Form 709: A Practicum

Summary

Oft ignored by the unwitting taxpayer and overlooked by the practitioner, gift tax returns are left unfiled. Find out when these returns are due and how to prepare them. This class will take an in-depth look at a hypothetical client who has made multiple gifts over a period of years, and now seeks your help to comply with all tax reporting requirements.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

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I. Introduction

At Christmas time, it sits beneath the decorated tree wrapped in shiny paper that will soon be torn to shreds by an eager child who spent a year begging Santa for the Lego Master Builder Academy, gold Buckycubes, or Rock Star Mickey. At a wedding, it is tastefully and professionally wrapped in gold or silver and will be returned to the store from whence it came to be exchanged for something the bride and groom really wanted.

Whether large or small, packaged in a box or buried beneath tissue paper in a gift bag, discretely hidden in a birthday card or simply given as a card, gifts one and all are fun to give and fun to get! They are offered as tokens of appreciation, to say thanks to a valued employee, as expressions of love and kindness, to assuage guilt or buy gratitude, to say "I care", "I love you."

Whatever the size or motivation, gifts are given, not taken. The giver may hope for reciprocity – he may hope to get something back in exchange, a quid pro quo. He may hope that his gift will be matched with kindness and generosity but, in truth, a gift may go unacknowledged without even a "thank you."

That's the thing about gifts. They are one-way transfers made with nothing more than hope and expectation but without guarantee that anything – tangible or intangible – will be returned. No money, no bigger or better Lego set, no hard work, no obligation or indebtedness, no recognition. Nothing! A gift is *given* but not *taken.*

II. Definition

For tax purposes, gifts are defined as "any transaction in which interest in property is gratuitously passed or conferred upon another."[1]

Example

In a 2006 statement, Commissioner Mark Everson reminded Oscar winners that they must report the value of the luxury goodie bags received from the Motion Picture Academy since they are given to curry favor and are, therefore, a form of compensation (not gifts). Some of the goodies included in the packets were (i) a $25,000 luxury package for a four-night stay on Waikiki Beach; (ii) a gift card entitling the holder to $2,500 of facials and massages; (iii) a leather-trimmed cashmere travel blanket valued at $1,495; and (iv) an exclusive dinner party at Morton's Steakhouse.[2] If a celebrity accepts and redeems the non-transferable vouchers in a gift bag, he must include the fair market value of the trip or personal service on his federal income tax return.[3]

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[1] Reg. § 25.2511-1(c).

[2] *2006 Oscars and Goodie Bags*, The Prophet Newsletter, March 2006.

[3] As per IRS *Gift Bag Questions and Answers* at http://www.irs.gov/newsroom/article/0,,id=161153,00.html [last accessed April 26, 2012].

Example

In contrast, the title to the family home transferred from father to son in exchange for care provided was deemed to be a gift since, under applicable state law, "parents are not required to pay a child, regardless of age and services performed, when they live with them."[4] In this case, Dad not only was held liable for unpaid gift taxes but the son, under theory of transferee liability, assumed Dad's previously unpaid income tax debts which had been secured by the IRS when it filed a lien against the home long before the title was transferred.

A gift is considered complete once the donor parts with dominion or control over the transferred property and no longer has the power to change the disposition of the property for his own benefit or that of others.[5]

Example

You've pushed your plate of food with uneaten morsels across the table and said, "Here, honey, I'm full; you can have the rest of my dinner." With that, you get up from the table to wash the dishes while your honey remains seated and enjoys his extra portion. Just as he savors that extra serving of steaming lasagna, you return to the table to collect dirty dishes. Watching your husband dig into the still-steaming dish of pasta afloat in its creamy béchamel sauce, you suddenly have a craving to have just one more bite and reach over to snatch that mouthful delicacy. Disappointed, your spouse mutters, "Indian giver!"[6]

So when is a gift a "gift"?

In the case of parents making an interest-free loan to their son, the Court determined that they conveyed an economic benefit (the use of money) without consideration (interest payments). They made a gift equal to the value of the interest income they could (should) have earned.[7]

On the other hand, despite donative intent, a gift is not made if the donor does not part with anything of value. In the case where the wife substituted her note for that of her husband's obligation but the bank continued to rely upon the husband's credit-worthiness, the Court held that an agreement to guarantee another's debt did not constitute a completed gift because there was no certainty that payment on the guarantee would be required.[8]

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[4] *Rubenstein v. Commissioner*, 134 TC No. 13 as cited in *Father Sells Condo to Son for $10*, NATP TAXPRO Monthly, May 2011.

[5] Reg. § 25.2511-2(b).

[6] *Indian giver* derives from the alleged practice of American Indians of taking back gifts from white settlers. It is more likely that the settlers wrongly interpreted the Indians' loans to them as gifts. This term, which is certainly American, may have been coined to denigrate of the native race. [*The Phrase Finder* available at http://www.phrases.org.uk/meanings/202850.html, last accessed April 24, 2012.]

[7] *Dickman v. Commissioner*, 465 U.S. 330 (1984).

[8] *Bradford v. Commissioner*, 34 T.C. 1059 (1960).

In another case of marital accord, the husband offered to give his fiancé $150,000 if she accepted his marriage proposal but because marriage is not deemed consideration, the Court held that the husband had made a (taxable) gift.[9] Conversely, the transfer of property pursuant to a divorce decree is not a gift since the surrender of marital rights does not occur voluntarily.[10]

A. Elements

The essential elements of a valid gift include:

- Delivery
- Intent
- Acceptance

Delivery may be actual (e.g., Dad parks a new car in the driveway for his teenage son) or implied (e.g., Dad hands his car key to his son), which requires some affirmative act to take place.[11] Delivery may be made directly or indirectly through a third party (e.g., Dad asks Mom to give the car keys to their son) but is considered complete only when the third party has transferred the property.

Donative intent may be expressed clearly and unmistakably or inferred from circumstances, such as the relationship between and the behavior of the parties. The intent must be present at the time of the gift and cannot vaguely indicate the transfer or property at some indeterminate time in the future.

Example

Police Officer Peebles discovered that his wife was having an affair with her physician Dr. Hestir. Peebles confronted Hestir and threatened to sue him for $150,000. Two days later, Hestir met Peebles and delivered $25,000 (the most he claimed he could raise). Peebles taped their conversation during the exchange: "Now, Doc, this isn't blackmail money." Hestir replied, "No, I didn't say it was blackmail money; I said I hope it helps you [and your wife]."

The following year, Hestir's accountant issued a 1099-MISC form to Peebles reporting the $25,000 payment. Peebles, however, did not report this income since he considered it to have been a "gift" from Hestir. The Tax Court disagreed, stating that the doctor's payment "was not the result of detached and disinterested generosity or paid out of affection, respect, admiration, or charity. Instead it was paid to avoid a lawsuit, to avoid public and professional embarrassment, and to assuage his own feelings of guilt or moral obligation."[12]

[9] *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

[10] *Harris v. Commissioner*, 340 U.S. 106 (1950).

[11] Essential Elements of a Gift, USLegal Inc., [available at http://gifts.uslegal.com/essential-elements-of-gift/, last accessed April 24, 2012].

[12] *Peebles v. Commissioner*, TC Summary Opinion 2006-61 as reported in California Enrolled Agent, August 2007.

Lastly, the recipient must unconditionally accept the gift at the time that it is made although he does have the right to reject the gift before the transfer is complete.[13] Once accepted, the donor forfeits all rights to the property and no longer has the power to alter, amend or revoke the gift.

