Jonathan D. Mishkin – NBI Speech August 23, 2012

A. FEDERAL GIFT TAX

1. What is a Gift?

A "gift," under federal tax law, is defined as the "gratuitous transfer of property by an individual to a donee in exchange for less than adequate and full consideration in money or money's worth."[1] The definition of "property" is interpreted broadly to include "every species of right or interest protected by law and having an exchangeable value." A "transfer" is given a broad meaning under §2511, construing "the tax imposed by §2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."

A gift is complete to the extent that the donor relinquishes all dominion and control over the transferred property. In other words, the donor retains no legal right or economic benefit in the transferred property. As a general rule, to the extent that the transferor retains any power to revoke the gift or to change the disposition of the property, the gift is incomplete.[2] A gift of less than a donor's entire interest in property generally is subject to gift tax only with respect to the interest transferred.[3]

To complete a gift, a donor generally is required to do everything reasonably permitted by the nature of the property and the circumstances of the transaction to deliver the property to the donee. If actual physical delivery is impossible or impractical, constructive or symbolic delivery is sufficient to effect a completed gift, provided that the transfer is not subject to recall by the donor. While certain formalities of delivery are required to complete a gift, this does not necessarily mean that delivery must be made directly to the donee. If a donor delivers property to a third person acting as the donee's agent, with explicit instructions that the third party deliver the property to the donee, and there is no right in the donor to retrieve or otherwise to control the property, the gift will be complete on the date of delivery to the agent.[4] A gift is incomplete, however, if the property that is the subject of the gift is delivered to the donor's agent to hold until a subsequent date or occurrence; such a transfer is not a delivery to or for the benefit of the donee.[5]

Although retained powers may cause a transfer to be incomplete, a transfer is not rendered incomplete if the donor retains only a fiduciary power over the transferred property "the exercise or non-exercise of which is limited by a fixed or ascertainable standard (generally relating to the health, education, support, or maintenance of the beneficiary).[6]

2. Gifts in Trust and Crummey Powers

The Supreme Court defined the essence of a gift in trust as the "abandonment of control" over the property.[7] A gift in trust is complete only when the donor reserved no power to change the disposition of the trust property, whether for the benefit of the donor or for the benefit of another person.[8] A gift in trust therefore is complete only if the donor has no power to (1) revoke the transfer; (2) re-vest beneficial title

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[1] I.R.C. Sec. 2501(a)(1); Treas. Regs. §25.2511-1(g)(1)
[2] Treas. Reg. §25.2511-2(b).
[3] *See* I.R.C. §7520.
[4] Gagliardi Est. v. Comr., 89 T.C. 1207 (1987).
[5] Richardson v. Comr., 126 F.2d 562, 568-69 (2d Cir. 1942).
[6] Treas. Reg. §25.2511-2(g).
[7] *Smith v. Shaughnessy*, 318 U.S. 176 (1943).
[8] Treas. Reg. §25.2511-2(b).

to the trust property in himself or herself; (3) name new beneficiaries; and (4) change the interest of the beneficiaries, unless the power is a fiduciary power limited by a fixed or ascertainable standard.[9] Completion of a gift in trust also requires the donor to deliver the executed trust document to the trustee (or to a third party who acts as the trustee's agent, with instructions that the third party deliver the property to the trustee) without any express or implied reservation by the donor of the power to demand the return of the property or otherwise control the use of the property.[10] However, a gift in trust is not considered incomplete merely because the donor reserves the power to change the manner or time of enjoyment.[11]

A transfer that may be revoked or amended by the donor is incomplete for purposes of the gift tax, regardless of whether the power (1) is held solely by the donor or (2) is exercisable only with the consent of another person who does not have a substantial interest that is adverse to the donor's exercise of the power.[12] Thus, if the other person has no reason not to accept the donor's exercise of a reserved power, the power is considered reserved in the donor alone.

