Gifting

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What is a gift? A gift is a transfer for less than full consideration. Two types of gifts are recognized Gifts during life – Inter vivos and gifts in contemplation of death – Gifts Causa mortis. State property laws will determine how and when gifts are effective and whether they are characterized as inter vivos or causa mortis. This discussion will focus on Gifts during life – Inter vivos gifts, how they are made and the tax consequences of lifetime gifts. But the making of gifts is more complex than understanding the property law in your state. Although state law creates legal interests and rights in property, federal law determines whether and to what extent those interests will be subject to federal taxation. Not only do you need to consider gifts from the state law stand point but also from the federal Gift tax law aspect.

To understand gifting some terms or definitions will help.

Annual exclusion: The donor to exclude gifts of up to a certain total amount (currently $12,000.00) which are made during any calendar year to a donee.

Donor: The person making the gift

Donee: The recipient of the gift

Form 709: United States Gift (and Generation-Skipping Transfer) Tax Return

Gift Tax: The transfer tax imposed on transfer by a natural person for less than full consideration to natural persons, charities, or corporations or other business entities.

Generation Skipping Transfer Ta (GSTT): The tax imposed on transfers to a “skip generation” that is usually beyond next generation i.e. grandchildren or great-grandchildren.

Joint of Split Gifts: Gift by spouses to a single donee (Requires a Gift Tax Return to be filed.)

Skip person: A donee who is a natural person is a skip person if that donee is assigned to a generation that is two or more generation below the generation assignment of the donor.

Unlimited marital deduction: Unlimited transfers between spouses that is tax exempt.

State Law

For a gift to be effective in Wyoming the essential elements of a gift must be met. Those requirements under Wyoming property law are:

1. The donor must be competent to make the gift;

2. The donor must make a clear, unmistakable, and unequivocal intention on his or her part to make a gift of his or her property;

3. There must be an absence of adequate consideration;

4. There must be a conveyance, assignment, or transfer sufficient to vest legal title in the donee without power of revocation at the will of the donor;

5. A relinquishment of dominion and control of the gift property by delivery to the donee; and

6. There must be an acceptance by the donee of the gift.

Federal Gift Tax Law

With two (2) modifications, this Wyoming property law definition of a gift may be applicable to gifts subject to federal gift tax. First, donative intent is not a significant element in determining whether or not a taxable gift has been made. Second, taxable gifts are not limited to transfers made without any consideration. Even if consideration is received in return for a transfer of property, the transfer will still be subject to the gift tax unless the consideration received is a full and adequate consideration in money or money's worth. Such consideration is more than the consideration sufficient at common law to enforce a contract. The consideration must be the full economic equivalent of the transferred property in terms of money.

In other words, an individual who receives for a transfer an equivalent value in money or money's worth has not made a taxable gift, but rather has made a sale, or exchange which generally is not subject to gift tax. If the transfer is made for less than an adequate and full consideration in money or money's worth, the amount of the gift is generally the excess of the value of the transferred property over the amount of the consideration received.

Gifts can be an effective estate planning tool. They provide an estate owner with the opportunity to transfer assets to family members to save income and death taxes and also to reduce probate costs on the owner's death. Since the enactment of the Tax Reform Act of 1976, which unified the previously separate estate and gift taxes, it is not as easy to reduce federal estate taxes in very large estates by making gifts as it formerly was.

The gift tax statutes (26 U.S.C. § 2501 et. seq.) have many refinements and complexities, well beyond this brief summary. However it is necessary to have a general understanding of the history of the tax, what the tax is, and how it operates.

A History of Gift Tax

The federal gift tax is transfer tax. It is imposed at graduated rates on the gratuitous transfer of property during each calendar year commencing after June 6, 1932, and ending with 1970, and after 1981, by any individual, resident or nonresident. For gifts made after 1970 and before 1982, the federal gift tax was imposed at graduated rates upon the total amount of taxable gifts made during each calendar quarter during such years. The gift tax was cumulative, which meant that the aggregate of gifts subject to the tax made in prior periods was added to the aggregate of taxable gifts for the current calendar period in determining the tax rate bracket applicable to the current period's taxable gifts.

For gifts made after December 31, 1976, one making gifts was allowed a "unified credit" of $3,000 annually against the gift tax. For gifts made prior to January 1, 1977, no unified credit was allowed, but instead, a $30,000, lifetime exemption was deducted in computing the pre-1977 taxable gifts. Since 1982 an annual exclusion has been applied.

The Economic Recovery Tax Act of 1981 (1981 Act) increased the amount of the annual exclusion starting in 1982 from $3,000 to $10,000. The 1981 Act also eliminated the gift tax on interspousal gifts (unlimited marital deduction.) As a result, gifts became a more widely used and more valuable estate planning tool.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act) made sweeping changes to the taxation of gifts and the coordination of the gift and estate tax. The changes under the 2001 Act are not permanent. Unless a future Congress provides otherwise, the new tax law sunsets (expires) after December 31, 2010. On January 1, 2011, the existing law will be re-instated. If the law is not extended or made permanent, then the gift tax changes will only be effective for the year 2010.