B. Select Types

While hardly an exhaustive or all-inclusive list, some common examples of gifts include:

- **Below-market loan**: The gift is equal to the interest that should have been charged if the applicable federal rate had been used.[14]
- **Debt forgiveness**: The gift is equal to the unpaid principal balance.
- **Below-market sale**: The gift is equal to the difference between the current fair market value [FMV] and the discounted sales price.
- **Transfer to an irrevocable trust**: The gift is equal to the value of all assets transferred into the trust.
- **Joint and survivor annuity**: The gift is equal to the difference between the premium paid for the joint annuity and the premium paid for a similar single-life annuity.
- **Year-end check**: Although the donor's check may not yet have cleared the donee's bank until the following year, the gift is considered complete if (1) the donor intended to make a gift, (2) the delivery was unconditional, (3) the deposit was made in the year for which completed gift treatment is sought and within a reasonable time of issuance, (4) the donor's bank did not reject the check and (5) the donor was alive when the donor's bank paid it.[15]
- **Corporate dissolution**: The gift is equal to the value of the distribution which exceeds the shareholder's interest in the corporate entity.

In some cases, placing assets into **joint ownership** may be deemed to be a gift when the joint tenancy is created; in other instances, the gift becomes complete only when the assets are withdrawn from the joint account – state law will govern. Generally, transfers of real property, mutual funds, stocks and bonds are considered complete upon re-titling of the assets but transfers of bank and brokerage accounts are complete only when the donee makes a withdrawal from the joint account for his own benefit.[16]

<u>Example</u>

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[13] If a donee makes a qualified disclaimer by irrevocably refusing to accept the proffered gift in writing, the transfer is treated as though it had never been made (IRC § 2518).

[14] As per IRC § 7872, the gift is treated as though made on the last day of the calendar year (if demand loan) or on the date the loan was made (if term loan). Gift loans that do not exceed $10,000 are exempt from gift tax.

[15] Rev. Rul. 96-56.

[16] Reg. § 25.2511-1(h)(4).

Divorced mom titles her condo in joint tenancy with her son to avoid probate [Gift # 1] but later re-marries and asks her son to quit claim the property back to her [Gift # 2].

Example

Father owns an apartment building worth $1 million and adds his daughter as joint tenant. Because the daughter may at any time sever the joint tenancy and hold title to her 50% share as a tenant-in-common, Father is deemed to have made a gift.[17]

If the property continues to be held in joint tenancy until the donor's death, the property is included in the donor's taxable estate. Thereafter, the donee – once a joint tenant – becomes the owner of the asset which he inherits with a stepped-up basis.[18]

Life estate and remainder interests, often used by donors wishing to transfer title to real property while reserving the right to use the property until death, are also governed by state law. Typically, a completed gift is made when the deed is recorded, although the value of the gift may be discounted since the donee does not receive all beneficial rights at the time of transfer.[19]

In some instances, **derivative or partial gifts** may arise as the result of a sale or other transaction which included insufficient consideration for the property transferred or the parties agreed that the donee (rather than the donor) would pay the attendant gift tax. In the instance where the donee pays the donor's tax, the donor may deduct the gift tax from the value of the transferred property (now considered a "net gift")[20] but must then also include the difference between the gift tax and the property's basis in his taxable income.[21]

[17] *The Tax Prophet* (Issue # 104, January 2012) recommends that transferors protect themselves against potential gift tax consequences by drafting a written agreement that states that (i), neither party has the right to sever the joint tenancy without mutual consent, (ii) the joint tenancy is for estate transfer purposes only, and (iii) the original owner will continue as sole owner until he dies or the parties agree to sever the joint tenancy.

[18] IRC § 1014.

[19] Refer to IRC § 7520 for valuation of annuities, life estates, remainders and reversions.

[20] Rev. Rul. 75-72.

[21] *Diedrich v. Commissioner*, 82-1 USTC 9419.

Example

Taxpayer gifted stock to his children on the condition that they pay the resulting gift tax of $60,000 which exceeded the donor's basis of the stock ($50,000). Since the taxpayer recognized a capital gain of $10,000, he is liable for income tax on this gain.

> **WHAT IS A "GIFT"?**
>
> - **A gratuitous transfer of property from donor to donee**
> - **3 elements required: Delivery (actual or implied), Intent (express or inferred), Acceptance (unconditional)**
> - **Common examples include family loans, joint accounts, below-market sales**

III. Taxation

In an attempt to tax the transfer of property whether during or after life, the Gift Tax as we know it today was enacted in 1932, about sixteen years after the Estate Tax was put on the books. It is a tax imposed on the donor based on the cumulative value of all gifts made during lifetime, even those which may have been previously taxed.

Like the Estate Tax, the Gift Tax is assessed at graduated rates, but because all of the donor's gifts – past and present – are aggregated, a gift may be taxed at a higher marginal bracket that a comparable asset would be taxed if transferred at death. While it is often advantageous to spread the receipt of taxable income over several years to gain the benefit of lower marginal tax brackets, it generally matters not whether one large gift is made in one year or multiple smaller gifts are made over several years since each successive gift is added to those previously made and the total is then subjected to the applicable gift tax rate.

A. Exceptions

Most gratuitous transfers of property ("gifts") are subject to gift tax with certain exceptions:

- Gifts made to IRS-approved charitable organizations are exempt from gift tax. Although there is no limit to this exemption for gift tax purposes, income tax deductions are limited to 50% of the taxpayer's Adjusted Gross Income [AGI] each year. Unused deductions may be carried forward for five years.[22]
- Direct payments to providers for another individual's **medical expenses** are not considered gifts. These payments may cover any type of expense deductible for income tax purposes, including payment of insurance premiums.[23]

[22] IRC § 170.

[23] Reg. 25.2503-6(b)(3).

- Similarly, direct payments of **tuition** for another person, if paid directly to a qualifying education organization, are not considered gifts.[24] Tuition for full- and part-time students qualifies, but payments for books, school supplies, room and board do not.

  Example

  Grandpa sent $40,000 directly to Brown University to pay for his grandson's tuition and also sent $13,000 to the teenager to pay for books, supplies and other expenses. Neither payment is reportable for gift tax purposes since the first was a direct payment for tuition and the second was eligible for the annual exclusion.

  If Grandpa had instead sent a check for $53,000 to his grandson and directed the teen to pay the tuition bill, Grandpa would have made a gift that while reportable, may still not have been taxable if Grandpa availed himself of his lifetime exclusion [see below].

Interestingly, payments to **Qualified Tuition Programs** [QTPs][25] are not covered by the tuition exemption and are instead treated as taxable gifts. However, QTP contributions are eligible for the annual gift tax exclusion [see below] and may even exempt as much as the aggregate of five years' worth of annual exclusions. In other words, a donor may elect to exclude up to $65,000, if no other gifts are made to the same donee in this or the next four years.[26] A QTP donor is not subject to gift tax on distributions from these plans unless the designated plan beneficiary is changed or the plan is rolled over to a beneficiary who is a generation below (younger than) the original beneficiary.[27]

A parent's **support payments** for the benefit of a minor child are not considered to be gifts if legally required to be made.

Example

Dad contributes to the living expenses of his 25-year old son who lives away from home; amounts in excess of the annual exclusion are deemed to be taxable gifts. On the other hand, if his son were only 17, his payments would be considered to be a part of his legal obligation to support his minor child and not taxable gifts.

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[24] IRC § 2503(e).

[25] IRC § 529.

[26] The election is made by checking the box on line B of Form 709, Schedule A and attaching a statement listing the amounts contributed for each beneficiary and the amounts for which the election is made. Twenty percent of the gift is reported each year for five years; however, if in any of the four years following the election, the taxpayer is not required to file Form 709 other than to report that year's portion of the election, the taxpayer does not need to file or otherwise report that year's portion. Any amount in excess of $65,000 must be reported in the year the gift is made [IRC §529(c)(2)].

[27] IRC § 529(c)(5).

