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The Role of Inter Vivos Giving in Estate Planning Under the Tax Reform Act of 1976

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Under the Tax Reform Act of 1976

The Tax Reform Act of 1976, in modifying the treatment of basis, changing the fiduciary income tax rules, and restructuring the estate and gift tax system, has had a significant impact on the field of estate planning. The greatest impact is on the role of inter vivos giving in the implementation of a successful estate plan. Established notions, based on tax considerations, regarding the advantages and disadvantages of utilizing lifetime giving in estate planning, the proper timing of such gifts, and the selection of property to give must now be largely revised or abandoned. In what follows an attempt will be made to identify the more significant situations in which inter vivos giving is made less advantageous by the new law and those in which inter vivos giving is made more advantageous. The selection of assets to give and the timing of giving will also be considered.

There are at least four circumstances or areas in which lifetime giving has been rendered less advantageous as a tool in estate planning. These involve the making of very large gifts, transfers of stock with retention of voting power, significant gifts within three years of death, and transfers of appreciated property into trust where the trustee is likely to sell the property within a short time after transfer.

As to very large gifts, the maxim that the very wealthy should effect substantial programs of lifetime giving to minimize transfer taxes has lost much validity. Formerly, for example, a person with assets of $10,000,000 might have been well advised to transfer several million during life because the combined gift and estate taxes would be much less than if he died without having made lifetime gifts. This was because the first dollar of taxable giving eliminated a dollar from the highest marginal estate tax rate at a cost determined at the bottom of the lower gift tax rate table. The Reform Act, however, in restructuring the system of taxing gifts and estates, eliminated the dual rate system applicable to lifetime and testamentary transfers and prescribed a single graduated rate table under which all gratuitous transfers are taxed. In short, we now have, for practical purposes, a unified gratuitous transfer tax under which inter vivos giving causes one to climb a graduated rate structure and whereby one's net estate at death is pragmatically treated as the last transfer occurring under a single system of taxing wealth transfers. As a consequence, and discounting the potential of a marital deduction and the availability of the $3,000 per donee annual exclusion, a person will pay as much federal tax on his transfers if he transfers all by gift, some by gift and some testamentarily, or all testamentarily. It should also be noted that the new single unified rate table is much more steeply graduated than the former separate gift tax rate table.

There is an established maxim of tax planning that taxes postponed is money saved. Where the same amount of tax liability can occur now or later, arranging for the liability to occur later in effect assures interest-free borrowing from the U.S. Treasury. A natural corollary of that maxim is that incurring the same amount of tax liability now, when it could have postponed until later, is money wasted, for it amounts to the taxpayer making an interest free loan to the Treasury. Because inter vivos giving that is subject to gift taxation is, by reason of the unification of the estate and gift tax systems, a process that incurs tax liability at a date earlier than would have incurred if the transfers were made at death, with little opportunity for transfer tax savings, taxable inter vivos giving is clearly discouraged by the Reform Act. It should be noted, however, that if the property being
considered for a lifetime transfer is, by reason of probable appreciation, likely to have a higher value if held until death, transfer tax considerations may well suggest an inter vivos gift.

Another situation in which inter vivos giving is less advantageous than before involves the device of transferring stock in trust with retention of voting power by the transferor. Under the old law, the transfer of stock with retention of voting power did not, of itself, result in the includibility of the stock in the transferor's gross estate. However, the new law now provides that a donor who retains voting rights in transferred stock until death has retained the "enjoyment" of the stock and it will be included in his gross estate. For example, if a donor is also trustee of the trust containing stock transferred, and as trustee can vote such stock, the stock is includible in his gross estate. This rule applies not only to stock in closely held corporations but to publicly traded issues as well.

A third area in which inter vivos giving is less advantageous than before involves gifts in contemplation of death. Under former law if a gift was otherwise appropriate, the fact that it might be occurring within three years of death was no reason not to make the gift. First, there was the possibility that a "life" motive could be proved, thus rebutting the presumption that the gift was in fact in contemplation of death. Secondly, even if it were determined that the gift was in contemplation of death, any gift tax paid usually would be a credit in the computation of estate taxes owing. Thirdly, and very importantly, the gift taxes paid reduced the net worth of the donor and thus depleted his taxable estate, affording what amounted to a deduction for transfer taxes in the computation of transfer tax liability.

