

1-1-1981

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Recommended Citation

William J. Turnier, *The Role of Gift Giving in Estate Planning*, 59 N.C. L. REV. 377 (1981).Available at: <http://scholarship.law.unc.edu/nclr/vol59/iss2/4>

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THE ROLE OF GIFT GIVING IN ESTATE PLANNING

WILLIAM J. TURNIER†

The Tax Reform Act of 1976 struck a blow at the frequent use of inter vivos gift giving as an estate planning tool. The 1976 Act produced many changes in the tax law that have diminished the advantage of inter vivos gifts. In this Article, Professor Turnier reviews these changes and their implications. He then examines the remaining tax advantages of gift giving, including those created by the 1976 Act as well as those time proven advantages left untouched, or only modestly reduced, by the 1976 Act. He concludes that, despite the adverse consequences of the 1976 Act, in many situations a well-structured plan of inter vivos gift giving can produce significant tax savings.

I. INTRODUCTION

The passage of the Tax Reform Act of 1976¹ has brought with it substantial changes in the estate planning techniques employed by attorneys. One of the most marked changes has occurred in the use of inter vivos gifts. Prior to 1976 inter vivos gift giving represented one of the simplest tax saving procedures an attorney could recommend to his clients. The integration of the estate tax and the gift tax into a unified gratuitous transfer tax² and the repeal of the lower rate schedule that applied to gifts³ are merely two of the changes wrought in 1976 that have diminished dramatically the role of gift giving in estate planning. Consequently, it is not uncommon to hear knowledgeable attorneys assert that the 1976 Act has rendered gift giving virtually meaningless as an estate planning device. This Article demonstrates that, despite the substantial changes in the function of gift giving produced by the 1976 Act, a well-conceived program of gift giving can play a significant role in a creative estate planning program.⁴

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1. Pub. L. No. 94-455, 90 Stat. 1520.

2. See I.R.C. § 2001(b).

3. See Int. Rev. Code of 1954, § 2502, 68A Stat. 403. Hereinafter, the Internal Revenue Code of 1954 as it stood prior to amendment by the 1976 Act will be referred to as I.R.C. (pre-1976 Act).

4. Immediately after the passage of the 1976 Act a number of articles appeared that discussed various facets of its impact on gift giving. See, e.g., Bamuth, *Is it Still Economical to Make Lifetime Gifts?*, 117 TRUSTS & EST. 165 (1978); Bird, *Methods of Transfer Tax Savings for Medium*

In order to establish the proper framework for discussion of the role of gift giving, it first will be necessary to examine some of the critical changes affecting gift giving that were made in 1976. Next, the remaining tax advantages of gift giving will be explored, and finally, several other selected problem areas will be examined.

II. PRINCIPAL CHANGES AFFECTING GIFT GIVING PRODUCED BY THE 1976 ACT

A. *Principal Tax Advantages Removed*

The Tax Reform Act of 1976 made a number of significant changes affecting the decisions of taxpayers and estate planners to engage in active programs of gift giving. Although a number of changes merely impacted on the law governing gift giving, several had a substantial, negative impact on previous gift-giving techniques commonly employed by estate planners. The three principal negative changes in the law affected the then existing rate differential, the separate tax regimes for gifts and estates, and the rule governing gifts made within three years of death.

1. Rate Differential Dropped

Prior to 1976 gifts had been taxed at rates that were three-quarters of the rates for estates.⁵ In addition, as the gift tax was imposed on the net benefit passing to the donee (whereas the estate tax was imposed on the amounts passing to the donee and to the tax authority), inter vivos gratuitous transfers bore an effective tax rate even lower than the three-quarter differential imposed by the rate structure. Thus, by simply making gifts rather than bequests, the donor could realize substantial tax savings. The 1976 Act provided a combined single transfer tax rate schedule that "nominally" resulted in a repeal of this advantage.⁶ But because the method employed for determining the base of the