B. Annual Exclusion

Each year, a donor may exclude the first $13,000 given to each donee. Husband and wife may join together and gift up to $26,000.[28] Gift-splitting, allows a married couple to treat gifts made by one spouse as though one-half had been made by each spouse. As a result, spouses are able to maximize their annual exclusions, sheltering gifts made from the assets of only one spouse and which would otherwise not be fully excluded by that individual's annual exclusion. To qualify, spouses must be (1) U.S. citizens or residents at the time of the gift, (2) married at the time of the gift, and (3) unmarried at the end of the calendar year.[29]

Example

Husband (H) and Wife (W) agreed to split the following gifts: H gave his nephew $21,000; W gave her niece $18,000. H's gift to nephew is treated as one-half ($10,500) from H and one-half ($10,500) from W. W's gift to niece is also treated as one-half ($9,000) from W and one-half ($9,000) from H.

Each donee is then viewed separately to determine if the amount gifted exceeds the annual exclusion. Although no taxable gifts have been made, each donor is required to file a gift tax return to report the gift-splitting.

To qualify for the annual exclusion, the donor must gift a present interest and grant the donee an immediate right to use and possess the property.[30] Generally, gifts in trusts do not constitute present interests unless the donee has a right to the income from the property and has the right to sell his interest in the property. However, gifts to a minor's trust[31] – such as those made under the Uniform Transfer to Minors Act (UTMA) – qualify as present interests if (1) the funds can be used immediately for the minor's benefit, (2) the minor will receive the property by age 21 and (3) the property will pass to the minor's estate if the minor dies before reaching the age of majority.[32]

Gifts of future interest given in trust may be "converted" to present interest with the insertion of a Crummey power granting trust beneficiaries to withdraw principal from the trust for a limited period of time. For example, Dad establishes an irrevocable life insurance trust [ILIT] to ensure that the eventual estate taxes due upon his death can be paid without compounding the tax liability by including

[28] These limits are those currently in effect for 2012. The exclusion is indexed for inflation but will not be increased until the inflation-adjusted amount reaches the next multiple of $1,000 [IRC § 2503(b)(2)].

[29] The election is made on lines 12 through 17 of Part 1 on Form 709. Each spouse must consent by signing line 18 of the other spouse's Form 709. The returns should be mailed to the IRS in the same envelope.

[30] The gift of publicly-traded stock is considered a gift of present interest, but gifts of restricted stock, family limited partnerships, and shares of a limited liability company have been deemed to be gifts of future interest since the donee could not freely transfer his interest. [*Hackl v. Commissioner*, 335 F.3d 664 (2003)].

[31] Beware of the Kiddie Tax that may apply the parents' tax rate to the investment income of children under age 19.

[32] IRC § 2503(c).

the insurance policy in his taxable estate. He funds the ILIT annually with just enough to cover the insurance premiums. His children, the beneficiaries of the trust, are notified each year of their right to withdraw the annual contribution. Wisely, they choose to leave the ILIT funds untouched and allow the trustee to make the scheduled premium payment but because they have the right – even only temporarily – to possess the gifted amount, Dad's contribution becomes a present interest eligible for the annual gift tax exclusion.

C. Lifetime Exclusion (Applicable Credit)

In addition to the annual exclusion, each donor is entitled to a lifetime exclusion of $5,120,000 ($10,240,000 for married couples)[33], which is *not* indexed for inflation. This exclusion translates to a gift tax credit of $1,772,800 (based on current applicable tax rates). If an individual makes taxable gifts in excess of the annual exclusion amount, he must report them on **Form 709** when made, but need not pay any tax until his current or subsequent taxable gifts cumulatively exceed the lifetime exclusion. Accumulated gifts excluded by the lifetime gift exclusion serve to reduce the applicable exclusion available to the decedent on his estate tax return.

Example

Taxpayer gives $25,000 to her daughter. The first $13,000 of the gift is not subject to gift tax because of the annual exclusion. The remaining $12,000 is a taxable gift but may be exempt from taxation under the lifetime exclusion. Nevertheless, a gift tax return must be filed for the year of the gift.

Example

In 2011, Taxpayer (who has not previously made any gifts) gifted the following:

- $8,000 Car to Son (no other gift was given to Son during the year)
- $25,000 Cash for Daughter's down-payment on a house
- $15,000 Paid college tuition of Nephew

Taxpayer must apply the exclusions as follows:

1. Apply the educational (medical or charitable) exclusion: Gift to Nephew is exempt.
2. Apply the annual exclusion: Entire gift to Son and first $13,000 of gift to Daughter are exempt.
3. Apply the lifetime exclusion: Remaining $12,000 of gift to Daughter is taxable. The tax thereon totals $4,680 which will reduce Taxpayer's available Unified Credit to $1,726,120.

Taxpayer does not owe gift tax in the current year but must file **Form 709**.

[33] Applicable limits in 2012.

Form 709 must be filed whenever a donor makes a reportable gift, whether or not he anticipates that his cumulative gifts will be exempt under the lifetime exclusion or that his estate will ultimately be too small and not subject to the estate tax.

NOTE: Non-resident aliens are eligible for the annual gift exclusion but not the lifetime exclusion.[34]

The lifetime exclusion is applicable to both gift and estate taxes and, in fact, has been unified under the Tax Reform Act of 1976 and renamed the "Applicable Credit Amount". While the effect is the same, the exclusion is used to reduce the amount of taxable gifts; whereas the credit is used to reduce the amount of tax due. Therefore, when properly computing the gift tax liability on **Form 709**, the taxpayer begins by reporting all taxable gifts and calculating the tax on the *full* amount of these gifts. Only after the tax is calculated, may the taxpayer then subtract the applicable credit to determine the actual tax due.

D. Applicable Individuals

The gift tax applies to donors who are U.S. citizens and residents, regardless of where the gifted property is situated.[35] Non-residents are subject to gift tax only if the gifted property is U.S.-sited real or tangible personal property.

<u>Example</u>

A Mexican citizen owns real property in Arizona which she gifts to her son (also a Mexican citizen). She is liable for U.S. gift tax.[36]

<u>Example</u>

A U.S. citizen owns real property in Mexico which he gifts to his daughter. He is liable for gift tax, whether or not his daughter is a U.S. or Mexican citizen.

An unlimited marital deduction is allowed for gifts (not including Qualified Terminable Interest Property [QTIP][37]) passing between citizen spouses. Gifts to

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[34] The estate of a non-resident alien receives a credit of only $13,000 against the federal estate tax (the equivalent of a $60,000 exemption), an exemption level that has remained unchanged since 1988 as per *Estate Planning Tools for Nonresident Aliens* [available at https://www.lexisnexis.com/community/lexishub/blogs/practiceareacommentary/archive/2011/02/11/estate-planning-tools-for-nonresident-aliens.aspx, last accessed April 25, 2012].

[35] IRC § 2501(a).

[36] Example given in Lockwood, *The Taxation of Gifts*, National Public Accountant, Nbr. 2003, June 2003.

[37] A QTIP is a trust in which the surviving spouse receives lifetime income from the trust's assets but the trust's corpus is left to an alternate beneficiary, such as the couple's child. A QTIP qualifies for the annual gift tax exclusion if the donee spouse receives income payments for life and no one retains a power of appointment to substitute the donee spouse as beneficiary. If the gift tax exclusion is claimed on the QTIP, the property must be included in the donee spouse's estate [IRC § 2523]. Gift taxes paid by donee spouse on transfers made by the donee spouse within three years prior to the donee spouse's death, are includible in the donee spouse's estate [*Estate of Morgens*, 109 AFTR 2d 2012-736].

non-citizen spouses are limited to an inflation-adjusted amount on transfers of present interests.[38]

WHAT IS TAXED?

- **All gifts except direct transfers for the payment of another's tuition and medical expenses.**
- **Only gifts in excess of $13,000 per year per donee.**
- **Spouses may use gift-splitting.**
- **Unlimited marital deduction between citizen spouses; limited to $139,000 (in 2012) for transfer to non-citizen spouse.**

IV. Tax Return Specifics

All gifts in excess of the annual exclusion are reportable on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return**. Gift tax returns cannot be filed jointly since each spouse has a separate annual exclusion attributable only to him, even when gift-splitting is elected.

