Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2001

Date: 23-Aug-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Bramwell and Mullen: Donative Promise Can Use Up Gift Tax Exemption**

"The authors propose a strategy that enables taxpayers to make substantial taxable gifts in 2012 without currently parting with any of their wealth. The strategy is simple: Instead of transferring cash or other property this year, an individual can promise to make gifts to the donees in the future.

If the promise is designed so that it is enforceable under local law, it will be treated as a taxable gift when made and may successfully use up the $5.12 million gift and GST tax exemption amounts while they are still available. The strategy also has nontax benefits that many individuals may find compelling.

Finally, the strategy enables married taxpayers to make gifts in 2012 while avoiding potential "clawback" tax upon the death of the first spouse to die.

For these reasons, many taxpayers who have not yet used the increased gift tax exemption amount should consider doing so this year by making an enforceable promise to make gifts in the future."

Austin Bramwell and **Lisi Mullen** provide members with commentary that is sure to spark interest – if not controversy – among **LISI** members: donative promise gifts as a claw-back management strategy.

LISI provides this commentary – not as an endorsement of the concept –

but as "food for thought." The views expressed herein are the authors' own. We'd be interested in reader's input – which you can readily add to **LISI's** COMMENTS BOX by clicking the link at the bottom of this newsletter.

Austin W. Bramwell is an associate in the trusts and estates department of **Milbank, Tweed, Hadley & McCloy LLP**. He has written previously for *Journal of Taxation*, *Estate Planning*, *Trusts & Estates*, *Probate & Property*, **LISI**, and other publications.

Elisabeth ("Lisi") Madden Mullen is an associate in the trusts and estates department of **Milbank, Tweed, Hadley & McCloy LLP**. She has written previously for *Journal of Taxation*, *Estate Planning*, *Tax Notes*, **LISI**, and other publications.

The authors thank **Jonathan G. Blattmachr** for his helpful comments.

Here is their commentary:

EXECUTIVE SUMMARY:

The authors propose a strategy that enables taxpayers to make substantial taxable gifts in 2012 without actually parting this year with any of their wealth. The strategy is simple: Instead of transferring cash or other property this year, an individual can promise to make gifts to the donees in the future. If the promise is designed so that it is legally enforceable under local law but is not in exchange for consideration in money or money's worth, it will be treated for federal gift tax purposes as a taxable gift when the promise is made (rather than when it is later paid) and will successfully take advantage of the $5.12 million gift and estate tax exemption amount while it is still available.

The strategy also has nontax benefits that many individuals may find compelling.

Finally, the strategy enables married taxpayers to make gifts in 2012 while avoiding potential "clawback" tax upon the death of the first spouse to die.

For these reasons, the authors suggest that many taxpayers who have not yet used up the increased gift tax exemption amount should consider doing so this year by making a legally enforceable promise to make gifts in the future.

FACTS:

The federal gift and estate tax exemption amount, currently $5.12 million, is scheduled to revert to $1 million after this year. The highest estate tax rate, meanwhile, is schedule to increase from 35% to 55% (and, in some cases, up to 60%).

The impending decline in the exemption amount and increase in estate tax rates create a powerful incentive to make taxable gifts this year. Absent further legislation, for example, a taxable estate of $5.12 million, if the decedent made no taxable gifts, will generate $2,111,000 of estate tax in 2013. Taxpayers can potentially avoid that tax entirely by making taxable gifts this year up to the $5.12 million exemption amount.

Unfortunately, not all taxpayers feel that they have the wherewithal to immediately part with $5.12 million of wealth. An individual worth exactly $5.12 million, for example, if he or she has made no prior taxable gifts, would need to give away 100% of his or her assets in order to use up the exemption amount in full this year.

Although the $2,111,000 in potential estate tax savings represents approximately 41% of the individual's wealth, he or she may nonetheless decide that the tax savings at death are not worth the lifestyle compromises required to make substantial taxable gifts this year. Consequently, many individuals, especially the relatively less affluent, will fail to take advantage of the increased exemption amount available in 2012.

COMMENT:

Happily for such taxpayers, we believe there is a strategy whereby they can use up the exemption amount available this year - yet still retain title to and control of all their wealth.

Under this strategy, an individual, instead of giving away cash or other property this year, promises to pay cash or other property to the donees in the future. If the promise (hereinafter, a "donative promise") is legally enforceable under local law, it will be treated as a taxable gift.[i] Although a donative promise will not qualify at the taxpayer's death for a deduction under Code section 2053(a)(3), it will also not be treated as an adjusted taxable gift under Code section 2001(b). Consequently, a donative promise can save estate tax on the difference between this year's exemption amount and the lower exemption amount that will be available beginning in 2013.

Example: Unmarried Taxpayers

For example, suppose that Ruth, an unmarried individual who has made no prior taxable gifts, has exactly $5.12 million of assets. She makes an enforceable promise to pay her children $5.12 million (plus interest at the applicable federal rate) in five years. The promise will be treated as a taxable gift at the time that it becomes enforceable under local law.[ii] In addition, as discussed in further detail below, the value of the gift can be reported as being equal to the full $5.12 million face amount of the promise. Ruth's donative promise, therefore, uses up all the entire gift tax exemption amount.

Now suppose that Ruth dies in 2013 with exactly $5.12 million of assets. Section 2053(c)(1)(A) of the Code provides that a claim founded on a promise or agreement cannot generally be deducted against the taxable estate - unless it was contracted bona fide and for full and adequate consideration in money or money's worth. Here, Ruth's promise was *not* made for a valuable consideration. Her children's claim against the estate, therefore, will not qualify for a section 2053 deduction. Assuming (for simplicity) that there are no other deductions, Ruth's taxable estate will be $5.12 million.

To determine the estate tax due under the calculation procedures of section 2001(b) of the Code, Ruth's executors will need to determine whether any "adjusted taxable gifts" need to be included in the amount subject to estate tax. Normally, a gift that is not included in a decedent's gross estate qualifies as an "adjusted taxable gift." In this case, Ruth's gift is not brought back into the gross estate under one of the "string" sections (i.e., sections 2035 through 2042 of the Code) that can cause property transferred during lifetime to be included in the gross estate.[iii]

Treating a donative promise gift as an adjusted taxable gift, however, would lead to double taxation: The assets used to satisfy the promise would be taxed once as part of the gross estate under section 2033 of the Code (but without a corresponding deduction under section 2053 of the Code) and a second time as an adjusted taxable gift. Public policy, therefore, would seem to demand that a donative promise gift *not* be treated as an adjusted taxable gift to the extent that the promise is not satisfied during lifetime.[iv]

In Rev. Rul. 84-25, the IRS confirmed that a donative promise gift, although it does not qualify for a deduction under section 2053 of the Code, is also not an adjusted taxable gift. Thus, Ruth's $5.12 million gift in 2012 is not added to the estate tax calculation. In other words, a tentative tax will be calculated on the taxable estate of $5.12 million and not on the sum of the taxable estate and Ruth's $5.12 million donative promise gift in 2012.

The next step in the estate tax calculation procedure will be to subtract the gift tax which "would have been payable" on the donative promise gift that Ruth made in 2012. Assuming that the IRS cannot recapture or "claw back" tax on gifts that at the time were under the gift tax exemption amount, the gift tax payable will be $2,111,000. After this amount is subtracted from the tentative tax, the remaining estate tax will be $345,800, which will be equal to the unified credit under section 2010 of the Code. No estate tax will be due at Ruth's death. Thanks to Rev. Rul. 84-25, Ruth's donative promise successfully uses up the $5.12 million exemption amount that was available to her in 2012.

Example: Married Taxpayers

The donative promise strategy also works for married couples who intend to defer the payment of estate taxes until the death of the surviving spouse. To be sure, if the first decedent makes a donative promise gift in 2012, his or her taxable estate may be larger than the estate tax exemption amount that will be available beginning in 2013. At first blush, therefore, it may seem that, contrary to the desire of many married taxpayers, the donative promise strategy will cause estate tax to be paid at the first decedent's death.

In fact, however, the donative promise strategy works as well for married taxpayers as for unmarried taxpayers. For example, suppose that Jake, a married individual with $10 million of assets who has made no prior taxable gifts, makes a $5.12 million donative promise gift to his children in 2012. He dies in 2013 leaving his entire estate, after the payment of debts, to his wife. Jake's executors pay over $5.12 million to Jake's children and the $4.88 million balance to Jake's wife.[v] Jake's estate, therefore, may only take a marital deduction of $4.88 million, which leaves a taxable estate of $5.12 million.

Just as in Ruth's case, Rev. Rul. 84-25 will prevent Jake's donative promise gift from being added to the amount subject to estate tax as an adjusted taxable gift. The gift taxes payable on the gift, meanwhile, will reduce the tentative estate tax to $345,800 (assuming no clawback of tax). Once again, the unified credit will absorb all of the tax and no estate tax will be due.

In short, despite that a donative promise in 2012 may generate a taxable estate that is larger than the exemption amount available after 2012, it will not cause estate tax to be due at the first decedent's death (assuming that clawback, discussed below and not a problem unique to donative promise gifts, does not apply).

Clawback Management

The examples discussed above assume that the gift tax that "would have been payable" on a gift made in 2012 by a decedent who dies in 2013 or later will reduce the amount of estate tax at death, even though no gift tax was actually assessed. As has been discussed in prior **LISI** newsletters,[vi] however, it is not entirely clear that the IRS must permit a reduction of estate tax for a hypothetical tax on gifts that were under the gift tax exemption amount. If the reduction is denied, the IRS could effectively recapture or "claw back" tax on the difference between the (higher) exemption amount available at the time of the gift and the (lower) estate tax exemption amount available at death.

It may be unlikely at this point that the IRS will actually assert the right to recapture tax on gifts that were covered by the exemption amount available at the time of the gifts. For one thing, Congress may eliminate the threat of clawback if the exemption amount is reduced.[vii] Recently published temporary and proposed Treasury Regulations also clearly foreclose the similar threat of clawback that could have arisen where a decedent, by remarrying and surviving a second spouse, lost gift tax exemption he or she had inherited from a prior deceased spouse.[viii] That the IRS does not believe in clawback in the portability context may indicate that the IRS likewise does not believe in clawback in the context of decreasing exemption amounts.

That said, any remaining threat of clawback is especially severe for married couples: If the first decedent's executors are required to pay clawback tax, they may be forced to pay the tax out of the marital share passing to the surviving spouse, which will reduce the marital deduction available to the estate, which will increase the estate tax, which will further reduce the marital deduction, and so forth in a vicious circle. Suppose, for example, that Marci, a married taxpayer worth $10 million who has made no prior taxable gifts, makes a $5.12 million cash gift in 2012 and dies in 2013 with $4.88 of assets remaining, all of which she attempts to leave outright to her husband. If the IRS successfully claims the power to claw back tax on the $5.12 million gift, Marci's estate will be required to pay $4,691,111.11 of estate tax. Only $188,888.89 will pass to Marci's husband.

Now suppose instead that Marci gives her children a $5.12 million note enforceable under local law. The note provides that, if it remains outstanding at Marci's death and Marci predeceases her husband, then the amount payable under the note will be reduced to the maximum amount that can be paid to Marci's children without causing estate tax to be due at Marci's death.[ix] Marci once again dies in 2013 survived by her husband. As the maximum amount that can be paid to Marci's children in 2013 without causing estate tax to be due would (if there is clawback) be $1 million, Marci's executors would be required to pay only $1 million to Marci's children. The balance of her assets ($9 million) could then be paid over to Marci's husband. Marci's taxable estate, therefore, would be $1 million, which is exactly equal to the exemption amount available in 2013. A partial cancellation provision that is incorporated into a donative promise gift, in short, can prevent clawback tax at the death of a married taxpayer.[x]

Making the donative promise enforceable

For the donative promise strategy to succeed, it is crucial that the promise be enforceable under local law. If the promise is unenforceable, no taxable gift occurs and no gift tax exemption will be used.[xi] Donors and donees, therefore, should take care that the donative promise is made pursuant to an agreement that satisfies the elements of a contract, i.e., that there be a manifestation of mutual assent and a bargained-for consideration.[xii]

To illustrate, consider the following example:

> Alvina loves her daughter, Vanessa, but privately has reservations about the way Vanessa is raising her own children. In particular, Vanessa has chosen to send her children to an elite private school where they rub elbows with the rich and famous. Alvina believes in supporting the public school system and fears that her grandchildren are learning the "wrong values."
>
> Alvina approaches Vanessa and tells her of the substantial potential estate tax savings from making taxable gifts this year. However, Alvina cannot afford to just give away the money this year. Instead, Alvina says that she will promise to give Vanessa $5.12 million in the future. Vanessa expresses deep gratitude to Alvina for even thinking about saving estate tax at Alvina's death.
>
> Alvina then explains that there is a catch: the promise must be

> enforceable in order to save estate tax, but the only sure way to make it enforceable is for Vanessa to do something in return for the $5.12 million promise. Alvina confesses that she had always wished that Vanessa had sent her children to public school. As a condition of promising to give her $5.12 million in the future, therefore, Alvina will ask that Vanessa send her children for one year to a local public school. Vanessa says that she will agree.
>
> Alvina and Vanessa then sign an agreement reciting that Alvina wishes to make a taxable gift to Vanessa in order to save estate taxes, and stating that, in consideration for the Alvina's promise to pay her $5.12 million, Vanessa will enroll her children in public school. Vanessa enrolls her children in public school in the fall.

Can Vanessa enforce Alvina's promise? In our view, the answer is yes. It is well-established that consideration (i.e., any bargained-for legal detriment, such as an act or forbearance that the promissee has no legal duty to perform[xiii]) need not be adequate in order to be sufficient.[xiv] As one authority has written:

> It is an elementary and oft quoted principle that the law will not inquire into the adequacy of consideration as long as the consideration is otherwise valid or sufficient to support a promise. By this is meant that so long as the requirement of a bargained-for benefit or detriment is satisfied, the fact that the relative value or worth of the exchange is unequal is irrelevant so that anything which fulfills the requirement of consideration will support a promise, regardless of the comparative value of the consideration and of the thing promised. The rule is almost as old as the doctrine of consideration itself.[xv]

Another states:

> The rule is too well settled, even to admit of argument, that consideration in fact bargained for is not required to be adequate in the sense of equality in value. The mere inadequacy, alone, is never sufficient to vitiate a contract or conveyance otherwise valid, and the courts are not disposed to enter upon nice calculations to strike a balance on the one side or the other. Absolute equality is not to be hoped for, and is seldom attained in men's dealings one with the other. Nor is consideration to be measured in terms of dollars and cents alone; convenience, avoidance of troublesome details and efforts are proper elements.[xvi]

Thus, a decedent's promise to pay a friend $5,000 for a canary – an extraordinarily exorbitant price at the time for a bird – was held enforceable against his estate.[xvii] Another promise to pay $5,000 – again, an exorbitant price, especially at the time – in exchange for ministering to the decedent's feet was held to be enforceable.[xviii] In *Hamer v. Sidway*,***[xix]*** the court famously held that refraining from using alcohol or tobacco was sufficient consideration to make a promise enforceable.

The IRS, citing *Hamer*, has itself held that a promise to pay a donee money in exchange for the donee graduating from college was a taxable gift when the donee graduated.[xx] Other considerations that have been held to be legally sufficient include attending the donor's funeral,[xxi] changing one's name,[xxii] quitting one's job[xxiii] or giving a child a certain name.[xxiv] Further examples of inadequate yet legally sufficient consideration abound.[xxv] In like fashion, that Vanessa's promise to enroll her children in public school has no fair market value nor even (compared to the potential estate tax savings) very much value to Alvina is, under traditional contract principles, irrelevant to whether Vanessa's consideration is sufficient.

