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. A gift-by-promise is not an adjusted taxable gift. 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).

[ii]

2. No "clawback" (at least not as commonly understood). 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.

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. 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).

Argument #2: No credit is available under Section 2001(b)(2) unless gift tax was actually paid. 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 [i.e., 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 [xiii] its holding, later overturned by Congress, 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.

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. 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

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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:

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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*

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