Filing Requirement

Gift tax returns must be filed for all taxable transfers of property for which inadequate consideration was received and must be filed in the following situations, even if no tax is due with the return:

- A taxpayer gave gifts in excess of the annual exclusion amount to someone other than his spouse.
- A taxpayer made a gift in excess of the annual limit to a non-citizen spouse.
- A taxpayer made a gift of a future interest of any amount since it is not exempted by the annual exclusion amount.
- A married couple elects to split gifts (regardless of amount) or one spouse makes a gift of jointly-held or community property.
- If the individual is a beneficiary, partner, or shareholder of a trust, estate, partnership, or corporation that has made a gift.
- If the donor has died prior to filing a gift tax return, the executor must do so on his behalf.
- If the donor has not paid the gift tax and the liability transfers to the donee.

No return is due for gifts that do not exceed the allowable annual exclusion to each donee, donations of the donor's full interest in the donated property, transfers to political organizations as defined in IRC § 527(e)(1), or payments that qualify for educational and medical exclusions.

[38] The exclusion is set to $139,000 in 2012.

Even when **Form 709** is required, not all gifts need to be reported since each donee is considered separately. If all gifts to one donee can be excluded by the annual exclusion, no gifts to that donee are reported; however, if gifts to a second donee exceed the exclusion, then those gifts must be reported.

Filing Deadline

Gift tax returns must be filed by April 15th of the year following the calendar year in which the gratuitous transfer was made, unless an extension for filing the taxpayer's income tax return has been requested using **Form 4868 Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.** If **Form 4868** has not been filed, **Form 8892 Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax** may be used instead to obtain an automatic six-month extension.

If reporting gifts made by an individual who has died since making the gift, the filing deadline is the earlier of April 15th or the deadline (with extensions) for the estate tax return. While extensions extend the time for filing, they do not extend the time for payment which, if late, is subject to penalties and interest.[39]

Tax Rates (in 2012)

The applicable gift tax rates are the same as those applied to the estate tax.

Taxable Amount ($)	Marginal Tax Rate (%)
0 – 10,00	18
10,001 – 20,00	20
20,001 – 40,00	22
40,001 – 60,00	24
60,001 – 80,00	26
80,001 – 100,00	28
100,001 – 150,00	30
150,001 – 250,00	32
250,001 – 500,00	34
500,001 and over	35

The Gift Tax Calculation

(Taxable Gifts during lifetime * Applicable Tax Rate)
– (Taxable Gifts in prior years * Applicable Tax Rate)
= Tentative Tax
– Applicable Credit Amount
= Tax Due

Calculated at *cumulative* graduated rate

[39] IRC § 6651(a)(1).

Example

Facts:

- 2003: Taxpayer made taxable gifts (after the annual exclusion) totaling $500,000
- 2006: Taxpayer made additional taxable gifts totaling $600,000
  Value of Taxpayer's estate at death was $2.9 million

Gift Tax Calculation:

$ 500K in 2003 → Tax = $155,800 but $0 paid since < $345,800 lifetime credit available
  600K in 2006
$ 1.1M cumulative gifts → Tax = $ 386,800 tentative tax on total gifts made in both years

$ 386,800	Tentative tax [see above]
– 155,800	Tax previously paid on 2003 gift
$ 231,000	Tax attributable to 2006 gift
– 190,000	Credit remaining after 2003 gift (= $345,800 – 155,800 used in 2003)
$ 41,000	Tax due in 2006

Estate Tax Calculation:

$ 2.90M	Value of estate in 2006
+ 1.10M	Prior taxable gifts [see above] added back to estate
$ 4.00M	Tax base used to compute estate tax

$ 1,700,800	Tentative tax on $4 million tax base
– 41,000	Tax previously paid on gifts [see above]
$ 1,659,800	Estate tax liability
– 780,800	Unified credit (based on $2M in 2006)
$ 879,000	Estate tax due @ 2006

Responsibility for the Tax

While the donor is principally liable for the gift tax, the liability may shift to the donee if the donor fails to meet his obligation. Assessment against the donee may be made up to one year after the expiration of the assessment statute against the donor expires.[40] The IRS may file a lien against the transferred property for a period of ten years from the date of the gift.

The personal representative of a donor's estate may become personally liable for unpaid gift taxes, although he may request release from personal liability by submitting a written application.[41]

[40] IRC § 6901(c)(1).

[41] IRC § 2204.

Penalties

Taxpayers may be subject to penalties ranging from late filing and late payment assessments[42] to penalties arising from valuation misstatements for which they will be assessed 20% of any underpayment caused by a substantial over- or understatement of value.[43]

Persons – including lawyers, appraisers, and tax practitioners – who knowingly aid and abet the understatement of another's tax liability may also be penalized.[44] In 2007, preparer penalties for understatement of a taxpayer's income tax liability were extended to include preparers of estate and gift tax returns.[45]

Statute of Limitations

For the purpose of giving taxpayers certainty that the government cannot pursue them for unpaid taxes after a certain period of time, the statute on gift tax returns is limited to three years (six years if the amount of unreported items exceeds 25% of the amount of the reported items).[46] However prior to the enactment of The Taxpayer Relief Act [TRA] of 1997, even gift valuations reported on properly filed gift tax returns could be challenged and changed by the IRS after the donor's death![47]

Under TRA 1997, in order to revalue a gift that has been adequately disclosed on a gift tax return, the Service must issue a final notice of redetermination of value within the statute of limitations applicable to the gift for gift tax purposes.[48] As a result, "there is now an added incentive for a taxpayer to file a gift tax return that includes details about the nature of the transfers made. This will ensure the taxpayer has met the adequate disclosure standard and will curtail the IRS's ability to challenge the valuation of gifts."[49]

To meet the adequate disclosure standard, gift tax returns should include a detailed description of the transaction – whether transferred or retained interests – as well as the

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[42] IRC §§ 6651(a)(1) and (2).

[43] IRC § 6662 defines "substantial" misstatements as those that are 65% or less of the determined value and cause a tax understatement of more than $5,000. The penalty is increased to 40% for "gross" valuation misstatements which are 40% or less of the determined value.

[44] IRC § 6701.

[45] IRC § 6694.

[46] The statute of limitations does not apply to unfiled returns or to those returns that, while filed, did not provide adequate information regarding the nature of the gift, its value, the valuation methodology used, or discounts applied.

[47] *Smith v. Commissioner*, 94 T.C. 872 (1990).

[48] Department of the Treasury, Internal Revenue Service, Office of Chief Counsel, Notice N (35) 000-151, February 27, 1998.

[49] Soled, *New Gift Tax Considerations*, Journal of Accountancy, October 1998 [available at TaxProf Blog, http://www.journalofaccountancy.com/Issues/1998/Oct/soled.htm, last accessed April 25, 2012].

identity of and relationship between donor and donee, and a detailed explanation of the method used to value the transferred property (less applicable discounts). Taxpayers today may wish to disclose even non-reportable gifts to establish valuation methods and preclude potential revaluation should they later make similar (taxable) transfers.

Example

Taxpayer owns all of Company's outstanding 100 shares, valued at $2 million. He gifts one share to his daughter and values that share at $10,000 by applying a 50% minority and marketability discount ($2,000,000/100 × 50%). Based on this value, the taxpayer's gift is less than the annual exclusion and therefore not reportable. However, by filing **Form 709**, the taxpayer can explain how he determined the value and prevent the IRS from challenging his valuation after the statute of limitations expires should he wish to gift additional shares or leave them for his heirs to inherit.