The principle that the law will not inquire into the adequacy of consideration, however, does not settle whether Alvina's promise is enforceable. The deeper question posed by Vanessa's performance for Alvina's promise is whether it was truly "bargained for." In the "classical" view, consideration is not insufficient merely because "obtaining it was not the motive or a material cause inducing the promissor to make the promise."[xxvi] As an illustration, the Restatement (First) of Contracts offers the following:

> A wishes to make a binding promise to his son B to convey to B Blackacre, which is worth $5000. Being advised that a gratuitous promise is not binding, A writes to B an offer to sell Blackacre for $1. B accepts. B's promise to pay $1 is sufficient consideration. [xxvii]

In other words, a donor may always make a promise enforceable by inducing a nominal consideration, even though both donor and donee know that the motive is simply to make a gift.[xxviii] Thus, that Alvina's primary purpose is to save estate tax by making a taxable gift would not, in the classical view, undermine the sufficiency of Vanessa's consideration.

More recent authorities, however, retreat from the Restatement (First) of Contract's flat assertion that motive is irrelevant. Restatement (Second) of Contracts instead warns that a "mere pretense of bargain does not suffice." As an illustration, it gives the following:

> A desires to make a binding promise to give $1000 to his son B. Being

> advised that a gratuitous promise is not binding, A offers to buy from B for $1000 a book worth less than $1. B accepts the offer knowing that the purchase of the book is a mere pretense. There is no consideration for A's promise to pay $1000.[xxix]

The Restatement (Second) acknowledges that "[e]ven where both parties know that a transaction is in part a bargain and in part a gift, the element of bargain may nevertheless furnish consideration for the entire transaction."[xxx] The Restatement (Second) also generally endorses the well-settled rule that a promissor's motivation for inducing a consideration is normally irrelevant to whether it was actually bargained for.[xxxi] Nonetheless, it clearly raises the possibility that, even though the donor and donee both wish to make donor's promise legally enforceable, a donative promise will be held unenforceable if they both know that the donor's motive in seeking consideration from the donee is to make a gift. In Alvina's case, since her overwhelming motive is to save estate tax by making a taxable gift, it is unclear whether Vanessa's act of enrolling her children in public school was truly bargained for.

The Restatement (Second)'s about-face on nominal consideration for a promise to make a gift has been widely criticized.[xxxii] As Samuel Williston remarked, "It is something, it seems to me, that a person ought to be able to do, if he wishes to do it—to create a legal obligation to make a gift. Why not? . . . I don't see why a man should not be able to make himself liable if he wishes to do so."[xxxiii] Unfortunately, there does not appear to any case law to settle which Restatement's position is correct.[xxxiv]

That said, in the our view, even under the Restatement (Second)'s position, Alvina's promise is enforceable. While Alvina's primary motive is to save estate tax, she also genuinely desires to see her grandchildren enrolled in public school. Even the Restatement (Second) allows that presence of some non-donative motive for seeking consideration suffices to make it legally sufficient.[xxxv] As there is at least some element of bargain in Vanessa's agreement to enroll her children in public school, therefore, Alvina's promise should be enforceable.[xxxvi]

As a general matter, it seems that the more strongly the donor actually desires the performance or forbearance furnished as consideration, the more likely the promise is to be upheld as enforceable. Planners recommending the donative promise strategy, therefore, should review carefully with the donor what lifestyle concessions he or she wishes to extract from the donees. The more meaningful to the concession (and the more reluctant the donees to make it), the more likely the strategy is to succeed. The requirement that a promise must be supported by consideration in order to use up gift tax exemption turns out to be a significant non-tax benefit: In order to make a taxable gift of a promise to pay money in the future, a donor simply has no choice but to demand, on the advice of counsel, that the donees take actions that they might otherwise be reluctant to perform.

Must the promise be bona fide?

Just because an instrument is enforceable under local law does not mean that it will always be respected for tax purposes. For example, the IRS has ruled, controversially, that if a taxpayer sells property for a note that he or she does not intend to enforce, the note will be disregarded in determining the value of the gift.[xxxvii] The IRS's attack on notes that are not bona fide in the context of installment sales may cause some concern that the IRS will similarly attack a donative promise gift on the grounds that the donors and donees did not intend to enforce the terms of the gift nor the donor and donee to honor it. Some might worry, in other words, that, contrary its usual practice, the IRS will actively seek to *prevent* taxpayers from reporting transactions as taxable gifts.

Needless to say, no individual should make a donative promise gift unless he or she fully intends to honor the terms of the promise. For taxpayers concerned that the IRS will question their intentions, however, it is comforting to observe that the *intent* of the parties is irrelevant to determining whether a transaction constitutes a taxable gift.[xxxviii] On the contrary, "application of the [gift] tax is based on the objective facts of the transfer and the circumstances in which it is made, rather than the subjective motives of the donor."[xxxix] In Rev. Rul. 79-384, for example, a child sued a parent to enforce a promise to pay money upon the child's graduating from college. Despite the parent's evident lack of intent to honor the promise, the IRS held that the parent made a taxable gift on the date the child graduated and the promise became enforceable under local law.

Consistent with the notion that subjective intent is irrelevant to whether a transfer is a taxable gift, Rev. Rul. 84-25 holds that the "gratuitous transfer of a *legally binding* promissory note is a completed gift." The ruling says nothing about whether the promissees intended to enforce the note or the whether the taxpayer intended to satisfy it. Therefore, so long as the promise is legally enforceable and the consideration received has no value in money or money's worth, the promise will be a taxable gift.

In any case, taxpayers can foreclose any "risk" that the IRS will attempt to void donative promise gifts by adequately disclosing them on their gift tax return. Once a donative gift is adequately disclosed and the period for assessment of gift tax lapses, any argument by the IRS that the gift was not bona fide would be precluded under Code section 2001(f). The gift tax assessment period will begin to run so long as the gift is adequately disclosed and reported as a completed gift, even if the gift is ultimately determined to have been incomplete.[xl] Thus, if a donative promise is reported as a taxable gift and the gift tax assessment period lapses, the IRS must treat the promise as a taxable gift when calculating estate tax at death.

Is there a downside?

Suppose that, despite the unbroken line of authority supporting the proposition that an enforceable promise is a taxable gifts,[xli] the IRS nonetheless seeks to void a donative promise gift made in 2012. If the IRS succeeds, the donor will simply have failed to have made a taxable gift and his or her estate will not be able to subtract from the amount of estate tax due the gift taxes that "would have been payable" on the donative promise gift. The same result would have obtained had the donor made no taxable gifts at all. For taxpayers who do not have the means to make conventional taxable gifts this year, therefore, there is no gift or estate tax downside to making a donative promise gift.[xlii]

Valuing the promise

In general, the value of property for gift tax purposes is the price at which it would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both being reasonably apprised of the relevant facts.

This general rule, however, is subject to a number of specific rules governing the valuation of various types of property. In particular, the value of a promissory note "is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value."[xliii] Under this rule, it seems that a taxpayer may report the value of a note as being equal to the amount due, even though the value of the note could in theory be discounted (such as for lack of security, insolvency of the borrower, date of maturity, etc.). Indeed, as the Treasury Regulations only permit the *donor* (not the IRS) to establish a lower value, it may be (although it is not certain) that the IRS is precluded from challenging a taxpayer's position that the value of a note is equal to the principal required to be paid.

In the context of the donative promise strategy, the presumption that a note is equal to its face value is helpful in a number of ways:

First, the donor need not engage an appraiser to value a donative promise gift; instead, he or she may simply report the face value of the promise as its value for gift tax purposes.

Second, the donor, to use up his or her exemption amount, need not increase the face value of the promise in order to make up for any discount.

Third, if the value of the promise is equal to its face value, there will generally not be any mismatch between the value of the gift in 2012 -- which will determine the amount of gift taxes which "would have been payable" under section 2001(b) of the Code -- and the amount that the taxpayer's executors will actually be required to pay to the donees at death -- which may (such as in the case of a married donor who plans to defer estate taxes until the death of the surviving spouse) determine the size the taxable estate.

Finally, for married taxpayers, the ability to report the value of a donative promise as being equal to the full amount of principal can help manage the risk of clawback tax. As discussed above, a married donor should consider including a partial self-cancellation provision that, if the donor predeceases his or her spouse, will automatically reduce the amount required to be paid under the note to the maximum amount that can be paid without causing estate tax to be due at the donor's death.

The presumption that a note is equal to its face value seems to permit the donor to take the position that there is no discount in virtue of the self-cancellation feature. That is, rather than attempt to determine what the discount would be based on such uncertain factors as whether the law permits the IRS to claw back tax or the probability that Congress will not act to prevent a decrease in the exemption amounts, it seems that the donor can report the value of the note as being equal to the full principal amount, without taking the partial cancellation clause into account.[xliv]

Is payment of the promise taxable income?

Donees who enter into a donative promise gift agreement with the donor should consider whether any payment to them is taxable income rather than a gift excludable from gross income under section 102(a) of the Code. Just because a transaction is a taxable gift for gift tax purposes does not mean that it is a gift for income tax purposes.[xlv] In particular, whereas a taxable gift is generally any completed transfer (other than in the ordinary course of business) for less than full and adequate consideration in money or money's worth, regardless of motive, a taxable gift for income tax purposes generally requires, in the words of the *Duberstein v. Comm'r*,[xlvi] a "detached and disinterested generosity . . out of affection, respect, admiration, charity or like impulses." Unless the donees can establish that that the payment by the donor was made with the requisite motive, therefore, the payment could conceivably be treated as taxable income earned by the donees.[xlvii]

That said, while there is no authority directly on point, it should not be difficult to establish that the donor was indeed motivated by a "detached and disinterested generosity." The donor's very purpose in making a donative promise gift is to cause more wealth to pass tax-free to the donees. Any payment to the donees, therefore, should be treated as a gift excludable from the donees' income.

In addition, courts have held where an individual deliberately overpays for property or services, the overpayment constitutes a gift.[xlviii] In making a donative promise, the donor deliberately agrees to overpay for the value of the donees' consideration. Consequently, the overpayment should be excluded from the donees' income just as in the case of a gift made for no consideration.

Finally, when the donor and the donee are intimately associated, courts have typically treated a payment to the donee, even if in exchange for some kind of benefit, as a gift.[xlix] As a donative promise will typically be made to family members, the donor's natural affection for the donees will tend to establish that the payment to the donees was a gift.

Careful planning can in any case minimize the risk that the donees will have taxable income:

First, wherever possible, the donor, rather than the donees, should initiate discussion of making a donative promise gift.

Second, the documents implementing the donative promise gift should emphasize the donor's wish to pass wealth to the donees. The donative promise documents can even recite that the donor has asked the donees to furnish consideration so as to enable the donor to make gifts to them in a tax-efficient manner.

Third, the donees of the donative promise gift should be the same as the beneficiaries named in the donor's will or other testamentary documents.

Finally, the donor should demand consideration that he or she genuinely believes will be beneficial to the donees. Good candidates may be an agreement to enroll minors in a particular school, to travel to a particular location, to release claims in order to resolve intra-family strife or to engage in some meaningful and significant life-improving activity.

Income and GST tax structuring

In almost all cases, the donative promise should be made to an irrevocable trust that is structured as a "grantor trust" for income tax purposes.[l] Making a donative promise gift to a grantor trust has several advantages:

First, as transactions between the donor and a grantor trust are ignored for income tax purposes, neither the donor nor the trust should be taxed on any interest on the note.[li]

Second, it should be possible for the donor to allocate exemption from generation-skipping transfer ("GST") tax to the trust so as to reduce to zero the GST tax rate that may apply.[lii]

Third, the donor's spouse can be included in the class of beneficiaries, thereby ensuring that all property of the donor will pass to or be held for the benefit of the spouse if he or she survives the donor.

Fourth, if the donative promise is satisfied during the donor's lifetime, it does not appear that the payment to the trust can be treated as taxable compensation income to the donees, as both the promise and the satisfaction of the promise would be ignored for income tax purposes under Rev. Rul. 85-13.[liii]

Finally, even if the promise is not satisfied until after grantor trust status is terminated (such as at the grantor's death), the creation of a private express trust, a traditional device for passing on family wealth, supports a finding that the donor was primarily motivated by "detached generosity" and thereby should lessen any risk that satisfaction of the promise will be treated as compensation income to the donees.

TECHNICAL EDITOR'S COMMENT

Will the IRS argue that the note was not a legitimate, enforceable obligation? The odds of this adverse result diminish if payments start to be made immediately.

Will the promissory note actually be enforceable under state law? If so, will it be enforceable to the extent of the note's full principal, or perhaps a reduced amount? These questions, of course, are something each attorney will need to research for his or her own state.

And, of course, it is absolutely essential that the parties act in good faith and honor their agreement and that the note be actually repaid.

Being conservative, I would tend to recommend this approach only if the client had no other assets to give, had short-term liquidity needs, and had a long-term plan for raising the money to repay the loan – and an intention to do so.

That's just my preliminary approach to this idea; each **LISI** reader should decide when this strategy is the most appropriate one to use under the circumstances.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

Lisi Mullen

TECHNICAL EDITOR: STEVE GORIN

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CITATIONS:

[i] A donative promise, as the term is used in this article, is "donative" in the sense that, if it is enforceable under local law, it will be treated as taxable gift for federal gift tax purposes. See, e.g., Rev. Rul. 79-384; Rev. Rul. 84-25. As discussed further in the text, however, a promise must generally be supported by some consideration,

even if not adequate in dollar terms, in order to be enforceable under local law.

[ii] Rev. Rul. 79-384; Rev. Rul. 84-25; *Comm'r v. Copley's Estate*, 194 F.2d 364 (7th Cir. 1952), acq. 1965-2 C.B. 4; *Rosenthal v. Comm'r*, 205 F.2d 505 (2d Cir. 1953); *Harris v. Comm'r*, 178 F.2d 861 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950); cf. *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981) ("The critical inquiry is whether the parties to the agreement intended to give the donees the right to enforce the [donor's] obligation to make the . . . payments").

[iii] The Line 4 Worksheet for adjusted taxable sheets in the IRS's Instructions for Form 706 seems to assume that a post-1976 gift cannot be excluded from adjusted taxable gifts unless the transferred property is included in the gross estate under one of the "string" sections. As discussed in the text, however, a donative promise gift, although not included in the gross estate under one of such sections, is also not an adjusted taxable gift.

[iv] The Second Circuit recognized the potential for double taxation of donative promise gifts in *Estate of Flandreau v. Comm'r*, 994 F. 2d 91 (2d Cir. 1993). There, the court held that deductions for donative promise claims against the estate were rightly denied under section 2053(c)(1)(A) of the Code. The court went on to note, however, that, to prevent double taxation of the donative promise gifts, which were made before 1977, the estate should have claimed a credit for gift taxes paid under section 2012 of the Code.

[v] It is assumed here that no interest is payable on the $5.12 million promise at death. To avoid accrued interest from increasing the amount taxable at death (thereby increasing the first decedent's taxable estate and potentially generating estate tax), it may be prudent for a married donor to make regular interest payments on the donative promise. Alternatively, the donor could make a donative promise gift by giving a zero-interest note to a grantor trust for the benefit of the donees. No income tax liability for foregone interest would be generated under section 7872(a) of the Code, as any transactions between the donor and the trust would be ignored for income tax purposes. Rev. Rul. 85-13. Any deemed transfer of foregone interest from the trust to the donor under section 7872 of the Code would be harmless for gift tax purposes, as the gift tax applies to individuals and not to trusts. Internal Revenue Code ("IRC") § 2501(a).

[vi] M. Jones, *Grasping Clawback's Applicability & Opportunities*, LISI Estate Planning Newsletter #1925 (February 16, 2012); D. Evans, *Clawback Has No Teeth*, LISI Estate Planning Newsletter #1929 (February 23, 2012).

[vii] See, e.g., U.S. Senate. 112th Congress. 2d Session. *Middle Class Tax Cut Act*. S. 3393 (July 17, 2012) ("If the taxpayer made a taxable gift in an applicable preceding calendar period, the amount of tax computed under subsection (a) shall be reduced by the amount of tax which would have been payable under chapter 12 for such applicable preceding calendar period if the applicable exclusion amount in effect for such preceding calendar period had been the applicable exclusion amount in effect for the calendar year for which the tax is being computed and the modifications described in subsection (g) had been applicable for such preceding calendar period."). As all lifetime taxable gifts, not just "adjusted taxable gifts," can generate a reduction of estate tax for the gift taxes that "would have been payable," a clawback cure will be just as helpful for decedents who made donative promise gifts (or other taxable gifts that are not adjusted taxable gifts, such as a gift to a personal residence trust where the grantor died during the fixed term) as decedents who made conventional gifts of cash or other property.