Some of the changes made by the 2001 Act included elimination of the 5 (5%) percent surtax

that was imposed on taxable transfers between $10 million and the amount necessary to phase out the benefit of the graduated rates. In addition to repealing the surtax the 2001 Act repealed and commenced a reduction in the maximum estate and gift tax rates from 50 percent for decedents dying and transfers after 2001 in excess of $2.5 million.

Reduction in maximum rate 2002 through 2009: The maximum gift tax rate will be phased down for years 2002 through 2009 The new rates are as follows:

Calendar Year	Tax Rate
2006	46%
2007	45%
2008	45%
2009	45%
2011	35%

New gift tax rate after 2009: After 2009, the estate and generation-skipping transfer taxes will be repealed. The gift tax will not be repealed. The maximum rate of gift tax will be reduced to the top individual income tax rate under the 2001 Act.

Exempt Gifts

Not all gifts are subject to the gift tax. Certain charitable and other gifts are specifically exempt from the tax. In addition, a donor making a gift is allowed a deduction for gifts made to a U.S. citizen spouse; that is, the unlimited marital deduction. The donor also is allowed a deduction for gifts made to third parties in which a spouse joins; that is, gift splitting. One making a gift also is allowed an annual exclusion, which permits the donor to exclude gifts of up to a certain total amount which are made during any calendar year.

What is Taxed

While the tax is not imposed upon property as such, the amount of tax is measured by the value of the property transferred. Gift tax is not applicable to transfers by corporations or persons other than individuals, but it is applicable to transfers by individuals to corporations or other persons.

In most cases, it is not difficult to determine if a transfer by gift has occurred for gift tax purposes. For example, when an individual gratuitously and irrevocably transfers outright ownership of property to another, a transfer by gift has occurred (and the gift is completed). Further, in many cases when an individual creates an irrevocable trust for beneficiaries other than that individual, and gratuitously and irrevocably transfers property to the trustee of that trust, the transfer is a transfer by gift (and the gift is completed).

More difficult cases arise when transfers occur or are deemed to occur between related parties. For example, if related parties enter into a debtor-creditor relationship, then a forgiveness of indebtedness or a failure to receive adequate interest on a loan may result in a gift. In a recent Letter Ruling, the IRS held that a guarantee of the indebtedness of the taxpayer's children constitutes a taxable gift when the guarantee became binding, whether or not any amounts were ever called on to be paid by the guarantor.

Sometimes mere inaction by a person can be considered a taxable transfer, such as when an income beneficiary of a trust fails to object to a transfer of trust corpus to the remainder beneficiaries in an acceleration of their interest. Similarly, a distribution from a purported constructive trust can result in a gift if the basis by which the constructive trust was to have been created is not conclusively established.

Payments alleged to have been for care giving services may be characterized as gifts. For payments made by the estate, the Service may challenge their deduction as debts of the decedent; if the payments were made by the decedent, they may be characterized as unreported gifts that are includible in the gross estate. A similar issue occurs when an employer "gives" something to a former

(or long-time) employee; the question is whether the transfer is actually a gift, rather than compensation for past services.

Another issue that can confuse the situation is ownership; the transferor must have owned the property in order for the transfer to constitute a gift. Such an issue might arise, for example, where an unmarried couple live together under an informal property sharing arrangement. The survivor's title to the property might then be disputed.

The Annual Exclusion

When the amount of the gift exceeds the amount of the annual exclusion, and the available applicable credit amount is not sufficiently large to eliminate the gift tax liability, a gift tax will have to be paid by the donor. The annual exclusion Economic Recovery Tax Act of 1981 increased the amount of the annual exclusion from $3,000 to $10,000. Later tax law changes indexed the annual gift tax exclusion and in 2002 it increased to $11,000 and this year to $13,000. This exclusion applies each year and is per donee.

Liability for the Tax

The donor is primarily liable for the federal gift tax, although the donee may become liable if the donor defaults.

The Generation Skipping Transfer Tax (GSTT)

The GSTT is a gift or transfer tax. GSTT is imposed in addition to gift tax for gifts made to a person who is defined as a "skip generation." The donee is liable for the tax although the donee may become liable if the donor defaults. Determining if a gift will also be subject to the GSTT is difficult and requires the assistance of professionals. For this discussion suffice it to say if a transfer is made to a second generation without the death of the intervening parent it is likely a gift has been made and the donor should immediately seek professional advice.

Like the gift tax the GSTT an exemption amount is allowed for gifts that would have to pay as GSTT. Currently (2006) $2,000,000 is the exemption amount. Unfortunately lifetime gifts are limited to $1,000,000. So a gift that would use all the GSTT exemption would require payment of gift tax on the excess above $1,000,000. Starting in 2004, the exemption amount was pegged to the applicable exclusion amount for estate tax purposes. In the year 2010, the GSTT is scheduled to be repealed and in 2011, the law prior to the 2001 Act is reinstated.