Example

Zuckerberg (of Facebook fame) placed some of his pre-IPO stock into a special trust – a grantor retained annuity trust [GRAT] – in the hopes that the value of that trust would increase exponentially when the company went public. Forbes magazine conservatively estimated that this transfer would successfully (and legally) shelter roughly $185 million from gift tax when the stock eventually passed to the trust's beneficiaries.[50]

FILING THE GIFT TAX RETURN

- **Form 709 must be filed to report all transfers made for inadequate consideration unless the gifted amount to each donee is less than the annual exclusion or is otherwise excludable.**
- **The filing deadline for Form 709 is April 15th of the year following the completed transfer or, if the gift was made in the year of death, Form 709 must be filed along with the estate tax return.**
- **The maximum marginal tax rate is 35% (in 2012) and is applied to the aggregate total of all lifetime gifts made.**
- **Each donor is entitled to a $5.12 million lifetime exclusion (in 2012).**
- **Taxpayers and preparers are subject to penalties for misstatements.**
- **The statute of limitations on a gift tax return adequately disclosing all reportable gifts is generally three years.**

V. Valuation

Gifted property must be valued at FMV[51] at the time that the transfer from donor to donee is completed. Certain gifts, such as gifts of partial interest, may be eligible valuation discounts unavailable to testamentary transfers that can lessen the gift tax bite.

[50] Jacobs, *Facebook Billionaires Shifted More Than $200 Million Gift-Tax Free*, Forbes [available at http://taxprof.typepad.com/taxprof_blog/celebrity_tax_lore/, last accessed April 26, 2012].

[51] The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of the relevant facts [Reg. §25.2512-1].

On the other hand, transfers by bequest but not gift generally receive a stepped-up basis which may serve to lessen a future capital gains tax.

FMV can be determined for assets, such as publicly-traded stocks and bonds that trade on an established market; but the valuation of other assets may become more challenging and may require valuation by a competent and professional appraiser. The IRS requires "qualified" appraisals to be prepared by "qualified" appraisers who must provide reports that contain information regarding the appraiser's background; a description of his fee arrangement with the taxpayer; the method, basis, and justification of the valuation used; in addition, of course, to the established value.[52]

Nevertheless, even valuations of gifts appraised in this manner may be disputed by the IRS which typically favors high rather than low valuations to boost tax collections. Taxpayers, on the other hand, obviously prefer the reverse and often seek to justify valuation discounts based on the lack of marketability, income, or control of the gifted property.

Lack of Marketability

Restricted stock (unregistered shares of publicly-traded companies), shares of closely-held or privately owned companies, limited and family partnerships, amongst others share a common trait – the inability to be readily converted to cash. Studies, which have compared the price of publicly-traded, unrestricted shares of companies to the price of restricted shares of the same companies sold in the private market, have found pricing differences ranging from 13% to 45%.[53]

Lack of Control

When minority shares are gifted, the donee often owns an asset but cannot meaningfully participate in the management of the entity or determine its destiny by voting. In the past, "[t]he IRS contended that a 'unity of ownership' theory espoused under Revenue Ruling 81-253 1981-2 CB 187 prohibited a minority discount for shares that a donor gives to relatives. The revenue ruling concluded that, absent family discord, no minority discount is allowed for transfers of a corporation's shares among a family's members if the family controls the corporation at the time of the transfer. However, courts have consistently rejected the IRS' position and ruled in favor of granting a minority discount to taxpayers who transfer shares of a closely-held corporation to family members. *Charles W. Ward,* 87 TC 78 (1986); *Estate of Samuel I. Newhouse,* 94 TC 193 (1990). Finally, the IRS announced recognition of minority discounts for intra-family transfers of closely held stock. Rev. Rul. 93-12, 1993-1 CB 202"[54]

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[52] Reg. § 301.6501(c)-1(f)(3).

[53] Ransome and Satchit, *Valuation Discounts for Estate and Gift Taxes*, Journal of Accountancy, July 2009 [available at http://www.journalofaccountancy.com/Issues/2009/Jul/20091463, last accessed April 24, 2012].

[54] Trott and Sutton, *Federal Gift Tax (and the Generation-Skipping Transfer Tax)*, page 21.

Built-in Gains

In some cases, property is gifted that includes built-in gains on assets held long before the donee acquired his ownership. These gains will eventually be taxed – presumably to the donee – creating a tax liability for gains that never truly belonged to him but for which, by virtue of the gift, he is now responsible. "While the courts and the IRS have agreed that built-in gains tax on a corporation's appreciated assets should be taken into account in valuing its stock using the net asset valuation method, they have not agreed on the proper method for quantifying the discount."[55]

Discounted valuations almost inevitably are disputed by the IRS and often must be settled in court where a battle of experts is waged.

> **VALUING THE GIFT**
>
> - **Gifts must generally be valued at FMV.**
> - **When FMV is not readily determinable, qualified appraisers should be used to establish value.**
> - **Certain gifts may be eligible for valuation discounts based on a lack of marketability or control.**
> - **Valuations – especially discounted values – are hotly contested by taxpayers and the IRS.**

VI. Basis & Holding Period

The donee's basis and holding period of property transferred by gift generally equals the donor's basis and holding period.[56] The donee's basis may be increased by the amount of gift tax attributable to the accumulated appreciation, if actually paid.

Example

Donee received a gift with a basis of \$100,000 and a FMV of \$120,000. Donor paid the \$5,000 gift tax. Donee later sold the gift item for \$150,000.

Donee's basis is calculated as follows:

Donor's Basis	100,000
Allocated Gift Tax Paid	
{(120,000 – 100,000) ÷ 100,000} * 5,000	1,000
Donee's Basis	101,000

However, if the donee sells the gifted property for less than what the FMV was at the time of the gift, his basis is the lower of the donor's basis or the FMV of the property at

[55] Ransome and Satchit, *Valuation Discounts for Estate and Gift Taxes*.

[56] IRC §§ 1015 and 1223(2).

the time of the gift. The chart below summarizes the rules governing the donee's basis depending upon whether the donee later sells the gifted property at a price more than, less than, or equal to the FMV at the time of the gift:

	Sell < FMV	Sell btw FMV & D's Basis	Sell > FMV
Donor's Basis	100	100	100
FMV at the time of gift	90	90	90
Donee's Sales Price	80	95	120
➔ Donee's Basis	90	90 or 100	100
Donee's Capital Gain (Loss)	(10) = 80 - 90	0	20 = 120 - 100
Donee's Basis equals…	The lower of FMV or Donor's Basis	Basis for gain is 100, but no gain; basis for loss is 90, but no loss	Donor's basis [GENERAL rule]

Part Sale / Part Gift

If an owner sells his property for less than its FMV, the transaction is deemed to be part sale/part gift. The buyer's basis is the greater of the amount paid for the property or the seller's basis increased for any gift tax paid attributable to the appreciation. However, the basis for loss cannot exceed FMV at the time of the gift. The seller's capital gain is the difference between the amount realized from the sale and the adjusted basis. (His loss, if realized, is not deductible).[57]

	Donee sells at gain	Donee sells at loss
Donor's Basis	12	40
FMV at the time of the gift	35	35
Donor sells to Donee for…	20	20
Donor's reportable gift	35 – 20 = 15	35 – 20 = 15
Donor's Capital Gain (Loss)	20 – 12 = 8	20 – 40 = (20) BUT Donor can't deduct loss
➔ Donee's Basis	20 Greater of amt. Donee pd. or Donor's basis	35 Greater of amt. Donee pd. or Donor's basis, BUT never more than FMV
Donee sells for…	50	15
Donee's Capital Gain (Loss)	50 – 20 = 30	15 – 35 = (20)

BASIS AND HOLDING PERIOD

- **Carry-over Basis: Generally, donee assumes donor's basis and holding period.**
- **However, if the gifted property is later sold at a loss, donee's basis is limited to the lesser of the FMV at the time of the gift or donor's basis.**
- **Donee's basis may be increased by an allocable portion of gift tax paid.**
- **Property sold at less than FMV results in part sale/part gift treatment.**

[57] Reg. § 1.1001-1(e).