[viii] See Treas. Reg. § 20.2010-3T(b); Treas. Reg. § 25.2505-2T(c).

[ix] To ensure that the donative promise gift is complete for gift tax purposes, care should be taken that the donor does not retain any power to affect the amount due under the note. For example, the note should provide that the maximum amount that can transferred free of estate tax is determined as if all property included in the donor's gross estate will qualify for an estate tax deduction, regardless of whether it actually so qualifies.

[x] The partial self-cancelling feature should not be void under *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). That case held as void as against public policy a provision that purported to automatically cancel a transfer of stock if it was determined to be subject to gift tax. The court in *Procter* gave three grounds for disregarding the provision: First, it would discourage the collection of taxes; second, it would frustrate the judicial process by rendering moot any determination by a court that the transfer was a taxable gift; third, the provision, if upheld, would be a condition subsequent that would render any judicial opinion a mere declaratory judgment. Recent cases have cast doubt on the first rationale by holding that the "Commissioner's role is to enforce the tax laws," not merely to maximize receipts. *Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). As for the second two rationales in *Procter*, a partial self-cancelling provision would not purport to undo *post hoc* the effects of a judicial decision as to whether the IRS can clawback tax on lifetime gifts. On the contrary, the amount payable under the note would in principle be determinable as of the moment of death. Recent cases have held that where an amount transferred is constant, even if unknown, *Procter* is not applicable. See *Petter v. Comm'r*, 653 F.3d 1012, 1023 (9th Cir. 2011); *Wandry v. Comm'r*, T.C. Memo 2012-88. A self-partial cancellation provision would simply fine-tune the decedent's taxable estate so that it is no greater than the exemption amount available at death. The IRS has approved similar clauses in its own regulations. See Treas. Reg. § 25.2518-3(d) Example 19.

[xi] Rev. Rul. 67-396; *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981).

[xii] Restatement (Second) of Contracts § 17(1). It is also possible that the promise would be enforceable based on a theory of promissory estoppel. See Restatement (Second) of Contracts § 90. Promissory estoppel, however, should be treated, at most, as a fallback theory. The safest course is to make the donative promise pursuant to a binding contract.

[xiii] Restatement (Second) of Contracts § 71.

[xiv] Restatement (Second) of Contracts § 79(b).

[xv] Williston on Contracts § 7:21 (4th ed.).

[xvi] Corbin on Contracts (Revised Edition) § 5.14 (quoting *Marcrum v. Embry*, 291 Ala. 400, 406 (1973).

[xvii] *In re Todd's Estate*, 47 Misc. 35 (Sur. Ct. 1905).

[xviii] *Yarwood v. Trusts & Guarantee Co.*, 94 A.D. 47, 87 N.Y.S. 947 (4th Dep't 1904).

[xix] 27 N.E. 256 (N.Y. 1891).

[xx] Rev. Rul. 79-384.

[xxi] *Earle v. Angell*, 157 Mass. 294 (1892).

[xxii] *Babcock v. Chase*, 36 N.Y.S. 879, 880-81 (N.Y. Gen. Term 1895).

[xxiii] *Brearton v. DeWitt*, 252 N.Y. 495, 499-500 (1930).

[xxiv] *Schumm by Whyner v. Berg*, 37 Cal. 2d 174 (1951).

[xxv] *In re Cole's Estate*, 195 N.Y.S. 541, 548-50 (N.Y. App. Div. 1922) (abandoning practice of medicine); *Werner v. Werner*, 154 N.Y.S. 570 (N.Y. App. Div. 1915) (refraining from attempting to join police force); *Lindell v. Rokes*, 60 Mo. 249 (1875) (abstaining from liquor); *Halliwell v. Gordon*, 878 N.Y.S.2d 137, 139 (N.Y. App. Div. 2009) (refraining from leaving employment); *Delisi v. Ficarrota*, 135 N.Y.S. 653, 655 (N.Y. App. Term 1912) (abandoning right to bid on property); *Farrar v. Young*, 216 S.E.2d 575 (1975) (providing maintenance and support).

[xxvi] Restatement (First) of Contracts § 84.

[xxvii] Restatement (First) of Contracts § 84 Illustration 1.

[xxviii] Of *Dementas v. Estate of Tallas*, 764 P.2d 628 (Utah Ct. App. 1988), where the decedent seems to have used every device possible to make his promise enforceable other than to demand consideration, E. Allan Farnsworth wrote that "[a] peppercorn would have sufficed, but there was none." *Promises to Make Gifts*, 43 Am. J. Comp. L. 359, 372 (1995).

[xxix] Restatement (Second) of Contracts § 71 comment b, Illustration 1; see also Restatement (Second) of Contracts § 81 comment b ("Disparity in value, with or without other circumstances, sometimes indicates that the purported consideration was not in fact bargained for but was a mere formality or pretense.")

[xxx] Restatement (Second) of Contracts § 71 comment c.

[xxxi] Restatement (Second) of Contracts § 81 comment b ("Unless both parties know that the purported consideration is mere pretense, it is immaterial that the promissor's desire for the consideration is incidental to other objectives and even that the other party knows this to be so."); see also Williston on Contracts (4th ed.) § 7:17 ("[T]he law . . . does not require that the cause or motive of the promissor actually induce the making of the promise or that the promissee in rendering its performance or in making its return promise actually be induced or motivated by the promissor's promise; rather, it is enough that one party manifests an intention to induce the other's response and to be induced by it and that other response in accordance with

the inducement"); Corbin on Contracts (Revised Edition) § 7:17 ("[T]he consideration need not be the actual inducing cause of the contract").

[xxxii] See Comment, 97 Nw. U. L. Rev. 1809 (2003); Richard A. Posner, Economic Analysis of Law 99 (6th ed. 2003) ("The real mystery . . . is why the law doesn't simply make available a form for making binding promises without requiring consideration . . . Promises made under seal were enforceable without consideration. This was, seemingly, a useful device; its disappearance is a puzzle."); Melvin A. Eisenberg, *The Principles of Consideration*, 67 Cornell L. Rev. 640, 660-61 (1982) ("Should the law then recognize some new formality to play the role once played by the seal? An obvious candidate is nominal consideration—that is, the form of a bargain—because it can be safely assumed that parties who falsely cast a nonbargain promise as a bargain do so for the express purpose of making the promise legally enforceable. A rule that promises in this form were enforceable would have obvious substantive advantages . . . ."); E. Allan Farnsworth, *Promises to Make Gifts*, 43 Am. J. Comp. L. 359, 373 (1995) ("Should no formality [be] available to give legal effect to [the donor's] intention?").

[xxxiii] Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings 194 (1925). Williston drafted a Uniform Written Obligations Act that provided that a written promise would be binding if it contained an express statement that the signer intends to be legally bound. Today, only Pennsylvania has adopted it. 33 P.S. § 6.

[xxxiv] See Comment, 97 Nw. U. L. Rev. 1809 (2003) ("At what point would the consideration rise to the level of mixed bargain and gift? The case law on this question is sparse.").

[xxxv] Restatement (Second) of Contracts § 71 comment c ("[T]he distinction between bargain and gift may be a fine one, depending on the motives manifested by the parties.") It may be noted that the main rationale offered for frustrating a donor's ability to make binding gratuitous promises – namely, to protect donors from promises they might later regret – does not apply to Alvina. Alvina's primary goal, after all, is not so much to make a gift (Alvina intends to hold onto her wealth, after all) but to save estate tax. The paternalist rationale for protecting would-be donors from themselves, therefore, arguably does not apply to Alvina.

[xxxvi] In theory, to take a controversial example from the literature on this topic, reading *Atlas Shrugged* in exchange for a promise to pay $5.12 million would make the promise enforceable, provided that the donor genuinely desires to induce the donees to read Ayn Rand's (notoriously long and, to many, tedious) novel. Bramwell, *Donative Promise Can Lock In Gift Tax Exemption*, 39 Estate Planning 8 at 9 (August 2012). As noted, however, planners recommending the donative promise

strategy should attempt to establish as strong a nondonative motive for inducing the donees' consideration as possible.

[xxxvii] Rev. Rul. 77-299; but see *Haygood v. Comm'r*, 42 T.C. 936 (1964), acq. in result, 1965-1 C.B. 4, nonacq., 1977-2 C.B. 2; *Estate of Kelly v. Comm'r*, 63 T.C. 321, 325 (1974) nonacq., 1977-2 C.B. 2.

[xxxviii] See, e.g., *Comm'r v. Wemyss*, 324 U.S. 303 (1945).

[xxxix] Treas. Reg. § 25.2511-1(g)(1).

[xl] Treas. Reg. § 301.6501-1(f)(5).

[xli] Not to mention the public policy reasons favoring donative promise gifts: While there is no indication that, in creating such strong incentives to make taxable gifts this year, Congress preferred one form of taxable gift over another, because donative promise gifts are ideally suited for the very class of taxpayers to which Congress meant to provide relief when it increased the exemption amounts – namely, taxpayers of modest but not extravagant wealth – the donative promise is, if anything, the form of taxable gift that is most favored by public policy.

[xlii] One exception may be that a married taxpayer could end up having made a promise enforceable against his or her estate that is nonetheless disregarded for estate tax calculation purposes. In that "worst case" scenario, the promise could generate estate taxes even though a decedent bequeaths all his or her property to the surviving spouse. As discussed in the text, however, it seems that the promise can have a partial self-cancellation feature that can prevent any estate tax from being payable at the death of the first spouse to die.

[xliii] Treas. Reg. § 25.2512-4; see also Prop. Reg. § 25.2512-4.

[xliv] Careful readers of Rev. Rul. 84-25 will find the curious statement that a donative promise gift becomes complete on "the date on which [the donor's] promise was legally binding *and determinable in value*." (Emphasis added.) The requirement that the promise be "determinable in value" in order to constitute a completed gift appears to allude to the IRS's position at the time that, under the so-called "open transaction" doctrine, a gift does not become complete until the amount transferred is susceptible of valuation. The open transaction doctrine was rejected in *Estate of*

DiMarco v. Comm'r, 87 T.C. 653 (1986) and the IRS subsequently revoked the ruling that adopted it. Rev. Rul. 92-68 (revoking Rev. Rul. 81-31). Consequently, it appears that the requirement in Rev. Rul. 84-25 that a donative promise be "determinable in value" in order to constitute a gift is no longer viable. See generally M. Gans, *Valuation Difficulties and Gift Completion*, 58 Notre Dame L. Rev. 3 (1983).

[xlv] *Farid-Es-Sultaneh v. Comm'r*, 160 F.2d 812 (2d. Cir. 1947).

[xlvi] 363 U.S. 285-86 (1960).

[xlvii] If the donor makes the donative promise to a trust for the benefit of the donees, the payment to the trust could be treated as taxable income earned by the donees under the assignment of income doctrine. Cf. Rev. Rul. 74-32.

[xlviii] See, e.g., *Veterans of Foreign Wars, Dep't of Mich. v. Comm'r*, 89 T.C. 7 (1987); *Romero v. Comm'r*, T.C. Memo 1967-157; *Johnson v. Comm'r*, 48 T.C. 636 (1967); see also *Peters v. Smith*, 221 F.2d 721 (3rd Cit. 1955).

[xlix] *Starks v. Comm'r*, T.C. Memo. 1966-134; *Libby v. Comm'r*, T.C. Memo. 1969-184; *Pascarelli v. Comm'r*, 55 T.C. 1082, 1090-1091 (1971), aff'd 485 F.2d 681 (3d Cir. 1973); *Reis v. Comm'r*, T.C. Memo. 1974-287; *Reynolds v. Comm'r*, TC Memo 1999-62.

[l] Even if the donor is legally obligated to deliver the note to the trustee, the donor should still be considered the grantor of the trust for income tax purposes so long as the note is not delivered for fair market value. Treas. Reg. § 1.671-2(e)(2).

[li] Rev. Rul. 85-13.

[lii] For further discussion of whether GST exemption may be allocated to the trust, see Bramwell, *Donative Promise Can Lock In Gift Tax Exemption*, 39 Estate Planning 8 at 11-12 (August 2012).

[liii] On the other hand, even if the promise is satisfied while the trust is a grantor trust, perhaps it is possible that the donees will be treated as having taxable compensation

income when grantor trust status ends. Cf. Rev. Rul. 1977-402.

2 Comments Posted re. *Bramwell and Mullen: Donative Promise Can Use Up Gift Tax Exemption*

Barry Rabinovich 24-Oct-12 01:56 PM

When the donative promise is made to an irrevocable trust, to whom is the promise made? the trustee or the trust beneficiaries? And which of them makes the return promise? If the beneficiaries must make the return promise, what if they are minors? If the trustee, then what can he or she promise to to do that is not already required of them to do as a fiduciary? What about simply agreeing to become the trustee? Is that a good enough return promise?

Barry Rabinovich 24-Oct-12 01:56 PM

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Submit comment by Alan S. Gassman

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2022

Date: 06-Nov-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Pennell and Baskies: Does the Gift by Promise Plan Work?**

The concept of using an enforceable "gift by promise" to shelter a client's $5.12 million gift tax exclusion amount without actually parting with any of the client's wealth has generated significant attention and discussion. At first glance, the plan appears to be simplicity itself: "Instead of transferring cash or other property this year, an individual can merely *promise* to make gifts to the donees in the future."

LISI has never been afraid of a spirited debate, and that's exactly what members get in today's commentary by **Jeff Baskies** and **Jeff Pennell**, who explore why they think the "gift by promise" plan does not work. And then, because some planners may be *discussing* the technique with certain clients, they explain how planners might protect themselves by properly calibrating client expectations regarding the viability and utility of this controversial technique.

Jeffrey N. Pennell is the **Richard H. Clark Professor of Law at Emory University School of Law**. Jeff is the author of a dozen books, includingWEALTH TRANSFER PLANNING AND DRAFTING, FEDERAL WEALTH TRANSFER TAXATION, and successor author of ESTATE PLANNING, the three volume treatise on estate planning originally written by legendary Harvard Professor A. **James Casner**.

Jeffrey A. Baskies is a Florida Bar certified expert in Wills, Trusts, and Estates law who has an emphasis on issues relating to Florida homestead law. He practices at **Katz Baskies LLC**, a Boca Raton, FL, boutique trusts & estates, tax & business law firm. In addition to over ten dozen published articles, he is the author of ESTATE, GIFT, TRUST, AND FIDUCIARY TAX RETURNS: PLANNING AND

PREPARATION(West 2013). He can be reached at www.katzbaskies.com.

Here is their commentary:

EXECUTIVE SUMMARY:

In **LISI** Estate Planning Newsletter #2001, **Austin Bramwell** and **Lisi Mullen** posited that a taxpayer can create a state-law enforceable promise, and thereby make a completed gift, by receiving consideration - like a child's promise to send grandchildren to a particular school – that is not money or money's worth. We accept this proposition as true (solely for purposes of this commentary) because our *concern* is the federal wealth transfer tax consequences of the proposition itself. If this technique worked as represented, it would be a boon to any client who would prefer to take advantage of the $5.12 million exclusion amount without actually transferring assets (or relinquishing the income generated from them).

Unfortunately, we think this technique is too good to be true. Even if the taxpayer has made a gift via a legally enforceable promise, both a technical tax analysis and a "common sense" evaluation reveal that the "gift by promise" plan does *not* work.

The concept *is* clever, however, and there are a few situations in which it might make sense for a client to *consider* the technique. But planners who recommend the "gift by promise" should protect themselves by properly setting client expectations – preferably in writing.

FACTS:

The "Gift by Promise" Concept

In **LISI** Estate Planning Newsletter #2001, reprising an idea also discussed by them in "Donative Promise Can Lock In 2012 Gift Tax Exemption," 39 *Estate Planning* 3 (Aug. 2012), authors **Austin Bramwell** and **Lisi Mullen** proposed a technique by which a taxpayer would make a taxable gift in 2012 to take advantage of the $5.12 million exclusion amount, without actually transferring any wealth.

