioner, 46 T.C.M. (CCH) 955 (1983); Whitesal v. Commissioner, 45 T.C.M. (CCH) 474 (1983).

52. Rev. Rul. 75-257, 1975-2 C.B. 251.

ity to deal with trust assets as they deemed fit and to make distributions to trust employees and themselves as compensation for services to the trust. The trustees were given total discretion in their actions and did not require court permission or approval to perform any trust act. A majority vote of the trustees was all that was needed for any action to be taken by the trust, except termination required unanimous consent. Both the grantor and his wife were deemed to be employees of the trust and were entitled to compensation for their services. The grantor and his family were permitted to reside in the residence transferred in trust as a convenience to the employer-trust. The trust also paid living costs and provided health care to the employees and their family.

The ruling took a two-part approach to defeat the trust's attempt to declare the income and deduct the employees' living expenses. It segregated the employment contract from income producing property and attacked them separately. As to the former, the ruling cited well established authority to support the proposition that income cannot be anticipatorily assigned, even if done irrevocably.[53] The "true earner of income," determined by a factual determination of control over the earning of the income,[54] is taxed for its production.[55] Based upon the facts, the ruling brushed aside any notion of the grantor serving as a mere nominee for the trust with respect to the salary and determined the real employer-employee relationship to be between the grantor in his individual capacity and his employer corporation. The trust had no more than the right to receive salary already earned by the grantor, and, accordingly, the income belonged to the grantor.[56]

The ruling dismantled the taxpayer's tax scheme with respect to the deductibility of the grantor's living expenses through the trust by taking recourse to the grantor-trust provisons.[57] Moreover, application of these provisions also works to attribute the income produced by the properties that were transferred to the trust back to the grantor. The ruling concluded that any one of three grantor-trust provisions, section 674, section 676 or section 677, or a combination thereof, was applicable and triggered section 671, forcing the grantor to account for the attributes of the trust with his other individual tax

53. *Id.* (citing United States v. Basye, 410 U.S. 441 (1973)). *See also* Commissioner v. Culbertson, 337 U.S. 733 (1949); Lucas v. Earl, 281 U.S. 111 (1930).

54. *See* American Sav. Bank v. Commissioner, 56 T.C. 828, 839 (1971).

55. *See* Galt v. Commissioner, 216 F.2d 41, 46 (7th Cir. 1954).

56. The ruling concludes that the assignment of income to the trust is of no consequence. Rev. Ruling 75-257, 1975-2 C.B. 251 (citing Comer v. Davis, 107 F.2d 355, 358 (5th Cir. 1939)); *In re* Gorham, 38 B.T.A. 1450, 1455 (1938); Luce v. Burnet, 18 B.T.A. 923, 924 (1930), *aff'd*, 55 F.2d 751 (D.C. Cir. 1932)).

57. I.R.C. §§ 671-678 (Law. Co-op. 1974 & Supp. 1984) discussed *supra* note 44. *See also* Treas. Reg. §§ 1.671-678 (1956).

items.[58]

The pivotal aspect of the trust that caused it to run afoul of the grantor-trust provisions was the fact that trustees, other than the grantor, were non-adverse parties.[59] Under section 674(a) a grantor is the owner of a trust wherein the beneficial employment of the corpus of income therefrom is under the control of the grantor, or a nonadverse party, or both, without the consent or approval of an adverse party. Since there were no adverse parties under the trust, and a majority of the trustees (who were the grantor and nonadverse parties) had unfettered control of the trust, section 674(a) applied. Section 676(a) treats the grantor as owner of a trust when title can be revested in him by himself, a nonadverse party, or both. Since unanimous consent by the grantor and the nonadverse party trustees could terminate the trust and revest title to the grantor, Section 676(a) applied. Section 677(a) treats the grantor as owner of a trust to the extent that its income, without the consent of an adverse party, or in the discretion of the grantor or non-adverse party, or both can be distributed or accumulated for the benefit of the grantor or his spouse. Although the instrument was silent as to the distributions to any beneficiary, the ruling concluded that under the inherent authority conferred in the instrument the trustees had made such distributions by discharging the grantor's obligations for housing and health care. Therefore, section 677 was also applicable. Through any one or combination of these sections the trust was deemed a grantor trust and its tax attributes were reportable by the grantor as his own. The income from the property was his own,[60] and all of the living expenses were treated as though they were made by him and were thus nondeductible.[61]

58. Rev. Rul. 75-257, 1975-2 C.B. 251, 254. Section 671 specifically provides that the grantor is considered the owner of any part of the trust to which any of the operative sections apply. As owner, all of the tax attributes to the trust including income, deductions, and credits are considered to be those of the grantor individually. I.R.C. § 671 (Law. Co-op. 1974 & Supp. 1984). *See also* Treas. Reg. § 1.671-1, T.D. 7148, 1971-2 C.B. 251, T.D. 7741, 1981-1 C.B. 430, 432; § 1.671-2 (1956).

59. Rev. Rul. 75-257, 1975-2 C.B. 251, 253. The definitions of an adverse and nonadverse party are found in I.R.C. § 672(a), (b) (Law. Co-op. 1974 & Supp. 1984). An adverse party is one with an interest in the trust. *Id.* § 672(a). On the other hand, a nonadverse party is simply a person who is not an adverse party. *Id.* § 672(b). *See also* Treas. Reg. § 1.672 (the determination of whether a party is or is not an adverse party is a question of fact, citing Paxson v. Commissioner, 57 T.C. 27 (1972)). In this ruling, a third party trustee and the wife, neither of whom had a beneficial interests, were not adverse parties.

60. Through this analysis it should become apparent that even if the assignment of income argument failed and the trust was the proper wage earner, all of the income would nonetheless be chargeable to the grantor. I.R.C. §§ 671, 674, 676, 677 (Law. Co-op. 1974 & Supp. 1984).

61. *Id.* § 262. A taxpayer cannot deduct his personal living expenses. Of course, to the extent that any of the expenses qualify under other sections of the code, they

The courts have been equally hostile to the family estate trust scheme when used as a device for minimizing tax obligations. In *Wesenberg v. Commissioner*,[62] one of the first tax court cases confronted with the family estate trust, tax planners were alerted in no uncertain terms that the trust scheme was *persona non grata*. The *Wesenberg* facts are identical to those of Revenue Ruling 75-257 with one slight variation.[63] Although Wesenberg personally executed a contract with a bona fide employer, the employer agreed to make all salary payments directly to the trust. Despite the payment arrangement the court held that the assignment of income doctrine controlled. The court noted that the most cogent theory to attribute the income to the trust would be to say that Wesenberg was a servant or agent of the trust.[64] After reviewing the facts the court concluded that there was no factual basis upon which the taxpayer could support such a position. Of particular interest to the court was the fact that Wesenberg himself, and not the trust, was personally obligated under the contract to the bona fide employer. This created skepticism as to whether the trust could ever enforce the contract and require Wesenberg to perform his duties under its terms.[65]

Having disposed of the employment contract issue, the court went on to apply the grantor-trust provisions to attribute all income earned from the trust property back to the taxpayer.[66] Similarly, once section 671 was triggered, all payments made by the trust were related back to Wesenberg and their deductibility had to stand or fall on their own merits as expenses made by an individual in a personal capacity.[67] This of course precluded a deduction for all of the personal expenses that were not specifically made deductible by statute.[68] Also, since the trust lost its separate tax identity, it was foreclosed from arguing that the expenses were properly deductible as expenses incurred in a trade or business,[69] or for the production of income.[70] Moreover, by disre-

would be permissible deductions. For example, mortgage interest could be deductible, *id.* § 163, as could health care costs to the extend that they exceed the five percent adjusted gross income threshold. *Id.* § 213(a).

62. 69 T.C. 1005 (1978).
63. *See supra* note 52 and accompanying text.
64. Wesenberg v. Commissioner, 69 T.C. 1005, 1010 (1978).
65. *Id.* at 1011.
66. *Id.* at 1011-14.
67. *Id.* at 1012.
68. *See supra* note 61. In addition to the previously mentioned permissible deductions, one could also deduct certain taxes. I.R.C. § 164 (Law. Co-op. 1974 & Supp. 1984).
69. The code permits the deduction for expenses incurred in a trade or business. *Id.* § 162. The § 162 deduction was denied in Annis v. Commissioner, 47 T.C.M. (CCH) 1341 (1984), where the taxpayer attempted to deduct the cost of clothing, cleaning, auto, housing, utilities, job placement, and legal expenses after transferring property and services to a family estate trust.

garding the trust for tax purposes, the issue of excludibility of meals and lodging provided for the convenience of the employer to an employee was sidestepped.[71] In all, the end result was a complete disregard of the trust for tax purposes and tax treatment for the settlor as if the trust had never been established.

Employing the same rationale used by the tax court, the circuit courts have also soundly repudiated the "family estate trust" as a legitimate means of minimizing or shifting tax obligations.[72] As further evidence of disenchantment with the scheme, the courts have denied taxpayers deductions sought for expenses incurred in setting up the trusts on the grounds that such costs have not been shown to be anything other than nondeductible personal expenses.[73] Some taxpayers have taken a more clever tack in seeking deductions for the set-up costs. After the determination that the trust scheme has failed, the settlor contends that he was swindled by the promoter who presented the family trust concept and took a fee for establishing it, and thus was entitled to a theft loss. Not surprisingly this theory has also been rejected.[74] Moreover, the judiciary is quite willing to approve negligence penalties[75] assessed on these transactions,[76] and has issued an injunc-

70. I.R.C. § 212 (Law. Co-op. 1974 & Supp. 1984). *See* Benningfield v. Commissioner, 81 T.C. 408 (1983).
71. I.R.C. § 119 (Law. Co-op. 1974 & Supp. 1984). Presumably, a taxpayer would rely on § 119 as a means for excluding from income expenses paid by the trust for the grantor's meals and lodging.
72. *See, e.g.*, Holman v. United States, 728 F.2d 462 (1984); O'Donnell v. Commissioner, 726 F.2d 679 (1984) (family trusts have been universally condemned and found it "incredible" that the taxpayer believed he could distinguish his trust because payments were funneled through him as an individual, rather than directly to the trust); Hanson v. Commissioner, 686 F.2d 490 (7th Cir. 1982); Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980).
73. Gran v. Commissioner, 664 F.2d 199 (8th Cir. 1981) (holding that property held by the trust was not intended to produce income and § 212(a) would not apply to the costs of establishing the trust). *See also* Belshaw v. Commissioner, 45 T.C.M. (CCH) 1062, 1063 (1983) (cost of trust materials not deductible when expended to retain ownership of property); Contini v. Commissioner, 76 T.C. 447 (1981) (deduction disallowed since nothing in record indicated trust materials related to tax preparation or legal assistance in tax matters); Kirst v. Commissioner, 45 T.C.M. (CCH) 1053, 1057 (1983) (materials used to create trust are non-deductible personal expenditures).
74. I.R.C. § 165(c)(3) (Law. Co-op. 1974 & Supp. 1984). The Tax Court has rejected the theft loss argument. *See* Crowder v. Commissioner, 48 TAX CT. MEM. DEC. (CCH) 1359 (1984); Luman v. Commissioner, 79 T.C. 846 (1982).
75. I.R.C. § 6653(a) (Law. Co-op. 1974 & Supp. 1984). Section 6653(a)(1) provides for a penalty equal to five percent of any underpayment of tax due to negligent disregard of the tax rules and regulations.
76. The Tax Court and the Circuit Courts have upheld the negligence penalty in a number of cases. *See* Hanson v. Commissioner, 696 F.2d 1232 (9th Cir. 1983); Schultz v. Commissioner, 686 F.2d 490 (7th Cir. 1982); Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980); Zettner v. Commissioner, 48 TAX CT. MEM. DEC. (CCH) 981 (1984); Bennington v. Commissioner, 81 T.C. 408 (1983).

tion against future promotion of the scheme.[77] The lesson to be learned is undeniably clear: the "family estate trust" will neither deflect income nor pay personal expenses on a tax deductible basis for its settlor or beneficiaries.

Perhaps an unfortunate sidelight for some "family estate trust" settlors is the loss of the baby with the bathwater. The tax benefits available to bona fide donors transferring property beyond their domain and control,[78] even if in trust, are lost when any of the grantor-trust provisions apply. When a trust is recognized as having independent integrity for tax purposes, it must account for income earned by its property.[79] Therefore, a settlor could fund a trust with income producing property and effectively deflect the earned income away from himself.[80] But section 671 does not distinguish income that legitimately could be shifted away from that which is anticipatorily assigned improperly. The section operates to attribute to the settlor the tax consequences of all items associated with that part of the trust he is deemed to own. The price for overreaching is the loss of benefits which could have been obtained.

Notwithstanding the "family estate trust" debacle, trusts can be valuable tax planning vehicles. To the extent the grantor-trust provisions can be avoided, significant tax benefits can be achieved. The protection from section 671 afforded the "Clifford" or "short term" trust makes it a very popular tax planning device. Common and relatively simple uses of this type of trust include its use to support non-dependents[81] or to assist in a low cost accumulation of funds for future use.[82]

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77. United States v. Landsberger, 692 F.2d 501 (8th Cir. 1982).

78. In order to make a valid gift, the donor must, to the best of his ability, relinquish all rights of ownership. That is, the donor can no longer exercise dominion and control over the property. *See* Corliss v. Bowers, 281 U.S. 376 (1930) ("[I]ncome that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income whether he sees fit to enjoy it or not."). *See also* Kuney v. Frank, 308 F.2d 719 (9th Cir. 1962) (retention and exercise of control over income in family partnership is taxed as income to donors of partnership interest); Parkhill v. United States, 385 F.Supp. 204 (N.D. Tex. 1974) (continued exercise of incidents of ownership afford ample basis for taxation of income to the donor of the interest); Stokes v. Commissioner, 22 T.C. 415 (1954); Desks, Inc. v. Commissioner, 18 T.C. 674 (1952).

79. *See supra* note 40.

80. It would seem that if the settlor could shift the income to the beneficiary through this gratuitous transfer and, in turn, the donee could exclude the receipt because it was a gift, the income would go untaxed. Such a scenario is too good to be true and of course is not permissible. Section 102(b) specifically provides that gifts of income are not covered by the general excludability rule of the section. I.R.C. § 102 (Law. Co-op. 1974 & Supp. 1984). *See also* Treas. Reg. § 1.102-1(c) (1956).

81. This is a common method for shifting an elderly relative. The income is paid directly to the individual who uses it for his or her support. The income is chargeable to the beneficiary and consequently does not force the grantor to use his after tax dollars on otherwise non-deductible costs.

82. A college fund can be developed in this way. A greater amount of money can be

Both objectives can be attained at a reduced tax cost because the trust income is taxed to the beneficiary, who is presumably in a lower tax bracket than the settlor. Thus the same amount of value can be provided to the beneficiary at a lower overall cost.[83]

The urge to maximize tax benefits has spawned attempts at more sophisticated uses of the Clifford trust which offer additional advantages to settlors. The "gift and leaseback" technique is one example.[84] Under such an arrangement, the settlor transfers property used in his trade or business to the trust, the income beneficiary of which is usually a close relative in a lower marginal tax bracket. The settlor then "leases back" the property from the trust. Rental payments on the lease are deductible by the settlor[85] and constitute income to the trust.[86] The settlor has generated deductible payments that pass to his intended beneficiary, who will in turn tax account for them with the benefit of potentially offsetting deductions.[87] Despite government opposition, the technique has received substantial, but not complete, judicial approval.[88] Other attempts for extra benefits have met a

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built up by subjecting the fund to the lower tax bracket of the child beneficiary rather than with the grantor trying to accumulate after tax dollars in his higher tax bracket.