A gift is generally incomplete in the case that the donor retains substantial adverse interest in which a legal or equitable interest in property, capable of monetary valuation, would be effected adversely by the exercise of power.[13] Similarly, a gift in trust generally is incomplete to the extent that a grantor reserves the power either to (1) name new beneficiaries or (2) allocate principal and income between beneficiaries so as to effect a change in the proportionate interests of the beneficiaries. Either of such transfers is incomplete even though the retained power may not be exercised to benefit the donor.[14]

Under trust law, a "power of appointment" is defined as any power to dispose of the property of another so as to effect the beneficial enjoyment of the property.[15] A power of appointment may allow the person who holds the power to exercise sufficiently broad powers over the appointive property such that the power is substantially the equivalent of fee simple ownership. A power of appointment includes "… all powers which are in substance and effect powers of appointment received by the donee of the power from another person, regardless of the nomenclature used in creating the power and regardless of local property law connotations."[16] The regulations exclude the following powers:

- The power to amend only the administrative provisions of a trust, which do not substantially affect the beneficial enjoyment of the trust property or income;[17] and
- Powers that may be exercised solely in a fiduciary capacity.[18]

Under §2514, a general power of appointment is any power that may be exercised in favor of one or more persons: (1) the power-holder; (2) the power-holder's estate; the power-holder's creditors; or (4) the creditors of the power-holder's estate. The exercise of a "general" power of appointment is treated as a transfer of property by the power-holder regardless of when the power was created. Thus, any unlimited power in an individual to consume, invade, or appropriate property for his or her benefit may be deemed a general power of appointment. However, if a power-holder is entitled to exercise the power for the power-holder's benefit, the power is not treated as a general power of appointment under §2514(c) if the exercise of the power is "limited by an ascertainable standard relating to the health, education, support, or

[9] Treas. Reg. §25.2511-2(c).
[10] *Matthews v. Comm'r.*, T.C. Memo 1989-3, aff'd, 887 F.2d 261 (3d Cir. 1989).
[11] Treas. Reg. §25.2511-2(d).
[12] Treas. Reg. §25.2511-2(e).
[13] *Comm'r. v. Prouty*, 115 F.2d 331, 335 (1st Cir. 1940); Rev. Rul. 58-395, 1958-2 C.B. 398.
[14] Treas. Reg. §25.2511-2(c).
[15] *See* I.R.C. 2514.
[16] Treas. Reg. §25.2514-1(b)(1).
[17] *Id.*
[18] *Id.*

maintenance of the possessor."

A gift in trust creates separate legal interests for income and remainder interests.[19] Whereas the income interest is deemed a present interest, thereby eligible for exclusion under 2503(b), the remainder interests are future interests, to which the exclusion does not apply. If an income beneficiary has an unrestricted right at the time of the gift to all income (or an ascertainable part of the income), the income interest (or the ascertainable part) is a present interest.[20] Other present interest requirements include:

i. Must commence income interest immediately after the gift;
ii. Must be payable to the income beneficiary in all events; and
iii. Must have ascertainable value.

Under section 2503(c), a special exclusion is granted for gifts that benefit persons less than 21 years of age that otherwise would be considered gifts of future interests under section 2503(b). A transfer of property for the benefit of a minor will not be considered a gift of a future interest under §2503(c) if three requirements are met, including:

i. Both the property transferred and the income from the property may be distributed to, or expended for the benefit of, the donee while the donee is less than 21 years of age;
ii. All undistributed property and income pass to the donee at the age of 21 years; and
iii. If the beneficiary dies before reaching the age of 21 years, any then existing property and income must be payable by the terms of the trust either to the donee's estate or to the donee's appointee pursuant to a general power of appointment.

Because §2503(c) is not restricted to transfers in trust, the provision was interpreted as permitting a gift in trust to be considered as being composed of separate gifts of principal and income. Under Treasury Regulations §25.2503-4(c) provides that a transfer of property in trust with income required to be paid annually to a minor beneficiary and corpus required to be distributed to the beneficiary upon attaining the age of 25 is a gift of a qualifying §2503(c) interest with respect to the right to income, but is a gift of a non-qualifying interest with respect to the right to corpus. An income interest also qualifies under §2503(c) if trust corpus reverts to the donor at the end of 10 years or at the beneficiary's death prior to the end of that period. Three requirements must be satisfied to qualify an income interest (only) under §2503(c):

i. The income may be expended by, or for the benefit of, the donee before his attaining the age of 21 years;
ii. All income accumulated before age 21 must be distributed at age 21; and
iii. If the beneficiary dies before reaching the age of 21, any accumulated income must be payable to the estate of the donee or by the beneficiary's exercise of a general power of appointment.

Trust settlors often use trusts to transfer property for the benefit of family members, and it is not uncommon for settlors to want the beneficiary not to have outright ownership over the property when the beneficiary attains the age of 21 years, as generally is required by §2503(c). Although the property may remain in the §2503(c) trust after the beneficiary attains age 21 if the beneficiary does not exercise the right to claim the property, many settlors are unwilling to give the beneficiary such a power at age 21.

