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Inter Vivos Giving in Estate Planning under the Tax Reform Act of 1976

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INTER VIVOS GIVING IN ESTATE PLANNING UNDER THE TAX REFORM ACT OF 1976

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The Tax Reform Act of 1976,[1] 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 using lifetime giving in estate planning, the proper timing of such gifts, and the selection of property to give must be largely revised or abandoned. This Article identifies 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. It also will consider the selection of assets to give and the timing of giving.

In at least four circumstances lifetime giving has been rendered less advantageous as a tool in estate planning: 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 when 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 dollars during life because the combined gift and estate taxes would be much less than if he died without having made lifetime gifts.[2] The first dollar of taxable giving eliminated a dollar

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1. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

2. H.R. REP. No. 1380, 94th Cong., 2d Sess. 11, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 469, explains:

> Under present law, there is a substantial disparity of treatment between the taxation of transfers during life and transfers at death. In general, there are three factors which provide a decided preference for lifetime transfers. First, the gift tax rates are set at three-fourths of the estate tax rates at each corresponding rate bracket. Second, lifetime transfers are not taken into account for estate tax purposes and the estate remaining at death is subject to tax under a separate rate schedule starting at the lowest rates. Thus, even if the rates were identical,

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, 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.[3] 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. Consequently, 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. Additionally, the new single unified rate table is much more steeply graduated than the former separate gift tax rate table.[4]

An established maxim of tax planning is that taxes postponed is money saved. If 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 United States Treasury. A natural corollary of that maxim is that incurring the same amount of tax liability now, when it could have been 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, due to the unification of the estate and gift tax systems, a process that incurs tax liability at a date earlier than it would have been incurred if the transfers were made at death, with little oppor-

separate rate schedules would provide a preference for making both lifetime and deathtime transfers rather than having the total transfer subject to one tax. Third, the gift taxes paid are not generally taken into account for either transfer tax base. In the case of a gift, the tax base does not include the gift tax but the payment of the tax results in a decrease in the value of the estate retained by the donor. However, if the property were retained until death, the tax base includes the full value of the property, even though a portion is likely to be required to satisfy estate taxes. Thus, even if the applicable transfer tax rates were the same, the net amount transferred to a beneficiary from a given pretax amount of property would be greater for a lifetime transfer solely because of the difference in the tax bases.

3. I.R.C. § 2001. "As a matter of equity . . . the tax burden imposed on transfers of the same amount of wealth should be substantially the same whether the transfers are made both during life and at death or made only upon death." H.R. REP. No. 1380, 94th Cong., 2d Sess. 11, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 469.

4. *See* I.R.C. § 20001(c). *Compare* INT. REV. CODE of 1954, ch. 11, § 2001, 68A Stat. 374.

tunity for transfer tax savings, taxable inter vivos giving is discouraged by the Reform Act. Notably, 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.

Comparatively, the unification rules operate much more harshly in their application to donors who made gifts prior to 1977 than in their application to donors who began programs of inter vivos giving after 1976. For gift tax purposes under the new rules the net taxable amount of pre-1977 giving is added to the taxable amounts of post-1976 giving to determine the marginal rate under the unified rate table applicable to post-1976 giving.[5] For example, one whose pre-1977 net taxable gifts after exemptions, exclusions, and deductions aggregated $1,000,000 will begin at the 41% marginal bracket as to any gifts made after 1976 whereas one who made no net taxable gifts prior to 1977 will begin his post-1976 program of giving at the bottom of the rate table in the 18% marginal bracket.

If a donor engaged in taxable giving prior to 1977, however, the calculation of gift taxes due on post-1976 gifts is made on the assumption that gift taxes paid prior to 1977 are the amount that would have been paid had pre-1977 gifts been taxed under the higher unified rate table.[6] Thus the gift tax payable on a 1977 gift is not the amount determined from the rate table less the gift taxes paid prior to 1977, but is the amount determined from the rate table less the gift taxes that would have been paid prior to 1977 had such pre-1977 gifts been taxed under the new unified rate table. Although pre-1977 giving affects the computation of post-1976 gift taxes by placing the donor in a higher tax bracket, such pre-1977 giving is disregarded in determining the application of the unified rate table to the taxable estate for estate tax purposes.[7] Consequently, it is possible that donors who made substantial pre-1977 gifts and who continue to make substantial gifts, in addition to pre-paying transfer taxes that would not otherwise be due until death, may in fact be overpaying such taxes.[8]