83. The mathematics are relatively simple. Assume grantor and beneficiary are in 50 percent and 20 percent marginal tax brackets, respectively. If the beneficiary needs $5,000 for support it would cost the grantor $10,000 in pre-tax dollars to supply it (in a 50 percent tax bracket it takes two dollars of pretax income to generate one dollar of after tax wealth). On the other hand, the grantor may fund a Clifford Trust with just enough property to produce only $7,142 of income and achieve the same result. The $7,142 of income will generate a $2,142 tax liability for the beneficiary and leave him with $5,000 after taxes. The use of this technique reduces the overall tax cost of providing support by $2,858.

84. A gift-leaseback transaction need not employ a Clifford Trust, nor a trust at all. *See, e.g.*, White v. Fitzpatrick, 193 F.2d 398 (1951), where the taxpayer made an outright transfer of the property that was leased back. *But see* Coombs v. Commissioner, 48 TAX CT. MEM. DEC. (CCH) 534 (1984). (Taxpayer was considered owner and deuction for lease payments was denied.)

85. I.R.C. § 162 (Law. Co-op. 1974 & Supp. 1984) (permitting a deduction for ordinary business expenses).

86. As owner of the property the trust is properly accountable for the income it generates. *See supra* note 14.

87. Since the property is being leased, it can be considered to be "producing income." The trust could, therefore, qualify for depreciation and other incidental upkeep deductions.

88. The gift-leaseback technique has, to varying degrees, been accepted by both the Tax Court and the numerous federal courts of appeals. In Mathews v. Commissioner, 61 T.C. 12 (1973), the Tax Court established the following four criteria for determining whether or not the rental payments were deductible:

1) The grantor must not retain substantially the same control over the property that he had before he made the gift.

2) The leaseback should normally be in writing and must require a reasonable rent.

3) The leaseback must have a bona fide business purpose.

different fate. In two instances[89] the Tax Court thwarted taxpayers in their efforts to fund Clifford trusts with promisory notes and deduct on their personal tax returns the interest paid thereon. The court concluded that because such notes given as gifts were unenforceable under applicable state law, there was no bona fide debtor-creditor relationship and therefore the interest was not deductible.[90] Doubtlessly this setback will not deter the search for further creative uses of non-grantor trusts.

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4) The grantor must not possess disqualifying "equity" in the property within the meaning of section 162 (a)(3).

These criteria have consistently been used by the Tax Court. *See* Wolfe v. Commissioner, 48 TAX CT. MEM. DEC. (CCH) 919 (1984). Matthews v. Commissioner, 61 T.C. 12, at 18-20 (1973). However, three years prior to the *Mathews* decision, the Ninth Circuit in Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972), developed its own guidelines consisting of: (a) the duration of the tranfer; (b) the controls retained by the donor; (c) the use of the property for the benefit of donor; and (d) the independence of the trustee. *Id.* at 1157. The Ninth Circuit reaffirmed these criteria in May v. Commissioner, 723 F.2d 1434 (9th Cir. 1984).

In addition to the Ninth Circuit, the gift-leaseback has also been approved by the Second, Third, Seventh, and Eighth Circuits. *See* Rosenfeld v. Commissioner, 706 F.2d 1277 (2nd Cir. 1983); Quinlivan v. Commissioner, 599 F.2d 269 (8th Cir. 1979); Brown v. Commissioner, 180 F.2d 926 (3rd Cir. 1950); Skemp v. Commissioner, 168 F.2d 598 (7th Cir. 1948). In *Rosenfeld*, a case involving the gift-leaseback of a doctor's office, the court relied on the *Mathews* criteria and found that the rental payments were deductible. The court rejected the argument of the IRS that the whole transaction, and not just the leaseback, must be imbued with a valid business purpose. Rosenfeld v. Commissioner, 706 F.2d 1277, 1281 (2nd Cir. 1983). The view of the IRS has been accepted by both the Fourth and the Fifth Circuits. *See, e.g.*, Mathews v. Commissioner, 520 F.2d 323 (5th Cir. 1975), *rev'g* 61 T.C. 12 (1973); Perry v. United States, 520 F.2d 235 (4th Cir. 1975); Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965). These decisions required the whole transaction to have a business purpose. Peroni, *Untangling the Web of Gift-Leaseback Jurisprudence*, 68 MINN. L. REV. 735 (1984). *See generally* Comment, *Is Trustee Independence a Prerequisite to Deductible Gift-Leaseback Rental Payments? May v. Commissioner*, 56 ST. JOHN'S L. REV. 156 (1981); Comment, *Gift Leaseback Transactions: An Unpredictable Tax-Savings Tool*, 53 TEMPLE L.Q. 569 (1980); Note, *Taxation-Grantor Control and its Effect on Gift-Leaseback Deductions*, 15 SUFFOLK U.L. REV. 1067 (1981); Note, *Use of Gift-Leaseback to Shift Income Given Substantial Boost by New Decision*, 12 TAX FOR LAW. 128 (1983); Note, *Gifts and Leasebacks: Is Judicial Consensus Impossible*?, 49 U. CIN. L. REV. 379 (1980).

89. Swecker v. Commissioner, 46 T.C.M. (CCH) 552 (1983); Strimling v. Commissioner, 46 T.C.M. (CCH) 211 (1983).

90. Swecker v. Commissioner, 46 T.C.M. (CCH) 552, 553-54 (1983) (concluding that since no consideration was given, the donee could not enforce the note against the donor and thus the payment of interest was gratuitous); Strimling v. Commissioner, 46 T.C.M. (CCH) 211, 212 (1983). *See also* Knetsch v. United States, 364 U.S. 361 (1960); Rev. Rul. 82-94, 1982-1 C.B. 31. This ruling addressed a situation where parents loaned $50,000 to their son, who then lent the money back to his parents in exchange for a mortgage note. The son received $8760 per year in interest (his educational costs amounted to $8000 per year). A § 163(a) interest deduction was not permitted because a debtor/creditor relationship was not considered to exist between the parties.

Gifts are also capable of providing secondary tax benefits. Cash-strapped donees could use a gift as the source of funds needed to take full advantage of retirement or employment benefits that they might otherwise have to forego. A contribution to an Individual Retirement Arrangement that could not have been afforded without receipt of the gift not only provides the donee with an immediate tax deduction but also postpones taxation of any income earned until withdrawals are made.[91] Similar benefits can be had through Keough,[92] section 401(k),[93] and other employer benefit plans.[94] Gifts can supply the means for donee access to other types of benefits. For example, in *Ruch v. Commissioner*,[95] a taxpayer was able to use money gifted to him by his mother to pay for his medical costs and thereby entitle him not only to a medical expense deduction,[96] but also to a dependency exemption[97] and favorable head of household filing status.[98]

It seems that as long as taxpayers are free to make tax saving maneuvers they will continue to do so in the search for the better "tax mouse trap." Tax planners must, however, be cognizant of the operating rules and be prepared to deal with the issue of deciding where legitimate tax avoidance ends and perhaps illegal tax evasion begins. Years of wrestling with this problem has not brought a totally satisfactory response, and probably none is forthcoming. Many transactions will continue to fall into gray areas and in turn force the judiciary to brighten the boundary lines for successful tax saving transactions.

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91. I.R.C. §§ 219, 408 (Law. Co-op. 1974 & Supp. 1984).
92. *Id.* § 401. A Keough plan is a retirement plan for the self-employed. For a thorough discussion of these plans, see Zadora, *Keough (H.R.10) Plans: Questions and Answers*, 61 MICH. B.J. 146 (1982).
93. I.R.C. § 401(k) (Law. Co-op. 1974 & Supp. 1984) (generally tax favored salary reduction plans). The gift could make the otherwise unaffordable salary reduction financially permissible. *See* J. MERTENS, *supra* note 14, at § 25B; B. BITTKEN, *supra* note 44, at §§ 60.2.3, 61.2.10.
94. Basically any plan wherein the employer makes a matching contribution for that of the employee will produce the benefit.
95. 718 F.2d 719 (5th Cir. 1983).
96. The *Ruch* decision is innovative with regard to § 213 medical expenses. The taxpayer in *Ruch* was found to have received a valid inter vivos gift, and it was held that payment of the donor's medical expenses with the funds of that gift gave rise to a valid deduction for the donee. Prior case law read § 213 in a very limited manner, denying the deduction to any taxpayer who received any type of reimbursement for the medical expenses. *See* Litchfield v. Commissioner, 330 F.2d 509 (1st Cir. 1964); Jewell v. Commissioner, 69 T.C. 791 (1978); McDermid v. Commissioner, 54 T.C. 1727 (1970); Hodge v. Commissioner, 44 T.C. 186 (1965). *See generally* J. MERTENS, *supra* note 14, at § 31A.07; 4 FEDERAL TAXES (P-H) ¶ 16,380(a), 16,395 (1984).
97. I.R.C. § 151 (Law. Co-op. 1974 & Supp. 1984).
98. *Id.* § 2(b). Section 2 defines the "head of household" as a person who is not married and maintains a household which constitutes the principal place of abode of the father or mother of the taxpayer, if the taxpayer is entitled to a deduction for such father or mother under § 151. *See also* J. MERTENS, *supra* note 14, at § 2.06.

The fact that the government doggedly scrutinizes taxpayer activities of this nature is proof in itself that transfers are potential income tax saving opportunities.

In the main, however, the small savings-to-value ratio is a stumbling block, preventing gifts from being justified solely on their income tax merit. But, even if the relative benefits to donors are small, they nonetheless exist. Moreover, proper attention to the income tax rules in the gift selection process can identify those asset(s) which will provide the most tax rewards, thus maximizing the value(s) ultimately received. Viewed in this light any income tax benefit obituary for gifts seems premature.

B. Transfer Tax[99]

1. *The Taxes Themselves*

In contrast to the income tax, the gift tax provisions are aimed directly at the donor. The primary obligation for paying the tax is on the donor,[100] and the basis for imposing the tax focuses exclusively on donor transactions.[101] In order to fully appreciate the gift tax and its implications, it is helpful to have a working knowledge of the estate tax since the two work hand-in-hand as one unified transfer tax system.[102]

In its most rudimentary form the estate tax is the government's last opportunity to tax an individual's assets. If the income tax is likened to a charge on putting money into an individual's capital account, then the transfer taxes can be considered the cost of moving that money to donees, heirs, and beneficiaries. The estate tax itself is really little more than a final charge on a decedent's net worth. Viewed in this framework, the gift tax is a charge upon reducing that net worth so as to ensure that the collection of the estate tax is not totally frustrated.

The estate tax is first tentatively computed on a tentative tax base

99. Transfer taxes as used herein refers to I.R.C. chapters 11 and 12, the estate and gift taxes under the unified credit system brought into being by the Tax Reform Act of 1976. The term does not include I.R.C. chapter 13, the generation skipping transfer tax. Since its introduction the effective date of this tax has been postponed. Although presently operative, the tax is clearly an endangered species and one should not be surprised to learn of its demise before it wrecks much havoc on estate plans. The tax did, however, survive the Tax Reform Act of 1984. *See* TRA 84, *supra* note 19.

100. I.R.C. § 2502 (Law. Co-op. 1974 & Supp. 1984).

101. *Id.* § 2511. *See* Treas. Reg. § 25.2511.2(a) (1958) (clearly establishing that the tax can apply to transfers even though the beneficiaries are unknown at the time of transfer).

102. I.R.C. §§ 2001-2209 (Law. Co-op. 1974 & Supp. 1984), also known as chapter 11, have their own separate identity as the estate tax provisions.

which includes the decedent's taxable estate[103] (basically, his net worth at death) and adjusted taxable gifts.[104] The tax rate is then applied to this base to determine the tentative estate tax, from which are deducted allowable credits, including the estate tax unified credit[105] and any gift taxes payable with respect to gifts included in the tentative tax base[106] to arrive at the estate tax liability.[107]

The gift tax is computed equally as easily. In any given year the sum of that year's current taxable gifts plus all prior taxable gifts is subjected to the appropriate rate to compute a tentative gift tax.[108] The resulting figure is reduced by any gift taxes previously paid (relating to the prior taxable gifts included in the gift tax base), and then again by any available gift tax unified credit[109] to arrive at the gift tax due.[110]

The underlying tenet of the transfer tax system is to have a cumulative tax whereby every taxable transfer, whether inter vivos or testamentary, is saddled with a tax cost and treated equally. By utilizing one rate schedule and one unified credit for both the estate gift taxes the efficacy of the system has been assured. The gift tax computation is a simple machanism ensuring that each taxable gift is taxed at increasingly higher tax rates. The estate tax computation integrates all prior taxable gifts into the final tax accounting so that the final gift (all property passing at death) is also taxed at the highest possible rate. The theory is sound and for the most part works.

In order to appreciate the practical effect of the transfer tax it is

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103. *Id.* § 2051, defining "taxable estate" as the gross estate minus the deductions provided by §§ 2053-2056 (§ 2053 "expenses, indebtedness, and taxes"; § 2054 "losses"; § 2055 "tranfers for public, charitable, and religious uses"; § 2056 "bequests, etc., to surviving spouse").

104. *Id.* at § 2001(b)(1)(B). This section defines "adjusted taxable gifts" as those gifts made after 1976 which are not included in the donor-decedent's gross estate. To eliminate any possibility of including the same item in the tax base twice, only post-1976 taxable gifts that are not included in the donor-decendent's gross estate are considered adjusted taxable gifts. *Id.* §§ 2035-2038, 2040 (providing the means for having completed gifts pulled back into the donor-decedent's gross estate).

105. *Id.* § 2010.

106. *Id.* § 2001(b)(2) (permitting taxes "payable" and not taxes actually paid with respect to post-1976 gifts to offset the tentative estate tax, thus preventing extra benefits from arising because of the phase-in of the reduced rates).

107. Having utilized the formula set forth in § 2001(b) to determine the estate tax base, reference must then be made to § 2001(c) which provides the rate schedules for taxation. *Id.* § 2001(c). It should be noted that the rate schedule of § 2001(c)(1) must be read in conjunction with § 2001(c)(2) which contains the phase-in of the 50 percent maximum rate. This phase-in was originally targeted to will be completed after 1984, *id.*, but it has recently been delayed until 1988. *See* TRA 84, *supra* note 19, § 21.

108. *Id.* § 2501.

109. *Id.* § 2505.

110. *Id.* § 2501.

necessary to comprehend the full impact of the unified credit. Originally targeted at $47,000[111] it is presently scheduled to increase to $192,800 by 1987.[112] One must remain mindful of the fact that these figures represent tax liabilities, and not taxable transfer amounts. It would take $175,625 of taxable transfers to generate a tax liability equal to the $47,000 credit.[113] Similarly, a $192,800 tax liability represents $600,000 worth of taxable transfers.[114] Regardless of the year of the phase-in involved, the credit is large enough to eliminate the transfer taxes as an item of concern for most individuals. But this fact does not detract from successful operation of the system in its effort to treat each taxable transfer equally. The following example is illustrative. To simplify matters, all transactions are considered to occur in 1987 and thereafter, although the theory also works during the credit phase-in period.