Their notion is to absorb the current exclusion amount before it snaps back to $1 million in 2013, but not to relinquish the financial security of that much wealth.

This would be a taxpayer's dream come true, to effectively gift property for wealth transfer tax purposes but continue to enjoy it until death. *If* it worked, taxpayers with less than enough wealth to make a completed gift of the full exclusion amount could lock in the benefits of a taxable gift of the exclusion amount before year end, and suffer no consequences at death. Even clients with enough wealth to make a completed gift might prefer to maintain their assets while accomplishing the same outcome.

To analyze the proposal, we assume that everything Bramwell and Mullen claim is true about the ability to incur an enforceable state law obligation in exchange for consideration that is not money or money's worth. The effect would be a binding obligation that triggers current federal gift tax – because a federal gift is defined as a transfer for less than adequate and full consideration in money or money's worth. This would be desirable because a gift made in 2012 would allow the taxpayer to use the 2012 exclusion amount to shelter more transferred wealth than the exclusion amount that may exist at death in a later year.

Tax Analysis of Why the Technique Fails

To understand why this technique fails requires a foray into the operation of Code Section 2001(b). For example, assume that a taxpayer made a binding lifetime commitment to transfer $5 million (for the sake of easy illustration we ignore the extra $120,000 of the inflation-adjusted exclusion amount). And assume also that the commitment is an effective gift in 2012 when the taxpayer's remaining exclusion amount is $5 million.

Relying on the effect of revenue rulings that we will accept for the sake of illustration, the federal gift tax is triggered in 2012, the year in which the promise becomes enforceable.

No money changes hands, however, so the taxpayer dies with the $5 million that was promised, and that amount is includible in the taxpayer's gross estate under §2033 because the taxpayer still owns it at death.

There is no §2043 consideration offset, because the taxpayer received no money or money's worth consideration in return, so the authors' premised tax calculation is in the right column:

No Gift		Gift

$6,000,000	Taxpayer's Net Worth	$6,000,000
0	Enforceable Gift	5,000,000
0	Gift Tax Payable	1,730,800
(0)	Unified Credit Used	(1,730,800)
0	Gift Tax Actually Paid	0
6,000,000	Taxable Estate	6,000,000
0	Adjusted Taxable Gifts	0
6,000,000	Total Amount Taxable	6,000,000
2,940,800	Tax on Total	2,940,800
(0)	Credit for Gift Tax Payable	(2,045,800)
(345,800)	Unified Credit	(345,800)
1,595,000	Tax at Death	550,000

There is some disconnect in the calculation as shown because the gift is made in 2012 when the maximum rate is 35%, but death occurs after the snap back to 2001 law. So the tax at death is computed with a maximum estate tax rate of 55%. Thus, the gift column calculates a tax at 55% on the $1 million that was not part of the inter vivos gift. That is the correct amount because the last million of the $6 million that the taxpayer owned should be taxed at the highest rate in the unified tax calculation.

Two numbers in this illustration beg explanation: the adjusted taxable gift in the seventh line of the right column is shown as zero, yet the credit for gift tax payable in the tenth line of the right column is shown as $2,045,800. These are the critical numbers in this proposal.

Here are the Code provisions that are fundamental to the calculation. These all are a part of the purge-and-credit regime in §2001(b), which are applied in this case without reliance on §2001(g), which disappears when snap back occurs after 2012; however, the result would be the same even if §2001(g) did not disappear under the snap back, because it is merely a more fulsome version of the traditional impact of §2001(b):

> §2001(b) COMPUTATION OF TAX.—The tax imposed by this section shall be the amount equal to the excess (if any) of—
>
> (1) a tentative tax computed under subsection (c) on the sum of—
>
> (A) the amount of the taxable estate, and
>
> (B) the amount of the adjusted taxable gifts, over
>
> (2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after

> December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts.
>
> For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

The paragraph (1)(B) adjusted taxable gift is correctly reported in this case as zero because of the operation of the flush language (the provision that follows subparagraph (2) – that is formatted to the flush left margin), also known as the purge rule. That provision specifies that the "amount of the adjusted taxable gifts" in paragraph (1)(B) does not include "gifts which are includible in the gross estate of the decedent."

Thus, if a lifetime transfer does not avoid estate tax inclusion of the same wealth at death, then double taxation is averted by operation of the purge rule. In this case the lifetime taxable gift must be purged from the calculation at death because the $5 million is included in the taxable estate. If the gift of that amount was never satisfied – if no money actually was transferred inter vivos – then that $5 million is part of the taxpayer's total $6 million net worth at death, all subject to inclusion (under §2033 in this case).

If line seven in the calculation is correct, then the critical figure in the illustrated calculation is line ten – the credit for gift tax payable. Bramwell and Mullen correctly understand §2001(b)(2) to refer to the amount of gift tax that *would have been* incurred on a $5 million gift made in the year of death (applying a 55% maximum marginal rate, and a unified credit of $345,800 – which is the tax on just $1 million). This *is* the correct calculation, but *only* if they are correct to assume that the faux-gift of $5 million is *not* purged for purposes of §2001(b)(2).

And *that* is the *questionable* element in their proposal.

Bramwell and Mullen calculate the credit for gift tax payable as if it was not tied to the amount of adjusted taxable gifts, <u>as purged</u>, for purposes of paragraph (1)(B). Indeed, they want the result to be the same as if the gift actually was made and gift tax actually was paid, *neither* of which is true in this case.

And that result would *not* be what Congress intended in this situation. Recall that the entire transaction is a mirage – a gift for federal transfer tax purposes, based on a promise that was enforceable for state law purposes, but that never was actually satisfied prior to death.

Bramwell and Mullen admit that there is no §2053(a)(3) deduction for the enforceable promise that was unsatisfied at death, because claims against an estate are deductible only to the extent they are supported by adequate and full consideration in money or money's worth. That doesn't matter, because they divine a credit for a gift that is purged, based on a tax that would have been paid if the gift was actually made. All of which depends on a technical reading of the flush language in §2001(b) that purges the gift for §2001(b)(1)(B) purposes but not for §2001(b)(2) purposes.

The mystery is why the flush language in §2001(b) does not purge the gift for §2001(b)(2) purposes, and why it does not limit the credit to gift taxes actually "paid," rather than payable. Congress' intent was to give a credit if a taxpayer transferred property inter vivos and actually *paid* a gift tax on that transfer, followed by the transfer being ignored for estate tax purposes (because of inclusion at death, typically under §§2035 through 2038 or 2042). In such a case the taxpayer should receive a credit for gift tax paid on that lifetime transfer. Having already remitted tax on the includible property, the taxpayer should not again pay tax on that property when it is included at death.

There are several reasons why the Code uses the word "*payable*" instead of "paid." One is because the taxpayer may die before any gift tax owed actually is paid. The word "payable" is more appropriate if the gift tax is owed but it has not yet been paid. A more important second reason is because Congress anticipated the exact opposite situation of what will occur at the end of 2012. Congress' vision was of the tax rates declining and the exclusion amount increasing. In which case, Congress did not want a taxpayer who paid gift tax at a higher rate, applicable in the year of an inter vivos transfer, to have a credit that exceeds the estate tax calculated at lower rates in the year of death. The gift tax payable language precludes the taxpayer from applying the excess gift tax paid inter vivos against the estate tax on other wealth that remains includible at death.

For purposes of this discussion, the overarching structure of §2001(b) is designed to tax a decedent's wealth at death as if no inter vivos transfers had been made. Congress did not intend to give a credit against estate tax when *no* gift tax was paid or payable. And there is no need to apply the §2001(b)(2) credit in the case of a faux-gift that did not generate the payment of any gift tax inter vivos.

To give the credit posited by Bramwell and Mullen would, in effect, give the unified credit *twice* – once in line ten of the calculation, and again in the next line – which is not appropriate. The bottom line is that the credit for gift tax paid should not apply in the case of an inter vivos faux-gift in which no inter vivos transfer actually was made.

Thus, it seems likely that the government will fight this transaction and the calculation suggested by Bramwell and Mullen, and that courts will rule against taxpayers who attempt to use it, because the result sought is neither realistic nor what Congress intended. Instead, the technique relies on a hyper-technical reading of the flush language to only apply for §2001(b)(1)(B) purposes but not for §2001(b)(2) purposes.

The Common Sense Analysis: Substance Over Form

Tax lawyers enjoy finding nuances and loopholes, and constructing planning strategies around them. But often these constructs are too good to be true, especially when the big picture is lost in the details.

We've seen "edgy" form over substance planning techniques before:

- Would you like an income tax write-off without really giving up anything (charitable split dollar)?
- Would you like to buy the remainder interest in a QTIP trust (said the life tenant to the remainder beneficiaries)?
- Would you like to remove half of your IRA/pension tax free with artificially depressed cash value life insurance (in a "pension rescue" plan)?

Although the "gift by promise" technique may not be abusive in the same manner as those plans, it likely will be examined by the government under a similar analysis. When it comes to these beguiling scenarios, the government theory that most easily exposes taxpayer flaws is the "substance over form" doctrine. The reciprocal trust and step transaction doctrines (both of which keep many planners awake at night) are subsets of the same substance over form doctrine.

In plain English, the substance over form doctrine allows the government to pierce legal niceties and hyper-technical readings of the Code, cases, and rulings, to reveal the true substance of a transaction, and apply the tax law based on that substance while ignoring the form.

In this case, the substance of the transaction is a client who has no change in economic circumstances as a result of the "gift by promise," who continues to manage and control the client's assets and benefit from them and their income, and who pays no gift tax inter vivos. At its core, the "gift by promise" technique has no substance.

And *that*'s the rub with the notion. The simple and direct path that blocks the intended tax outcome is both a common sense analysis of the transaction, and a careful, technical reading of §2001(b).

COMMENT:

Who *Might* Still Consider the "Gift by Promise" Plan?

We believe that the "gift by promise" plan will fail to achieve the tax results intended. Nevertheless, some planners might discuss it with clients whose $5.12 million exclusions will expire but who have no assets with which to make gifts (notwithstanding a desire to do so). For example, the primary wealth of a family may exist currently at the grandparent generation, and their children may have little wealth that they currently can gift. But when the grandparent generation dies, funds will pass to the children (either outright or in trust) that will be taxable when the children subsequently die. If the grandparent generation cannot easily loan wealth to their children to fund gifts by the children, then the "gift by promise" technique may interest the children who have no other means to consume their soon-to-expire exclusion amounts.

The technique also may appeal to clients whose wealth primarily is tied up in pension plans or IRAs that would trigger income tax as the price for accessing funds for gifting. Or for clients with valuable homes that they do not want to transfer (for non-tax reasons).

For clients who are asset rich but cash poor, the technique may be worth discussing if the planner concludes that consideration of the technique is ethically acceptable and that entering into such a transaction poses very little risk to the client – even if the technique fails. Filing a gift tax return and reporting that the client used the exclusion amount in 2012 on a "gift by promise" should not create any tax, penalty, or interest, even if the plan ultimately fails under government scrutiny.

Thus, the "gift by promise" plan may present a problem only if the client dies before the courts determine whether the plan works, in which case the taxpayer's personal representative must decide how to report the situation. For example, there might be penalties if the estate tax return improperly claims a credit for gift tax payable that produces a substantial underpayment of estate tax (i.e., substantial interest and penalties may be incurred if a decedent reports the "gift by promise" technique as suggested in the tenth line of the right column of the illustrated calculation above and the government denies the claimed credit for gift tax payable). But the issue can be deferred until the federal estate tax return is due, and the planner (and client) can wait to evaluate the state of the law regarding the planning until that time.

Who Should *Not* Employ the "Gift by Promise" Technique?

Because we believe that the "gift by promise" technique does not work, we suggest that any client who has other assets and who could use the $5.12 million exclusion amount now, in a manner that clearly is valid, should not rely on the "gift by promise" technique. Clients who can make effective gifts should not miss the opportunity to employ planning that is more certain to succeed. Use of the "gift by promise" plan may foreclose other, more effective gifting opportunities. Clients who wish to use their exclusion amount and have the means to do so with other gifting techniques likely will not benefit from taking the "easy way out."

Planners Should Properly Set Expectations

Finally, given the likelihood that the government and the courts will see through the "gift by promise" plan, we suggest that, to protect themselves, planners who introduce this technique should properly inform their clients' expectations.

For example, clients need clear information about the potential failure of the "gift by promise" plan and the risk that the technique might fail if or when it is challenged. If relying on the technique will not entail much legal, accounting, or other advisor fees, and poses little risk of incurring interest or penalties, a properly advised client may be disappointed but not likely surprised or damaged by the technique. Clients can fairly decide whether to experiment with the technique if their expectations are properly set and their eyes are wide open.

Wise planners will protect themselves from potential liability to a disaffected client, if the technique doesn't work, by proposing the plan only with clear admonitions (preferably in writing), and should not tout the technique to clients who have other more viable options.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Pennell
Jeff Baskies

CITE AS:

2 Comments Posted re. *Pennell and Baskies: Does the Gift by Promise Plan Work?*

J. Frank Hall, Jr. 07-Nov-12 08:01 PM

I agree with Pennell and Baskies. To my simple mind, there is no transfer. If there is no transfer, how could there be any transfer tax consequences?

Ken Margetts 09-Nov-12 02:45 PM

What if the gift is effected by a self-amortizing promissory note requiring adequate interest and payable over a reasonable period--say 10 years (assuming the donor's life expectancy at the time of the gift is more than the note term)? What if the note is fully satisfied before death?

Post a comment on this newsletter:

Submit comment by Alan S. Gassman

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2033

Date: 03-Dec-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Austin Bramwell: The Gift-by-Promise Plan Works as Advertised**

Austin Bramwell and **Lisi Mullen**, in LISI Estate Planning Newsletter # 2001, proposed a strategy that enables taxpayers to make substantial taxable gifts in 2012 to take advantage of the $5.12 million gift tax exemption amount without currently parting with any of their wealth. Instead of transferring cash or other property this year, they suggested an individual make a *promise* to make gifts to the donees in the future.

In Estate Planning Newsletter #2022, **Jeff Pennell** and **Jeff Baskies** question whether the "Gift-by-Promise" strategy works as advertised. Their commentary highlights what they consider to be some common misconceptions and raises doubts as to whether it is possible, even with many conventional strategies, to "lock in" today's higher gift tax exemption amount. Pennell and Baskies also lend support to some crucial premises of the Gift-by-Promise strategy.

The "Gift-by-Promise" strategy has touched off a spirited debate in the estate planning bar, and **LISI** members know from past experience that **LISI** has never been shy about fostering an open debate on important issues. Now, **Austin Bramwell** returns and provides members with his thoughts on why the Gift-by-Promise plan does work as advertised. Austin's rebuttal to the Pennell and Baskies commentary will be followed by a **LISI** commentary by **Pam Schneider**, **Carlyn McCaffrey**, and **Kim Heyman. Jeff Pennell** and **Jeff Baskies** will weigh-in with some final thoughts next Monday.

Austin W. Bramwell is an associate in the trusts and estates department of **Milbank, Tweed, Hadley & McCloy LLP**. He has written previously for **LISI**, *Journal of Taxation*, *Estate Planning*, *Trusts & Estates*, *Probate & Property*, and other publications. He is a member of the New York State Bar.

The views expressed herein are his own.

Here is Austin's commentary:

EXECUTIVE SUMMARY:

Austin Bramwell returns to rebut the arguments made by Jeff Pennell and Jeff Baskies and to bulwark his support for the "Gift-by-Promise" technique as a means of utilizing the $5.12 million exemption amount without actually transferring cash or other property this year.

FACTS:

The author maintains that, to use up the $5.12 million gift tax exemption amount available this year before it reverts to $1 million next year, a taxpayer, rather than transfer money or property this year, may instead promise to transfer money or property to the donees in the future.[i] If the promise is enforceable under local law and is made for less than a full and adequate consideration in money or money's worth, it will be treated as a taxable gift. Further, under the estate tax calculation procedure of Section 2001(b), a gift-by-promise will, the author maintains, successfully lock in today's higher gift and estate tax exemption amount.