5. I.R.C. § 2502.

6. I.R.C. § 2504.

7. I.R.C. § 2001(b)(2).

8. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 13, *reprinted in* [1976] U.S. Code Cong. & Ad. News 460, 471, provides:

> As a transitional rule, the complete lifetime transfers taken into account in determining cumulative transfers at death for purposes of imposing the estate

Transferring stock in trust with retention of voting power by the transferor is another situation in which inter vivos giving is less advantageous than before. 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.[9] The new law now provides that a donor who retains voting rights in transferred stock until death has retained the "enjoyment" of the stock; thus it will be included in his gross estate.[10] For example, if a donor is also trustee of the trust containing stock transferred, and as trustee he 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 type of transfer that is less advantageous than before is the gift in contemplation of death. Under former law a gift otherwise appropriate occurring within three years of death did not result automatically in transfer liability.[11] First, there was the possibility

> tax are only to include taxable gifts made after December 31, 1976. Correspondingly, the gift tax paid with respect to gifts made before January 1, 1977, is not to be included as a part of the subtraction or offset in computing the estate tax. The subtraction or offset is to include the aggregate amount of gift tax payable on gifts made after December 31, 1976.

9. United States v. Byrum, 408 U.S. 125 (1972). In *Byrum* the Supreme Court held that the stock of a closely held corporation was not includible in the decedent's gross estate when the decedent had irrevocably transferred the stock in trust reserving the power to (1) remove the trustee and appoint another corporate trustee, (2) vote the closely held stock, (3) veto the sale or other transfer of the trust property, and (4) veto any change in investments. The Court found that the reserved rights did not constitute retained enjoyment of the stock or the right to designate the person or persons who would enjoy the stock or the income from the stock.

10. I.R.C. § 2036 provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death -
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> (1) the possession or enjoyment of, or the right to income from, the property or
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> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock.

11. INT. REV. CODE of 1954, ch. 11, § 2035(b), 68A Stat. 381 (now I.R.C. § 2035(a)), provided:

> If the decedent within a period of 3 years ending with the date of his death (except in case of a bona fide sale for an adequate and full consideration in money or money's worth) transferred an interest in property, relinquished a power, or exercised or released a general power of appointment, such transfer,

that a "life" motive could be proved, thus rebutting the presumption that the gift was in fact in contemplation of death.[12] 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.[13] 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.[14] The new law largely curtails the former inducements to make gifts in contemplation of death. First, because of unification, the separate, lower gift tax rate structure is unavailable. 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.[15] Thirdly, the new law also brings back into the gross estate any gift taxes paid on transfers occurring within three years of death.[16] This "gross-up" requirement prevents gift taxes paid on transfers within three years of death from being reductions in the computation of the taxable estate. As will be noted later, however, a favorable change from former law now excludes from the gross estate transfers qualifying for the $3,000 per donee annual

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> relinquishment, exercise, or release shall, unless shown to the contrary, be deemed to have been made in contemplation of death . . . .

12. Bel v. United States, 452 F.2d 683 (5th Cir. 1971), *cert. denied*, 406 U.S. 919 (1972).

> [T]he Supreme Court has held that a transfer is made in contemplation of death only if the thought of death is the impelling cause of the transfer. This means that the taxpayer has the task of persuading the court that in transferring property the decedent was not motivated by purposes associated with the distribution of property in anticipation of death.

Id. at 687.

13. INT. REV. CODE of 1954, ch. 11, § 2012(a), 68A Stat. 375, provided:

> If a tax on a gift has been paid . . . and thereafter on the death of the donor any amount in respect of such gift is required to be included in the value of the gross estate of the decedent for purposes of this chapter, then there shall be credited against the tax imposed by section 2001 the amount of the tax paid on a gift . . . .