Assume in Year One, Donor makes as his initial transfer a $100,000 taxable gift[115] to his daughter. This results in a $23,800 tax.[116] The as yet unused unified credit of $192,800 will more than eliminate any potential out of pocket tax payment. In the next year, Donor makes an additional $600,000 taxable gift to his daughter. This results in a $206,000 tax[117] which can be reduced by $169,000[118] of unused unified

111. The $47,000 figure was established in 1976. *See* TRA, *supra* note 7.

112. In 1981, § 2505 was amended, with the $47,000 figure increased to $192,800. The "phase-in" is to be completed by 1987. I.R.C. § 2505(a), (b), *amended by* Pub. L. No. 97-34, §§ 401(b), 442(a)(5), 95 Stat. 172, 299, 321 (1981). Similar adjustments were made to § 2010 (unified credit against estate tax). *Id.* § 401(b), 95 Stat. 299 (1981).

113. This can be shown by computing the tax on $175,625. From the rate schedule of § 2001(c)(1), I.R.C. § 2001(C)(1) (Law. Co-op. 1974 & Supp. 1984), the tax on the first $150,000 is $38,800, and the excess thereof ($25,625) is taxed at 32 percent, or $8,200. Thus, the total tax liability equals $47,000 ($38,800 plus $8,200).

114. To calculate the tax on $600,000, the tax on the first $500,000 is $155,800, and the excess thereof ($100,000) is taxed at 37 percent, or $37,000. The total tax liability therefore, equals $192,800 ($155,800 plus $37,000).

115. "Taxable gifts" is a term of art defined by § 2503(a) to mean "the total amount of gifts made during the calendar year, less the deductions provided in subchapter C (section 2522)." I.R.C. § 2503(a) (Law. Co-op. 1974 & Supp. 1984). "Total gifts" are computed after taking the annual exclusion into account. *Id.* § 2503(b).

116. The gift tax on $100,000 is computed as follows:

Current plus Prior Taxable Gifts	$100,000		
Tentative Tax Thereon	23,800	(A)	[§ 2502(a)(1)]
Tentative Tax on Prior Taxable Gifts	-0-	(B)	
Gift Tax Imposed	$ 23,800	(A)-(B)	[§ 2502(a)(2)]

117. Computed as follows:

Current plus Prior Taxable Gifts	$700,000	
Tentative Tax Thereon	229,800	[§ 2502(a)(1)]
Tentative Tax on Prior Taxable Gifts	23,800	[§ 2502(a)(2)]
Gift Tax Imposed	$206,000	

118. The donor is required to reduce his remaining credit by amounts previously al-

credit leaving a $37,000 current tax payable.

If the donor made no other transfers and died four years later with a taxable state of $500,000, the tentative estate tax would be $427,800.[119] This figure would be reduced to $390,800 by the $37,000 gift tax already paid, and then again by the $192,800 unified credit. The resulting $198,000 figure would be the estate tax due nine months from the decedent's death.[120]

At first blush it may seem that the donor-decedent received a double use of the unified credit—first during life to reduce the gift tax, and then again at death to offset the estate tax. A closer look at the computation structure shows that this is not the case. Although the donor-decedent did benefit from the unified credit during life, at his death he was only able to offset his tentative estate tax liability by the amount of gift tax actually paid, the $37,000. When computing the estate tax, however, the estate was forced to include *all* taxable gifts in the tentative estate tax base as adjusted taxable gifts, and not just those on which a tax was paid. This meant the full $700,000 was included in the estate tax base, not just the $100,000 increment that generated the tax.[121] Thus, upon death, a tax rate was applied to $1,200,000 when in fact the decedent's taxable estate was only $500,000. By throwing adjusted taxable gifts back into the estate tax computation, these transfers are given the appearance of being taxed twice. But, by directing that an unreduced unified credit be taken at death, there is no added cost attached to the gift transaction. A quick run through the numbers of a decedent dying with an $1,200,000 taxable estate and no prior taxable transfers will prove the point.

An $1,200,000 taxable estate that is also the tentative estate tax base generates a $427,800 tentative tax,[122] which is also the imposed estate tax because there is no credit for gift taxes paid. After deducting the $192,800 unified credit, a $235,000 estate tax payable figure results. When the donor made taxable gifts, he credited a $37,000 gift tax and his estate paid a $198,000 estate tax. The two payments together total $235,000. In both instances, the total transfer tax liability

lowed. I.R.C. § 2505(a) (Law. Co-op. 1974 & Supp. 1984). Since the donor started with $192,800 and used $23,800 in the first year, $169,000 is left. Note that subsection (d) only permits the credit to be used up to the amount of the tax imposed, so taxpayers cannot request refunds for unused credit. *Id.* 2505(d).

119. The tentative estate tax is computed as follows:

Taxable Estate	$500,000	[§ 2001(b)(1)(A)]
Adjusted Taxable Gifts	700,000	[2001(b)(1)(B)]
Tentative Estate Tax Base	$1,200,000	
Tentative Estate Tax	427,800	[§ 2001(c)]

120. I.R.C. § 6075(a) (Law. Co-op. 1974 & Supp. 1984).

121. Since the first $600,000 is shielded by the unified credit it follows that the other $100,000 taxable transfer created the tax exposure.

122. *See supra* notes 114-15.

is identical. By making taxable gifts, the donor did not reduce his tax liability, but merely pre-paid part of the total amount ultimately due. Thus, from a strict theoretical perspective, the transfer tax system works. Whether it be an actual out-of-pocket payment or a forced use of unified credit,[123] every taxable transfer carries with it a tax cost and thus is treated equally.

For those individuals whose net worths exceed the taxing threshold created by the unified credit, there are escape hatches for minimizing and even avoiding the tax. Perhaps the two most noteworthy are the annual exclusion and the marital deduction. Both permit the tax free movement of wealth and come into play in arriving at the key term "taxable transfer."[124] The value of a gratuitous transfer may be and often is larger than its taxable portion. This is especially true with respect to the estate tax as there are usually outstanding liabilities at the time of death which will be permitted to be deducted from the decedent's aggregate asset values to create his net worth or taxable estate.[125] To the extent an item is deductible with regard to the determination of a taxable transfer, it is an escape hatch for passing wealth without the interference of a transfer tax, and thus can prove beneficial. In this respect, the annual exclusion and the marital deduction are extremely valuable to donors' and decedents' estates.

Recently increased to $10,000 per donee per year,[126] the annual exclusion will reduce or completely eliminate any tax cost for many transfers previously within the grasp of the gift tax. The mechanics of the benefit are quite simple. The first $10,000 of value of a present interest[127] given to an individual in any calendar year is not included in the computation of total gifts for that year,[128] and thus is never part of a taxable gift or the gift tax base. Moreover, since the exclusion

123. The use of the unified credit to offset gift tax liability is mandatory, thus prohibiting the taxpayer from using or eschewing it as he sees fit to obtain more favorable overall tax results. Rev. Rul. 79-160, 1979-1 C.B. 313.

124. It may have been noted in the earlier examples that tax rates were applied only to a "taxable" item, whether it was a taxable gift or a taxable estate.

125. For a definition of "taxable estate," see *supra* note 103.

126. I.R.C. § 2503(b), *amended by* ERTA, *supra* note 8, at 319.

127. The present interest is "[a] unrestricted right to the immediate use, possession or enjoyment of property or the income from property." Treas. Reg. § 25.2503-3(b) (1983). This is to be contrasted with a future interest which has been defined as "any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date." S. REP. NO. 665, 72nd Cong., 1st Sess. 41 (1932), *reprinted in* 1939-1 (Part 2) C.B. 496, 526. *See also* Treas. Reg. § 25.2503-3(c) (1958) (giving six examples of what would be considered present or future trust interests). *See generally* Bittken, *The $10,000 Annual Per-Donee Gift Tax Exclusion*, 44 OHIO ST. L.J. 447, 451-59 (1983) (providing a comprehensive review of the future interest/present interest distinction).

128. As previously explained, *see supra* note 116, I.R.C. § 2503(a) (Law. Co-op. 1974 & Supp. 1984) defines a "taxable gift." The annual exclusion of § 2503(b) is an exclusion "off the top" of any transfer made during the year.

amount is not part of the taxable gift, it also avoids being pulled into the estate tax based as an adjusted taxable gift. Values protected by the annual exclusion forever escape transfer taxation.

The usefulness of the exclusion increases when a donor splits gifts with his spouse.[129] With a spouse joining in the split gift, $20,000 per donee per year can be transferred tax-free. This will amount to an ultimate $10,000 estate tax saving for the donor whose estate would be in the fifty percent tax bracket at his death.[130] The potential value of the exclusion is great. For example, with only three years of gift giving at the $20,000 split gift figure, a $30,000 overall tax saving can be achieved.[131] There is little dispute that the elevated annual exclusion will make the cost of giving less difficult for the donor to swallow. Additionally, there are now certain "qualified transfers"[132] that can be totally excluded from the transfer tax base regardless of amount, but their special nature limits their pure estate planning appeal.

If one is impressed by the benefits flowing from the annual exclusion, then the marital deduction may prove overwhelming. Liberalized in 1976[133] and liberated in 1981,[134] the marital deduction which is available for both the gift tax and the estate tax permits interspousal transfers to escape taxation entirely. As with the annual exclusion, the marital deduction is used to create taxable transfers,[135] so the transferor never incurs a tax cost for the property transferred.

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129. *Id.* § 2513(a)(1). This section permits a gift made by either the husband or the wife to a third party to be treated for tax purposes as made one half by each spouse. But it is necessary that both spouses consent to this treatment. *Id.* § 2513(a)(2).
130. *Id.* § 2001(c)(1) contains a rate schedule with a maximum tax rate of 50 percent for estates in excess of $2,500,000. However, this will not be the maximum tax rate until 1988. A rate "phase-in" schedule is provided. *See* § 2001(c)(2), *id., as amended by* TRA 84, *supra* note 19, § 21.
131. The $30,000 figure is the result of $60,000 of value excluded from the tax base multiplied by the applicable 50 percent tax rate.
132. "Qualified transfers" are defined to include any amount paid on behalf of a person for tuition to an educational institution or for medical care to the provider of the same. *See* I.R.C. § 2503(e) (Law. Co-op. 1974 & Supp. 1984).
133. Prior to TRA, *supra* note 7, under § 2523 the marital deduction could not exceed 50 percent of the value of the gift. Afterwards, the deduction was permissible on a dollar-for-dollar basis up to the first $100,000 of value transferred. No deduction was allowed on the next $100,000 of value transferred, and amounts thereafter were deductible up to 50 percent of the value transferred. The estate tax marital deduction was changed from 50 percent of the adjusted estate to the greater of $250,000 or 50 percent of the adjusted gross estate. TRA, *supra* note 7, at § 2009(b)(4)(e).
134. The restrictions of marital deductions were further relaxed by eliminating the limit of the amount of deduction a taxpayer could claim. *See* ERTA, *supra* note 8, at §§ 403(b)(1), 403(a)(1)(B).
135. "Taxable gifts" as defined in § 2503(a) (Law Co-op. 1974 & Supp. 1984), equal the total gifts reduced by certain deductions, one of which is the marital deduction. *Id.* § 2523(a).

Because the marital deduction is unlimited in amount, a qualifying transfer[136] generates a deduction equal to the value of the transfer itself. For gift tax purposes, the qualifying property is a deduction from total gifts to determine taxable gifts; therefore, a transfer could quality for both the annual exclusion and the marital deduction, and potentially leave some unused deduction to offset gifts to other donees.[137] Unfortunately, that portion of the marital deduction that is unused because of the annual exclusion is lost and cannot serve to reduce other gifts.[138] Insofar as the estate tax is concerned, the marital deduction is used to convert the adjusted gross estate into the taxable estate[139] and, as in the case of the gift tax qualifying transfer, is never considered a taxable item.

The marital deduction now effectively permits spouses to freely transfer property between themselves without encountering any adverse transfer tax consequences. All such transfers result in a tax "wash." The magnitude of change ushered in by the new deduction rules will undoubtedly necessitate a rewriting of the marital tax planning book.

It requires little imagination to see that gifts can produce transfer tax savings. Although all tranfers are treated uniformly, only taxable transfers are taxed. Gifts or portions thereof that do not constitute taxable gifts can move wealth without it ever being considered part of the transfer tax base. Moreover, there are additonal tax saving opportunities available through gift-giving that flow from the structure of the transfer tax system itself. These opportunities will be explored more fully in the following section of this Article.

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136. The following requirements must be met for property to qualify for the marital deduction: (1) the donor must have been a citizen or resident of the United States at time of the gifts; (2) the donee must have been the donor's spouse at the time of the gift; (3) the interest in property must pass to that spouse; and (4) the interest must be a non-deductible terminable interest. *Id.* § 2523(a), (b). Similar rules apply for the estate tax marital deduction. *See id.* § 2056(a), (b). *See also* C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 17.5 (3d ed. 1974) (listing and discussing the four requirements of property for the marital deduction). *See generally*, R. COVEY, THE MARTAL DEDUCTION AND THE USE OF FORMULA PROVISIONS (1966) (recommending use of formula provisions to ensure that requirements are met); J. LEWIS, THE MARITAL DEDUCTION 15-33 (P.L.I. 1984) (ERTA does not change the four requirements qualifying property for the marital deduction).

137. An example will help to illustrate this point. If husband makes a $100,000 gift to his wife, the first $10,000 is not considered to be part of the total gift. I.R.C. § 2503(b) (Law. Co-op. 1974 & Supp. 1984). However, for purposes of the marital deduction, *id.* at § 2523(a), the amount of the gift is the value of the property transferred, the full $100,000, and not the $90,000 taxable gift. The husband has a $100,000 deduction, but a total gift of only $90,000 against which to offset it. *Id.*

138. *Id.* at § 2524.

139. *See supra* note 103.

2. The Transfer Tax Arithmetic

There are four identifiable transfer tax benefits directly associated with gift-giving. These benefits are attributable to the annual exclusion; the non-taxation of post-transfer income; the non-taxation of post-transfer appreciation; and the reduction in the tax base resulting from gift taxes actually paid. Examples can easily illustrate each of these benefits and its relative worth.

The value of the annual exclusion should be evident from the earlier discussion. Quite simply, the excluded amount can forever escape taxation. This amount is not considered part of taxable gifts for gift tax purposes and, consequently, is also excluded from the estate tax base because only adjusted taxable gifts which, by definition, exceed the exclusion are included in the computation of the tentative estate tax.[140] The annual exclusion is a pure transfer tax free move. A quick run through the numbers proves this point.

To simplify this, and all other examples in this part, all transactions should be regarded as having taken place in 1987 and thereafter with the unified credit at the $192,800 level. This will not distort the picture because the examples are designed only to demonstrate tax savings, not actual tax liabilities.

Assume two individuals, *A* and *B*, each possess $700,000 worth of property. In Year one, *A* makes a $10,000 gift, *B* does not. *A* does not encounter any adverse gift tax consequences because the annual exclusion is equal to the value of the gift. *A* and *B* both die in Year two, neither having made any other transfers. *A* has a $690,000 estate, *B* a $700,000 estate. If there are no deductions available to either estate these figures will represent the taxable estates *and* tentative estate tax bases for each individual, respectively. Remember, *A* is not required to add the gift into the tax base as an adjusted tax gift because the original transfer was not a taxable gift. Consequently, *A*'s tentative estate tax will be $226,100, which will generate a $33,300 tax liability.[141] On the other hand, *B* will have a $229,800 tentative estate tax and a $37,000 tax liability.[142] The $3,700 difference is attributable solely to the annual exclusion. This figure is the amount by which the tax base was reduced (the annual exclusion of $10,000) multiplied by *A*'s marginal transfer tax rate of thirty-seven percent. The benefit, of course, increases for taxpayers in the higher marginal brackets. When

140. I.R.C. § 2001(b) (Law. Co-op. 1974 & Supp. 1984). *See also supra* notes 104, 108.

141. Computed as follows:

Tentative Estate Tax Base	$690,000		
Tentative Estate Tax	226,100	(A)	[§ 2001(c)]
Gift Taxes Payable	-0-	(B)	[§ 2503(b)]
Unified Credit	192,800	(C)	[§ 2010]
	$ 33,300	(A) - (B+C)	

142. Computed by:

the fifty percent maximum transfer tax rate is in place,[143] the annual exclusion will be worth up to $5,000 in tax savings for each qualifying transfer. Moreover, since the exclusion is allocated annually to individual donees, an aggressive gift program can go a long way toward minimizing, if not entirely eliminating, the transfer taxes.