Pennell and Baskies question whether the estate tax calculation procedure truly produces that favorable result. Specifically, they disagree that a gift-by-promise can generate the equivalent of a credit under Section 2001(b)(2) for gift tax "which would have been payable" on the gift. The reasons for their disagreement are discussed below.

First, however, it is worth noting that Pennell and Baskies seem to agree with the author on at least two important issues:

1. <u>A gift-by-promise is not an adjusted taxable gift</u>. First, Pennell and Baskies agree that a gift-by-promise is not an "adjusted taxable gift." The conclusion that a gift-by-promise is not an adjusted taxable gift is crucial if the strategy is to succeed. Otherwise, the gift would be added to the calculation of estate tax under Section 2001(b)(1)(B), which would erase any benefit from the gift. Although the IRS has confirmed in Rev. Rul. 84-25 that a gift-by-promise is not an adjusted taxable gift, some might worry that the IRS may revoke the ruling in whole or in part. Nevertheless, as the author has argued, Rev. Rul. 84-25 correctly interprets the definition of "adjusted taxable gift." Even if the ruling is revoked, therefore, a gift-by-promise should still not be treated as an adjusted

taxable gift.

Pennell and Baskies agree. A gift-by-promise, they write, is "includible in the taxpayer's gross estate under §2033 because the taxpayer still owns it at death." Thus, it "must be purged from the calculation [of estate tax] at death . . . ." Pennell and Baskies use the verb "purge" to refer to the application of the rule, contained in the flush language of Section 2001(b), that gifts includible in the gross estate are not "adjusted taxable gifts." As a gift-by-promise is included in the taxpayer's gross estate under Section 2033, it is not, under the Section 2001(b) flush language, an "adjusted taxable gift." Therefore, Pennell and Baskies correctly conclude that, even without Rev. Rul. 84-25, a gift-by-promise should not be treated an adjusted taxable gift.

> *Sidebar: The "no double-counting" rule of Section 2001(b) vs. the alleged "purge" rule.* As noted, Pennell and Baskies dub the "purge rule" the rule, found in the flush language of Section 2001(b), that gifts already included in the gross estate are not added a second time to the calculation of estate tax as "adjusted taxable gifts." The term "purge rule" may cause unnecessary confusion in the minds of some readers: A gift already included in the gross estate, after all, even if not also an adjusted taxable gift, is not actually "purged" or removed from the calculation of estate tax. The rule simply prevents gifts from being double counted. It would be more accurate, therefore, to call it the "no double counting" rule than the "purge" rule.
>
> That said, as discussed below, Pennell and Baskies go on to argue that there exists a hidden rule in Section 2001(b)(2) that prevents an estate in some cases from taking a credit for "gift taxes payable" on post-1976 gifts. *That* rule, if it existed, would be a true "purge" rule, in that it would eliminate the availability of a credit. The flush language of Section 2001(b), by contrast, does not do any "purging" but, as discussed, simply prevents double counting. In sum, the "no double counting" rule of the Section 2001(b) flush language should not be confused with but rather distinguished from the "purge" rule that Pennell and Baskies imagine to exist in Section 2001(b)(2).

2. No "clawback" (at least not as commonly understood).[ii] Second, Pennell and Baskies add their voices to the chorus of commentators, including the author, who do not believe that there is a substantial risk of "clawback" of tax

on gifts that use up the temporarily increased gift tax exemption amount available through 2012. The alleged clawback risk (which, if real, would affect all taxable gifts, not just gifts-by-promise) is that, when calculating the effective credit for gift taxes that "would have been payable" on lifetime gifts under Section 2001(b)(2), an executor must apply the unified credit amount that was actually available at the time of the gift, even if the exemption amount at death is lower. Gifts made in 2012 up to the $5.12 million gift tax exemption amount would, in that case, be included in the amount subject to estate tax (either as part of the taxable estate or as adjusted taxable gifts) without any offset for gift taxes payable. Thus, if the estate tax exemption amount goes down, the IRS could effectively recapture tax on gifts that had been sheltered by the higher exemption amount that was available at the time of the gifts.

Pennell and Baskies nowhere use the term "clawback" or its less sinister synonym "recapture." Nonetheless, they write that "Bramwell and Mullen correctly understand § 2001(b)(2) to refer [after 2012] to the amount of gift tax that would have been incurred on a $5 million gift made in the year of death applying a 55% maximum marginal rate, *and a unified credit of $345,800 – which is the tax on just $1 million*)." (Emphasis added.) In other words, in their view, to calculate the effective credit for gift taxes payable, an estate uses not only the tax rates as of death but also any then lower exemption amount. Thus, like the author, Pennell and Baskies reject the view that the IRS may recapture tax on 2012 gifts based on the theory that the Section 2012(b)(2) credit must always be calculated using the gift tax exemption available at the time of the gift.

COMMENT:

Despite those two encouraging areas of agreement, Pennell and Baskies go on to make what appear to be five distinct arguments against the gift-by-promise strategy.

<u>Argument #1: No credit is available under Section 2001(b)(2) for gift taxes payable on gifts that are included in a decedent's gross estate</u>. First, Pennell and Baskies seem to argue that unless a gift is an "adjusted taxable gift" within the meaning of the flush language of Section 2001(b), then it cannot generate a credit under Section 2001(b)(2) for gift tax that "would have been payable" on the gift.[iii] Thus, they describe the "questionable element" in the gift-by-promise strategy as follows:

> Bramwell and Mullen correctly understand §

> 2001(b)(2) to refer to the amount of gift tax [on a $5 million gift made during lifetime] that *would have been* incurred on a $5 million gift made in the year of death . . . . This *is* the correct calculation, but *only* if they are correct to assume that the [gift-by-promise] is *not* purged for purpose of § 2001(b)(2).

(Emphasis in original). Pennell and Baskies go on to explain that the "mystery is why the flush language in §2001(b) does not purge [a gift-by-promise] for §2001(b)(2) purposes."

Contrary to Pennell and Baskies, there is no "mystery" nor is it "questionable" to assume that all post-1976 taxable gifts, not just adjusted taxable gifts, generate a credit under Section 2001(b)(2). As mentioned, by "purge," Pennell and Baskies refer to the application of the rule that gifts already included in the gross estate are not added a second time to the calculation of estate tax as adjusted taxable gifts.[iv] Pennell and Baskies suggest that a second, albeit hidden rule lurks in Section 2001(b)(2). That section, as it currently reads, provides that estate tax must be reduced by "the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the modifications describe in section (g) had been applicable at the time of such gifts." Section 2001(g) goes on to provide that the rates to be used in calculating the gift tax that "would have been payable" are the rates in effect at the decedent's death.[v] In other words, if a gift made during lifetime would generate a gift tax assuming the rates applicable at death (as well as, as Pennell and Baskies believe, any lower exemption amount at death), then the amount of gift tax so generated is subtracted from the estate tax.

It might appear, at least at first blush, that the meaning of the term "gifts made by the decedent after December 31, 1976" as used in Section 2001(b)(2) is straightforward: it refers to all post-1976 gifts. Yet Pennell and Baskies contend that the term "gifts," as used in Section 2001(b)(2), actually refers to something *less* than the decedent's total post-1976 gifts. In their view, the rule found in the definition of adjusted taxable gifts must be incorporated into Section 2001(b)(2), so that the term "gifts" really means "gifts *other than gifts which are includible in the gross estate of the decedent*." To put it another way, they read into the term "gifts" a technical limitation that is in fact only found in the definition of "adjusted taxable gifts."

A moment's reflection reveals that the construction of the term "gifts" urged by

Pennell and Baskies is untenable. Suppose – to take an example not very different from one the author learned several years ago in Professor Mitchell Gans's estate and gift tax class – that a taxpayer creates a QPRT and reports a taxable gift (equal to the value of the remainder interest) of $2 million. Suppose, further, that the taxpayer had already used up his or her unified credit at the time of the gift, so that he or she must pay a gift tax of $1,100,000 million (assuming, for simplicity, a flat 55% rate). The taxpayer dies during the fixed term at a time when the property is worth $5 million. The entire $5 million is included in the taxpayer's gross estate under Section 2036(a)(1). Assuming, for simplicity, a flat 55% rate applicable at death, the inclusion of the property in the gross estate generates an estate tax of $2,750,000, which is the same tax that would have been generated had the taxpayer not created the QPRT but simply died holding the property outright.

At the same time, according to Pennell and Baskies, the taxpayer's estate should not receive a credit for the $1.1 million of gift taxes payable. In their view, under the hidden "purge" rule, the QPRT gift fails to generate a credit under Section 2001(b)(2) because the QPRT is included in the taxpayer's gross estate. Thus, the total gift and estate taxes paid are not $2,750,000 but $3,850,000,[vi] or the sum of (i) the $2,750,000 estate tax payable at death and (ii) the $1,100,000 of gift tax payable during life. Pennell and Baskies, in other words, would have taxpayer pay tax not on $5 million, which is the total value that the taxpayer actually transferred, but $7 million. They think that the taxpayer should be double-taxed.

Happily, the "purge" rule purportedly lurking in Section 2001(b)(2) is not, in fact, there. Section 2001(b)(2) grants the equivalent of a credit for gift taxes payable on "gifts made by the decedent" after 1976. It does not say that the credit is only available for only certain gifts, such as gifts that meet the definition of "adjusted taxable gifts." The IRS, for its part, in its "line 7 worksheet" never suggests that such a limitation applies. Even members of Congress, in devising a "clawback cure," seem to agree that the credit is available for all "taxable gifts."[vii]

That Congress meant what it said when it used the term "gifts made by the decedent" is decisively established by Section 2001(d). That section addresses the application of Section 2001(b)(2) when a gift is included in the decedent's gross estate and the decedent had elected to "split" the gift with his or her spouse. In that case, the section states, the Section 2001(b)(2) credit includes any gift taxes payable by the consenting spouse.

For example, suppose that, in the QPRT hypothetical discussed above, the taxpayer had elected to split the $2 million gift of the QPRT remainder with his or her spouse. The taxpayer and his or her spouse would have been jointly and severally liable for the $1.1 million gift tax (assuming that the spouse, like the taxpayer, had used up his or her unified credit).[viii] Once again, if the taxpayer dies during the fixed term, the property (once again worth $5 million at death) will be included in the taxpayer's gross estate, thereby generating an estate tax of $2,750,000, which is the same amount of tax that would have been generated had the taxpayer not created the QPRT but simply died hold the property outright. Section 2001(d) ensures that all gift taxes payable, whether by the decedent or his or her spouse, are effective restored by the Section 2001(b)(2) credit. No double taxation, therefore, results from the inclusion of the property in the taxpayer's gross estate.[ix]

Section 2001(d) provides, in short, that if a gift is included in the gross estate, any gift taxes payable by the spouse will be added to the credit for gift taxes payable under Section 2001(b)(2). There would be no point in *adding* to the credit, however, if the credit were not there to begin with. Section 2001(d), in other words, confirms what both the logic and text of Section 2001(b)(2) dictate: Estate tax is reduced under Section 2001(b)(2) for gift taxes payable on *all* post-1976 gifts, even if those gifts are included in the decedent's gross estate.[x]

In fairness, the estate tax calculation procedures embodied in Section 2001(b) are complex and can cause even the most experienced attorneys to blunder. Pennell and Baskies may have found their "purge rule" moniker more beguiling than the actual statutory text. In any case, the most natural reading of that text also happens to be the correct one: Section 2001(b)(2) grants a credit for gift taxes payable on *all* post-1976 taxable gifts, regardless of whether they are included in the decedent's gross estate or not. There is no "purge" rule lurking in Section 2001(b)(2).

<u>Argument #2: No credit is available under Section 2001(b)(2) unless gift tax was actually paid</u>. The second argument that Pennell and Baskies seem to make is that estate tax may not be reduced under Section 2001(b)(2) unless some gift tax on the gift was actually paid.[xi] For example, they write:

> [Bramwell and Mullen] want the result to be the same [<u>i.e.</u>, they want a credit for gift taxes payable] as if the

> gift actually was made and gift tax actually was paid, neither of which is true in [the case of a gift-by-promise]. And that result would not be what Congress intended in this situation. . . . Congress' intent was to give a credit if a taxpayer transferred property inter vivos and actually paid a gift tax on that transfer, followed by the transfer being ignored for estate tax purposes (because of inclusion at death, typically under §§2035 through 2038 or 2042). . . . *Congress did not intend to give a credit against estate tax when no gift tax was paid or payable.* And there is no need to apply the §2001(b)(2) credit in the case of a faux-gift that did not generate the payment of any gift tax inter vivos.

(Emphasis added.) Now, there is both a narrow and a broad possible reading of the foregoing remarks. Under the broad reading, Pennell and Baskies are urging a novel theory of how IRS can "claw back" tax on *all* gifts made in 2011-12 that are within the higher gift tax exemption amount: in their view, even it is true the Section 2001(b)(2) credit is calculated using any lower exemption amount that applies at death, the IRS can *still* deny the credit if no gift tax was actually paid on the gifts. That theory will no doubt come as a shock to the thousands of taxpayers this year who, on the advice of their attorneys, are making substantial taxable gifts yet not actually paying any gift tax because their gifts do not exceed their lifetime gift tax exemptions. Nor does it seem to fair to penalize taxpayers for using a credit that, after all, they are not even allowed to forego.[xii] Nevertheless, the theory seems at times to be what Pennell and Baskies are, in fact, suggesting. If it is true that the Section 2001(b)(2) credit can be denied when no actual gift tax was paid, then the many wealthy individuals who making substantial gifts this year are in for a rude awakening.

Under the narrow reading of the foregoing remarks, the Section 2001(b)(2) credit for gift taxes payable can only be denied if both (i) no gift tax was actually paid on the gift and (ii) the gift is included in the donor's gross estate. That is a less radical assertion than that Section 2001(b)(2) does not apply to any gifts that did not actually generate a gift tax. Nonetheless, it will still come as a shock to many. For example, many taxpayers may be using up gift tax exemption by creating QPRTs. Those taxpayers accept that their QPRTs may be included in their gross estates if they do not survived the fixed term, yet they have assumed that, even if they do not survive the fixed term, they would still have successfully locked in today's higher exemption amounts. According to

Pennell and Baskies, however, they would in fact have failed: in their view, it seems, if no gift tax was actually paid and the gift is included in a donor's gross estate, then no credit for gift taxes payable is available under Section 2001(b)(2).

Fortunately, the courts have already considered the theory, newly reintroduced by Pennell and Baskies, that a Section 2001(b)(2) is only available if gift tax was actually paid. In *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990), the IRS, in computing estate taxes, increased the value of the decedent's adjusted taxable gifts, even though the period for assessing gift on tax such gifts has lapsed. In addition, the IRS failed to grant a Section 2001(b)(2) credit for gift taxes payable on the increased amount of the gift. *Smith* is mostly known for its holding, later overturned by Congress,[xiii] that the IRS could increase the value of adjusted taxable gifts, notwithstanding that no additional gift tax could be assessed.

Smith goes on, however, to consider to whether the Section 2001(b)(2) credit is available even though no gift taxes had actually been paid. In addressing that issue, the court began with the observation that "[n]either the statute nor the legislative history limit the taxes payable to the amount of gift tax previously paid." On the contrary, the court noted, Congress contemplated that, as a result of changing rates, the Section 2001(b)(2) credit would be different in many cases from the actual gift taxes paid. The court saw "no reason why another situation should be eliminated from consideration when the statutory language is sufficiently broad to include it." In other words, the statutory language permits a credit for "gift taxes payable," regardless of any discrepancy between actual gift taxes paid and gift taxes payable and regardless of the cause of that discrepancy.

Under *Smith*, in short, a credit under Section 2001(b)(2) may not be denied just because gift taxes actually paid were less than the gift taxes "which would have been payable." Pennell and Baskies observe, correctly, that one purpose of Section 2001(b)(2)'s use of the word "payable" (as opposed to "paid") was to prevent taxpayers from recouping at death the full amount of gift taxes paid during lifetime if marginal rates had been higher at the time of the gifts. From this, they seem to infer that it cannot work the other way: in their view, a decedent cannot receive a credit under Section 2001(b)(2) that is greater than the gift tax that was actually paid. Yet *Smith* rejects the view that Section 2001(b)(2) is a one-way downward ratchet: as *Smith* concludes, the word "payable" implies that the Section 2001(b)(2) credit may be lesser or greater than the gift tax that decedent actually had to pay.