The following table shows the GSTT exemption amount and tax rate under The Economic Growth and Tax Relief Reconciliation Act of 2001 (2001 Act).

Calendar Year	GST Exemption Amount	GST Tax Rate
2002	$1,100,000	50%
2003	$1,120,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	Tax repealed	
2011	$1,000,000 + indexing	55%

Comparing lifetime and deathtime transfers

The effect of the unified rate schedule was that lifetime gifts and deathtime transfers were aggregated in computing the estate tax. Therefore, no advantage in terms of a lower tax rate is gained by making lifetime gifts rather than transfers at death since lifetime gifts will be added back to the taxable estate in computing the estate tax. Even though we are now limited to using only one-half of what way previously a unified credit lifetime gifts and deathtime transfers there are still several advantages to making lifetime transfers. These include the following:

- Any gift tax paid by the donor is not included in the donor's estate except for gift taxes paid within three (3) years of death.
- If the gifted property increases in

value, the post-gift appreciation is excluded from the donor's estate.

• A gift is less costly than a transfer at death, A transfer at death is paid out of the property on a "tax inclusive basis" while the gift tax is paid in addition to the transfer on a "tax exclusive basis."

Illustration: John is in the 50 percent gift and estate tax bracket. A gift of $50,000 to his child costs John $75,000 (gift tax of $25,000 in the 50 percent bracket, plus the gift of $50,000), while the same transfer at death requires $100,000 ($50,000 estate tax, in the 50 percent bracket, plus the transfer of $50,000).

Observation: A key disadvantage of a lifetime transfer is that the donee takes the donor's basis (carryover basis) in the transferred property. If the basis is less than fair market value, the donee will recognize gain if the property is sold.

Fair Market Valuation Discounts

Gifting of entities such as corporations (a regular C or subchapter S), partnerships (general or limited), limited liability companies (LLCs), and ownership as tenants in common, joint ownership create opportunities for making a discounted gift. What the discount permits is transfers of assets at less than what might otherwise be considered full book or fair market value.

Types of valuation discounts: The most common discounts allowed are those for lack of marketability and minority interest (or lack of control). A discount which applies most frequently to real estate is the discount for fractional ownership. There are other discounts, including those for key man discount, built-in capital gains, blockage, restrictive covenants, and the discount applicable to restricted securities under the Federal securities laws.

Real estate may be owned in several different forms. These include ownership by entities such as corporations (a regular C or subchapter S), partnerships (general or limited), limited liability companies (LLCs), and ownership as tenants in common, joint ownership and individual ownership. Generally, the discounts for lack of marketability and minority interest are effective when real estate is owned by an entity. The discount for fractional ownership is applicable when real property is owned by different interests as tenants in common. Those ownership interests may be individuals, entities or any combination of entities and individuals.

The blockage discount is applicable to publicly issued securities, but may also apply whenever a large quantity of an item (even real estate) is suddenly available but may be too much for the market to absorb (the market absorption discount discussed below). The discount for restricted securities is applicable to securities restricted under the Federal securities laws. The discount for built-in capital gain is applicable to regular C corporations. The discount for restrictive covenants refers to agreements among individuals and/or entities which impose restrictions on the ability of the owner to dispose of the interest. The various discounts are discussed below.

What is the proper amount of a discount? That is a fact and circumstances test. Preparation is important. The discount should be supported by a valuation performed by a qualified valuation expert (Certified Valuation Appraiser, CVA is a common designation.) If the entity owns real estate, the valuation expert will need recent appraisals showing the fair market value of each property owned by the entity. This must all be completed prior to any gift.

Illustration: John and wife Jane are the owners of Ranch LLC. Each own 100 units. Ranch LLC only asset is the land appraised at $6 million dollars. John and Jane each transfer by gift to their child 65 shares or a total of 130 of the 200 units. Prior to the transfer a certified appraiser appraised the land at $6 million dollars and then a business evaluation

was done on the Ranch LLC. The Certified Valuation Appraiser determined because of lack of marketability and minority interest or lack of control the value of each unit of the LLC would not be $30,000 but would be reduced to $18,000, a 40% discount. The same transfer without the fair market valuation discount would mean only 80 units total could be transferred without paying gift tax. With discount up to 133.33 of the 200 units can be transferred without John and Jane paying any gift tax. They use their annual exclusion of $12,000 per year per donee and their lifetime exemption or tax credit of $345,800 which is equal to a $1 million dollar gift each. This can mean the difference of keeping the ranch in the family when John and Jane die or their child having to sell the ranch or a portion to pay the estate tax upon the last of their deaths.

Conclusion

Gifting one of several tools used in estate and financial planning. Like all tools gifting has advantages and disadvantages. Before making a significant gift you should seek professional advice. Speak with your financial advisor, and your attorney and CPA or accountant know the gift tax consequences, the GSTT consequences and possible discounting of the gift. Also understand the tax advantages as well the disadvantages for both the donor and donee of gifting.