VII. Generation-skipping Tax (GST)

The GST is imposed on a direct transfer of property to a grandchild which would otherwise be subject to two levels of estate (or gift) taxation if first taxed as part of the parent's estate, then transferred from parent to child, taxed as part of the child's estate, and finally transferred to the grandchild.[58] Because the GST rate equals the top bracket of the estate tax rate currently in effect, this tax usually exceeds that which would have otherwise been incurred at graduated rates if the property had been transferred and taxed at each successive generation.

GST is imposed on the following transfers:

- A transfer of property, subject to gift or estate tax, made to a skip person.
- A termination of a trust interest that passes property to a skip person.
- Any other trust distribution to a skip person.

Exclusions

Each transferor has a $5 million exemption.[59] The tax is not applied to outright gifts that are excluded by the annual gift tax exclusion or qualified transfers for medical and tuition payments. However, a gift to a trust which qualifies for the gift tax annual exclusion must meet additional requirements to qualify for the GST tax exclusion – for example, Crummey Trusts qualify for the annual gift tax but not the GST exclusion.

Example

A taxpayer, who for years has made annual gifts to his three grandchildren to take advantage of the annual gift tax exclusion, has now created a trust for the benefit of all three children and made one lump-sum gift to the trust equal to three times the annual gift tax exclusion. This gift, while eligible for the gift exclusion does not qualify for the GST exclusion.

Gifts to trusts must first satisfy the annual exclusion for all gifts ($13,000) and then two additional requirements: (1) the trust must be for the benefit of a *single* skip person[60] and (2) the trust must be includible in the skip person's gross estate if the trust does not terminate before that person's death.[61]

[58] GST is imposed on direct skips, taxable terminations, and taxable distributions made to a skip person defined as a relative who is at least two generations below the transferor. Spouses, former spouses, tax-exempt organizations and charitable trusts are non-skip persons. If the transferor's child is deceased, the grandchildren by that child are not considered skip persons [IRC § 2612]. If the transferor has no lineal descendants and a niece or nephew of the transferor is deceased, the children of the deceased niece or nephew are not skip persons [IRC § 2651].

[59] While the estate tax exclusion is portable between husband and wife during 2011 and 2012, any unused portion of the GST exclusion is not transferable.

[60] IRC § 2613(a).

[61] IRC § 2642(c)(2).

The GST exemption is not an exemption in the customary sense but serves instead to reduce the applicable rate of tax on the GST transfer [see computation below]. Any portion of an individual's GST exclusion that is not used during a calendar year, is automatically allocated to lifetime transfers that are not direct skips but are indirect skips to GST trusts. If the GST tax exemption is not allocated by the due date of Form 706, the remaining exemption is automatically allocated, first to direct skips occurring at death, and next to all transfers to GST trusts for which the decedent is the most recent transferor. Transferors can elect not to have the automatic rules apply.[62]

Computation

The GST Tax is calculated using the maximum estate tax rate currently in effect; it is not a graduated tax but simply the product of all GST transfers during the year multiplied by the maximum estate tax rate (35% in 2012) times an inclusion ratio which is used to convert an allocated portion of the GST exemption into a tax rate deduction. Thus, in 2010, when the estate tax rate was temporarily at zero, there was no GST.

Example

Taxpayer transfers $2 million to a trust for her son and grandson which permits the trustee to make discretionary distributions to either or both beneficiaries. Taxpayer allocates $500,000 of her GST exemption to the transfer. When the son dies in 2011, there is a taxable termination. With the value of the trust now at $3 million, the applicable rate of tax is calculated as follows:

$$3{,}000{,}000 * 35\% * \{1 - 500{,}000 \div 2{,}000{,}000)\} = 3{,}000{,}000 * 26.25\% = 795{,}000$$

Reporting

Direct skip transfers made during lifetime are reported on **Form 709** on Schedule A, Part 2[63]; direct skips made at death are reported on **Form 706** on Schedule R.

Liability for the GST is assigned to the transferor for direct skips, to the trustee for taxable terminations, and to the transferee for tax distributions from trusts.

GENERATION-SKIPPING TAX

- **GST is assessed based on the value of property transferred to a skip person.**
- **The GST exemption is currently set at $5 million.**
- **In general, GST transfers are eligible for the annual gift exclusion but GST transfers to trusts must satisfy additional requirements.**
- **The GST tax rate equals the maximum current estate tax rate times an inclusion ratio.**
- **GST transfers are reported on Form 709 if made during life; on Form 706 if made at death.**

[62] IRC § 2632(b) and (c).

[63] The tax is computed on Schedule C.

VIII. Gift Tax in Concert with the Estate Tax

When the Estate Tax was enacted in 1916, it did not take long for clever taxpayers to circumvent the tax giving the government the ability to share in the transfer of wealth at death. While some taxpayers mulishly announced, “I just won’t die!” others simply chose to transfer their wealth while still alive and avoid what is often called the “Death Tax”.

And so, the Gift Tax was first enacted in 1924, repealed in 1926, overhauled and reintroduced in 1932 as a protective measure to minimize estate and income tax avoidance. Later, the Economic Growth and Tax Relief Reconciliation Act [EGTRRA] of 2001 began to phase out the Estate Tax,[64] but maintained the Gift Tax precisely for the same reasons it was originally enacted.[65]

To ensure that all transfers – whether during life or after death – are similarly taxed, estates and gifts are subject to a common rate schedule. Additionally, cumulative taxable gifts made during life are added back to the taxable estate, thereby bumping the taxable estate into a higher tax bracket and increasing the resulting tax due from which taxpayers may then subtract the amount of gift tax actually paid in prior years. This convoluted calculation has the effect of eliminating double taxation but ensures that all gifts are ultimately taxed at the highest applicable tax bracket based on their cumulative value at death.

The Gift Tax is said to be tax-exclusive since the tax is assessed only on moneys that are actually transferred, while the Estate Tax is tax-inclusive since taxpayers are required to pay tax on moneys that will be transferred as well as moneys that will be used to pay the tax due. As a result, the Estate Tax is more onerous than the Gift Tax.

Example

Assume that the tax rate on both estates and gifts is a flat 50% and that all of the unified credit has been used: If Taxpayer gave a $2 million gift, he would pay $1 million tax from moneys that he retained and did not transfer to the donee. He has just “spent” $3 million of which the donee pocketed ⅔.

But if Taxpayer has a net worth of $3 million at the time of death, the estate tax would consume $1.5 million, leaving the heirs with only ½.

It is important to note that any unified credit that is used up to reduce the gift tax, no longer remains available to offset the estate tax.

Deathbed Transfers

Often, proactive taxpayers attempting to prevent the inclusion of assets at death, “quickly” transfer assets before passing away. While the appreciation

[64] Many of EGTRRA’s provisions were scheduled to sunset at the end of 2010 but were extended through December 31, 2012 by TRA 2010.

[65] Joulfaian, *The Federal Gift Tax: History, Law, and Economics*, U.S. Department of Treasury, OTA Paper 100, November 2007.

on these last-minute transfers[66] between the date of transfer and death is never included in the estate, the value (at the time of the gift) of certain gifted property[67] – along with the gift tax previously paid – is added back to the gross estate and subject to estate tax.[68]

Example

Dad gifted his personal residence valued at $5,263,000 to Son in 2011, retaining the right to live in the home rent-free. After excluding $13,000, the tentative gift tax totals $1,818,300; subtract the credit attributable to Dad's previously unused lifetime exclusion and the gift tax equals $87,500 which Dad paid.

Dad dies in 2012. Both the value of the gift *and* the gift tax paid are added back to Dad's estate which is now taxed on an additional $5,350,500 even though the property transferred before death. After computing the estate tax tentatively due, the tax will be reduced by the amount of gift tax previously paid.

To prevent the deathbed transfer of assets from a healthy spouse to one who is ill, a one-year waiting period is imposed on the basis step-up rule – if during that year a transferred asset is returned to the donor-spouse, the donor will not be entitled to a basis step-up.[69]

The value of life insurance policies gifted within three years of the transferor's death will be included in the decedent's estate.[70]

Capital Gains

Recall that the basis and holding periods of assets transferred by gift differ from those transferred by bequest:

- Gifted assets generally retain the donor's basis and holding period.
- Inherited assets receive a stepped-up basis and always have a long-term holding period.