It is almost axiomatic that there is a transfer tax savings on post-transfer earnings generated by a gift. To the extent a donee owns the gifted property, he also owns all the income it generates. Since the income is removed from the donor's wealth, it it not property owned by the donor at his death; thus, it is not part of his taxable estate,[144] nor is it a part of the original gift that comprises the adjusted taxable gift component of the estate tax base. The benefit can prove to be quite valuable depending upon the amount of income generated, a function of both economic yield and the donor's life span after the gift, and the donor-decedent's estate tax bracket.

Consider the following example in which *C* and *D* each own $700,000 of non-productive assets. *C* gifts away $10,000 of property which the donee invests in ten percent interest yielding certificate of deposit. *D* invests $10,000 of his own property in a similar investment. Both *C* and *D* live five full years after these transactions. The comparative results are as follows. Assuming no deductions are available, *C* will have a taxable estate and tentative estate tax base of $690,000, and the estate tax thereon will, as before, be $33,300. *D* on the other hand will have an estate of $705,000. (The original $700,000 plus five years of $1,000 of interest from the certificate of deposit.) Again, assuming no deductions are available, the tax liability will be $38,850.[145] The $5,550 difference is solely attributable to the gift. From the previous example it is known that $3,700 of this amount is attributable to the annual exclusion. Thus, the $1,850 balance is a tax savings flowing

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Tentative Estate Tax Base	$700,000	
Tentative Estate Tax	229,800	[§ 2001(c)]
Gift Taxes Payable	-0-	
Unified Credit	192,800	[§ 2010]
Estate Tax Payable	$ 37,000	

143. *See supra* note 130.

144. "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death." I.R.C. § 2033 (Law. Co-op. 1974 & Supp. 1984).

145. Computed as follows:

Tentative Estate Tax Base	$705,000	
Tentative Estate Tax	231,650	[§ 2001(c)]
Gift Taxes Payable	-0-	
Unified Credit	192,800	[§ 2010(a)]
Estate Tax Payable	$ 38,850	

from the post-transfer earnings.[146]

Perhaps the best known incentive for making gifts is the benefit obtained from moving post-transfer appreciation entirely out of the donor's transfer tax accounting. It is similar to the post-transfer earnings benefit, but there is a different reason for the saving. The key to tax savings on post-transfer appreciation is the valuation of the two components of the estate tax base. All items eventually comprising the taxable estate component are valued as of the decedent's date of death[147] or the alternate valuation date.[148] Regardless of which date applies, all assets are valued at death or relatively soon thereafter. Conversely, the items pulled into the estate tax base through the adjusted taxable gifts route are included at their date of gift values.[149] Thus, to the extent an item enters the final tax calculus as an adjusted taxable gift, any change in its value between the date of gift and date of death is ignored. If the gifted property declines in value an overall loss will ensue, but if the asset appreciates, the gains are veritably limitless. Recourse to an example will be made to illustrate this point.

Assume *E* and *F* each own $700,000 worth of property. *E* gives away $10,000 which the donee invests in *X* Company stock. *F* buys $10,000 worth of *X* Company stock for himself. *X* Company triples in value before *E* and *F* die. Again assuming no deductions are available to either estate, the tax consequences are as follows. *E*'s estate will owe $33,000 in estate tax. *F*'s estate will have a tentative estate tax base of $720,000 (the original $700,000 plus $20,000 appreciation on the stock), and a concomitant tax liability of $44,400.[150] The total tax saving affected by the gift is $11,100. As in the previous examples, part of the difference results from the annual exclusion benefit, amounting to

146. The same result can be obtained by multiplying the $5,000 additional interest by the applicable tax rate of 37 percent ($5000 .37 = $1850).

147. I.R.C. § 2031(a) (Law. Co-op. 1974 & Supp. 1984).

148. *Id.* § 2032. This section permits the executor to value the gross estate at its value no later than six months after the death of the decedent. Congress recently added subsection (c) to § 2032 which limits the use of alternate valuation to those instances where both the value of the gross estate and the amount of the tax imposed after credits are reduced by the election. *See* TRA 84, *supra* note 19, § 1023. Valuation of certain special use property is provided for in § 2032. The availability of these alternate valuation provisions do not detract from the tax savings enunciated in the text.

149. Adjusted taxable gifts are just that. The value of the gifts does not change with the death of the decedent. *Id.* § 2001.

150. Computed as follows:

	E	F	
Tentative Estate Tax Base	$690,000	$720,000	
Tentative Estate Tax	226,100	237,200	[§ 2001(c)(1)]*
Gift Taxes Payable	-0-	-0-	
Unified Credit	192,800	192,800	[§ 2010(a)]

*The result of $155,800 plus 37 percent of the amount over $500,000.

$3,700. Thus the $7,400 balance is the direct result of the shifted appreciation. The total benefit in the instant case is quite substantial and actually exceeds the original cost of the gift.[151] Although this will not always be the case, it is suggested that certain assets, if gifted away early enough in the donor's lifetime, can easily produce comparable results. But even without the assistance of hindsight, it is clear that the benefit associated with the elimination of post-transfer appreciation from the tax base has immense potential for the astute donor.

The last benefit, the tax savings on gift taxes paid, is the most subtle, but not necessarily of the smallest value. Since the transfer taxes are imposed on the accumulation of wealth, it stands to reason that any transaction that reduces one's wealth also reduces one's transfer tax liability. Gifts are the major exception to this rule in that they reduce wealth but are themselves subject to the tax. The payment of one's own liabilities, however, is a wealth reducing transaction that is not treated as a gift.[152] Thus, to the extent a donor makes gifts and incurs a gift tax, the payment of that tax reduces this wealth, leaving less to be taxed at his death, but is not itself taxed as a transfer. Although somewhat confusing in the abstract, the next example demonstrates that the benefit is a logical consequence of the system.

Assume *G* and *H* each have assets of $2,000,000. *G* makes a gift of a future interest worth $700,000 and pays a $37,000 gift tax on the transfer.[153] A few years later both *G* and *H* die. Assuming no estate tax

151. Although the $11,100 saved exceeds the $10,000 that was transferred, without the transfer the donor/decedent would have had an estate valued at $720,000 rather than $690,000, reflecting the appreciation of the gifted property. Thus, the gift of $10,000 may still be seen as being only $10,000, but $20,000 viewed as from the donor's perspective as lost appreciation.

152. Gifts are transfers for less than adequate consideration of money or money's worth. To the extent a transfer is made in payment of bona fide debt or in the ordinary course of business no gift results. *See* Treas. Reg. § 25.2512-8 (1958). Interestingly, since the gift tax itself is considered to be an obligation of the donor, *see* I.R.C. § 2502(c) (1982), its payment by the donee constitutes a reduction of the value of the gift by the donor. *See* Rev. Rul. 75-72, 1975-1 C.B. 310. This in turn creates potential income tax problems for the donor who is deemed to have sold a portion of the property for the gift tax paid by the donee. *See* Diedrich v. Commissioner, 457 U.S. 191, 198-99 (1982).

153. Computed as follows:

Current and Prior Taxable Gifts	$700,000*	
Tentative Tax Thereon	229,800**	[§ 2502(9)(1)]
Gift Tax Paid on Prior Taxable Gifts	-0-	
Unified Credit	192,800	[§ 2505(9)]
Gift Tax Payable	$ 37,000*	

*Since the gift is not of a present interest, the annual exclusion is inapplicable and the full value of the transfer is part of the tax base. I.R.C. § 2503(b) (Law. Co-op. 1978 & Supp. 1984).

**Utilizing § 2001(c) rate schedule to reach the amount through $155,800 plus 37 percent over $500,000.

deductions will be available, *H*'s tax liability will be $588,000.[154] *G*'s adjusted taxable gifts will be $700,000, but his taxable estate will be only $1,263,500, ($1,300,000 left after the gift minus the $37,000 gift tax that was paid). His tentative estate tax base will be $1,963,000 which will generate a $534,350 estate tax payable.[155] Thus, *G*'s total transfer taxes were $571,350. This is $16,650 less than *H* paid, yet the two individuals owned and transferred the same amount the wealth. Since there was no annual exclusion utilized and no post-transfer income or appreciation to account for, the difference can be attributed to only one source: the gift taxes paid during life that reduced the overall amount of property actually subjected to the tax rates.[156] The donor must make substantial gifts to be subjected to the higher end of the rate schedule and obtain the savings associated with this benefit, nonetheless, it is there awaiting the tax conscious donor.

The transfer tax benefits obtainable through gift giving are not received without risks. For example, it does not require a strong grasp of mathematics to appreciate that the effort to avoid tax on post-transfer appreciation may go for naught if the property given actually declines in value from the date of gift to the date of the estate tax valuation. Instead of achieving a savings, in such an instance the gift could generate an unnecessary expense. Also, improvident gift giving can create untoward results because of the phasing-in of an increasingly larger unified credit. Although the examples presumed the $192,800 credit, in actuality, because of the phase-in, it is possible that a gift made today could generate a gift tax payable; yet, if the donor had retained the property, he could have eventually transferred it tax-free. This could occur, for example, if the gift plus all of the donor's other assets exceeded the taxable transfer equivalent of the unified credit for the year of the gift, but the credit available at death should have shielded the value of the gift plus all of the donor's other assets.

154. Computed as follows:

Tentative Estate Tax Base	$2,000,000	
Tentative Estate Tax	780,800	[§ 2001(c)(1)]
Gift Taxes Payable	-0-	
Unified Credit	192,800	[§ 2010(a)]
Estate Tax Payable	$ 588,000	

155. Computed as follows:

Tentative Estate Tax Base	$1,963,000	
Tentative Estate Tax	764,150	[§ 2001(c)(1)]
Gift Taxes Payable	37,000	[§ 2012(a)]
Unified Credit	192,800	[§ 2010(a)]
Estate Tax Payable	$ 534,350	

156. The savings can be calculated by multiplying the gift tax paid ($37,000) by the rate at which that amount would have been taxed had it remained a part of the estate (45 percent).

These and similar problems are often the offspring of the vagaries of asset value fluctuation and, short of possessing prescience in the market place, such fluctuations can never be completely overcome. Current and projected valuation of assets is an important part of estate planning, and should not be overlooked. There are, however, other more serious traps awaiting the unwary donor which can easily frustrate otherwise prudent gift-giving programs. The main culprits are the estate tax sections.

Some of the benefits associated with gift giving are a consequence of the fact that gifts are made part of the estate tax base as adjusted taxable gifts. This treatment permits all post-transfer growth to avoid inclusion in the estate tax base. But, adjusted tax gifts are only those gifts not otherwise included in the donor-decedent's gross estate. Some gifts can be pulled into the gross estate,[157] which is the starting point for determining the taxable estate component of the tentative estate tax base. Such transfers are then treated like any other gross estate asset and are valued at the date of death, or alternate valuation date. Not only is all post-transfer appreciation taken into account when this happens, but there is no decrease in the amount includable for the annual exclusion. Thus, two chief gift giving incentives are lost.

A third detriment is the donor's loss of the use of the tax money. The gift taxes are not considered a pre-payment of the estate tax. Consequently, donors do not receive interest for paying part of the overall transfer tax cost earlier than may otherwise have been necessary. Although this is a hidden cost of any transfer that generates a gift tax liability, it is particularly onerous when none of the benefits normally associated with the giving of gifts are present. Specific gifts that are susceptible to these risks include transfers over which the donor-decedent retained a "life" interest, certain transfers made within three years of death, and gratuitously created joint tenancies. There are other transfers of equal vulnerability, but they are not usually made for the purpose of achieving tax benefits.[158]

Generally, any transfer over which the donor retains a statutory life interest,[159] will be included in the donor-decedent's gross estate.

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157. The value of the gross estate is the total value of all property at the time of death. I.R.C. § 2031(a) (Law. Co-op. 1978 & Supp. 1984). This value is comprised of the interests described in §§ 2033-2044. Treas. Reg. § 20.203.1(a), T.D. 6684, 1963-2 C.B. 413.

158. One example is the transfer taking effect at the death of decedent, or a reversionary interest embraced by § 2037. I.R.C. § 2037 (Law. Co-op. 1978 & Supp. 1984). While it is conceivable that such a transfer may have been made for the purpose of achieving certain tax benefits, it is unlikely.

159. Section 2036 identifies three measuring periods: (1) the transferor's life, (2) any period not ascertainable without reference to the transferor's death, and (3) any period which does not in fact end before the transferor's death. I.R.C. § 2036

Again, the includable amount is calculated under the estate tax valuation rules which effectively require all post-transfer appreciation to be subject to the transfer tax accounting. The adverse tax exposure can be the unwanted result of innocent agreements or understandings[160] between the deceased donor and donee(s) irrespective of the parties' intention.[161] Moreover, a retained life interest can arise from a tacit understanding between the parties and need not be legally enforceable.[162] The crucial test is whether the donor-decedent arranged to retain the use of or economic benefit from the transferred property.[163]

Sometimes the obtrusive interest is obvious, and knowingly retained by the donor. A grantor may retain the right to income because of economic need or a desire to continue to exert control over the property. In such instances the purpose of the transfer is not to minimize the tax, but rests in a non-tax motive, perhaps that of establishing a trust to ensure that assets avoid probate.[164] Regardless of the reason, the end result is always the same. The post-transfer apprecia-

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(Law. Co-op. 1974 & Supp. 1984). Treas. Reg. § 20.2036-1(a); T.D. 6501, 1960-2 C.B. 271. *See generally* C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 136, at §§ 174-97 (legislative history and analysis of § 2036).

160. *See* Estate of Garner v. Commissioner, 44 T.C.M. (CCH) 903 (1982) (value of farmland transferred to another was included in the estate of decedent because of an implied understanding that he could retain possession and enjoyment of the property for a period that did not end prior to his death); Estate of Hendry v. Commissioner, 62 T.C. 861 (1974) (value of farm transferred twenty years prior to death includable because of no change in relationship to thd property); Estate or Kerdolff v. Commissioner, 57 T.C. 643 (1972) (value of a residence includable in gross estate because of implied agreement for continued possession). *See also* Rev. Rul. 79-109, 1079-1 C.B. 297 (value of retained use of vacation rental property transferred by decedent to children includable in the gross estate); Rev. Rul. 70-155, 1970-1 C.B. 189 (value of residence included in gross estate because of agreement for continued occupation). *But see* Estate of Subblefield v. Commissioner, 42 T.C.M. (CCH) 342 (1981) (valued of farm transferred to children not includable in gross estate although the decedent continued to live on property and raise crops); Diehl v. Commissioner, 68-1 U.S. Tax Cas. (CCH) ¶ 12,506 (W.D. Tenn. 1967) (value of residence conveyed to son not includable in gross estate although father continued to live there).