14. "Under the new unified transfer tax system this payment would not affect the tax imposed upon most estates in a major way because the gift tax paid would be allowed as a credit in determining the net estate tax due." H.R. REP. No. 1380, 94th Cong., 2d Sess. 12, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 470.

15. I.R.C. § 2035(a). *See also* H.R. REP. No. 1380, 94th Cong., 2d Sess. 13, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 471.

16. I.R.C. § 2035(c) provides in pertinent part: "The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death."

exclusion even when the transfers occur within three years of death.[17]

A fourth way in which the new law discourages certain inter vivos gifts involves the possibility that the donor's tax posture will be used to measure the tax that will be due when transferred appreciated assets are sold later. 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.[18] Obviously, in such cases the trustee, to determine the tax owing, will have to be privy to tax data of the donor that 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 of "net gifts", the donee trust would have to sell some of the transferred property to fund the payment of the donor's transfer tax, 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 the Tax Reform Act of 1976 significantly 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 in 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 increased amount that can be transferred tax free. The $30,000 lifetime exemption and the $60,000 estate tax 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.[19] From January 1, 1977 until June 30, 1977 the

17. I.R.C. § 2035(b)(2). *See* text accompanying note 38 *infra*.
18. I.R.C. § 644.
19. I.R.C. § 2010.

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 will be $175,625. Notably, the per donee exclusion of $3,000 has been retained[20] as has the option for a joint gift election between husband and wife.[21] Thus a person who, having made no previous taxable gifts, could have made a single tax free transfer of $33,000 prior to September 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 unifed 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.[22] 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 at which tax free giving ends and taxable giving begins is a point at which substantial transfer tax liability begins to occur.

Donors who engaged in taxable inter vivos giving prior to 1977 are not denied the benefits of the unified transfer tax credit and may claim the credit in computing gift taxes payable.[23] However, because such donors frequently will begin their post-1976 giving at a marginal rate on the unified table above the 18% bottom bracket because of pre-1976 giving, their exemption equivalent of the unified credit can be significantly less than $175,625.[24] Additionally, donors who made gifts between September 8, 1976 and January 1, 1977 and claimed any part of the old $30,000 lifetime exemption suffer a reduction in the unified credit amount available against post-1976 transfer taxes of 20% of the lifetime exemption previously claimed in such period.[25]

20. I.R.C. § 2035(b)(2).

21. I.R.C. § 2513(a)(1) provides: "A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse . . . ."

22. I.R.C. § 2505.

23. I.R.C. § 2010(c).

24. I.R.C. § 2010.

25. I.R.C. § 2010(c) provides:

> The amount of the credit allowable under subsection (a) shall be reduced by an amount equal to 20 percent of the aggregate amount allowed as a specific ex-

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 using 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; 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, operates to avoid transfer taxes. Suppose the year is 1981, husband is worth $1,000,000, wife has no net worth, wife is dying, and neither have made taxable gifts after 1976. Further, 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 included unnecessarily in husband's estate at his subsequent death.

If, however, each spouse has substantial assets, joint gift elections for transfers made by one spouse may be inadvisable because of the interplay between the unification rules and the rules applicable to transfers within three years of death. If a donor dies within three years of making such a joint election the amount brought back into his gross estate is the entire amount of the transfer less the $3,000 exclusion, not merely the one-half that was effectively subject to gift tax because of the joint-gift election.[26] The non-donor spouse who consented to the joint-gift election has, of course, raised her tax bracket by the election;[27] no adjustment is made for the non-donor

emption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the decedent after September 8, 1976.

26. I.R.C. § 2035(a).

27. I.R.C. § 2513.

spouse when the entire amount of the donor's transfer is brought back into his estate because of his death within three years of the gift.[28] Therefore, a joint gift election followed by the untimely death of the actual donor can result in taxing the amount of the gift one and one-half times rather than merely once.

Another area in which limited inter vivos giving can be advantageous in minimizing transfer taxes is 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.[29] 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.[30] Consequently, 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 using 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 if he made no life time 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 use the $100,000 gift tax marital deduction if the donor is worth more than $600,000.