Under the new law, the former inducements to make gifts in contemplation of death are largely curtailed. First, by reason of unification, the separate, lower gift tax rate structure is not available. Secondly, the rebuttable presumption device of former law has been supplanted by a flat rule that property transferred within three years of death is includible within the gross estate. Thirdly, the new law also brings back into the gross estate any gift taxes paid on transfers occurring within three years of death. This "gross-up" requirement prevents gift taxes paid on transfers within three years of death from being reductions in the computation of the gross estate. As will be noted later, however, a favorable change from former law now excludes from the gross estate transfers to the extent qualifying for the $3,000 per donee annual exclusion even where the transfers occur within three years of death.

A fourth way in which certain inter vivos gifts have been discouraged involves the potential of the donor's tax posture measuring the tax that will be due when transferred appreciated assets are later sold. A new provision, which is limited to transfers in trust, provides that any gain, to the extent of unrealized appreciation determined at the time of gift, derived from the sale of property within two years of transfer will be taxed to the trustee in an amount equivalent to the tax that would have been due had the donor made the sale, plus, in some cases, an interest penalty. Obviously, in such cases the trustee, in order to determine the tax owing, will have to be privy to tax data of the donor which otherwise would have remained confidential. A further consequence of this new rule is that the "net gift" device under which the donee trust would agree to pay the donor's transfer tax is less feasible. In many cases involving "net gifts," the donee trust, in order to fund the payment of the donor's transfer tax, would have to sell the transferred property, thereby generating the same tax on gains that the donor would have paid had he sold the property. Because a principal advantage of the "net gift" under prior law was the opportunity to fund the payment of transfer taxes from the proceeds of transferred property at a smaller capital gains tax exposure, the "net gift" device as applied to transfers in trust has considerably less utility.

Although, as has been noted above, the Tax Reform Act of 1976, in very significant ways, discourages inter vivos giving as a tool in estate planning, there are a number of ways in which the Act, by removing former constraints and providing additional inducements, encourages inter vivos giving. This encouragement to inter vivos giving arises from changes involving the new unified transfer tax credit, inter-spousal transfers, gifts in contemplation of death, basis rules, and rules involving post-mortem opportunities.

The most significant way in which the Act operates to encourage inter vivos giving is the increasing of the amount that can be transferred tax free. The $30,000 lifetime exemption and the $60,000 estate exclusion have been replaced by a unified transfer tax credit against tax liability which between July, 1977 and 1981 will increase from $30,000 to $47,000. From January 1, 1977 until June 30, 1977 the credit for gift purposes is limited to $6,000. The exemption equivalent of a credit of $30,000 is $120,667 and by 1981 the exemption equivalent of the unified credit
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Thus a person who, having made no previous taxable gifts, could have made a single tax free transfer of $33,000 prior to September of 1976 can, if he has made no other taxable gifts after January 1, 1977, make a single tax free transfer in 1981 of $178,625 ($3,000 per donee exclusion plus $175,625 exemption equivalent of the unified credit available). By having his spouse join in a joint gift election, the 1981 amount that could be transferred free of tax would be doubled to $357,250. The inducement to inter vivos giving attributable to the exemption equivalent of the unified credit ends when the unified credit has been fully utilized. The first taxable dollar transferred after the maximum unified credit is exhausted, whether the transfer be inter vivos or at death, is taxed on the unified rate table at the 32% bracket. Thus the point where tax free giving ends and taxable giving begins is a point at which substantial transfer tax liability begins to occur.

It must be stressed, in the examples used above, that, apart from the availability of the $3,000 annual exclusion and considerations unique to property that is likely to appreciate in value if held until death, there is little transfer tax advantage in utilizing the unified credit inter vivos rather than at death. The unified credit offsets the same amount of transfer tax liability, whether arising inter vivos or testamentarily. However, the desire to witness the enjoyment of one's assets by loved ones, or the desire to shift income producing property to persons in lower income tax brackets can be accommodated free of transfer tax constraints up to the exemption equivalent of the unified credit, and in this there is a greater inducement to inter vivos giving than before.