Thus, just because an exemption amount was higher at the time of the gift than at death does not mean that the Section 2001(b)(2) credit is unavailable. On the contrary, the amount of gift taxes actually paid is irrelevant to the determination of the credit. The theory of Pennell and Baskies that there is no reduction of estate tax under Section 2001(b)(2) where no gift tax was actually paid is an ingenious, if cramped way of interpreting the term "payable." That said, they do not adequately distinguish *Smith*.[xiv]

Finally, just like their theory that a Section 2001(b)(2) credit is not available for gifts included in the gross estate, the theory of Pennell and Baskies that the credit is not available unless gift tax was actually paid founders on the gift-splitting rules. Recall that Section 2001(d) permits a credit for all gifts taxes payable on a gift included in the gross estate, including gift taxes payable by the decedent's spouse under Section 2513(d). As gift tax liability in the case of "split" gifts is joint and several, some decedents end up paying *none* of the gift taxes on gifts included in their gross estates. Yet Section 2001(d) nonetheless allows a credit for all gift tax that was "payable." Conversely, a decedent who consented to split a gift may obtain a credit for gift taxes payable under Section 2001(b)(2), even if the donor spouse's spouse paid all of the tax and the decedent none.[xv] Contrary to Pennell and Baskies, therefore, Congress intended that the Section 2001(b)(2) credit to be available even where the decedent did not actually pay any gift tax.[xvi] Evidence of that intent can be found directly in the Code.

<u>Argument #3: No credit is available under Section 2001(b)(2) in the case of a gift-by-promise because it is not really a gift for estate tax calculation purposes</u>. The next argument raised by Pennell and Baskies is that a gift-by-promise cannot generate a credit under Section 2001(b)(2) because it is not, in fact, a "gift." Thus, they write:

> [Bramwell and Mullen] want the result to be the same as if the gift actually was made and gift tax actually was paid, neither of which is true in this case. And that result would not be what Congress intended in this situation. Recall that the entire transaction is a mirage – a gift for federal transfer tax purposes, based on a promise that was enforceable for state law purposes, but that never was actually satisfied prior to death. . . . [T]here is

> no need to apply the §2001(b)(2) credit in the case of a faux-gift that did not generate the payment of any gift tax inter vivos. . . . The bottom line is that the credit for gift tax paid should not apply in the case of an inter vivos faux-gift in which no inter vivos transfer actually was made.

The words "mirage" and "faux-gift" suggest that a gift-by-promise is not a real "gift" for estate tax calculation purposes. Indeed, in the first comment excerpted above, Pennell and Baskies go so far as to deny that "the gift was actually made."

Yet, as the author has discussed in his prior articles, it is well established that a gift-by-promise is a gift. Circuit courts and the IRS in binding rulings are unanimous in holding that a taxable gift is made when a promise (for less and full and adequate consideration) becomes enforceable under local law.[xvii] Section 2001(b)(2), meanwhile, allows a credit for gift taxes payable "under chapter 12" (i.e., gift tax) with respect to all of a decedent's post-1976 gifts. If a decedent made a taxable gift in any form after 1976, in other words, gift taxes payable on that gift (using the rates applicable at death) must be subtracted from estate tax under Section 2001(b)(2). The section does not give the IRS the authority to pick and choose which taxable gifts to respect and which to disregard for estate tax calculation purposes.[xviii] Thus, contrary to Pennell's and Baskies' creative suggestion that a gift-by-promise, even if a taxable gift, can be disregarded when estate tax is calculated at death, the IRS is, in fact, bound to view a gift-by-promise as a gift for both gift tax and estate tax calculation purposes.

Argument #4: It just can't work! The final "technical" argument made by Pennell and Baskies is not so much as an argument as a protest. In their view, the IRS will find some way or other to deny a credit for gift taxes payable under Section 2001(b)(2). Perhaps the IRS will claim that, even if each argument fails on its own, when fired collectively like grapeshot from a blunderbuss, they succeed. Perhaps the IRS will say a taxpayer is simply not allowed to have his cake and eat it too.

It cannot be denied that the IRS may always try to find some way to challenge a new strategy. Taxpayers considering the gift-by-promise strategy should always be aware of the potential for IRS attack. That said, there are a couple points worth making in response.

First, it should not simply be assumed that there is something "wrong" with the gift-by-promise strategy that cries out for rebuke. A gift-by-promise is simply one way among many others to make a taxable gift. There is no indication that Congress, when it increased the gift and estate tax exemptions (at a time when it was well-settled that an enforceable promise could produce a taxable gift and would not be treated as an adjusted taxable gift), meant to disfavor gifts-by-promise. On the contrary, Congress intended to provide gift and estate tax relief to the millions of individuals who are not super wealthy. It would be a perverse to single out for harsh treatment the one strategy that, more than the others, makes it possible for the middle class to take advantage of the same planning opportunities this year that are available to the super rich.

Second, even if the gift-by-promise strategy is somehow abusive, the IRS has to avoid taking a position that proves too much. That is, in any litigation, the IRS would have to explain why some gifts can successfully lock in today's higher exemption while others must fail. Pennell and Baskies struggle to articulate the distinction between the two. Sometimes they seem to suggest that *all* gifts this year that are under the $5.12 million gift tax exemption amount will fail to lock in the higher exemption, because no gift tax is actually paid on such gifts. At other times, they seem to say that a gift will fail to lock in the higher exemption amount if it will be included in the donor's gross estate. At still other times, they seem to attack those gifts that go "too far" in allowing the donor to retain access to his or her wealth.[xix] In each case, Pennell and Baskies potentially sweep into their indictment many uncontroversial techniques. Perhaps the IRS will eventually be able to figure out what, exactly, makes a gift-by-promise somehow "different." So far, for all the ingenuity that Pennell and Baskies display, the distinction has proved elusive.

Argument #5: The gift-by-promise is void under the substance-over-form doctrine. Lastly, Pennell and Baskies argue that a gift-by-promise technique has no substance and, therefore, should be disregarded. Yet they concede that a gift-by-promise is a taxable gift. They even warn that a gift-by-promise will "foreclose other, more effective gifting opportunities." Pennell and Baskies do not explain how a transaction that, they admit, has substance for purposes of one tax somehow lacks substance for purposes of another, especially where the two taxes, like the gift and estate tax, are required to be construed in pari materia.[xx]

In any case, the author has already addressed whether the IRS may disregard a gift-by-promise as not bona fide or as lacking in substance. To recap, "application of the [gift] tax is based on the objective facts of the transfer and the circumstances in which it is made."[xxi] In its own binding rulings, the IRS has treated a gift-by-promise as a gift, even where not there no intent to honor the terms of the promise.[xxii] The IRS, in short, is bound to respect the form of a gift-by-promise.

Further, in Rev. Rul. 77-299, the IRS reaffirmed the principle that the form of a transaction controls the determination of whether it is a gift. Where a taxpayer transfers property in exchange for a note and intends to forgive the note over time, on the other hand, the IRS takes the view that the note may be disregarded and the entire transfer treated as a single disguised gift in the year of transfer. The form of the transaction, in that narrow circumstance, will be disregarded, at least by the IRS.[xxiii]

With a gift-by-promise, however, the situation is the opposite: Instead of attempting to *defer* gifts, as in the Rev. Rul. 77-299, the donor in the gift-by-promise strategy seeks to *accelerate* gifts. The argument that the accelerated form of a gift-by-promise should be disregarded and treated as, in substance, a "faux" gift, therefore, is not available to the IRS. Rather, the IRS is bound under Rev. Rul. 77-299 to its general position that a taxable gift occurs based on an objective determination of enforceability. While the IRS believes in one narrow exception to the general rule that the objective form of a transfer must be respected for gift tax purposes, the exception does not apply where, as in the case of a gift-by-promise, the gift is accelerated rather than deferred. In that context, contrary to Pennell and Baskies, the IRS is bound to its own decision to respect the form chosen by the taxpayer. The IRS may not, therefore, disregard a gift-by-promise under the substance-over-form doctrine.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

CITE AS:

LISI Estate Planning Newsletter #2033 (December 3, 2012) at http://www.leimbergservices.com

CITES:

IRC §§ 2001, 2012, 2036, 2513; *Middle Class Tax Cut Act*. S. 3393; Treas. Reg. § 25.2511-1(g)(1); Rev. Rul. 79-398; Rev. Rul. 84-25; Rev. Rul. 77-299; *Comm'r v. Wemyss*, 324 U.S. 303 (1945); *Estate of Sanford v. Comm'r*, 308 U.S. 39 (1939); *Merrill v. Fahs*, 324 U.S. 308 (1945); *Harris v. Comm'r*, 340 U.S. 106 (1950); *Comm'r v. Copley's Estate*, 194 F.2d 364 (7th Cir. 1952), acq. 1965-2 C.B. 4; *Rosenthal v. Comm'r*, 205 F.2d 505 (2d Cir. 1953); *Harris v. Comm'r*, 178 F.2d 861 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950); *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981); *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990); *Estate of Kelly v. Comm'r*, 63 T.C. 321, 325 (1974) nonacq., 1977-2 C.B. 2; *Haygood v. Comm'r*, 42 T.C. 936 (1964), acq. in result, 1965-1 C.B. 4, nonacq., 1977-2 C.B. 2; Bramwell and Mullen, "Donative Promise Can Use Up Gift Tax Exemption," LISI Estate Planning Newsletter #2001 (August 23, 2012); Bramwell, "Donative Promise Can Lock In 2012 Gift Tax Exemption," Estate Planning, Vol. 39, No. 8; U.S. Trust - Practical Drafting Quarterly Commentaries at 2171-2172 (April 1990); Zeydel, "Gift-Splitting: A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 Journal of Taxation 06 (June 2007); Bramwell, "Considerations and Consequences of Disclosing Non-Gift Transfers," Journal of Taxation, Vol. 116, No. 2 (January 2012).

CITATIONS:

[i] Bramwell and Mullen, "Donative Promise Can Use Up Gift Tax Exemption," LISI Estate Planning Newsletter #2001 (August 23, 2012); Bramwell, "Donative Promise Can Lock In 2012 Gift Tax Exemption," Estate Planning, Vol. 39, No. 8.

[ii] As we shall see, although Pennell and Baskies reject "clawback" as commonly understood, they nonetheless go on to invent a new theory as to how the IRS can still effectively deny a Section 2001(b)(2) credit for hypothetical gift taxes on gifts made in 2012. The theory, if sound, would pose a very grave, if heretofore unidentified threat to efficient estate tax planning in 2012.

[iii] It is not certain that Pennell and Baskies really mean to say that the credit for gift tax that "would have been payable" is only available for adjusted taxable gifts. As that interpretation is supported by the language of their article, however, the author responds to it here.

[iv] The rule is designed, as Pennell and Baskies note, to prevent double taxation of lifetime gifts that are later included in the donor's gross estate at death. For example,

suppose a taxpayer makes a gift to qualified personal residence trust or "QPRT," reports a taxable gift of the value of the remainder but dies during the fixed term of the QPRT. All of the QPRT property is included in the taxpayer's gross estate tax under Section 2036(a)(1). If the taxable gift that the taxpayer made when QPRT was created were also an adjusted taxable gift, then the QPRT property would be subject to estate tax twice: first, as property included in the gross estate, and, second, as an adjusted taxable gift (to the extent of the value of the remainder at the time of the gift). The rule of the Section 2001(b) flush language prevents this result by excluding the taxpayer's QPRT gift from the definition of "adjusted taxable gifts."

[v] A similar rule to that of Section 2001(g) was formerly contained in Section 2001(b)(2) itself.

[vi] Although it does not affect the underlying point, we assume, for simplicity, that that the taxpayer died within three years of the QPRT gift.

[vii] See, e.g., U.S. Senate. 112th Congress. 2d Session. *Middle Class Tax Cut Act*. S. 3393 (July 17, 2012) ("If the taxpayer made a *taxable gift* in an applicable preceding calendar period, the amount of tax computed under subsection (a) shall be reduced by the amount of tax which would have been payable under chapter 12 for such applicable preceding calendar period if the applicable exclusion amount in effect for such preceding calendar period had been the applicable exclusion amount in effect for the calendar year for which the tax is being computed and the modifications described in subsection (g) had been applicable for such preceding calendar period.") (emphasis added).

[viii] Gift tax liability in the case of a "split" gift is joint and several. IRC § 2513(d).

[ix] When the donor's spouse dies, his or her estate will receive a credit for gift taxes payable on the spouse's one-half share of the gift. For a discussion, see U.S. Trust - Practical Drafting Quarterly Commentaries at 2171-2172 (April 1990). Although off-topic, it is interesting to note that, because both spouses had already used up their exemption amounts, the spouses are not harmed in this example by Section 2001(e)'s failure to exclude from adjusted taxable gifts the consenting spouse's share of the QPRT gift. For the definitive discussion of gift-splitting issues, see Zeydel, "Gift-Splitting: A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 Journal of Taxation 06 (June 2007).

[x] Further support for this view comes from Section 2012, which provides a credit (subject to certain limitations) for gift taxes paid on pre-1977 gifts that are required to be included in the decedent's gross estate. For post-1976 gifts, Section 2001(b)(2) takes over where Section 2012 leaves off: it too provides a credit for gift tax on gifts includible in the gross estate. The only difference is that Section 2001(b)(2) also provides a credit for gift taxes on adjusted taxable gifts, i.e., gifts *not* includible in the gross estate. Section 2001(b)(2) simply carries on Congress' longstanding policy of providing relief against potential double taxation by granting a credit for gift tax on gifts included in the gross estate.

[xi] Once again, although it is not certain that Pennell and Baskies really mean to make this argument, the interpretation is supported by the actual language of their article and therefore must be addressed.

[xii] Rev. Rul. 79-398. It is unclear how much gift tax must actually be paid to satisfy Pennell and Baskies. Perhaps they would actually approve the gift-by-promise strategy if it produces a small gift tax that actually must be paid.

[xiii] Congress overturned *Smith* by enacting Section 2001(f), which provides that the finally determined value of a gift is the value that must be used for estate tax calculation purposes. For a detailed discussion, see Bramwell, "Considerations and Consequences of Disclosing Non-Gift Transfers," Journal of Taxation, Vol. 116, No. 2 (January 2012).

[xiv] Indeed, *Smith* is not mentioned in their article.

[xv] See U.S. Trust - Practical Drafting Quarterly Commentaries at 2171-2172 (April 1990).

[xvi] It is true that, if the decedent's spouse paid the gift tax, at least the gift tax was paid by someone, even if a third party. But gift tax on a gift that uses up the higher exemption amount in 2012 is likewise, in a sense, "paid" by a third party, namely, the United States government through the increased unified credit. Pennell and Baskies might reply that that's not enough; the gift tax has to be paid by a taxpayer. But is not the existence of a credit evidence that Congress did not intend for it to be recaptured at death? There is a certain perversity in the arguments raised by Pennell and Baskies: they take the very existence of a credit, because it prevents taxpayers from paying gift tax, as evidence that Congress actually intended gifts that use up the credit to be taxed.

[xvii] Rev. Rul. 79-384; Rev. Rul. 84-25; *Comm'r v. Copley's Estate*, 194 F.2d 364 (7th Cir. 1952), acq. 1965-2 C.B. 4; *Rosenthal v. Comm'r*, 205 F.2d 505 (2d Cir. 1953); *Harris v. Comm'r*, 178 F.2d 861 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950); cf. *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981) ("The critical inquiry is whether the parties to the agreement intended to give the donees the right to enforce the [donor's] obligation to make the . . . payments").

[xviii] Even if the reference to chapter 12 were not by itself sufficient to make clear what Congress means, the term "gift" would still have to be construed to have the same meaning for estate tax calculation purposes as for gift tax purposes. *Estate of Sanford v. Comm'r*, 308 U.S. 39, 44 (1939); *Merrill v. Fahs*, 324 U.S. 308, 311 (1945); *Harris v. Comm'r*, 340 U.S. 106, 106 (1950).