Although it may be rare in practice, a situation in which significant inter vivos giving might be advisable would arise if a husband with a net worth of $601,250 could take advantage of the interplay between the unified credit, the gift tax marital deduction, and the special minimum estate tax marital deduction of $250,000.[31] He

28. I.R.C. § 2035(a).

29. I.R.C. § 2523(a)(2)(A).

30. I.R.C. § 2523(a)(2)(B).

31. I.R.C. § 2056(c)(1).

> [The Tax Reform Act of 1976] increases the maximum estate tax marital deduction for property passing from the decedent to the surviving spouse to the greater of $250,000 or one-half of the decedent's adjusted gross estate. [The Act] also amends the gift tax marital deduction to provide an unlimited deduction for transfers between spouses for the first $100,000 in gifts. Thereafter, the deduction allowed will be 50 percent of the interspousal lifetime transfers in excess of $200,000. Under this provision, the limitation on the estate tax marital

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.[32] 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 frequently would rule out the desirability of this approach. Also, should the 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.[33] Prior to 1977 the includibility of jointly held property in the estate of the first spouse to die was determined by the percentage of consideration furnished by each spouse in the acquisition of the property.[34] 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

> deduction is to be reduced by the amount of the marital deduction allowed for lifetime transfers in excess of 50 percent of the value of the transfers (i.e. where lifetime gifts eligible for the marital deduction are less than $200,000).

H.R. REP. No. 1380, 94th Cong., 2d Sess. 18, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 476.

32. I.R.C. § 2056(c)(1)(A).

33. H.R. REP. No. 1380, 94th Cong., 2d Sess. 19, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 477, explains:

> For estate tax purposes, present law provides that on the death of a joint tenant the entire value of the property owned in joint tenancy is included in a decedent's gross estate except for the portion of the property which is attributable to the consideration furnished by the survivor. Thus, if the decedent furnished the entire purchase price of the jointly owned property, the value of the entire property is included in his gross estate. If it can be demonstrated that the survivor furnished part of the purchase price, only the remaining portion of the value of the property is included in the decedent's gross estate.

34. INT. REV. CODE of 1954, § 2040.

be applicable.[35] One still is permitted the option of treating the termination rather than the creation of joint interests in real estate as the gift taxable event.[36] 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, use 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.[37] In any event, the filing of gift tax returns probably 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. The new rules, however, encourage death bed transfers in a limited way. Transfers within three years of death that qualify for the $3,000 per donee annual exclusion are expressly excepted from inclusion in the gross estate.[38] Consequently, a dying man with ten loved ones may be well advised to give each of them $3,000 from his death bed. Because effective transfer tax exposure under the phased-in unified credit begins between now and 1981 at either marginal 30% or 32% brackets, the indicated death bed transfers of $30,000 could effectively avoid at least $9,000 in transfer tax liability.

35. I.R.C. § 2040(b)(1), provides: "Notwithstanding subsection (a), in the case of any qualified joint interest, the value included in the gross estate with respect to such interest by reason of this section is one-half of the value of such qualified joint interest."

36. I.R.C. § 2040(a).

> If the donor does not elect (in the case of real property) to treat the transaction as a gift at the time of the creation of the interest (by not including the transfer on a timely filed gift tax return) then, upon the death of a spouse, the joint property is to be subject to inclusion in the gross estate at the full value of the property less the value attributable to any contribution that can be traced to the survivor.

H.R. Rep. No. 1380, 94th Cong., 2d Sess. 20, *reprinted in* [1976] U.S. Code Cong. & Ad. News 460, 478.

37. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 20, *reprinted in* [1976] U.S. Code Cong. & Ad. News 460, 478, provides:

> The provision is to apply to joint interests created after December 31, 1976. For this purpose, the chain of title of the property before the creation of the joint tenancy is immaterial. Thus, if a severance or partition of an existing joint tenancy is made after December 31, 1976, and the joint tenancy between the spouses in that property is then recreated, the creation of the new joint tenancy would be eligible for the election so long as the other requirements are satisfied and the creation of the new joint tenancy is valid under local law.