161. *See* Kokes v. United States, 21 A.F.T.R.2d (P-H) ¶ 147,213 (D. Neb. 1968) (value of five farms transfered by deed includable in decedent's estate although there was no evidence that decedent had a right to use property or to receive its economic benefits); Estate of Sullivan v. Commissioner, 10 T.C. 961 (1948), *rev'd* 175 F.2d 657 (9th Cir. 1949) (savings account in two names includable in gross estate of decedent); Estate of Fry v. Commissioner, 9 T.C. 503 (1947) (value of gift mortgage certificates included in estate, evidence did not rebut presumption that gift was in contemplation of death). *See also supra* note 160 (additional cases).

162. *See* Union Planters Nat'l Bank v. United States 361 F.2d 662, 666 (6th Cir. 1966).

163. For an excellent discussion of the "retention" issue, see R. STEPHENS, G. MAXFIELD & S.LIND, FEDERAL ESTATE AND GIFT TAXATION, ¶ 4.08(4)-(6) (5th ed. 1983).

164. It must be remembered that estate planning is not solely concerned with taxes. Finding an appropriate and easy means of devolving property is of equal importance.

tion benefit is lost. Also, transfers with a retained life estate accelerate the potential overall out-of-pocket transfer tax cost. Of course to the extent that the transfer itself generates an immediate gift tax liability, the donor is deprived of the use of that tax money, although some corresponding transfer tax benefit may ultimately materialize.[165]

Whereas the tax detriments of a retained life interest can usually be avoided with proper planning, the same cannot always be said for certain transfers made too close to the donor's death. The progeny of a stormy history,[166] the current treatment of transfers made within three years of death is relatively inoffensive. Outright gifts are no longer pulled back into the gross estate unless the gift is a life insurance policy,[167] or the release of otherwise taxable powers.[168] The associated value is added to the tax base only once, even though some transfers may be includable in the gross estate under the authority of more than one provision. Nonetheless, once a transfer is made part of the tentative estate tax base, the chief tax benefits associated with having made the gift vanish. In addition, any potential benefit flowing

165. One of the benefits of giving gifts is the reduction of the estate tax base by gift taxes paid on previous transfers. *See supra* text accompanying notes 151-56.

166. Section 2035 deals with the tax treatment accorded to inter vivos gifts made close to the donor's death. In its original form the section created a rebuttable presumption that transfers made within two years of death would be considered in "contemplation of death." Revenue Act of 1916, ch. 463, § 202(b), 39 Stat. 756. This proved to be unworkable and Congress reconstructed this part of the statute so that there was an irrebutable presumption that the transfer of property without consideration, having a value of over $5,000 and within two years of death was in contemplation of death. Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 9. This revision had limited success, however, because of Heiner v. Donnan, 285 U.S. 312 (1932). In *Heiner*, the court found that a conclusive presumption, like the one contained in the Revenue Act of 1926, violated the due process clause of the fifth amendment. In response to *Heiner*, Congress again changed course and went back to a rebuttable presumption. Revenue Act of 1934, ch. 277, § 401, 48 Stat. 680. In 1950, the rebuttable presumption period was increased from two to three years. Revenue Act of 1950, ch. 994, 64 Stat. 906. The 1950 act also added a test which called for a review of the "bodily and mental condition to the decedent and all other attendant facts and circumstances." *Id.* The purpose of this new test was to determine if, in fact, the gifts were being made in contemplation of death. This change prompted many courts to permit property to avoid estate taxation if at least one important motive for giving the gift was present. *See, e.g.*, Estate of Sprague v. Commissioner, 33 T.C.M. (CCH) 794 (1974). In 1976, TRA, *supra* note 7, created automatic inclusion in the gross of estate for all taxable gifts made within three years of death. However, this provision was again altered in 1981 when Congress for the most part eliminated the includability of almost all outright transfers made within three years of death. *See* ERTA, *supra* note 8, at 312. The gift tax paid on all transfers made within three years of death is pulled back into the gross estate irrespective of the tax treatment accorded the gift itself. I.R.C. § 2035(c) (Law. Co-op. 1974 & Supp. 1984).

167. I.R.C. § 2035(d)(2) (Law. Co-op. 1974 & Supp. 1984).

168. *Id.*

from the fact that gift taxes have already been paid is lost because of the "gross up" rule.[169]

The "gross up" rule was designed to ensure that the effect of the since repealed automatic inclusion of all gifts within three years of death was not undermined.[170] Congress recognized that shrinkage of the tax base by the amount of gift tax paid on substantial "death bed" transfers could effect sizable transfer tax savings. The rule simply requires that all gift taxes paid on gifts made within three years of death be added back into the gross estate. Thus donors are discouraged from pursuing aggressive last minute gift programs in order to obtain large and perhaps undeserved tax breaks. When the automatic inclusion rule for gifts within three years of death was eliminated,[171] there was no corresponding repeal of the gross-up rule. The rule is still in effect. Moreover, its application is not limited to gifts which are eventually pulled into the gross estate, but pertains to *all* gifts made within three years of death. Thus, all of the tax benefits attributable to gift giving are not always available. Taken objectively, however, the gross-up rule itself should not be considered a deterrent to gift giving. Concededly, it minimizes the overall tax savings, but it does not outweigh the other incentives which are still available, even if the donor dies within three years of making the gift.

The final and perhaps most perplexing trap for unwary donors concerns gifts in joint tenancy between the donor and others. To properly analyze the current state of affairs in this area it is necessary to distinguish spousal from non-spousal joint tenancies. Exclusively interspousal joint tenancies no longer generate immediate transfer tax problems, but non-marital tenancies still do.

The gratuitous creation of a joint tenancy is considered a gift of the donee's moiety for gift tax purposes,[172] unless it involves a bank account[173] or government savings bond[174] in which case no gift is recognized until the donee realizes an actual benefit. The gift tax marital deduction[175] does come into play so that no taxable gift,[176] and consequently no tax exposure results when the donee is the donor's spouse.

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169. *Id.* § 2035(c).
170. The congressional intent was to eliminate, as much as possible, any tax incentives that "death bed" gifts would provide for the taxpayer. *See* H.R. Rep. No. 1380, 94th Cong., 1st Sess. 13, 13-14, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3367-8. *See also* M. WINBERGER, ESTATE AND GIFT TAX AFTER TAX REFORM 32-33 (1977).
171. I.R.C. § 2035(d)(1) (Law. Co-op. 1974 & Supp. 1984) makes the automatic inclusion rule inapplicable for decedent's dying after 1981.
172. *See* Treas. Reg. § 25.2511-1(h)(5) (1983).
173. *Id.* § 2511-1(h)(4).
174. *Id.*
175. I.R.C. § 2523 (Law. Co-op. 1974 & Supp. 1984).
176. The marital deduction is used to convert "total gifts" into "taxable gifts." *Id.* § 2503a.

Upon the death of either spouse, the fractional interest rule[177] forces the decedent to include the value of only his (or her) moiety in the gross estate. But, the estate tax marital deduction[178] will work to prevent the value of the moiety from increasing the taxable estate. The joint tenancy and marital deduction rules operate in unison to ensure that the gratuitous creation of marital joint tenancies do not produce any adverse transfer tax consequences.[179]

Joint tenancies not exclusively between spouses can create transfer tax problems.[180] Since the creation of the tenancy estate is a gift, the usual transfer tax consequences are encountered. Whether or not a tax will actually have to be paid will depend upon the size of the gift, the donor's prior taxable gifts, and the remaining available unified credit. Unlike the estate tax treatment accorded other gifts, the full value of the joint tenancy property is presumed to be includible in the donor-decedent's gross estate.[181] The executor can exclude from the gross estate that percent of the value of the property which can be shown to be attributable to the surviving tenant's consideration or contribution.[182] Thus, joint tenancy provides a donor with all of the

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177. *Id.* § 2040(b)(1). *See infra* note 180.
178. I.R.C. § 2056(a) (Law. Co-op. 1974 & Supp. 1984).
179. Too much joint tenancy between spouses can undermine attempts to maximize the use of two unified credits and cause needless tax exposure. *See infra* note 232.
180. The fractional interest rule applies to "qualified joint interests": tenancies exclusively between spouses. I.R.C. § 2040(b)(2)(B) (Law. Co-op. 1974 & Supp. 1984).
181. The general rule is that:

> The value of the gross estate shall include the value of all property to the extent of the interests therein held as joint tenants with right of survivorship by the decedent and any other person, or as tenants by the entirety by the decedent and spouse, or deposited, with any person carrying on the banking business, in their joint names and payable either or to the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth: *Provided*, that where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than an adequate and full consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person: *Provided further*, that where any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy by the entirety by the decedent and spouse, then to the extent of one-half of the value thereof, or, where so acquired by the decedent and any other person as joint tenants with right of survivorship and their interests are not otherwise specified or fixed by law, then to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship.

Id. § 2040(a).

182. A close reading of § 2040(a) indicates that the surviving tenant must prove an

drawbacks of gift giving without guaranteeing any of the benefits. The easy and cost-effective manner with which title to joint interest passess should not cloud the estate planner's judgment to the point that the tax disincentives are overlooked.

Along with the direct dollar savings that can be effected, gifts can also provide indirect, but not necessarily less valuable, transfer tax benefits. Certain relief provisions relating to the income and the estate taxes are available only to qualifying estates. The potential benefits are impressive. Section 303 provides access to favorable capital gains treatment for qualifying stock redemptions[183] which can, in some instances, effectively eliminate sixty percent of the taxable gain from income taxation. Section 6166 permits the estate tax payment attributable to qualifying business interests to be deferred for five years, and then payable in installments subject to a low interest rate on a portion thereof.[184] The special use valuation of Section 2032A is of particular interest to farmers who can avoid the "highest and best use" test for valuing qualifying property.

All three of these sections offer potentially large benefits, and all have stringent qualification requirements. Non-qualifying property sitting in a gross estate can easily deny access to these benefits. Through planned gift giving a donor could reduce the amount of non-qualifying property and pave the way for successful election of any these sections, and obtain the advantageous tax treatment they provide. Interestingly, all transfers made within three years of death will be pulled back into a hypothetical gross estate used for the purpose of computing whether or not the estate qualifies for these benefits.[185]

In contrast to their limited impact with respect to the income tax, gifts can produce significant transfer tax savings. This is not totally unexpected given the nature of the transfer tax versus that of the income tax, and the way gifts provide benefits in these respective tax structures.[186] The important point worth emphasizing is that gifts

independent source of funds, because money supplied to the survivor by the deceased tenant will not count as contribution for the survivor.

183. *Id.* § 303. This section permits the redemption of stock from a decedent's estate to be considered a sale rather than a § 301(a) distribution. Sale or exchange recognition allows any gain to qualify for capital gain treatment instead of being considered as ordinary income pursuant to normal redemption rules. Moreover, application of § 1014 will eliminate most, if not all, of the gain attendant a sale. *See* Barnett & Rhrine, *Estate and Gift Taxation After the '81 Act: Estate Planning Is Not Dead,* 12 TAX ADVISOR 718, 722-23 (1981).

184. I.R.C. § 6166 (Law. Co-op. 1974 & Supp. 1984). *See* Kahn, *Closely Held Stocks—Deferral and Financing of Estate Tax Costs Through Sections 303 and 6166,* 35 TAX LAW. 639 (1982). *See also* Barnett & Rhrine, *supra* note 183.

185. I.R.C. § 2035(d)(3) (Law Co-op. 1974 & Supp. 1984).

186. Not surprisingly, after comparing the income versus transfer tax benefits of gift giving, those associated with the latter surfaced as a greater motivational force to donors. This fact is primarily attributable to the distinct natures of the taxes

continue to provide these benefits despite the recent legislative surgery performed on the transfer taxes. In the face of escalating credit amounts there remains both direct and indirect benefits sufficient to induce gift giving. Granted, higher credits may reduce the number of transfer tax motivated donors; but once the credit thresholds are surpassed, gifts are left as the only meaningful method for tax reduction. Each particular situation must be individually examined to determine the prospective donor's ability and desire to make gifts. But it is welcome knowledge that the tax benefits will still effectively reduce the ultimate cost of implementing the decision. On balance, from a tax perspective, it appears that the potential tax savings in themselves remain sufficient justification for making gifts.

III. EXTRA INGREDIENTS

A. Formal Substantive Concerns

It is imperative that the gift be properly structured or in correct form. Failure to do so can either defeat any tax savings or minimize the available rewards. For example, any gift over which the donor retains a statutory life interest will cause the gift to be included in his gross estate.[187] Thus, even though the gift caused a transfer tax accounting when made, major benefits normally associated with gift giv-

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involved. When discussing gifts in the income tax setting, the recurring theme was that the cost of the loss of the property was not justified by the tax savings alone. Since the income tax requires an annual accounting, any benefits associated with the giving of gifts are only measured in one given year. Although this approach seems short-sighted, it should be clear that any savings in subsequent years can never exceed 50 percent of the after-tax amount the donor would have had if no gift were made. Thus, despite its perennial nature, the income tax benefits will never exceed the cost of lost capital. These results occur because it is not the gift itself that provides the donor the tax benefit, but the earnings on the gift. The donor could accomplish the same tax end by investing the property to be given away in non-productive or exempt-income producing assets. Consequently, for purposes of the income tax, gifts do more to avoid tax detriments than they do to provide direct tax benefits. Conversely, the gift in the transfer tax environment achieves the tax saving from a more positive approach. Even though there may be annual reporting, the true transfer tax accounting is done on a cumulative, not an annual, basis. Today's transfer will effect subsequent gifts and ultimately the final disposition of property at death. By making the gift, the actual overall tax reduction can be accomplished.

This reduction could not be otained any way. The structure of the transfer tax is such that inaction serves only to delay the day of reckoning. Unlike the case of the income tax, there are no investments that can ripen into transfer tax free assets. For these reasons the two taxes are distinguishable in evaluating the cost effectiveness of giving gifts.

187. I.R.C. § 2036(a) (Law Co-op. 1978 & Supp. 1984) defines a retained life interest as the right, possession, or enjoyment of income, or the ability to designate the same for the transferor's life, any period not ascertainable without his to death or any period which does not in fact end before his death.

ing will be lost.[188] Creating a joint interest by gift can cause similar unwanted results. Establishing the joint estate can be considered a gift,[189] but the full value of the tenancy property attributable to the donor-decedent tenant's gift is nonetheless included in his gross estate.[190] Again, significant gift giving benefits are lost.[191] However, if the tenancy is exclusively between spouses, any gift element is excused from tranfer tax liability and some tax advantage may be had.[192]

In a more positive vein, a simple outright transfer, when properly structured, can have significant impact beyond the apparent benefits. By coupling an immediate gift with a series of delayed gifts a donor can accomplish much more than he might have thought possible. For instance, if the objective is to transfer a substantial property value, the donor could make an outright gift of a percent of the property equal to the annual exclusion (or double that amount if gift splitting is available) and "sell" the remainder of the property to the donee. The donee "pays" for the balance by executing a note. Each payment on the note is subsequently foregiven by the donor as it becomes due. Each installment will be a gift in the year it is forgiven.[193] From the transfer tax perspective, the entire value of the note may be given away without the assessment of a gift tax through the felicitous use of annual exclusions.

Manipulating the timing of transfers is a proven method of eliminating gift tax exposure despite the government's objection.[194] To en-

188. Once the transfer is pulled back into the gross estate all post transfer appreciation comes with it. *Id.* § 2031(a). Also, any post-transfer income that remains within the statutory proscription is made part of the gross estate thereby eliminating another benefit. *See* United States v. O'Malley, 383 U.S. 627 (1966). Section 2036 transfers may or may not involve initial gifts of present interests and, depending upon the facts, the annual exclusion and its potential benefit will never be lost or never come into play.