[xix] Although some of the theories of Section 2001(b)(2) proposed by Baskies and Pennell would cause all gifts this year to fail to lock in the higher exemption amount, strategies that seem particularly vulnerable include not just the gift-by-promise strategy but two others discussed in prior LISI articles, namely, the GRIT strategy proposed by David Lane in LISI Estate Planning Newsletter #1951 (April 19, 2012) and the QTIP strategy, also proposed by David Lane, in LISI Estate Planning Newsletter #2003, September 10, 2012. Indeed, as the author has observed in prior articles, the gift-by-promise strategy is structurally identical to a lifetime GRIT. A lifetime GRIT or an artificial triggering of Section 2519 would seem to deserve just as much indignation from Pennell and Baskies as a gift-by-promise.

[xx] Pennell and Baskies do not mention that, to make a gift-by-promise, a bargained-for consideration must be extracted from otherwise reluctant donees. Meanwhile, by making a gift-by-promise, the donor essentially forfeits his or her testamentary freedom over the promised payment. These are substantial, non-tax consequences that, in addition to those consequences that Pennell and Baskies themselves acknowledge as reasons to avoid to strategy, belie their suggestion that the gift-by-promise form somehow lacks substance.

[xxi] Treas. Reg. § 25.2511-1(g)(1); see also *Comm'r v. Wemyss*, 324 U.S. 303 (1945).

[xxii] Rev. Rul. 79-384.

[xxiii] Rev. Rul. 77-299 is contrary to the holdings of *Haygood v. Comm'r*, 42 T.C. 936 (1964), acq. in result, 1965-1 C.B. 4, nonacq., 1977-2 C.B. 2; *Estate of Kelly v. Comm'r*, 63 T.C. 321, 325 (1974) nonacq., 1977-2 C.B. 2.

0 Comments Posted re. *Austin Bramwell: The Gift-by-Promise Plan Works as Advertised*

Post a comment on this newsletter:

Submit comment by Alan S. Gassman

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2034

Date: 04-Dec-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Heyman, McCaffrey & Schneider: The Gift by Promise Plan SHOULD Work-At Least in Pennsylvania**

LISI has provided members with significant commentary on the "Gift-by-Promise" planning technique:

- In Estate Planning Newsletter #2001, **Austin Bramwell** and **Lisi Mullen** proposed a strategy that enables taxpayers to make substantial taxable gifts in 2012 to take advantage of the $5.12 million gift tax exemption amount without currently parting with any of their wealth. Instead of transferring cash or other property this year, they suggested an individual make a *promise* to make gifts to the donees in the future.

- In Estate Planning Newsletter #2022, **Jeff Pennell** and **Jeff Baskies** questioned whether the "Gift-by-Promise" strategy works as advertised. Their commentary highlighted what they consider to be some common misconceptions and raised doubts as to whether it is possible, even with many conventional strategies, to "lock in" today's higher gift tax exemption amount. Pennell and Baskies also lent support to some crucial premises of the gift-by-promise strategy.

- In Estate Planning Newsletter #2033, **Austin Bramwell** returned and provided members with his thoughts on why the Gift-by-Promise plan does work as advertised.

Now, **Kim Heyman**, **Carlyn McCaffrey**, and **Pam Schneider** provide members with their commentary. They weigh-in on the side of the proponents, but think the technique is better referred to as a gift of the donor's own promissory note. **Jeff Pennell** and **Jeff Baskies** will weigh-in with some final thoughts on the planning technique next Monday.

Kim V. Heyman is counsel at **Gadsden Schneider & Woodward LLP**. Kim has previously written and presented on a variety of estate planning topics. Her practice focuses on sophisticated estate planning, business succession planning and charitable planning.

Carlyn S. McCaffrey is a partner in the **Private Client Group** at **McDermott, Will & Emery. LLC**. She is an adjunct professor of law at the **University of Miami Law School** and a frequent lecturer and writer on topics related to the taxation of high net worth individuals and trusts.

Pam H. Schneider is a founding partner in the Pennsylvania law firm of **Gadsden Schneider & Woodward LLP**, a boutique firm concentrating in estate planning and related areas of tax, personal and fiduciary law. She is a past **Chair** of the **ABA's Section on Real Property, Trust and Estate Law** and has written and lectured extensively on various estate planning topics.

Before we get to their commentary, members should take note of the fact that a new **60 second Planner** by **Bob Keebler** was just posted to the **LISI** homepage. Bob provides members with commentary on what he describes as "an important but urgent planning opportunity for charitable remainder trusts" that has been created by the recently released proposed regulations dealing with the 3.8% surtax. You don't need any special equipment - just click on this link

Now, here is Kim, Carlyn and Pam's commentary:

EXECUTIVE SUMMARY:

Three newsletters have already been written respectively proposing and opposing the same 2012 year-end planning technique, described in each as a gift of a "promise." See Estate Planning Newsletters #2001, #2022 and #2033. We wish to weigh in on the side of the proponents, but think the technique is better referred to as a gift of the donor's own promissory note. The gift of a donor's own promissory note was the subject of Rev. Rul. 84-25, 1984-1 C.B. 191, the linchpin of the technical analysis of the technique.

FACTS:

In Estate Planning Newsletter #2001 Austin Bramwell and Lisi Mullen explain why, as a technical matter, a note that is enforceable as a matter of state law can be used to make a 2012 taxable gift As long as the so-called claw back issue is resolved,[1] this type of gift will enable a donor to use his or her $5.12 million exemption in 2012 and save federal estate tax on the amount of the portion of the exemption, if any, that does not exist at the donor's death.

In Estate Planning Newsletter #2022, Jeffrey Pennell and Jeffrey Baskies describe this technique as "too good to be true" and state that "[e]ven if a taxpayer has made a gift via a legally enforceable promise, both a technical tax analysis and a 'common sense' evaluation reveal that the 'gift by promise' plan does not work." We disagree with this statement on every level. More specifically, we think that:

- The implicit skepticism of the Pennell/Baskies piece concerning whether a gratuitous "promise," or rather, the donor's own promissory note, can be made legally enforceable is misplaced;
- The Bramwell/Mullen analysis is correct – at least as long as Rev. Rul. 84-25 is in effect;
- The first holding of Rev. Rul. 84-25,[2] that a gift of a legally enforceable debt obligation for which no (or inadequate) consideration was given constitutes a taxable gift at the time it is made and not when it is satisfied, is clearly correct;
- The second holding of Rev. Rul. 84-25 providing a mechanism to prevent the donor from having to pay estate tax (or use exemption) on the outstanding principal balance of the note if the note has not been satisfied in full at the donor's death is a clever and equitable solution to a gap in the statute; and
- Common sense and good tax policy dictate that the technique should work. There is no reason to believe that Congress intended that only the "super-wealthy" should be able to use the $5.12 million credit before it sunsets in 2013. We believe it should be available to the "merely wealthy," those individuals who have the wealth to pay off such a note but not the liquidity or easily transferrable assets to use their exemptions this year.

COMMENT:

The bases for our views and some recommended actions are described below.

Making the Note Enforceable

The enforceability of a promissory note, like a contract, is a question of state law. The two most common methods of making a promissory note enforceable are (1) to deliver it in exchange for consideration, which may take the form of a property transfer, or a promise to act or refrain from acting and (2) for the promissee to detrimentally rely on the note. There are some state laws that make promises enforceable under other circumstances, however.[3] Most significantly for potential donors who reside in Pennsylvania, or who wish to make a gift to a Pennsylvania resident (including a Pennsylvania trust), Pennsylvania law provides that --

> A written release or promise, hereafter made and signed by the person releasing or promising, shall not be invalid or unenforceable for lack of consideration, if the writing also contains an additional express statement, in any form of language, that the signer intends to be legally bound.[4]

This provision of Pennsylvania law was derived from the Uniform Written Obligations Act ("UWOA"). Professor Williston, the drafter of the UWOA, declared that the purpose of the UWOA was to make the law "substantially the same as it was when seals were in force, so far as the doctrine of consideration is concerned, except that in lieu of the formality of the seal, the formality of this statement is substituted."[5] Despite the intentions of its drafters, the UWOA is effective only in Pennsylvania, so it is a "Uniform Act" in name only. Nonetheless, under the UWOA, a written agreement may not be avoided for lack of consideration if it contains a provision expressing the intent of the parties to be legally bound by the agreement. The statement of intent of the parties to be legally bound acts as a "valid substitute for consideration" for the agreement.[6] Courts in Pennsylvania have followed this rule in enforcing contracts with this statement, even where there was no consideration. It is, in fact, common practice in Pennsylvania to include in legal documents, the phrase "intending to be legally bound, the parties hereto, hereby … ."

Getting the Desired Tax Result: Revenue Ruling 84-25

The IRS held in Rev. Rul. 84-25 that the donor of a legally enforceable gratuitous promise makes a completed gift under section 2511 of the Internal Revenue Code of 1986, as amended (the "Internal Revenue Code")[7]—on the date when the promise is binding and determinable rather than when the promised payment is actually made.[8]

Rev. Rul. 84-25 also held that if the note is outstanding at the donor's death, the gift that was implemented by the delivery of the promissory note is not included in the donor's adjusted taxable gifts for purposes of calculating the estate tax.[9] However, it does not similarly remove the gift tax deemed payable on the gift of the promissory note from the amount of the deduction provided for in section 2001(b)(2). By purging the taxable gift from the estate tax base but including the tax payable in the computation of the tax to be deducted from the estate tax base, this approach subjects the donor's gross estate to essentially the same amount of estate tax to which it would have been subjected had either (1) the obligation to pay the note been deductible for estate tax purposes[10] or (2) the assets needed to pay the note (other than the payment of accrued interest, if any,) been excluded from the donor's gross estate for estate tax purposes.[11]

This holding is a creative solution to what would otherwise cause two transfer taxes to be paid on the same transfer – one on the gift of the note and the second on the amount (or portion of the estate) to which the holder of the note has a claim by reason of the note. The computation works the same way as it does when a taxable gift is later included in the gross estate of the donor due to a retained interest or power. The IRS was correct in treating these two situations in the same manner because the equities of the two situations are identical. In each case a completed gift was made and gift tax paid (or exemption used) and in each case the gift, absent this adjustment, did not reduce the value of the donor's gross estate for federal estate tax purposes.

Accordingly, while we believe that Rev. Rul. 84-25 on its face reaches the desired result, and that the result is appropriate and not abusive in any way, it is possible that the IRS will change its mind at some point and revoke this ruling. The two critical portions of the ruling are (1) that a gift of the donor's own enforceable promissory note is a completed gift and (2) that the principal amount of the note that remains outstanding at the time of the donor's death will be excluded from his or her adjusted taxable gifts. The IRS is unlikely to revoke the first portion of this ruling because it is based on many prior judicial decisions and IRS rulings.[12] It is unlikely to revoke the second portion because the ruling in this portion or a similar ruling is necessary to avoid a double transfer tax on the same assets. Presumably any such revocation would, at worst, be applicable to donors who die after the date of the revocation. If this were to happen, the benefit of the 2012 gift of a note would be lost unless the note is satisfied prior to the donor's death.

Possible Protection of the Statute of Limitations

Adequate disclosure on the gift tax return of the promissory note as a completed gift will commence the statute of limitations for assessment of gift tax on the transfer, even if the IRS later takes the position that such a transfer is an incomplete gift.[13] Once the period of assessment has expired (usually three years from the later of the date the gift tax return was filed or the due date of the return including actual extensions), the IRS cannot treat the satisfaction of the note (in whole or in part) as a gift at the time of satisfaction.

Conclusion and Recommendations

We believe that a donor's own legally binding promissory note (which in the case of a note governed by Pennsylvania law would include a note that explicitly states that the maker intends "to be legally bound") is a viable way for the "merely wealthy" (as opposed to the "super wealthy") to take advantage of the increased available lifetime gift tax exemption and GST exemption before it sunsets. This strategy will not remove future appreciation on assets not used prior to death to pay off the note and unless the note is to be satisfied during life should not be used in connection with gift splitting.[14] On the other hand, retention of the assets to be used to satisfy the note will allow the donor's estate to receive a new income tax basis at death.

If a taxpayer has available other appropriate assets for gifting, the use of other assets will generally be preferable even if the donor later purchases the other assets from the donee (perhaps for a note). Furthermore, we would recommend that

- The note have a fixed term no longer than the life expectancy of the donor;
- The note not include a prepayment penalty;
- At a minimum, the note require that interest be payable currently at a rate at least equal to the AFR and all required payments be made timely;
- The donor pledge security for the note;
- The note be transferred to a grantor trust, so no tax will be due on the interest payments made pursuant to the terms of the note and no capital gains tax will be due if the note is satisfied in-kind during the grantor's lifetime;[15]
- The transaction be adequately disclosed on a timely filed gift tax return; and,
- No principal payments be made on the note until after the statute of limitations on the gift tax return has lapsed unless Rev. Rul. 84-25 is revoked, in which event the note should be satisfied as soon as possible so that it is not outstanding at the donor's death.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Kim Heyman
Carlyn McCaffrey
Pam Schneider

CITE AS:

CITES:

Estate Planning Newsletter #2001; Estate Planning Newsletter #2022; Estate Planning Newsletter #2033; Rev. Rul. 84-25, 1984-1 C.B. 191; section 2001(b)(2); section 2511 of the Internal Revenue Code; Uniform Written Obligations Act ("UWOA")

CITATIONS:

[1] See LISI Estate Planning Newsletter #2001 for a discussion of this concern and the use of a note with a partial self-cancelling feature to minimize the risk of claw back. For purposes of this piece, however, we assume the claw back concern will be resolved in the taxpayer's favor. If so resolved for 2012 gifts generally, there is no reason to believe the resolution will not also apply to gifts of legally enforceable promissory notes. At least two bills that have been introduced in Congress to deal with the 2010 estate tax rules have included legislation to "fix" this problem and neither excluded any type of transfer from the "fix." See section 2(c) of H.R. 3467 and section 201(b) of S. 3393.

[2] Rev. Rul. 84-25, 1984-1 C.B. 191 clarified Rev. Rul. 67-396, 67-2 C.B. 351, "to the extent that is (sic) implies that the transfer of a legally enforceable promissory note is an incomplete gift. The promissory notes in the court cases cited in Rev. Rul. 67-396 were unenforceable."

[3] *See, e.g.*, section 2-205 of the Uniform Commercial Code and section 5 of

the New York General Obligations Law.

[4] 33 P.S. §6. This statute was approved as a Uniform Act by the National Conference of Commissions on Uniform State Laws and by the American Bar Association in 1925, and was enacted in Pennsylvania in 1927.

[5] *Fed. Deposit Ins. Corp. v. Barness*, 48 F. Supp. 1134, 1148 (E.D. Pa. 1980) (citation omitted).

[6] *Interdigital Comms. Corp. v. Federal Insurance Company*, 392 F. Supp. 2d 707, 712 (E.D. Pa. 2005) (citation omitted).

[7] All section references herein are to the Internal Revenue Code unless specifically provided otherwise.

[8] *See also Commissioner v. Copley's Estate*, 194 F.2d 364 (7th Cir. 1952), *aff'g* 15 T.C. 17 (1950), *acq*., 1965-2 C.B. 4.

[9] The estate tax is computed by determining a tentative tax on the sum of the taxable estate and the adjusted taxable gifts (section 2001(b)(1)) and subtracting from that amount the tax payable, calculated as provided in section 2001(b)(2), with respect to gifts made after 1976. The adjusted taxable gifts include only the value of the taxable gifts made by the decedent after 1976 that are not includible in the decedent's gross estate.

[10] Section 2053(c)(1) does not permit a deduction for obligations other than certain charitable pledges that even though bona fide were contracted not for "an adequate and full consideration in money or money's worth."

[11] By not limiting the deduction for gift tax deemed payable to tax on "adjusted taxable gifts" Congress allowed a deduction for gift tax even when the gift had been purged from the tax base. This was intentional as is made clear in the Blue Book to the 1976 Tax Reform Act (at page 528), which states in pertinent part:

> "Transfers included in the tax base as lifetime transfers (described as "adjusted taxable gifts" by the Act) are not to include transfers which are also included in the decedent's gross estate (i.e., transfers made within three years of the date of death and lifetime transfers where the decedent had retained certain interests, rights, or powers in the property). This is to preclude having the same lifetime transfers taken into account more than once for transfer tax purposes. However, the gift tax payable on these transfers is to be

subtracted in determining the estate tax imposed."