There is one instance, however, in which inter vivos giving, in the light of the unified credit, clearly operates to avoid transfer taxes. Suppose the year to be 1981, husband to be worth $1,000,000, wife to have no net worth and wife to be dying, and neither having made taxable gifts after 1976. And regard, for purposes of analysis, the unified credit of $47,000 available to each spouse as being in effect bank accounts on which withdrawals can be made only for the purpose of paying transfer taxes. If husband transfers $357,250 to child and wife consents to a joint gift election, there is no transfer tax liability because the transfer absorbs, but does not exceed, the two exemption equivalents and per donee exclusions. Failure to effect the above joint gift arrangement prior to the wife's death would mean that she would forfeit her unified credit "bank account" and that an
additional $178,625 would have been unnecessarily included in husband's estate at his subsequent death.

Another area in which limited inter vivos giving can be advantageous in minimizing transfer taxes involves inter-spousal transfers. Under the Tax Reform Act transfers between spouses after 1976 are exempt from tax as to the first $100,000 because the first $100,000 of inter-spousal transfers fully qualifies for the marital deduction. The second $100,000 of inter-spousal transfers is not eligible for the marital deduction. Above $200,000, the marital deduction is one-half of the amount transferred. As a consequence, a man whose estate plan presumes that his spouse will survive him, whose net assets do not exceed $600,000, and who wishes her to have more than one-half his assets may be well advised to transfer to her $100,000, which can be done tax free and without utilizing any of the available unified credit. Although his estate tax marital deduction ceiling would be reduced by $50,000 (the amount by which the $100,000 marital deduction claimed exceeds one-half the value transferred to her) he would be effecting a larger amount of tax free inter-spousal transfers than would be the case if he made no lifetime gifts to her and instead left her one-half his adjusted gross estate. Because of a complex interplay between the gift and estate tax marital deductions, there are few transfer tax inducements to utilize the $100,000 gift tax marital deduction where the donor is worth more than $600,000.

Another situation, although in practice rare to occur, in which significant inter vivos giving might be indicated would involve a husband with a net worth of $601,250 who takes advantage of the interplay between the unified credit, the gift tax marital deduction, and the special minimum estate tax marital deduction of $250,000. He could make a gift of $351,250 to his spouse and claim one-half, or $175,625, as a gift tax marital deduction and as to the balance, assuming the year to be 1981, he could claim the unified credit which is equivalent to an exemption of $175,625. At his death, his remaining assets of $250,000, if left to his wife, would be offset by the minimum estate tax marital deduction of $250,000. He thus would have transferred all of his assets to his wife without transfer tax liability. However, attention to transfer tax considerations at his spouse's subsequent death would frequently rule out the desirability of this approach. Also, should husband die within three years of the lifetime transfer, the new "contemplation of death" rule would recreate the transfer tax liability he had sought to avoid in transferring his entire wealth to his spouse.

Another change bearing on the advantageousness of certain inter-spousal transfers involves the treatment of jointly held property. Prior to 1977 the includibility of jointly held property in the estate of the first spouse to die was determined by reference to the percentage of consideration furnished by each spouse in the acquisition of the property. Thus, if husband furnished all the consideration, and he died first, the jointly held property would be fully includible in his gross estate, even if he had paid a gift tax on the creation of the joint tenancy. The new rules now provide that joint interests created by inter-spousal transfers after 1976, if subject to gift tax, or if taxable but for the per donee exclusion or availability of the unified credit, will be includible in the estate of the first to die only to the extent of one-half the value, and the "consideration furnished" test will not be applicable. One is still permitted the option of treating the termination, rather than the creation, of joint interests in real estate as the gift taxable event. However, in most cases it would appear advantageous to treat the creation of a joint tenancy in real estate as the taxable event, file a gift tax return, utilize the per donee exclusion and the $100,000 marital deduction, and thereby avoid the application of the "consideration furnished" test. Under the new law it is possible, after 1976, to sever a joint tenancy created prior to 1977, recreate it, and qualify for the new treatment. In any event, it is likely that the filing of gift tax returns will become a standard part of real estate closings involving acquisitions by married couples.