189. Treas. Reg. § 25.2511-1(5) (1958) (Law Co-op. 1978 & Supp. 1984).

190. I.R.C. § 2040(a) requires inclusion in the decedent's gross estate the full value of joint tenancy property for which the decedent supplied the consideration. *See supra* notes 181-82.

191. Not only is the post-transfer appreciation benefit eliminated, but so too is that for the annual exclusion. However, any post-transfer income that is earned and segregated from the joint estate by the donee-tenant will avoid estate inclusion and still provide some benefit.

192. I.R.C. § 2040(b)(1) will force only one-half of the value of a qualified joint interest (defined in I.R.C. § 2040(b)(c) (1982)) to be included in the decedent's gross estate. Thus, all of the benefits of gift giving are to some extent available. Of course, the marital deduction will operate to prevent adverse transfer tax exposure. Thus, the benefits of the gift lost if no transfer had been made would be absorbed anyway.

193. Treas. Reg. § 25.2511-1(a) (1958).

194. This technique was approved in Haygood v. Commissioner, 42 T.C. 936 (1964), *acq.* 1965-1 C.B. 4, *nonacq.* 1977-2 C.B.2; Estate v. Commissioner, 63 T.C. 321 (1974), *nonacq.* 1977-2 C.B. 2. The government does not acquiesce in these results. Rev. Rul. 77-299, 1977-2 C.B. 343.

sure that similarly oriented practices do not become abusive, intrafamily activities are closely monitored to see whether the tax savings ends are achieved through acceptable means. Of immediate interest is the scrutiny given transfers for purposes of the gift tax.[195] The government jealously guards is broad interpretation of "gift" to block clever attempts to obtain more donor benefits than are perhaps deserved.

Although not specifically defined by statute, "gift" has been consistently interpreted to include *all* gratuitous transfers.[196] Donative intent is not an essential element of the transfer tax gift, since the term "gratuitous" is measured by consideration received in return for the transfer.[197] Questions continue to arise, however, over whether a transfer was actually made, and if so, of what or by whom. The answers to these inquiries have important transfer tax ramifications. A quick look at some recent developments in the area will illustrate how donors' efforts to obtain tax benefits have been thwarted by the government's vigilance.

The intrafamily interest-free loan has long received favorable income tax treatment.[198] When the government first attacked on the gift tax front it suffered defeat.[199] Renewed pursuit, however, culminated in a glowing victory.

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195. This is not to suggest that "gifts" are a dead issue in the income tax arena. Commissioner v. Duberstein, 343 U.S. 278 (1960), and its progeny are testimony to the fact that the income tax aspects of this issue are alive and well. However, transfers made in the estate planning setting are usually not pursued for income tax purposes. *But see* Hardee v. United States 708 F.2d 661 (Fed. Cir. 1983) (the government unsuccessfully sought to include imputed interest on an interest-free loan in income).

196. *See* Treas. Reg. § 25.2511-1(c) (1958) (interest passes gratuitously); Dickman v. Commisioner, 104 S. Ct. 1086 (1984) (imputed interest on interest free loan is a gift); Commissioner v. Wemyss, 324 U.S. 303 (1945) (property transferred to compensate for lost trust income is a gift); Smith v. Shaughnessey, 318 U.S. 176 (1943) (transfer of life estate with reversion and remainder interests in a gift). The genesis of this broad interpretation can be found in the legislative history of the gift tax. *See* H.R. Rep. No. 708, 72nd Cong., 1st Sess. 27, *reprinted in* 1939-1 C.B. (Part 2) 457, 476 (1932); S. Rep. No. 665, 72nd Cong., 1st Sess. 39, *reprinted in* 1939-1 C.B. (Part 2) 496, 524 (1932).

197. *See* Treas. Reg. § 25.2511-1(g)(1) (1958); Treas. Reg. § 25.2512-8 (1958). *See also* Commissioner v. Wemyss, 324 U.S. 303, 306 (1945) (gift tax imposed when property transferred for less than an adequate and full consideration other than that made in the ordinary course of business).

198. *See* Hardee v. United States, 708 F.2d 661 (Fed. Cir. 1983); Commissioner v. Greenspun, 670 F.2d 123 (9th Cir. 1982); Beaton v. Commissioner, 664 F.2d 315 (1st Cir. 1981); Martin v. Commissioner, 649 Fed. 1133 (5th Cir. 1981); Suttle v. Commissioner, 625 F.2d 1127 (4th Cir. 1980); Dean v. Commissioner, 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4.

199. *See* Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978); Johnson v. United States, 254 F. Supp. 73 (N.D. Tex. 1966).

In *Dickman v. United States*,[200] the Supreme Court held that interest-free loans involve transfers of property that are within the ambit of the gift tax. The Court pointed out that Congress intended the use "property" in its most comprehensive sense[201] and concluded that "property rights" were meant to be included in the definition.[202] The use of money is perhaps the best example of such a property right, and therefore is properly subject to the tax. The Court had little difficulty in overcoming the taxpayer's contention that there was no actual transfer of property because the donor retained control over the notes. It found that although the demand notes themselves were still within the lender-donor's domain and control, it was the donee's free use of the principal which constituted a transfer.[203] The tax attaches only to the "reasonable value of the use of money lent,"[204] which is a completed gift for the period of time in which the lender-donor does not call in the loan. The Court may have settled the seminal matter concerning the applicability of the gift tax to interest free loans, but it certainly did not put the issue to quietus. Some questions were left unanswered. How is the gift valued?[205] Are gift tax returns for previous years required? What impact will prior interest-free loan periods have on adjusted taxable gifts?

The more troublesome aspect of the *Dickman* opinion is the Court's sweeping assertion that all gratuitous uses of property are in effect potential taxable gifts.[206] The Court tried to downplay the significance of the position by pointing to the annual exclusion and unified credit as ways to avoid any tax exposure. But, as suggested in the dissenting opinion the attempted dilution misses the mark.[207] The majority's interpretation of what constitutes a transfer for gift tax purposes has probably exposed to the gift tax transfers never before considered within its reach.[208] The onus is now on the government

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200. 104 S. Ct. 1086 (1984).
201. *Id.* at 1089.
202. *Id.* at 1089-90.
203. *Id.* at 1091 n.7.
204. *Id.* at 1094-95.
205. The valuation problem is discussed in the dissent where it is noted that the government has used three different methods for valuing such transfers. *Id.* at 1097-98, 1098 n.9. The Treasury Department quickly responsed to this concern. *See* Announcement 84-60, 1984-23 I.R.B. 58 (concerning News Release I.R.-84-60, May 11, 1984). The department provided applicable interest rates for years as far back as 1960 and examples of how to apply them. The announcment also promised that a revenue procedure would be forthcoming on this matter. Congress then addressed the problem, *see* TRA 84, *supra* note 19, § 172, by adding § 7872 to the code, which provides an elaborate set of rules for handling the tax consequences of loans with below market rates.
206. The Court specifically makes reference to the rent free use of commercial property having a rental value. *Id.* at 1091.
207. *Id.* at 1098 (Powell, J., dissenting).
208. The dissent points out that the potential abominations include taxing rent free

not to overact to its new authority and proceed within the spirit of the Court's decision.[209] Many problems remain unresolved. Thus, transferors must use care in order to avoid unexpected tax results.

The interest-free loan is an example of the government pressing to prove a transfer. In other instances, the government focuses its attention on who the transferor is and what is actually being transferred. In *Exchange Bank and Trust Co. of Florida v. United States*,[210] the government was concerned with the former issue. It succeeded in invoking the reciprocal trust doctrine[211] over custodial accounts which the decedent neither formally transferred nor had any interest in. The decedent and his spouse had each made gifts to their minor children naming the other as custodian of their respective transfers. Since neither retained a substantial economic interest in the property transferred, the estate argued that there was no basis for gross estate inclusion.[212] Unfortunately, the court dismissed this contention and held that, because of the interrelated nature of the cross-custodianships, the decedent was, for tax purposes, the custodian of the property he transferred. Thus the gift was included in the donor-decedent's gross estate,[213] depriving him of the chief tax benefits of

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use of a home by an adult child or free use of the family car. *Id.* at 1097 (Powell, J., dissenting).

209. The Court assumes that the Internal Revenue Service will not focus upon the traditional intrafamily or neighborly transaction, and, if it does, suggests that "there will be time enough to deal with such a case." *Id.* at 1093. In Announcement 84-60, 1984-23 I.R.B. 58, the Service stated that it would not require gift tax returns for pre-1984 interest-free demand loan gifts if the average annual outstanding balance of such notes did not exceed $50,000 ($100,000 for married taxpayers). Although the reason for this restraint was attributed to administrative convenience, it may spill over to other vulnerable transfers.

210. 694 F.2d 1261 (Fed. Cir. 1982).

211. The reciprocal trust doctrine, originated in Lehman v. Commissioner, 109 F.2d 99 (2nd Cir.), *cert. denied*, 310 U.S. 637 (1940), and approved in United States v. Estate of Grace, 395 U.S. 316 (1969), basically applies a substance over form test to determine the "true" transferor of property. The doctrine is best explained by example. If *A* conveys Blackacre giving *B* a life estate and *C* the remainder, and *B* simultaneously conveys Whiteacre, giving *A* a life estate and *C* the remainder, then for the purposes of applying I.R.C. §§ 2036 & 2038 (Law. Co-op. 1974 & Supp. 1984), *A* is considered to be the transferor of Whiteacre and *B* the transferor of Blackacre. Now both *A* and *B* are transferors of property over which each has retained an interest and the transfers are susceptible to gross estate inclusion.

212. The estate tried to distinguish *Grace* on this ground. It was argued that *Grace* essentially stands for the proposition that to be a transferor an individual must have an economic interest in the transferred property. Exchange Bank and Trust Co. of Fla. v. United States, 694 F.2d 1261, 1266 (Fed. Cir. 1982).

213. To the extent transferor is the custodian of property subject to the Uniform Gifts to Minors Acts the custodial property is includable in the gross estate of the transferor-custodian under § 2038(a). Rev. Rul. 70-348, 1970-2 C.B. 193. *See also* Stuit v. Commissioner, 452 F.2d 190 (7th Cir. 1971) (Ill. law); Eichstedt v. United States, 345 F. Supp. 484 (N.D. Cal. 1972) (Cal. law); Estate of Jacoby v. Commissioner, 29 T.C.M. 737 (1970) (Mo. law).

making the gift.

The cost of losing tax benefits associated with gift giving because the transfer is eventually made part of the gross estate can become quite expensive when life insurance is involved. This point was made painfully clear in *Kurihara v. United States*[214] where the issue was not whether a gift was made or who made it, but actually centered on what property had been transferred by the donor. In *Kurihara*, the decedent established an irrevocable trust agreement which identified him as the "initiator" of a one million dollar life insurance policy. The trustee, an independent party, formally applied for the life insurance on the same day. The application provided that the policy would not take effect until, inter alia, the first premium had been paid. The policy was issued in August. In September, the grantor-decedent drew a check in the amount of the premium payable to the trustee. The trustee then endorsed the check over to the insurer. The grantor died unexpectedly in an accident shortly thereafter. The estate excluded the policy from the decedent's gross estate because the decedent had no interest in either the policy or the trust. The government sought to include the proceeds of the policy in the gross estate pursuant to section 2035[215] on the theory that the policy itself, and not merely the premium, had been transferred by the decedent within three years of death. The central issue then became, what characteristics control making a transfer: the formal procedure or the underlying substance? The court unsurpisingly opted for the latter. This result should not, however, be construed as condemning all life insurance transfers to a similar fate. The court clearly expressed that the facts compelled them to conclude that the trustee had acted only as the decedent's agent.[216] Thus, the decedent's initial premium payment created ownership rights for the trustees and constituted a transfer of the policy for purposes of section 2035. The court conceded that under different circumstances (primarily if the trustee was not obligated to use the check to pay for insurance) the relevent gift for purposes of applying section 2035 would be of the funds supplied by the decedent.[217] The nature of insurance makes it critically important for taxpayers to adhere to the form that safeguards the substance.[218]

The illustrations should leave no doubt that from or structure be a foremost tax planning concern. The format employed can strike to

214. 82 T.C. 51 (1984).
215. The court notes that the transfer in issue was subject to § 2035 prior to its amendment by ERTA. 82 T.C. 51, 51 n.1 (1984). However, the issue of whether the transaction in dispute constitutes a transfer retains its importance because life insurance is still pulled back into the gross estate if it is transferred within three years of death. *See* I.R.C. § 2035(d)(2) (Law. Co-op. 1978 & Supp. 1984).
216. Kurihara v. United States, 82 T.C. 51 (1984).
217. *Id.* at 58. *See* Hope v. United States, 691 F.2d 786 (5th Cir. 1982).
218. The tax difference in *Kurihara* amounted to $317,513.19.

the heart of the gift tax itself (i.e., is there a transfer at all), or become a material issue when the donor's gross estate is ultimately computed (i.e., what was transferred and by whom). Despite the government's effort to ensure that constructive or disguised transfers are uncovered and treated appropriately, the proper form of a transfer can nonetheless be the legitimate means to a desire end. However, as with its income tax counterpart, it seems, the transfer tax benefits associated with gifts are available only when donors are realistically willing to part with dominion and control.

B. Choice of Asset

Any discussion of gifts and taxes in an estate planning setting would be incomplete if the "choice of asset" aspect of the situation were ignored. The proper choice of asset to be given away can be a crucial decision. If a gift is made with an eye toward tax benefits, it becomes incumbent upon the tax planner to maximize the advantage. Since gifts are not made in isolated tax environments, the impact of the transfer must be measured by both its income tax and transfer tax consequences. Donors usually consider their own tax needs first, but may secondarily concern themselves with the impact the gifts will have on the donees. In this way the best synergystic result can be obtained at the expense of the government.[219] Prompting the need to select assets carefully is the fact that the donor's desire to limit his transfer tax exposure may conflict with the effort to minimize income tax consequences. This conflict arises because the transfer taxes are directed at lifetime ownership value, whereas the income tax is only charged to annual realized increases in capital.

Viewed solely from a transfer tax perspective the donor will want to transfer an asset that is expected to appreciate in value, produce unneeded income, or do a combination of both. This, of course, follows from the fact that transfer tax benefits do not result from the actual value given away, but from related elements. The ability to exclude post-transfer appreciation and earnings from future transfer tax exposure is a chief attraction of gift giving. Thus, it is imperative that gifts be of assets capable of providing future growth or earnings. The greater the asset's appreciation and/or earning potential, the higher the chance that transfer tax savings will be achieved. The correlation is straight forward and requires little elaboration.

The income tax considerations must be viewed from a slightly different perspective. The donor has to determine the impact, if any, the

219. When planning an estate, it is sometimes best to look at the end results rather than the immediate advantage to be gained. Thus, to transfer the most value at the least cost, one must examine the effects on both the donor and the donee. This practice is not uncommon since most estate planning situations involve close family members.

gift will have on his own taxes, and may or may not be concerned with the tax effect the transfer will have on the donee. It is quite possible that the best asset to be given is also the worst to be received.

Only the donor's adjusted basis of appreciated property can pass to a donee absolutely free from any income tax. The donee's subsequent sale of the asset, assuming it does not decline in value, will trigger adverse tax consequences. Therefore, the donee would prefer to receive property that has not substantially appreciated in value. Unfortunately, appreciated assets may be exactly the type of property the donor is willing to give away, especially if he does not want to pay taxes on the appreciation himself. Of course, if the donor is in a position where he does not have to convert the property for his own personal needs, the problem is partially ameliorated, and such an asset can be retained without harm. But there is no guarantee that the donor will be able to hold the property indefinitely. A change in economic climate may dictate the donor's dispostion of the asset and saddle him with the unwanted tax accounting.