38. I.R.C. § 2035(b)(2).

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. Specifically, opportunities for post-mortem elections are available to certain estates 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.[39] 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.[40] 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 closely held business interests and the adjusted gross estate are prescribed.[41] In all of these situations, the higher the gross estate, the more difficult it is to qualify. A well considered program of inter vivos giving, if effected more than three years prior to death, can operate to reduce the size of the gross estate and thereby enable the percentage tests that govern the post-mortem elective privileges to be met. Because of the unified credit and liberalized gift tax marital deduction, the pursuit of the post-mortem goals often can be undertaken with little or no gift tax liability.

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39. I.R.C. § 2032A(b)(1)(B).

40. I.R.C. § 303(b)(2)(A). *Compare* INT. REV. CODE of 1954, ch.1, § 303(b)(2)(A), 68A Stat. 88, which provides:

> Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate is either - (i) more than 35 percent of the value of the gross estate of such decedent, or (ii) more than 50 percent of the taxable estate of such decedent.

41. I.R.C. § 6166.

> Under the bill, the executor may elect to defer the estate tax (but not interest on the tax) for a period of up to 5 years and thereafter pay the tax in equal annual installments over the next 10 years.
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> To qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must be at least 65 percent of the value of the gross estate reduced by expenses, indebtedness and losses.

H.R. REP. No. 1380, 94th Cong. 2d Sess. 31 *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 489.

A full analysis of how the new basis rules bear on the wisdom of giving assets inter vivos rather than testamentarily is beyond the scope of this summary. 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 because of an automatic step up in basis.[42] Basis to the executor or heir was equivalent to value for estate tax purposes; 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 generally would mean that the son would take the father's basis although 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.[43] Thus if a person acquired an asset on or after January 1, 1977 that has since appreciated in value, a gratuitous transfer will have essentially the same consequence to the transferee whether received by gift or by legacy because 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. As to assets acquired prior to 1977 to which a significant amount of unrealized appreciation is attributable to the period prior to 1977, the inducement to hold the asset until death will continue because of the "fresh start" exception that provides grandfather clause treatment to pre-1977 unrealized appreciation when the asset is included in the decedent's estate.[44]

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42. INT. REV. CODE of 1954, ch. 1, § 1014(a), 68A Stat. 296, provided:

> Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death . . . .

43. I.R.C. § 1023(h). "Under . . . [the] bill, the basis of most property acquired from or passing from a decedent who dies after December 31, 1976, is no longer to be stepped up (or stepped down) to reflect the fair market value of the property on the date of death." H.R. REP. No. 1380, 94th Cong., 2d Sess. 37, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460, 495.

44. I.R.C. § 1023(h). Appreciated property held by the decedent is stepped up to its fair market value as of December 31, 1976, providing a "fresh start" basis.

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 costs of probate and administration.

Under the new law, as under the old, the selection of assets to be given inter vivos is essential to the effective implementation of programs of family wealth transfers. Assets that are certain to appreciate in value remain, as before, prime candidates for gift consideration. Life insurance policies of the owner-insured are especially appropriate for no asset is more certain to appreciate over the life of the owner than such policies.

The Reform Act, however, has introduced a number of new factors that bear on the proper selection of assets to be given during life and has modified a number of former factors. In some instances land used in farming or in a closely held business can be valued, for estate tax purposes, at a "use" value that is lower than fair market value, thereby reducing transfer taxes payable at death.[45] This special valuation opportunty is available only for qualified land included in a gross estate and only for estate tax purposes. If a potential donor has such qualified land, he may be well advised to dispose of it at death because transfer taxes on an inter vivos gift would be measured by actual value rather than "use" value.[46]

As has been noted, unrealized appreciation reflected in an asset acquired prior to 1977 is "grandfathered" as to such appreciation, which, under the applicable rules, is determined to be attributable to the period prior to Jannuary 1, 1977.[47] These assets, if held until death, will have a "fresh start" basis that is the higher of the decedent's basis or the value as of December 31, 1976.[48] Consequently, assets that contain significant "grandfathered" unrealized appreciation may be more appropriate for testamentary disposition than for inter vivos giving.