As a result, heirs get a fresh start, whereas donees become liable for any gains accumulated during the transferor's tenure. To ensure that these accrued gains are not subjected to both gift and income taxes, the asset's basis is increased for gift taxes paid that are allocable to the gains.[71]

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[66] The IRS imposes a three-year look-back period.

[67] Affected gifts include retained life estates (§ 2036), transfers affective at death (§ 2037), revocable transfers (§ 2038), and life insurance proceeds (§ 2042).

[68] IRC § 2035(b) – known as the "Gross-up Rule".

[69] IRC § 1014(e).

[70] IRC § 2035(a).

[71] IRC § 1015(d)(2).

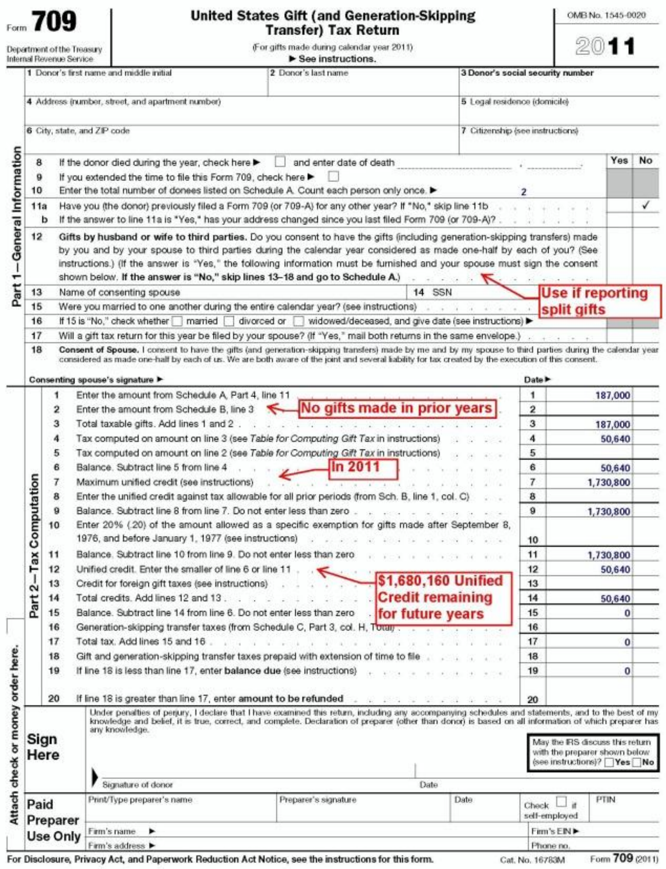
ESTATE VERSUS GIFT TAX

- **The value of all taxable gifts made during life are added back to the decedent's estate, ensuring that gifts and bequest are always taxed at the highest applicable marginal rate.**
- **An executor may claim a credit against the estate tax liability for gift taxes previously paid.**
- **Gift Tax is tax-exclusive; Estate Tax is tax-inclusive.**
- **The Three-year Rule is intended to discourage deathbed transfers.**
- **The donor's accumulated appreciation will be taxed to the donee.**

IX. Comprehensive Example

Single taxpayer made the following cash gifts in 2011:

- $200,000 Cash to son Bob
- $100,000 Church donations
- $13,000 Checks to each of five grandchildren



Form **709**
Department of the Treasury
Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return
(For gifts made during calendar year 2011)
► **See instructions.**

OMB No. 1545-0020
2011

Part 1—General Information

1 Donor's first name and middle initial | 2 Donor's last name | **3 Donor's social security number**
4 Address (number, street, and apartment number) | 5 Legal residence (domicile)
6 City, state, and ZIP code | 7 Citizenship (see instructions)

		Yes	No
8	If the donor died during the year, check here ► ☐ and enter date of death		
9	If you extended the time to file this Form 709, check here ► ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once. ► 2		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		✓
b	If the answer to line 11a is "Yes," has your address changed since you last filed Form 709 (or 709-A)?		
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. **If the answer is "No," skip lines 13–18 and go to Schedule A.**)		
13	Name of consenting spouse — 14 SSN		
15	Were you married to one another during the entire calendar year? (see instructions)		
16	If 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date (see instructions) ►		
17	Will a gift tax return for this year be filed by your spouse? (If "Yes," mail both returns in the same envelope.)		
18	**Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		

Consenting spouse's signature ► Date ►

Part 2—Tax Computation

1	Enter the amount from Schedule A, Part 4, line 11	1	187,000
2	Enter the amount from Schedule B, line 3	2	
3	Total taxable gifts. Add lines 1 and 2	3	187,000
4	Tax computed on amount on line 3 (see *Table for Computing Gift Tax* in instructions)	4	50,640
5	Tax computed on amount on line 2 (see *Table for Computing Gift Tax* in instructions)	5	
6	Balance. Subtract line 5 from line 4	6	50,640
7	Maximum unified credit (see instructions)	7	1,730,800
8	Enter the unified credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)	8	
9	Balance. Subtract line 8 from line 7. Do not enter less than zero	9	1,730,800
10	Enter 20% (.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977 (see instructions)	10	
11	Balance. Subtract line 10 from line 9. Do not enter less than zero	11	1,730,800
12	Unified credit. Enter the smaller of line 6 or line 11	12	50,640
13	Credit for foreign gift taxes (see instructions)	13	
14	Total credits. Add lines 12 and 13	14	50,640
15	Balance. Subtract line 14 from line 6. Do not enter less than zero	15	0
16	Generation-skipping transfer taxes (from Schedule C, Part 3, col. H, Total)	16	
17	Total tax. Add lines 15 and 16	17	0
18	Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19	If line 18 is less than line 17, enter **balance due** (see instructions)	19	0
20	If line 18 is greater than line 17, enter **amount to be refunded**	20	

Attach check or money order here.

Sign Here — Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.
Signature of donor | Date
May the IRS discuss this return with the preparer shown below (see instructions)? ☐ **Yes** ☐ **No**

Paid Preparer Use Only — Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ► | Firm's EIN ►
Firm's address ► | Phone no.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see the instructions for this form. Cat. No. 16783M Form **709** (2011)

Step 1:
Use Schedule A, Part 1 to report gifts to Son and Church – report gifted amounts in full (and provide as much detail as possible).

Step 2:
Do not report gifts to grandchildren in Part 2 or 3 since they are exempt under the annual exclusion.

Step 3:
Carry totals from Part 1 to Part 4 (on Page 3) – deduct annual exclusion and non-taxable charitable deduction (net of its exclusion) to determine taxable gifts.

Step 4:
Carry total of taxable gifts on Line 11 of Schedule A, Part 4 to Line of Form 709, Page 1 and complete tax computation using tax rate schedule provided with Form 709 Instructions; then subtract available Unified Credit to determine tax due.