If property is held until death it will be transferred as a tax inheritance.[220] Although both gifts and inheritances are tax free receipts,[221] the latter can be more favorable because the donee will receive a basis equal to the property's fair market value on the date of the decedent's death[222] instead of carry-over basis.[223] The advantage of the so-called "stepped up" basis rule is evident. All appreciation on this property is forever eliminated from income tax accounting, and the post-death owner is only required to pay taxes on the appreciation occurring during his ownership. Thus, all else being equal, donees would prefer to receive assets which have little or no built-in gain as gifts, and acquire substantial appreciation through inheritance. Following this formula will minimize the donee's income tax exposure on the ultimate disposition of assets received by gift and avoid tax on pre-death appreciation for inherited property.

Unfortunately for donees, this path does not always provide the donor the tax incentives he wants. One of the donor's reasons for making the gift may be to shift appreciation away from his own high tax bracket and over to that of the donee. Of course, the donee will (or should) not decline the gift merely because the specific asset to be received will generate a tax liability upon its disposition. Even if taxed at the highest rate, there is still a substantial economic benefit

220. Section 102(a) is quite general and specifically includes bequests and devises as inheritances, which is the title of the section. This section has been broadly construed to include most forms of testamentary receipts. I.R.C. § 102(a) (Law Co-op. 1974 & Supp. 1984). *See* Lyeth v. Hoey, 305 U.S. 188 (1938).

221. I.R.C. § 102(a) (Law Co-op. 1974 & Supp. 1984).

222. *Id.* § 1014. *But see id.*, § 1014(e) (prohibiting the "step-up" in certain situations).

223. *Id.* § 1015.

in receiving the appreciation-laden asset. The donee is always assured of an increase in wealth equal to at least the donor's adjusted basis plus one-half of the built-in gain.[224] The same can be said for income-producing assets. The donee cannot be unhappy with the receipt of such property since, even in the worst of tax scenarios, one half of the income along with the donor's adjusted basis in the property is still added to the donee's personal capital account. Remembering that transfer tax considerations will prompt the donor to give away property believed to be capable of future appreciation, it is quite possible that such assets will be ones that already have experienced some growth. Thus, they become even more likely gift candidates, even though the donee may prefer to receive such assets upon the death of the donor.

Can one achieve the best of both worlds? Perhaps, with a little manipulation of the new transfer tax rules one can. Consider the individual who gives appreciated property to an elderly relative and then reacquires it through inheritance soon thereafter. Assuming all of the donee-decedent's assets, including the value of the gift, are shielded from transfer tax by the unified credit, the donor could reacquire his own property with a stepped-up basis and no transfer tax costs. This simple maneuver permits an income tax saving on all of the appreciation in the hands of the donor. Although Congress foresaw this problem and closed the loophole before it could be used,[225] some room for maneuverability and the opportunity to obtain a limited step-up in basis remains.[226]

It seems that the new unlimited marital deduction provides an opportunity for some income tax advantages. The marital deduction now permits free transfers of assets between spouses. Consequently all property acquired because of the death of the spouse will not generate any transfer tax liability, but will nonetheless be given a stepped-up basis. The best of both worlds is assured.

The situation becomes a little more complex, however, when joint interests are involved. Upon surviving her spouse, what basis does a widow take in the previous joint assets? The moiety that became hers by reason of her husband's death will undoubtedly take a stepped-up basis. But what of the other half? If she had purchased the moiety, then she has a cost basis and there are no difficulties. But what if she

224. This results because the receipt of the property is tax free but the donee acquires a carry-over basis. Thus the donor's adjusted basis is received free of tax. Any appreciation acquired may have to be accounted for by the donee in taxes, but the highest tax bracket is 50 percent. Consequently, the donor's adjusted basis and the untaxed half of the appreciation is received free. *Id.* § 102(a).

225. *Id.* § 1014(e).

226. To the extent the donor is willing to (1) transfer property in the hope that the donee will survive the one-year taint period of 1014(e), *id.*, and (2) devise the property to the donor, the "step-up" can be obtained.

received her interest by gift from her husband? Does she take one-half of her husband's original basis in the entire property or, since she supplied no consideration for the property, is her basis in this moiety zero? Similarly, what happens if the husband survives? Does he get a step-up in basis predicated upon his contribution or is he limited to a "step-up" for only the moiety in which he is reacquiring full title? The answers to these questions may have a significant effect on interspousal generosity.

Without having fully explored the matter, it should be apparent that choosing the correct asset to give away can be important. Not all assets are appropriate gift candidates. The trade-off created by the "carry-over" and "step-up" basis rules and the impact of the transfer tax benefits force the donors to carefully think out the most advantageous way to go about completing the transaction. These competing interests often make selecting the best asset a somewhat difficult decision.

IV. SIMPLIFIED ESTATE PLANNING

Since the instant primary objective is to investigate whether there are still sufficient tax incentives to prompt gift giving, it is not necessary to scrutinize new estate planning practices ushered in by the recent tax changes. Perhaps, however, some discussion noting the proper role of gifts in the overall estate planning picture is warranted. To this end some very general models will be introduced. The broad asset value range for each model is a deliberate effort to reinforce the fact that the discussion is not intended to be a detailed analysis, but instead, is designed to suggest generally how gifts can be of tax usefulness. The value ranges correspond to the full implementation of the $192,000 credit ($600,000 taxable transfer equivalency) due in 1987. Thus, for planning in earlier years, the threshold figures should be adjusted downward to the appropriate credit level for the year in question. Also, because of the limited scope of the analysis, it must be remembered that there is actually a great deal of maneuverability beyond the suggestions.

In small estates, up to the applicable unified credit equivalent, gifts will not offer any transfer tax benefits since these estates will not be concerned with the transfer taxes. If and when growth (earnings and/or appreciation) increases the estate values above the then applicable taxing threshold level, gifts may be capable of playing a limited role. At that time individuals might be willing or able to part with some assets to achieve tax benefits.[227] Once the accumulated wealth exceeds the applicable unified credit threshold, gifts can be used to cre-

227. There may also be an inheritance tax consequence in this value range. These taxes, where still applicable, can be reduced by gift-giving programs. The exemp-

ate and maintain a non-taxable estate level, and thereby eliminate the transfer tax entirely.

Most probably, income taxes are the pressing tax concern of individuals in this low value estate range. Unfortunately, there is probably little that gift giving can do to alleviate the burden. Generally, taxpayers at the lower end of this group will not have sufficient assets to permit them to make gifts and obtain the related benefits. They will need the assets for their own care. For practical reasons it is uncertain whether individuals at the higher end of the range will be capable of parting with the property. Despite the possibility of a relatively high value, the assets may be quite illiquid and not readily transferable. For example, pension and insurance benefits or a personal residence may represent potential high asset values, but are not realistic gift candidates. Moreover, these types of assets are not in themselves income tax burdens and therefore would not provide the tax benefit usually associated with gifts.

On balance, it seems fair to conclude that gifts will serve little tax purpose for individuals in the lowest net worth range. Concededly, there might be some isolated instances where an income tax advantage can be achieved, e.g., where a short term trust could be used as a support vehicle for an elderly relative. But without the transfer tax consequences as a prime concern, from a pure tax perspective gifts are not particularly useful planning tools for individuals in this group.

In medium sized estates (values ranging from the unified credit equivalent to twice the dollar equivalent amount, or ultimately up to $1,200,000) there is still a role for gifts to play. Gifts can reduce a donor-decedent's net worth below the taxable base equivalency for the applicable credit level. Moreover, through felicitous use of the annual exclusion, this can probably be accomplished without incurring a gift tax cost. Of course, to the extent a surviving spouse would succeed to the property, the marital deduction would eliminate any immediate tax exposure and gifts would not be immediately necessary. It must be realized, however, that the marital deduction does not eliminate the tax liability completely, but merely serves to delay or postpone it. Assuming there is no remarriage, the surviving spouse will eventually leave an estate that will not have the benefit of the marital deduction. The net effect of the deduction then is merely to shift all of the property and the concomitant tax problems into the survivor's lap. A simple example can demonstrate how the full use of the marital deduction, i.e., transferring one's entire estate tax free to a surviving spouse, is only a deferral technique and is not always the best path to follow.

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tions are generally lower than the unified credit and, therefore, even in this low value range, tax exposure is possible.

Assume two married couples—*H* and *W*, and *P* and *M*—each have an estate of $1,000,000, and all of the property is in the names of *W* and *M* for each of the respective families. None of the individuals have ever made any taxable transfers. For simplicity's sake it is assumed that there are no available deductions other than the marital deduction and that all events occur after 1987. *H* and *W* have estate plans that call for all of the property owned by either of them to pass outright to the survivor. *M* and *F* have executed documents that will create an "A-B" trust distribution upon the death of either. That is, one half of the property will pour-over into a trust which qualifies for the marital deduction;[228] the other half will be held in a trust which the survivor will have only a life income interest, with the remainder passing to other beneficiaries.

Upon *W*'s death there is no estate tax exposure. The marital deduction will be equal to the adjusted gross estate and will result in a taxable estate of zero dollars and no tax liability. When *H* eventually dies, there will be a $1,000,000 taxable estate and a $153,000 tax liability.[229] Clearly, the marital deduction did not eliminate the tax, but merely postponed its collection.

When *M* dies there will be a $500,000 taxable estate but no tax will be due because of the unified credit.[230] Nor will there be any tax due upon *F*'s subsequent death. *F* will have a $500,000 taxable estate and the same tax consequence as *M*. The net result is that the transfer taxes are completely avoided.

Although felicitous use of the marital deduction in conjunction with the two unified credits can eventually shield up to $1,200,000[231] of family wealth from the transfer tax exposure, this will not always happen. First, until 1987, the protected amounts must be reduced according to the phase-in schedule of the unified credit. Second, popular forms of ownership such as joint tenancy can easily obstruct the tax

228. Property held in trust will qualify for the marital deduction provided the requirements of § 2056(b)(5) are met. Basically the spouse must have a general power of appointment, even if only testamentary, coupled with a life estate in the qualifying corpus.

229. The tax on $1,000,000 is computed as follows:

Tentative Tax Base	$1,000,000
Tentative Tax	345,800
Gift Taxes Payable	-0-
Unified Credit	192,800
Estate Tax Liability	$ 153,000

230. A detailed computation is really not necessary since the gross estate equivalent of the unified credit is known to be $600,000. This is more than enough to shield *M*'s estate from tax exposure.

231. Each individual is entitled to a unified credit. Therefore, a couple can use two, one for each spouse, and thus protect $1,200,000 from transfer taxation.

efficacy of an "A-B" trust distribution plan.[232] But, interspousal gifts and concomitant estate equalization can minimize the prospect of tax exposure by guaranteeing the availability of two credits. For these reasons, gifts can still play a key role for even otherwise seemingly safe tax positions.

An interesting progeny of the unified credit is a variation on the "A-B" theme: the unified credit trust plan. Basically, this plan includes two trusts: a marital trust which qualifies for the marital deduction and a unified credit trust which does not. The unified credit trust is funded with an amount equal to the taxable equivalent of the applicable unified credit at the time of the decedent's death. The trust income can be payable to the surviving spouse with the corpus passing to other beneficiaries upon that spouse's death. The remainder of the estate falls into the marital trust. Upon the decedent's death there is no tax exposure. The full value of the marital trust is deductible and leaves a taxable estate equal to the value of the unified credit trust. The tax on this latter amount will be eliminated by the unified credit.[233] Upon the survivor's death, another unified credit will be available and it can be used to help offset any tax liability created by marital trust assets which will be included in the survivor's gross estate.[234] The unified credit trust is not includable in the survivor's gross estate.[235] A taxpayer using this format can maximize the use of two unified credits and also obtain the tax deferral advantage of the marital deduction.

Gifts are a potentially valuable tool for those individuals in this middle value range who eschew estate equalization in favor of tax deferral under full utilization of the marital deduction. The gift giving burden, however, will be on the surviving spouse. The primary objec-

232. The "A-B" can only work if there are sufficient assets for the decedent to pass at death. Title to jointly owned assets will remain in the survivng tenant regardless of any will or trust provisions attempting to create an "A-B" disposition. If too much property is jointly held between spouses there will be insufficient asset values to by-pass the survivor's estate in the "B" part. A simple example will illustrate the point.

Decedent died with a net estate of $1,000,000, $700,000 of which was jointly held with his wife. The decedent had only $300,000 to put into a "B" trust since the wife automatically acquired full title to the tenancy property. The wife is left with an amount in excess of the unified credit equivalent, and, with her estate, will suffer tax exposure unless it is somehow reduced. Thus, even though the husband did not encounter an estate tax (a result of the marital deduction and unified credit), the full benefit of the "A-B" distribution was lost.

233. The dispositive instrument must be worded carefully to ensure that the trust will be funded with an amount of property equal to the unified credit equivalent for the year of the decedent's death.

234. Property qualifying for the marital deduction in the estate of the first spouse will be included, to the extent it exists, in the estate of the surviving spouse.

235. The surviving spouse is either given a non-taxable income interest in the unified credit trust or is not a beneficiary at all.

tive will be to move property tax free out of the survivor's estate. Unfortunately, the only vehicles for this effort will be the annual exclusions. Although the other tax benefits associated with gift giving will be present they will offer little assistance in remedying the problem created by the first spouse leaving the entire estate to the survivor. Post-transfer appreciation and earning will escape ultimate taxation, but these items are only additions to the property that is the source of the true problem: the wealth acquired from the deceased spouse. The same can be said for any benefits flowing from the elimination of gift taxation from the estate tax base. Despite the magnitude of the job, the annual exclusion is up to the task.

In the earlier example which left *H* with $1,000,000, consider what a simple gift program could have accomplished. If *H* had two primary beneficiaries and five years to work with, $100,000 could have been taken out of the estate tax base tax free. This would have left a $900,000 taxable estate and a $114,000 estate tax payable,[236] a nifty tax savings of $41,000. Given more time and a larger number of beneficiaries, a more significant reduction in the tax exposure could have been made.

Of course, throughout this entire analysis it has been assumed that the asset poor spouse is the survivor. What happens if the asset rich spouse survives? All of the problems encountered in the preceding examples remain. A taxpayer will be left with property exceeding the available unified credit. The same benefits conferred by gifts in the other examples are again present. Clearly gifts still have a transfer tax usefulness in the middle size estate range.

Perhaps of equal importance to medium-sized estate taxpayers are the income tax savings that can be achieved through gift giving. These individuals can probably afford the loss of the use of property for limited periods of time and benefit from deflecting income through short term trusts. Also, some may be in a sufficiently secure economic position to make outright gifts, the cost of which can be reduced by the future income tax savings flowing from transferred appreciation and earnings thereon. Although possibly insufficient to motivate a gift, these factors when coupled with the potential transfer tax benefits make gifts quite attractive.

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236. Computed as follows:

Tentative Tax Base	$900,000*	
Tentative Tax	306,800	[§ 2001(c)(1)]
Gift Tax Payable	-0-	
Unified Credit	192,800	[§ 2010(a)]
Estate Tax Payable	$114,000	

*Even though transfers were made, the annual exclusion prevented them from becoming taxable gifts. Correspondingly, they are not adjusted taxable gifts to be added into the tentative tax base.