The "Crummey" trust, describes a trust the contributions to which qualify for the annual exclusion under §2503(b) because the beneficiary has an unrestricted right to withdraw all, or a portion of, annual additions to trust corpus.[21] The withdrawal right, which generally is limited to a specific period of time

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[19] I.R.C. §2503(b).
[20] Treas. Reg. §25.2503-3(b).
[21] *Crummey v. Comm'r.*, 397 F.2d 82 (9th Cir. 1968).

following a contribution to the trust, is referred to as a "Crummey" power. Because a beneficiary may obtain immediate enjoyment of trust property by exercise of the demand right, the beneficiary has a present interest in property transferred in trust to the extent the property is subject to the power.[22] The donor therefore is entitled to the §2503(b) annual exclusion with respect to contributions that are subject to such a "Crummey" power.

A power of appointment deemed "*Crummey* powers" must be applied to provide beneficiaries with the possibility of possession equal to immediate possession and enjoyment of the property. Under §2514(e), a "lapse" of a general power of appointment will be treated as a "release" to the extent the lapsed *Crummey* power exceeds the greater of $5,000 or 5% of the value of the assets from which the power could be satisfied. Thus, the powers are limited to the greater of $5,000 or 5% of the trust corpus, even though the maximum annual exclusion amount under §2503(b) is $13,000. Such a limitation prevents any amounts from lapsing and being included in the power holder's gross estate under §2041 or being a gift transfer under §2514.

3. Indirect Gifts

A gift can occur without a direct transaction between donor and donee. As with direct transfers, an indirect transfer will not constitute a gift unless the transferor receives less than adequate and full consideration in money or money's worth from the person receiving the benefit.[23]

Typically, valuation serves as the critical issue in indirect gift cases. If a contribution, redemption, recapitalization or other change in the capital structure of a corporation or partnership has the effect of giving one family member liquidation or distribution rights different from those held by other family members, the transaction may be treated as a gift.[24] Indirect gifts can also occur by inaction. For example, if one shareholder gratuitously waives or fails to exercise legal rights in such a way to benefit other shareholders, a gift may occur. Where a corporation is involved in a gift, the shareholders are generally treated as the real parties in interest.[25]

4. Determining Fair Market Value of Gifts

If a transfer of property by an individual is deemed to be a gift, the value of the property transferred is the fair market value of the property transferred at the time the transfer is complete.[26] Fair market value is defined as the price at which the property would change hands between a willing buyer and willing seller, neither being under a compulsion to buy or sell, and knowing all of the facts.[27]

Specific interests in property are valued in accordance with actuarial tables prescribed by the regulations instead of the willing seller-willing buyer standard, including life estates, interests for a term of years, remainders or reversions following life or term estates, and interests in private annuities.[28] The IRS applies two tests to determine whether the standard factors from the tables may be used:

i. <u>Beneficial Interest Test</u> - Whether the transfer instrument provides the beneficiary with a degree of beneficial enjoyment that is consistent with the type of property interest that the

[22] *See* Rev. Rul. 80-261, 1980-2 C.B. 279.
[23] I.R.C. §2512(b).
[24] I.R.C. §2701(e)(5).
[25] Treas. Reg. §25.211-1(h)(1).
[26] I.R.C. §2512(a). *See also* Polack v. Comm'r., 366 F. 3d. 608 (8th Cir. 2004).
[27] Treas. Reg. §25.2512-1.
[28] *See* Treas. Reg. §25.2512-5A(b).

standard valuation tables are designed to measure.[29]

ii. Mortality Test – Depending upon the mortality assumption about a person's life expectancy, different tables used to value an interest.[30] If the individual who is a measuring life of the interest to be valued is terminally ill at the time of the gift, a special §7520 actuarial factor, rather than the §7520 factor using the standard mortality component, must be used in valuing the interest.

5. Exclusions and Deductions

(a) Exclusions

i. Section 2503(b) Per Donee, Per Year – Under §2503(b), each donor may exclude the first $10,000 (as adjusted for post-1997 inflation) of gifts (other than gifts of future interests in property) made to each donee during a calendar year in determining the total amount of gifts for that calendar year. For example, the exclusion is set at $13,000 for the 2012 tax year.[31] The number of donees, up to an unlimited number, to whom gifts are made determines the number of exclusions allowed each donor.