As was noted above, the new "gift in contemplation of death" rules generally operate to discourage transfers within three years of death. There is a limited way, however, in which the new rules encourage deathbed transfers. Expressly excepted from inclusion in the gross estate are transfers within three years of death to the extent qualifying for the $3,000 per donee annual exclusion. As a consequence, a dying man with ten loved ones may be well advised to give each of them $3,000 from his deathbed. If he has substantial worth, and given the fact that effective transfer tax exposure under the phased-in unified credit begins, between now and 1981, at either marginal 30% or 32% brackets, the indicated deathbed transfers of $30,000 could effectively avoid at least $9,000 in transfer tax liability.

A number of changes in the Tax Reform Act affecting post mortem planning opportunities interplay
with inter vivos giving in ways that can make limited inter vivos giving advantageous to the implementation of an effective estate plan. These involve situations in which opportunities for post mortem elections are available only if minimum prescribed relationships exist between assets included in the gross estate and the size of the gross estate or gross estate “modified.” For example, to qualify for the privilege of valuing farm land at “use” value rather than fair market value, the land, in addition to other requirements, must equal or exceed 25% of the “adjusted value” of the gross estate. Similarly, to qualify for the privilege of effecting a redemption under Section 303, closely held stock must exceed 50% of the adjusted gross estate, a requirement more stringent than that formerly applicable. Also, to qualify for automatic ten-year and fifteen-year extensions of time for the payment of estate taxes, percentage relationships between the value of a closely held business interest and the adjusted gross estate are prescribed.

In all of the above situations involving post mortem elective privileges, the higher the gross estate, the more difficult it is to qualify. A well considered program of inter vivos giving can, if effected more than three years prior to death, operate to reduce the size of the gross estate and thereby enable the percentage tests which govern the post mortem elective privileges to be met. Because of the unified credit and liberalized gift tax marital deduction, in many instances the pursuit of the post mortem goals can be undertaken with little or no gift tax liability.

A full analysis of the new basis rules as they bear on the wisdom of giving assets inter vivos rather than testamentarily is beyond the scope of this undertaking. In one major way, however, the modified basis rules operate to reduce or eliminate a constraint that formerly operated against inter vivos transfers and in favor of testamentary transfers. Under prior law the unrealized appreciation reflected in assets held until death effectively escaped income taxation after death by reason of the automatic step-up in basis that occurred. Basis to the executor or heir was equivalent to value for estate tax purposes. As a result, for example, the owner of a closely held business who on reaching retirement age was inclined to give his stock to a son, was deterred from doing so if the stock had appreciated in value, for a gift would generally mean that the son would take the father’s basis while a legacy to the son would carry with it a much higher basis.

The Tax Reform Act has changed the basis rules to reduce the incentive to hold appreciated assets until death. Under the Act the basis of assets acquired from a decedent will not reflect unrealized appreciation attributable to the period the assets were held after December 31, 1976. Thus where a person acquired an asset on or after January 1, 1977 and it has since appreciated in value, a gratuitous transfer to a loved one will have essentially the same consequence to the transferee whether received by gift or by legacy. That is, basis to the donee or legatee will be donor’s or decedent’s basis with appropriate upward adjustments for transfer taxes attributable to the unrealized appreciation element. However, as to assets acquired prior to 1977 as to which a significant amount of unrealized appreciation is attributable to the period prior to 1977, the inducement to hold until death will continue because of the “fresh start” exception which provides grandfather clause treatment to pre-1977 unrealized appreciation when the asset is included in the decedent’s estate.

To the extent, however, that the new basis rules eliminate basis as a consideration in whether to give inter vivos or at death, a constraint on inter vivos giving has been removed. A consequence is likely to be the increased use of gifts causa mortis made with a view, in part, to reducing the costs of probate and administration.

From the foregoing discussion it is clear that previously established notions in estate planning of whether, when, what and how much inter vivos giving is appropriate to a well conceived estate plan are no longer valid. The above coverage is in no sense exhaustive and is rather an attempt to point out the principal ways that the new law bears on inter vivos giving in estate planning. A number of finer points in the new law relevant to the role of inter vivos giving have from a desire for brevity been omitted. A summary is not a substitute for a careful reading to the pertinent provisions of the new law.

Editor’s Note: This is the first of a proposed series of articles by Prof. Donaldson about the effects of the Tax Reform Act of 1976 on estate planning and administration. Additional aspects of this field will be discussed by Prof. Donaldson in future issues of the Journal.