For large estates (values in excess of double the applicable unified credit equivalent: $1,200,000 and higher) all of the direct benefits of gift giving come into play. Gifts are the most profitable for individuals in this range. Since the accumulated wealth exceeds two unified credit equivalents, it is impossible to "stand pat" and avoid the imposition of the tax. Again, full use of the marital deduction only defers the tax but does not waive it. And, unfortunately, "A-B" trusts will not provide the relief in this wealth bracket that was had in the lower value-ranged estates. Once this level of wealth has been accumulated taxpayers must take a close look at the numbers and plan accordingly.

Consider first the consequences of fully utilizing the marital deduction to effecuate a complete tax deferral. The survivor is left with enough property to possibly be pushed into the highest marginal transfer tax bracket. Thus, although the government had to wait to get its share, what it finally receives may be the highest possible amount. Taxable estate division through an "A-B" disposition plan could, however, have lessened the government's share. Although both estates will pay a tax, by dividing the wealth equally, the overall tax paid by the family unit would be less. This happens because a second unified credit is used and lower marginal tax rates are applied to the taxed property.[237] Even so, eventually an accumulated wealth level is reached that, when halved, the highest marginal brackets still apply. The "A-B" plan becomes less and less appealing as wealth levels reach that amount. Also, even if the "A-B" plan provides an overall tax saving, when compared to the results from a full marital deduction plan, it is necessary to take into account the loss of the use of the tax money paid by the estate of the first spouse. Viewed from this perspective, the complete deferral may be more advantageous despite the fact that the total tax liability itself is higher. The time value of money concept makes the unified credit trust plan even more attractive to the extent that it primarily postpones the tax while simultaneously using two unified credits to minimize the overall tax due.

There can be no doubt that, in this high value estate range, gifts can play a major role in minimizing transfer taxes. All four of the earlier noted direct benefits can work in unison to assist in the effort. The following hypothetical should illustrate the positive impact gifts can have in estate planning for prospective donors with substantial wealth.

By tracing the tax consequences of *J* and *K*, the potency of gifts as

237. The advantage of the unified credit is readily apparent. By 1985, any taxable value in excess of $2,500,000 will be taxed at a 50 percent marginal rate. Thus, once the sum of these two figures is reached, there is no way to minimize taxes through rate manipulation. However, when asset values are below this amount, property can be split between taxpayers to obtain access to lower rates and less tax exposure.

tax saving devices in the asset value range can be fully explored. Both are widows whose only property is the respective estates left to them by their deceased husbands. Each husband left his entire estate worth $4,000,000 to his wife and did not pay any transfer taxes courtesy of the marital deduction. *J* and *K* have each invested their wealth identically in the following mix of assets: $3,000,000 in low-income producing, static assets; $600,000 in tax-exempt income securities generating a ten percent yield; and $400,000 in a speculative non-dividend paying stock issue. The income, net of income taxes, from the static assets, is exactly equal to each widow's living needs and is entirely consumed annually. Both widows have two children who are expected to share their mothers' estates equally. Assume that each widow dies at the end of the fifth year following her husband's death and, by that time, the speculative stock has doubled in value and is then worth $800,000. *J* never made any gifts during her lifetime. Her entire estate will pass to her children in two equal shares through an inter vivos revocable trust. *K*, on the other hand, pursued an active gift giving program immediately following her husband's death. In Year One she gave each of her children $150,000 worth of the speculative stock ($300,000 total). In Years Two through Five, inclusive, she gave each child $50,000 worth of fixed income securities. All the remaining assets were placed in a trust identical to the one established by *J*. Assuming that all of these events occurred after 1987 and disregarding any estate tax deductions that may be available, the comparative results are set out below, and prove the value of gifts as pure tax saving tools.

J's gross estate, and, for the purposes herein, taxable estate, will include the date of death value of all of the revocable trust assets.[238] The trust corpus includes the $3,000,000 worth of static assets; $600,000 worth of fixed income securities; $300,000 of income generated by the securities;[239] and the speculative stock woth $800,000. The taxable estate is, therefore, $4,700,000, and the estate tax payable thereon is $1,933,000.[240] The property, net of transfer taxes, passing to the children is $2,767,000, which means each child will receive $1,383,500.

238. The power to revoke the trust will make the copies fully includable in the gross estate. I.R.C. § 2038(a)(1) (Law. Co-op. 1978 & Supp. 1984).

239. The actual amount could be higher since the money earned would probably be reinvested. For example, if a modest five percent after tax returned is assumed, the $60,000 per year would be worth $331,538 by the beginning of year six. ($60,000 5.52563 (the factor at 5 percent for amount of five-year ordinary annuity) = $331,538).

240. Computed as follows:

Tentative Tax Base	$4,700,000	
Tentative Tax	1,655,800	[§2001(c)(1)]
Gift Tax Payable	-0-	
Unified Credit	192,800	[§ 2010(a)]
Estate Tax Payable	$1,463,000	

In contrast, *K* will have completely different transfer tax consequences. To the extent that these consequences are more favorable than *J*'s, the advantage can be directly attributed to the gifts, since they are the only distinguishing factors between the two situations.

In Year One, *K* made total gifts of $300,000, but did not incure an out-of-pocket gift tax cost since the taxable gifts of $280,000 ($300,000 minus a $10,000 annual exclusion for each donee) generated only a $81,000 gift tax,[241] which was more than eliminated by the available $192,800 unified credit. In Year Two, *K* made additional total gifts of $100,000, but again no immediate out-of-pocket tax cost was encountered, because of the gift tax on the $80,000 taxable transfer was only $27,200[242] and still shielded by the unused portion of the unified credit.[243] In fact, over the years, despite the numerous gifts, *K* will not be required to pay any gift tax whatsoever.[244]

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241. The gift tax computation is as follows:

Aggregate Current and Prior Taxable Gifts	$280,000	
Tentative Tax Thereon	81,000 (A)	[§2012(a)]
Tentative Tax on Prior Taxable Gifts	-0- (B)	
Tax Imposed	81,000 (C)	= (A)-(B)
Unified Credit	$192,800 (D)	[§ 2010(a)]
Gift Tax Payable	-0-	(C) - (D)

242. Computed as follows:

Aggregate Current and Prior Taxable Gifts	$360,000*	
Tentative Tax Thereon	108,200	[§ 2012(a)]
Tentative Tax on Prior Taxable Gifts	81,000**	
Tax Imposed	27,200	
Unified Credit	$111,800***	[§ 2010(a)]
Tax Payable	-0-	

*Current taxable gifts of $80,000 plus prior taxable gifts of $280,000.
**Tax on taxable gifts of $280,000.
***This represents the $192,800 credit reduced by the $81,000 used in the prior periods. *See* I.R.C. § 2505(a)(2) (Law. Co-op. 1974 & Supp. 1984).

243. The credit against the gift tax must be reduced by prior years' use. *Id* § 2505. *See also* Rev. Rul. 79-160, 1979-1 C.B. 313 (making the use of the credit mandatory).

244. The following schedule illustrates the point:

	(A)	B[1]	(C)[2]	(D)	(E)	(F)[3]	(G)[4]
Year	Total Transfers	Current Taxable Transfers	Total Taxable Transfers	Tax Imposed	Current Use of Unified Credit	Credit Remaining	Tax Payable
1	$300,000	$280,000	$280,000[5]	$81,000	$81,000	$111,800[6]	0
2	100,000	80,000	360,000	27,200	27,200	84,600	0
3	100,000	80,000	440,000	27,200	27,200	57,400	0
4	100,000	80,000	520,000	27,800	27,800	29,600	0
5	100,000	80,000	600,000	29,600	29,600	0	0
Total	$700,000	$600,000		$192,800			0

1. Total transfers minus available annual exclusions.

Upon *K*'s death, her taxable estate will be comprised of the trust assets. The $3,000,000 worth of static assets is still present, but only $200,000 worth of the fixed income securities are left.[245] Moreover, the securities have generated only $200,000 of earnings for *K* (the balance of the $300,000 total having inured to the benefit of the donees).[246] Also, only one-fourth of the speculative securities, $200,000 worth, are includable in *K*'s gross estate.[247] Her taxable estate is, therefore, $2,600,000. It must be remembered, however, that in determining her estate tax liability all adjusted taxable gifts have to be added to the taxable estate to calculate the tentative estate tax from which the actual estate tax payable is computed. In the instant case, although *K* transferred $700,000 of value, only $600,000 are adjusted taxable gifts.[248] Thus, the tentative estate tax base is $4,200,000 and the estate tax payable is $1,653,000.[249] Since *K* did not incure any gift taxes on her inter vivos gifts, the $1,653,000 also represents her total

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2. Current year's taxable transfer (B) plus previous year's total taxable transfers.
3. Previous year's balance (F) minus current year's use (E).
4. (D) minus (E).
5. Since this is the first year of transfers, current taxable transfers equal total taxable transfers.
6. Assumes no prior use of unified credit. Thus opening credit balance was $192,800.

245. The original $600,000 figure reduced by the four annual $100,000 ($50,000 per child) transfers.

246. Assuming that interest is earned at year's end and gifts are made at the beginning of the year, *K*'s earnings are:

INCOME PRODUCING EARNINGS

Year		Fund at 10%
1	$600,000	$ 60,000
2	500,000	50,000
3	400,000	40,000
4	300,000	30,000
5	200,000	20,000
Total		$200,000

*Previous year's amount minus current year's gift.

247. Since $300,000 worth of the original $400,000 of securities was given away, only $100,000 of the initial investment is left. Based upon its having doubled in value, it is worth $200,000.

248. The annual exclusions for each donee each year are not part of adjusted taxable gifts.

249. Computed as follows:

Taxable Estate	$3,600,000	(A)
Adjusted Taxable Gifts	600,000	(B)
Tentative Tax Base	4,140,000	(A) + (B)
Tentative Tax	1,845,800	(C)
Gift Tax Payable	-0-	(D)
Unified Credit	192,800	(E)
Estate Tax Payable	$1,653,000	(C) - (D + E)

transfer tax charge. The total value of property, net of transfer taxes, passing to her children is $3,047,000 (or $1,523,500 each). This amounts to an additional $140,000 per child, or $280,000 in overall tax savings effected by the gifts.

The $280,000 saving can be further linked to the different ways in which gifts provide tax benefits. The instant computation is made easy by the fact that all values excluded from transfer taxation in *K*'s estate are in the fifty percent marginal tax bracket. Thus, one can quickly determine that the use of $10,000 annual exclusions produced a $50,000 transfer tax savings: fifty percent of the total $100,000 escaped transfer taxation entirely. Although the gifts of securities and stock did not in themselves provide a benefit (these items were made part of the tentative estate tax base despite the fact that *K* no longer owned them), the post-transfer appreciation on the stock and earnings on the securities created the $230,000 balance of the overall tax savings.

The value of excluding post-transfer earnings from the transfer tax base can be readily determined. It was stated earlier that *K* was able to shift $160,000 of the security income earnings to her children. Applied to the fifty percent marginal tax rate, this produces a $80,000 tax saving. The savings from the post-transfer appreciation on the stock should therefore be the remaining $150,000 (the $230,000 balance minus $80,000 attributable to post-transfer earnings excluded from the tax base). To verify this figure all one need do is compute the post-transfer appreciation attributable to the transfer of the stock and multiply the result by the fifty percent marginal tax rate. *K* gifted away $300,000 worth of her stock holdings. The holdings doubled in value. Therefore, she had to include only $200,000 in her gross and taxable estates instead of $800,000. The $600,000 difference is allocated $300,000 to the value of the gift itself (already noted as not producing a benefit) and $300,000 to the appreciation. The tax value of excluding $300,000 as post-transfer appreciation from transfer taxation in a fifty percent marginal tax bracket is, of course, $150,000. *Voila*! The total $280,000 tax saving resulting from gift giving is equal to the sum of its separately identifiable parts ($50,000 + $80,000 + $150,000).

The numbers in the hypotheticals bear consideration. The estate tax reduced *J*'s estate by almost $2,000,000; and even though *K* saved over $250,000 by making gifts, her estate still suffered a tax shrinkage in excess of $1,500,000. The magnitude of these numbers forces one to step back and take notice.

As *K*'s heirs discovered, despite substantial gifts in a relatively short time period (a total of almost $750,000 in five years, which at the time of her death was effectively worth $1,125,000) the government "inherited" approximately thirty-five percent of of *K*'s wealth. In *J*'s case, the government obliged itself to a forty-one percent share of the

overall value transferred. The percentages and gross numbers are eye-opening. Even if *K* had more time to make gifts and had increased the amounts, there was only so much she could have done. By leaving their entire estates to their spouses, the husbands of *J* and *K* helped create a most unsatisfactory situation. Their failure to make use of the unified credit needlessly cost their children $300,000.[250] Also, by leaving all of their property to their surviving spouses, they stacked all of the values into one estate forcing the ultimate tax accounting at the highest marginal tax rate possible.

Had the husband's of *J* and *K* pursued a prudent gift program, they could have ameliorated the harsh tax consequences of the "stacking" problem without impairing the welfare of their surviving spouses. Even this approach is limited. At sufficiently high asset value levels there is little that can be done to reduce the absolute tax liability. In these situations gifts take on a different but equally important role. As a taxpayer's wealth reaches beyond the fifty percent marginal tax bracket, the gifts serve primarily to prevent increased taxes on future growth and earnings rather than to actually reduce asset value ownership for the purpose of eventually being taxed at a lower marginal rate. The integrated nature of the transfer taxes prevent the latter from happening either directly (by forcing a gift tax accounting itself at the fifty percent level) or indirectly (by including all taxable gifts in the tentative estate tax base). Once the taxpayer's wealth eclipses $3,100,000 any subsequent increase in wealth will be taxed at fifty percent regardless of whether it is taxed as a gift or as a part of the taxable estate. For these individuals gifts become the chief means of avoiding the needless stacking of wealth in one's own estate which, as previously demonstrated, is a role for which it is well suited. In these higher value ranges, gifts still have a share of center stage in the estate planning theater.

V. CONCLUSION

After wading through the sea of numbers, it becomes clear that gifts are capable of providing tax benefits. Future income tax liabilities can be reduced by shifting post-transfer income and unrealized appreciation over to donees. Although the potential income tax benefits may not in themselves be sufficient incentive to prompt a gift, even after the recent rate reductions, the benefits point the way for maximizing any available advantage. Beyond the gift-related scope of the income tax field lies for some the more significant realm of the transfer taxes. Despite substantial recent changes to the transfer taxes, gifts continue to be viable tax reducing transactions. Conced-

250. The arithmetic is simple enough. The unified credit equivalent of $600,000 at the highest marginal tax rate of 50 percent is $300,000.

edly, under the current system most taxpayers are not subjected to either gift or estate taxation; but for those who are, gifts play a crucial role. When properly structured or incorporated in an aggressive program, gifts prove to be more than up to the task of minimizing tax exposure. The important role of gifts seems well entrenched in the overall tax system as it presently exists, and subsequent changes to rates and credits will serve only to limit the degree and number of individuals who can avail themselves of their usefulness.[251] Gifts are and will remain leading players in the estate planning theater and should not be dismissed as being solely the concern of tax archeologists.

251. If the much discussed "flat" tax replaced the current income tax, gifts would still provide the means of moving the income tax accounting for post-transfer income and unrealized appreciation to donees. The major difference under the flat tax system would be that the actual tax savings would probably be less because of the lower rates. Similarly, if the unified credit were to be increased, or the transfer tax rates were further reduced, gifts would continue to provide the same benefits they presently do. Again, the only difference would be in the fewer number of taxpayers exposed to transfer taxation and the amount of the savings effected.