The §2503(b) annual exclusion is not allowed for a gift of a future interest in property. The entire value of any future interest, including reversions, remainders, and all other interests in property that are limited to commence in use, possession, or enjoyment at some future date or time, is a taxable gift for the year in which the gift is made.[32]

ii. Educational and Medical Expense - Pursuant to §2503(e), any amount paid on behalf of an individual as tuition to an educational organization described in §170(b)(1)(A)(ii) for the education or training of such individual is not treated as a transfer by gift for purposes of the gift tax.[33] However, this exclusion is not available for amounts paid for books, supplies, fees, board or other expenses that do not constitute direct tuition costs.[34]

Under §170(b)(1)(A)(ii), an "educational organization" is one that normally maintains a regular faculty and curriculum and has a regularly-enrolled body of students in attendance at the place where its educational activities are carried on regularly. Further, the regulations require that the organization have as its primary function the presentation of formal instruction.[35] The term "educational organization" includes primary, secondary, preparatory, and high schools, and colleges and universities. While it includes federal, state, and other publicly supported schools that otherwise come within the definition, it does not include organizations engaged in both educational and non-educational activities unless the latter are merely incidental to the educational activities.[36]

An unlimited gift tax exclusion is also allowed for amounts paid on behalf of a done directly to a provider for medical care.[37]

iii. Waiver of Pension Rights – Under section 2503(f), the waiver of certain qualified

[29] Treas. Reg. §25.7520-3(b)(2)(ii).
[30] Treas. Reg. §25.7520-3(b)(3).
[31] Rev. Proc. 2011-52, 2011-45 I.R.B. 701, §3.31(1).
[32] Treas. Reg. §25.2503-3(a).
[33] *See also* Treas. Reg. §25.2503-6(a), (b)(1)(i).
[34] Treas. Reg. §25.2503-6(b).
[35] Treas. Reg. §1.170A-9(c)(1).
[36] *Id.*
[37] Treas. Reg. §2503(e)(2)(B); Regs. §25.2503-6(b)(1)(ii), (b)(3), (c).

retirement plan benefits is not treated as a gift transfer of property.

iv. Loans of Qualified Works of Art to Exempt Organizations – Section 2503(g) provides that any loan of a "qualified work of art" to a §501(c)(3) exempt organization (other than a private foundation) is not treated as a transfer subject to the gift tax. The term "qualified work of art" is defined as "any archaeological, historic, or creative tangible personal property.[38] The use of the work of art by the exempt organization must be related to the organization's charitable purpose or function on which its tax-exempt status is based.[39]

v. Transfers to §529 Plans - Any contribution to a §529 qualified tuition program on behalf of any designated beneficiary (1) is treated as a completed gift to the beneficiary that is not a future interest in property and (2) is not treated as a qualified transfer under §2503(e).

vi. Transfers to §530 Educational Savings Accounts – Any contribution to a §530 Educational Savings Account is treated similarly to the rules under §529.

vii. Transfers to Political Organizations - The gift tax does not apply to a transfer to a §527(e)(1) political organization under I.R.C. section 2501(a)(4).

[38] Treas. Reg. §2503(g)(2)(A).
[39] Treas. Reg. §2503(g)(2)(B).

(b) Deductions

i. Marital Deduction – A donor may deduct the amount of qualifying inter vivos gifts to, or for the benefit of, the donor's spouse if the transfer meets certain statutory requirements. The marital deduction is not allowed for a transfer to a spouse of a "terminable interest" in property thereby allowing the interest to terminate or fail be cause of the lapse of time or the occurrence or non-occurrence of a contingency.[40] The amount of the marital deduction is unlimited in amount for transfers.[41]

However, under section 2523(i)(2), each year to the donor's spouse who is not a citizen of the United States are not subject to the gift tax.

ii. Charitable Deduction – A gift tax deduction is allowed for or gratuitous transfers of property to, or for the use of, certain prescribed charitable entities if the property is used for specified purposes.[42] The deduction is unlimited in amount. Under section 2522(a)(1), the charitable deduction is permitted for gifts to four categories of donees, including:

  i. The United States, any state, territory, or political subdivision thereof, and the District of Columbia, if the gift is "for exclusively public purposes,"
  ii. Any corporation, trust, community chest, fund, or foundation that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes including the encouragement of art, and the prevention of cruelty to children or animals, or to foster national or international amateur sports competition (but only if no part of the activities of the organization involve the provision of athletic facilities or equipment), if:
    1. The entity is organized and operated exclusively for one or more of the specified purposes;
    2. no part of the net earnings of the entity inures to the benefit of any private shareholder or individual other than as legitimate objects of the exempt purposes;
    3. the entity is not disqualified for tax exemption under §501(c)(3) by reason of attempting to influence legislation; and
    4. the entity does not participate in or intervene in any political campaign (including the publishing or distributing of statements on behalf of (or in opposition to) any candidate for public office),
  iii. A fraternal society, order, or association, operating under the lodge system, provided that the gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes including the encouragement of art and the prevention of cruelty to children or animals; or
  iv. Any post or organization of war veterans or auxiliary unit or society thereof, if organized in the United States or any possession, and if no part of its net earnings inures to the benefit of any private shareholder or individual.