[12] *See Commissioner v. Copley's Estate*, *supra*; *Harris v. CIR*, 178 F.2d 861 (2nd Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950); *Rosenthal v. Commissioner*, 205 F.2d 505 (2nd Cir. 1953); Rev. Rul. 69-347, 1969-1 C.B. 227; Rev. Rul. 80-186, 1980-2 C.B. 280, and Rev. Rul. 81-110, 1981-1 C.B. 479.

[13] Reg. §301.6501(c)-1(f)(5).

[14] The gift of the note should not be "split" with a spouse because the mechanism used in Rev. Rul. 84-25 to avoid double tax may not work completely when the gift is split and remains unpaid at the death of the actual donor. Generally, if a gift that was split is later included in the donor's estate, section 2001(d) provides that the section 2001(b)(2) reduction in the estate of the actual donor includes the gift tax payable on the spouse's portion of the gift. This implies that the reference in 2001(b)(2) to the gift made by the decedent includes only the portion of the gift actually made after gift splitting is taken into account. Rev. Rul. 84-25 does not explicitly import subsection 2001(d) into the computation. As a result, the gift of the note, or the property that will be used to pay off the note, is effectively subjected to tax one and a half times instead of just once.

This can best be understood by an example. Suppose W, having assets valued at $25 million, makes a gift of a $10 million note to C and then dies before any principal on the note has been paid, still owning assets worth $25 million. In the absence of Rev. Rul. 84-25, W's tax would be computed on a tax base of $35 million (the $25 million gross estate plus the $10 million adjusted taxable gift). This situation is corrected by Rev. Rul. 84-25, under which the $10 million gift drops out of the calculation but the reduction for the gift tax payable stays in effectively resulting in estate tax on $15 million (the tax base is $25 million but the tax computed is reduced by the tax on $10 million). However, if the facts were the same but W's spouse H had split her gift of the note, then on W's death her tax base would be the same $25 million (due to Rev. Rul. 84-25) but the reduction for the gift tax payable would appear to be only the tax payable on the $5 million gift W is considered to have made after H agreed to treat one-half of the gift as if it had been made by him, thus estate tax would effectively be paid on $20 million, rather than on $15 million.

[15] The income tax consequences of payment post-death are not entirely clear. There seems, however, to be a reasonable basis for concluding that, under current law, such payment should have no tax consequences except, possibly, to

the extent of the payment of accrued interest.

1 Comment Posted re. *Heyman, McCaffrey & Schneider: The Gift by Promise Plan SHOULD Work-At Least in Pennsylvania*

Edward Butz 06-Dec-12 07:21 PM

There are old Pa. cases, such as Hummel's Estate, 161 Pa. 215, and Kern's Estate, 171 Pa. 55, which indicate that a gift note with the benefit of a consideration substitute (being under seal, in those days) is nonetheless subordinate to the maker's creditors, even though it is binding against the maker and his heirs. If this is still good law, it would seem to make such a gift incomplete for Federal Gift tax purposes.

Post a comment on this newsletter:

Submit comment by Alan S. Gassman

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2036

Date: 10-Dec-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Pennell & Baskies: Final Words on Gift-by-Promise Technique**

"Perhaps we have been too subtle. To repeat the gist of our analysis, we don't believe the §2001(b)(2) credit will apply in the case of a gift that is treated at death as if it never was made, in this situation because no property was transferred inter vivos. The lack of an actual property transfer distinguishes this concept from the QPRT and similar examples that Bramwell relies upon in his reply.

In the gift-by-promise scenario the taxpayer owns and controls all of the taxpayer's wealth (both the principal and the income it generates) until the taxpayer dies, which differs from a GRIT, GRAT, QPRT, or other transactions in which assets are transferred - in fact - and the taxpayer's economic circumstances have actually changed. That critical distinction is a primary concern raised in our critique."

LISI has provided members with significant commentary on the "Gift-by-Promise" planning technique:

- In Estate Planning Newsletter #2001, **Austin Bramwell** and **Lisi Mullen** proposed a strategy that enables taxpayers to make substantial taxable gifts in 2012 to take advantage of the $5.12 million gift tax exclusion amount without currently parting with any of their wealth. Instead of transferring cash or other property this year, they suggested an individual make a promise to make gifts to the donees in the future.

- In Estate Planning Newsletter #2022, **Jeff Pennell** and **Jeff Baskies** questioned whether the "Gift-by-Promise" strategy works as advertised. Their commentary highlighted what they consider to be some common misconceptions and raised doubts as to whether it is possible, even with many conventional strategies, to "lock in" today's higher gift tax exclusion amount. Pennell and Baskies also lent support to some crucial premises of the gift-by-promise strategy.

- In Estate Planning Newsletter #2033, **Austin Bramwell** returned and provided members with his thoughts on why the Gift-by-Promise plan does work as advertised.

- In Estate Planning Newsletter #2034 **Kim Heyman**, **Carlyn McCaffrey**, and **Pam Schneider** provided members with their commentary. They weigh-in on the side of the proponents, but think the technique is better referred to as a gift of the donor's own promissory note.

Now, Jeff Pennell and **Jeff Baskies** weigh-in with some final thoughts on the planning technique.

Jeffrey N. Pennell is the **Richard H. Clark Professor of Law at Emory University School of Law**. Jeff is the author of a dozen books, includingWEALTH TRANSFER PLANNING AND DRAFTING, FEDERAL WEALTH TRANSFER TAXATION, and successor author of ESTATE PLANNING, the three volume treatise on estate planning originally written by legendary Harvard Professor A. **James Casner**.

Jeffrey A. Baskies is a Florida Bar certified expert in Wills, Trusts, and Estates law who has an emphasis on issues relating to Florida homestead law. He practices at **Katz Baskies LLC**, a Boca Raton, FL, boutique trusts & estates, tax & business law firm. In addition to over ten dozen published articles, he is the author of ESTATE, GIFT, TRUST, AND FIDUCIARY TAX RETURNS: PLANNING AND PREPARATION(West 2013). He can be reached at www.katzbaskies.com.

Here is their commentary:

EXECUTIVE SUMMARY:

Heyman, McCaffrey, and Schneider (HMS) and Bramwell responded to our November 6th **LISI** Newsletter ("Does the Gift by Promise Plan Work?"), notwithstanding Mark Twain's admonition to "never argue with a fool." For most readers this conversation is too much, especially because few advisors have time to debate the meaning of arcane Code provisions and revenue rulings, and even more obscure provisions of Pennsylvania law.

We wrote originally only to urge caution, and we remain reluctant to write a government brief in opposition. So, the following response is intended only for clarification. It is not a full rebuttal.

COMMENT:

- Note first that we have no dog in this fight. Pennell does not represent clients, and Baskies' clients are not executing gift-by-promise transactions.

- Readers who are skeptical about the gift-by-promise technique should focus on what Bramwell labels as our third and fourth arguments. Pennell's wealth transfer tax casebook and his estate planning treatise both extensively detail the operation of §2001(b). We agree that the purge-and-credit rules normally work as Bramwell suggests in the first two portions of his Comment, but they are not a "clever and equitable solution to a gap in the statute" as labeled by HMS. These rules, enacted in 1976, preclude inappropriate double taxation of lifetime transfers that fail to effectively avoid estate tax inclusion. We do *not* offer any new or innovative interpretation of those rules, nor did the government in Rev. Rul 84-25. Any suggestion to the contrary reflects a misappreciation for how these rules work and misstates what we said about the gift-by-promise concept.

- Perhaps we have been too subtle. To repeat the gist of our analysis, we don't believe the §2001(b)(2) credit will apply in the case of a gift that is treated at death as if it never was made, in this situation *because no property was transferred* inter vivos. The lack of an actual property transfer distinguishes this concept from the QPRT and similar examples that Bramwell relies upon in his reply.

  In the gift-by-promise scenario the taxpayer owns and controls all of the taxpayer's wealth (both the principal and the income it generates) until the taxpayer dies, which *differs* from a GRIT, GRAT, QPRT, or other transactions in which assets are transferred - in fact - and the taxpayer's economic circumstances have actually changed. That critical distinction is a primary concern raised in our critique.

- HMS mirror our concerns regarding faux-gifts by distinguishing their advice from a naked gift-by-promise. They recommend a unique Pennsylvania-law-enforceable and adequately secured promissory note, given by a debtor who has adequate net worth/credit-worthiness, for a term that informs full payment before the debtor dies, and serviced by annual payments. These bells and whistles improve the transaction to the extent they represent *real* inter vivos changes in the taxpayer's economic circumstances. They also underscore the riskiness of the naked gift-by promise suggestion.

- Supporters of the gift-by-promise technique rely almost exclusively on Rev. Rul. 84-25, which merely states a timing rule and then, because the promise never was fulfilled, applies the rule that the lifetime gift is excluded (purged or removed) from the §2001(b)(1)(B) calculation at death. It does *not* address the crucial §2001(b)(2) issue that is central to our evaluation of the gift-by-promise technique. There is no indication in the revenue ruling whether gift tax was paid in that case, nor what the §2001(b)(2) credit would be if the gift was sheltered by the gift tax exclusion amount. As such, that ruling is a slender reed that does not address the proposition that we considered.

- We don't know the proper definition of a "transfer" for wealth transfer tax purposes. Two possible interpretations exist. But the gift-by-promise falls short of each.

  One interpretation measures a transfer by what the transferee receives. This is what discount entity proponents rely upon. The other measures any diminution in the transferor's net worth. This is explained by Pennell in "Wealth Transfer Taxation: 'Transfer' Defined," 128 Tax Notes 615 (2010).

  By either count we doubt that a naked promise to transfer $5.12 million in the future is valued at $5.12 million today. Even if a transferor's credit worthiness is diminished by making the promise (which presumes that an outsider could discover the enforceable promise), we doubt that any appraiser would value the naked debt at $5.12 million – especially if litigation was needed to enforce a promise that is not supported by full and adequate consideration. Rev. Rul. 84-25 states that "the amount of the gift is the fair market value of the contractual promise on the date it is binding." The ruling says nothing more about that value.[1]

- As an aside, the operation of §2001(b) has been known as the purge-and-credit rule, literally since before Bramwell was born. We have never before encountered his "no-double-counting" terminology, nor do the semantics alter the substance of the analysis. Similarly, whether the technique is labeled a gift-by-promise or a gift of the donor's promissory note also does not change the reality that *no property changes hands prior to satisfaction of the promise or note.*

- The gift-by-promise technique is a hyper-technical reading of the Code, like similar hyper-technical arguments that have failed under government scrutiny. For example, commentators once read the Code, regulations, and rulings to support charitable split dollar. Reading each step technically and independently, those advisors concluded that the technique would work. But the government examined the entirety of the technique (looking at the entire forest, and not just each single tree) and applied a substance over form analysis to defeat the technique. The HMS and Bramwell articles never adequately address the risk of a similar response to the gift-by-promise gambit.

- Finally, HMS and Bramwell each suggest that every American alive in 2012 should be able to lock in the $5.12 million exclusion, simply by declaring before year end that they promise to transfer that amount. We would not be engaged in this debate if this was Congress' intent. It equates with receiving a §2053(a)(3) deduction for the difference between today's exclusion and whatever lesser amount applies in the year of death, yet each article concedes that no §2053 deduction is available. The functional equivalent also should not succeed.[2]

We expect that Congress will restore the exclusion to current levels whenever it finally addresses the wealth transfer tax aspects of the snap back to 2001 law. Thus, we suspect that year-end scramble planning to make gifts – especially without actually parting with any wealth – is unnecessary. So, please forgive us for extending this debate.

As the President suggested in his re-election campaign, we encourage readers to "follow your common sense" on this (and similar) end-of-2012 gift recommendations.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Pennell

Jeff Baskies

CITE AS:

CITATIONS:

[1]. HMS condition their commentary on the taxpayer having the wealth to pay off a promissory note. We think that this form of credit worthiness speaks to the value of the promise itself and not to the substance of the gifting technique proper.

[2]. This is how a colloquy with a court might proceed:

Court: So, counselor, your client made a promise to transfer wealth in the future but didn't actually transfer any property.

Tax Lawyer: Correct, your honor.

C: And you're claiming that the gift tax properly was incurred on that transaction, even though no tax was paid.

T: Also correct.

C: And now you want a credit for the tax your client didn't pay, on the transfer that your client didn't actually make.

T: Well, your honor, we disagree with your statement that no transfer was made.

C: How so — what transfer was there?

T: State law says the transfer was our client's enforceable promise.

C: It looks to me as if you're seeking a result that is the same as if the note generated a deduction under section 2053(a)(3). Even though there was no consideration in money or money's worth to support that deduction.

T: I can explain the difference.

We think that HMS and Bramwell *cannot* explain the difference. Indeed, HMS admit that the result they advocate is "essentially the same" as if a §2053(a)(3) deduction was available for the promissory note.

1 Comment Posted re. *Pennell & Baskies: Final Words on Gift-by-Promise Technique*

Larry Keech 18-Dec-12 07:06 AM

Subtle? How about the not-so-subtle dark side in retort: "We expect that Congress will restore the exclusion to current levels whenever it finally addresses the wealth transfer tax aspects of the snap back to 2001 law. Thus, we suspect that year-end scramble planning to make gifts – especially without actually parting with any wealth – is unnecessary. So, please forgive us for extending this debate. As the President suggested in his re-election campaign, we encourage readers to "follow your common sense" on this (and similar) end-of-2012 gift recommendations."

Forgive me, but "common" sense tells my 94-year old it is abject malpractice on the part of a hamstrung inept Congress to ever put in place or allow a $5M estate cliff to stand this close to its Cinderella's Ball year ending Midnight call. (Aren't we now having a bawl).

Why would she feel that way you might ask (a question Congress and a President in their collective ineptitude should have had the common decency and morality to ask regardless of budgetary concerns)?

Take her very real situation; in her mind it is possible and not a remote chance that over the upcoming holidays she could stroke out leaving her in the hospital with, say, a 30% chance (or more) to survive but with subjective quality of life issues, not to mention the (her 20% share cost to her heirs) cost of maintaining her life, that expensive chance, for who knows how long.

Given that suspect chance, that stark reality, she must consider the morbid if not specious decision her two loved one heirs MAY face holding her health care power of attorney sometime before that Midnight Cliff; not to mention, the perverse incentive bestowed upon them (and all of us that possibility) by our elected leaders, one of which includes our President asking them to use "common" sense (they'd fix it eventually leaving us guessing, anyone might ask).

Oh, I see, the citizenry should trust in him and them, you say?

Thankfully under law that may have come over on the Mayflower landing at Plymouth Rock and ported over to Ben's Philadelphia she remembers his quote saying: "If you would not be forgotten, as soon as you are dead and rotten, either write things worth reading, or do things worth the writing." ~ B. Franklin

For her lying in wait of a definitive answer from our President and his Congress is simply not good enough; act right now she must. For her worth an illiquid $5 million dollars she has no choice. She must buy the insurance now.

She now finds the only "insurance" available to her is a donative promise promissory note conditioned upon her heirs maintaining good and moral lifestyle choices under PA law thanks to Ben Franklin, who she remembers also saying there are two things certain in life: "death and taxes".

With that stroke of a pen she may now rest in peace now in sleep at night comfort her legacy is in better capably informed hands of her beloved heirs (with her durable POA) entrusted to simply handle a few chores by making annual interest payments (using, say, her income streams and perhaps even a dip-or-two some principal, from a brokerage account, etc.) into her independently trustee'd PA-IDGT account payment in bona-fide satisfaction of her clever donative promise promissory note bearing interest at AFR (.95%) due in 3.X years, a little less than her life expectancy, having given and received this bargain more than adequate "consideration".

You see she may be thinking President and Congress obviously have not so given adequately; consideration that is.

Three years from now IRS might ask upon carefully examining her Form 709 was there adequate consideration for her Estate Cliff closing donative gift bargain. Maybe IRS will save