Now, as before, with respect to a gift, the donee's basis for purposes of gain is the donor's basis increased by an adjustment for gift taxes paid, but not above fair market value determined at the time of giving.[49] Now, however, only gift taxes attributable to the donor's

45. *See* I.R.C. § 2032A.
46. I.R.C. § 2032A(a)(1)(B).
47. *See* note 44 *supra.*
48. I.R.C. § 1023(h).
49. I.R.C. § 1015(d)(1)(A).

unrealized appreciation are taken into account in making the upward adjustment for the donee.[50] Therefore, with due regard to the availability of the unified credit, a donor whose program of inter vivos giving includes a combination of highly appreciated assets, slightly appreciated assets, nonappreciated assets and cash should time his program of giving carefully. Cash and nonappreciated assets should be given away first to absorb the exemption equivalent of the unified credit. As to these assets, the donee's basis will be fair market value, the donor's basis.[51] Had such assets been given after use or the exemption equivalent of the unified credit, any gift taxes actually paid could not have afforded a basis increase to the donee.[52]

Slightly appreciated assets should comprise the next gifts given as the donor continues his climb up the unified rate table. The gift taxes attributable to the unrealized appreciation will be relatively small, but because the unrealized appreciation is assumed to be slight the donee's basis will be close to fair market value. For obvious reasons, substantially appreciated assets should be given at the end of the giving program to generate the maximum amount of gift taxes attributable to unrealized appreciation, thereby assuring the donee the highest basis available to him from an inter vivos gift.

The determination of gift taxes attributable to unrealized appreciation is made on a quarterly basis.[53] Consequently, the timing of gifts, as outlined above, should be undertaken with an awareness of the quarterly determination technique, and gifts of highly appreciated assets should not be made in the same calendar quarter as gifts of cash or slightly appreciated assets.[54] It also should be stressed that because the net taxable estate is essentially treated as the last transfer occurring on the graduated unified rate table[55] and because estate taxes attributable to post-1976 unrealized appreciation reflected in assets included in the taxable estate can be added to the transferee's basis, it may be advantageous, considering the transferee's basis, to retain substantially appreciated assets for testamentary disposition. In any event, a large estate that consists

50. I.R.C. § 1015(d)(1)(B).

51. I.R.C. § 1015(a).

52. I.R.C. § 1015(d)(1)(A). The basis of property acquired by gift may be increased by the amount of gift tax paid, but not above the fair market value of the property at the time of the gift.

53. I.R.C. § 2501(a)(1).

54. This is to maximize the basis increase of the highly appreciated assets.

55. I.R.C. § 2001 provides a single unified transfer tax for both testamentary and inter vivos transfers.

substantially of nonappreciated assets will be less able to pass on to transferees meaningful upward basis adjustments.

Considering the marginal income tax brackets of potential donees in the selection of assets to be given inter vivos to such donees is also wise. From income tax considerations at the donee level, assets given to high income donees should contain lesser amounts of unrealized appreciation than assets given to low income donees.[56] In appropriate cases, a donor may be well advised to sell an asset and give away the proceeds. This is particularly true of depreciated property because an unrealized loss cannot be assigned or given away for income tax purposes.[57] Also, a potential donor, contemplating death, may be well advised to sell appreciated property and make death bed transfers of the proceeds rather than give away such property. Income taxes incurred in making the sale will reduce the donor's taxable estate and the transfer taxes payable on the proceeds of the sale thus will be less than those applicable to a disposition of the appreciated asset by gift or legacy.

The foregoing discussion demonstrates the invalidity of previously established notions in estate planning of whether, when, what, and how much inter vivos giving is appropriate to a well conceived estate plan. The coverage is in no sense exhaustive; rather it is an attempt to point out the principal ways 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 been omitted in a desire for brevity. A summary is not a substitute for careful scrutiny of the pertinent provisions of the new law.

56. In the case of sale of an appreciated asset, the donee in the higher tax bracket would pay more income tax on the appreciation than would a donee in a lower tax bracket. Thus if equal bequests of $5,000 for a high and low income donee were desired, it would be best to bequeath the high income donee $5,000 in cash which takes its face amount as basis and to bequeath $5,000 in stock with a basis of $2,000 to the low income donee.

57. If the donor sells the property and then makes a gift of the proceeds, the donee is receiving the same value as if the property were transferred to him. The donor, however, then will be able to take a capital loss deduction. I.R.C. § 1211.