Form 709 (2011) Page 2

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . Yes ☐ No ☐

B ☐ ◄ Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. (see instructions)

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1	Bob (Son)		200,000	6/15/11	200,000		200,000
	1234 Main Street Anytown, USA 99999						
2	First Church		100,000	8/3/11	100,000		100,000
	1111 Pennsylvania Avenue Anytown, USA 99999						

Gifts made by spouse —*complete* ***only*** *if you are splitting gifts with your spouse and he/she also made gifts.*

Charitable gifts must be included if Form 709 is required to report other gift

Total of Part 1. Add amounts from Part 1, column H . . . ► 300,000

Part 2—Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							

$13,000 gifts to skip persons are excluded by the annual exemption and not reportable

Gifts made by spouse —*complete* ***only*** *if you are splitting gifts with your spouse and he/she also made gifts.*

Total of Part 2. Add amounts from Part 2, column H . . . ►

Part 3—Indirect Skips. Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							

Gifts made by spouse —*complete* ***only*** *if you are splitting gifts with your spouse and he/she also made gifts.*

Total of Part 3. Add amounts from Part 3, column H . . . ►

(If more space is needed, attach additional sheets of same size.) Form **709** (2011)

Form 709 (2011) Page 3

Part 4—Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3	1	300,000
2	Total annual exclusions for gifts listed on line 1 (see instructions)	2	26,000
3	Total included amount of gifts. Subtract line 2 from line 1	3	274,000
	Deductions (see instructions)		
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers .... of Schedule A — 4		
5	Exclusions attributable to gifts on line 4 — 5		
6	Marital deduction. Subtract line 5 from line 4 — 6		
7	Charitable deduction, based on item nos. 2 less exclusions — 7: 87,000		
8	Total deductions. Add lines 6 and 7	8	87,000
9	Subtract line 8 from line 3	9	187,000
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule C, Part 3, col. H, Total)	10	
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1	11	187,000

$13,000 annual exclusion per donee

Terminable Interest (QTIP) Marital Deduction. (See instructions for Schedule A, Part 4, line 4.)

If a trust (or other property) meets the requirements of qualified terminable interest property under section 2523(f), and:

a. The trust (or other property) is listed on Schedule A, and

b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule A, Part 4, line 4,

then the donor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under section 2523(f).

If less than the entire value of the trust (or other property) that the donor has included in Parts 1 and 3 of Schedule A is entered as a deduction on line 4, the donor shall be considered to have made an election only as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule A, Part 4, line 6. The denominator is equal to the total value of the trust (or other property) listed in Parts 1 and 3 of Schedule A.

If you make the QTIP election, the terminable interest property involved will be included in your spouse's gross estate upon his or her death (section 2044). See instructions for line 4 of Schedule A. If your spouse disposes (by gift or otherwise) of all or part of the qualifying life income interest, he or she will be considered to have made a transfer of the entire property that is subject to the gift tax. See *Transfer of Certain Life Estates Received From Spouse* in the instructions.

12 Election Out of QTIP Treatment of Annuities

☐ ◄ Check here if you elect under section 2523(f)(6) **not** to treat as qualified terminable interest property any joint and survivor annuities that are reported on Schedule A and would otherwise be treated as qualified terminable interest property under section 2523(f). See instructions. Enter the item numbers from Schedule A for the annuities for which you are making this election ►

SCHEDULE B **Gifts From Prior Periods**

If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C, if applicable). See instructions for recalculation of the column C amounts. Attach calculations.

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of unified credit against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts
	None previously made			

1 Totals for prior periods . . . 1

2 Amount, if any, by which total specific exemption, line 1, column D is more than $30,000 . . . 2

3 Total amount of taxable gifts for prior periods. Add amount on line 1, column E and amount, if any, on line 2. Enter here and on page 1, Part 2—Tax Computation, line 2 . . . 3

(If more space is needed, attach additional sheets of same size.) Form **709** (2011)

X. The Gift Tax – What's to come…

A. Rationale

"Supporters of the estate and gift tax argue that it provides progressivity in the federal tax system, provides a backstop to the individual income tax and appropriately targets assets that are bestowed on heirs rather than assets earned through their hard work and effort."[72] Critics on the other hand, claim that these taxes stifle and even discourage savings and economic growth, that it unfairly burdens small businesses and family farms, and that it is assessed at an inopportune time when families should devote energies to the grieving process rather than tax compliance.

Whatever the pros and cons, gift and estate taxes generated only about 1% of total federal tax collections in 2009 and 2010.[73] That statistic alone may argue in favor of eliminating these transfer taxes altogether due to their ineffectualness or

[72] Gravelle, *Economic Issues Surrounding the Estate and Gift Tax: A Brief Summary*, CRS Report for Congress, The Library of Congress, Order Code RS20609, April 24, 2007.

[73] SOI Tax Stats - Collections and Refunds, by Type of Tax - IRS Data Book Table 1 [available at http://www.irs.gov/taxstats/article/0,,id=171960,00.html, last accessed April 27, 2012].

argue in favor of expanding legislation to foster a potentially lucrative source of revenue.[74]

B. Tax Law – Old and New

We are currently operating under gift and estate law enacted with the Unemployment Insurance Reauthorization and Job Creation Act of 2010, which extended (and modified) provisions originally introduced with the enactment of EGTRRA 2001 and scheduled to expire at the end of 2010. The new law is also temporary and will expire at the end of the current year (December 31, 2012), once again leaving taxpayers and their estate planners in legislative limbo. Barring further extensions or passage of new laws, governing rules will revert to "old" law; law in effect before 2001.

	Gift & Estate Exemption	Maximum Tax Rate	GST Exemption
Current Law (expires 12/31/12)	$5.12 million	35%	$5 million
Old Law (reversion on 1/1/13)	$1 million	55%	$1 million

C. The Year of the Big Gift

Wealthy taxpayers have been advised to take advantage of a planning opportunity by making large gifts in 2012 and transferring sufficient property to take advantage of the $5 million lifetime exclusion currently in effect before the exclusion reverts to pre-EGTRRA levels. By making transfers in the current year, planners hope that their clients can lock in the exclusion currently in effect and shelter large portions of their wealth from gift tax now (and estate tax later).

The Claw-Back

Legislative language, however, has left an important issue unclear: Under current law, the amount of a taxpayer's lifetime exclusion is based on law in effect on the date of death; under old law, the exclusion is fixed based on law in effect at the time of the gift. The Association for Advanced Life Underwriting computed a $400,000 tax savings on a $10 million estate if the exclusion in effect was based on date of death rather than on the date of gift.[75]

This unfortunate effect, known as the "claw-back", is due to the fact that taxable gifts must be added back to the taxable estate to ensure that all transfers are taxed at the highest marginal bracket. Nevertheless, most planners still favor lifetime gifting – whether or not those gifts are added back to the state and taxed

[74] *The Tax Prophet* (Issue # 104, January 2012) reports that the IRS has received judicial permission and "is trolling in California for gift taxes" by reviewing state records in search of family transfers of real property between 2005 and 2010. Although the lifetime gift tax exclusion is currently $5 million, it was limited to $1 million in earlier years.

[75] *Will 2011 and 2012 Taxable Gifts be "Clawed Back" after 2012*, AALU Bulletin No. 11-09, January 21, 2011.

based on old or new law – simply because the effect of gifting is to reduce the taxable estate which is subject to a tax that is tax-inclusive and more "expensive" than its tax-exclusive counter-part, the gift tax. Furthermore, capital appreciation of gifted assets which increase in value between the dates of gift and death is permanently sheltered from taxation.

D. Crystal Ball

Mine is as cloudy as yours and for every cloud, there's a proposal for change. In February 2012, the Obama administration introduced legislation to set the maximum estate and gift tax rates at 45% on transfers in excess of $3.5 million while limiting the GST exclusion to only $1 million.[76] Other proposals abound; even the complete elimination of one or both taxes but with the federal deficit mushrooming, it is more likely that estate and gift taxes, in some incarnation, are here to stay.

LOOKING AHEAD

- **Despite their critics, estate and gift taxes have been a fixture on the legislative landscape since 1916 and 1932, respectively.**
- **However, the laws are ever-changing, often making it difficult for taxpayers to implement an effective estate plan.**
- **Wealthy taxpayers have been advised to make gifts now before the provision for a generous $5 million exclusion expires at year-end.**
- **President Obama has proposed to lower the exclusion to $3.5 million and raise the maximum tax rate from its current 35% to 45%.**

[76] Ward, *2012 – 2013 Estate Tax Planning for US Residents – Gift and Estate Tax Strategies*, posted March, 2012 at http://hutcheson.ca/articles/2012-2013-estate-tax-planning-for-us-tax-residents-gift-and-estate-tax-strategies#more-670 [last accessed April 27, 2012].