6. Reporting Requirements and Who is Responsible for Paying the Gift Tax

[40] I.R.C. §2523(b); Treas. Reg. §25.2523(b)-1(a)(3).
[41] The Economic Recovery Tax of 1981 Act, P.L. 97-34, §403(b)(1), (a)(1)(A), reprinted in 1981-2 C.B. 256, 324 (1981).
[42] I.R.C. §2522.

Any individual citizen or resident of the United States who makes a transfer by gift is required to file a gift tax return for the calendar year in which the gift is made, unless the transfer is excluded from gift tax under the §2503(b) annual exclusion, the §2503(e) exclusion for transfers for educational or medical expenses, the §2522 charitable deduction, or the §2523 gift tax marital deduction.[43] Gift tax returns are filed on a calendar year basis.[44]

A gift tax return must be filed (whether or not any tax is due) for any calendar year in which an individual makes a present interest transfer by gift to a donee, other than the donor's spouse, of a value in excess of the §2503(b) annual exclusion that does not meet the requirements of a qualified educational or medical expense under §2503(e). A return must be filed for any gift of an interest that is not a present interest for purposes of §2503(b), regardless of the amount. If married persons make a gift of property held by them as joint tenants or tenants by the entirety, each spouse must file a gift tax return because each spouse has made a gift transfer. Similarly, a gift of community property to a third person is considered made one-half by each spouse, and each spouse must file a gift tax return.

7. Carryover Basis Rules

The donee of gift property generally acquires a "transferred" or "carryover" basis in the gift property.[45] The basis of the property in the hands of the donee is the same as the donor's adjusted basis.[46] The effect of the carryover basis rule is that gain inherent in the property in the hands of the donor will be realized by the donee on a subsequent taxable disposition of the property.

If the fair market value of the gift property on the date of the gift is less than the donor's adjusted basis, the donee's basis on a subsequent disposition of the property will depend on whether the donee realizes a gain or a loss.[47] Thus, if the donee realizes a gain, the donee's basis (the gain basis) is the donor's adjusted basis. Likewise, if the donee realizes a loss, the donee's basis (the loss basis) is the fair market value at the time of the gift.

Under, section 1223(2), if a transferee's basis is determined in whole or in part by reference to the basis of the transferor, the transferee is permitted to add (tack) the donor's holding period to the donee's actual holding period for purposes of determining the duration of the donee's holding period of the property. The holding period of the property is relevant, for example, as to whether gain or loss on the property qualifies as "short-term" or "long-term" capital gain or loss under §1222 or whether §1231 applies.

B. **Generation Skipping Transfer Tax** (basic definition and explanation)

The generation skipping tax is imposed on every "generation-skipping transfer" (GST) under §2601. A GST is defined as any "direct skip," "taxable termination," or "taxable distribution.[48] Each type of GST requires a "skip-person," which can either be a natural person or a trust, and is determined by establishing the identity of the "transferor" of the property.[49]

A transferor is present at any time property is subject to either the estate or gift tax. For property

[43] I.R.C. §6019.
[44] *Id.*
[45] I.R.C. §1015.
[46] I.R.C. §1015(a).
[47] *Id;* Treas. Reg. §1.101501(a)(1).
[48] I.R.C. §2611.
[49] I.R.C. §2652(a).

"subject to" the gift tax, the transferor is the donor. [50]

The tax on a taxable termination is to be paid by the trustee. To compute the GST tax, the "taxable amount" is multiplied by the "applicable rate.[51] The "applicable rate" is the product of the "maximum Federal estate tax rate" (45%) multiplied by the inclusion ratio. Taxable terminations are tax inclusive. For gift tax purposes, the payment of the GST tax itself is treated as a taxable gift, in addition to the gift of the property transferred.[52]

C. State Gift Taxes -

Oregon does not impose state gift taxes.

[50] I.R.C. §2652(a)(1)(B).
[51] I.R.C. §2602.
[52] I.R.C. §2515.