Sized Estates, 57 TAXES 247 (1979); Castleman, *Lifetime Gifts in Estate Planning under the Tax Reform Act*, 26 DRAKE L. REV. 313 (1976); Cummins & Hakala, *Defunding the Estate*, 37 N.Y.U. INST. FED. TAX ¶ 37 (1979); Donaldson, *Inter Vivos Giving in Estate Planning under the Tax Reform Act of 1976*, 18 WM. & MARY L. REV. 539 (1977); Fiore, *Ownership Shifting to Realize Family Goals Including Tax Savings*, 37 N.Y.U. INST. FED. TAX ¶ 38 (1979); Hodges, *Current Strategies for Leaving Lifetime Gifts to Reduce Total Estate and Gift Tax*, 47 J. TAX 266 (1977); Lentz, *Lifetime Gifts after 1976*, 12 REAL PROP. PROB. & TR. J. 339 (1977); Madden, *Is Living Gift Really Dead?*, 56 TAXES 435 (1978); O'Sullivan, *Gifts Under the Tax Reform Act of 1976: What's New? What's Left?*, 16 WASHBURN L.J. 275 (1977); Worfman & Fox, *Advantages of Giving*, 117 TRUSTS & EST. 768 (1978). This Article is an attempt to synthesize much of that work and to make a number of original contributions to the understanding of the role of gift giving in estate planning. It will focus primarily on the tax advantages of gift giving and will not deal with the nontax role of gift giving. Nontax considerations, of course, will be important in devising an overall estate plan. The principal nontax functions of gift giving that often override tax considerations are: (1) reduction of probate expenses and administrative complications; (2) defeat of the spouse's forced share; (3) minimization of the likelihood of successful challenge; and (4) defeat of claims of potential creditors.

5. Compare I.R.C. (pre-1976 Act) § 2001, 68A Stat. 373 (1954) with I.R.C. (pre-1976 Act) § 2502(a)(2), 68A Stat. 403 (1954).

6. See I.R.C. § 2001.

gift tax and the estate tax remained unchanged, a significant vestige of the benefit of a lower effective tax rate for gifts has been preserved.

2. The Separate Regimes Replaced by Unified Transfer Tax

Prior to 1976 there existed two separate and distinct rate structures and mechanisms for calculating the gift and the estate taxes.⁷ Since each system employed its own progressive rate structure, which generally was unaffected by transactions covered by its complementary counterpart, estate planners often found it desirable to recommend that a client adopt a significant inter vivos gift-giving campaign. This would result in a portion of the client's estate being taxed at the lower end of the progressive rate schedule applicable to gifts and the balance being taxed at the lower end of the progressive rate schedule applicable to estates. This "estate splitting," which was made possible by the pre-1976 "two basket" approach of the Code, when coupled with the lower rates applicable to gifts, often resulted in substantial tax savings for a taxpayer who adopted a meaningful inter vivos gift-giving program.⁸ In 1976 these two separate regimes were replaced by a unified transfer tax subjecting all gratuitous transfers to the same progressive rate structure.⁹ In essence, the estate of the taxpayer who made meaningful inter vivos gifts is taxed at the same marginal rate as if his inter vivos gifts were part of the estate. This cumulative basis, when coupled with the repeal of the more favorable rates governing gifts, has altered dramatically the role that gift giving previously played in many estate plans.

3. Gifts Within Three Years of Death

Prior to 1976, section 2035 brought back into the estate of the decedent-donor only those gifts made in contemplation of death and within three years of death.¹⁰ Moreover, the gift tax paid on such gifts was not included in the estate but was available as a credit against any estate tax liability ultimately imposed on the donor's estate.¹¹ These rules provided the estate planner with a "can't lose" situation. If the donor died within three years of making a gift, his executor could argue against inclusion of the gift in the estate based on the individual facts of the particular case. Even if the executor did not prevail on this issue, the estate still came out ahead of where it would have been absent

7. See note 5 and accompanying text *supra*.

8. The following example demonstrates the tax saving inherent in these two features of the law as it stood prior to the 1976 Act. Assume that an unmarried individual had died with an estate of \$1,000,000. His estate tax liability after allowing for the old \$60,000 exemption would have been \$303,500. On the other hand, if he had made an inter vivos gift of \$500,000 and left the balance (\$398,645) after payment of gift taxes of \$101,355 in his estate, his estate tax liability would have been \$113,266.40, resulting in a combined estate and gift tax liability of \$214,621.40. Although \$7920 of this \$88,878.60 saving is due to the \$3000 annual exclusion and the old \$30,000 lifetime exclusion, the balance of \$80,958.60 is due to the more favorable method and rates employed in calculating gift taxes and the double use of the lower portion of two separate progressive rate structures.

9. See I.R.C. § 2001.

10. I.R.C. (pre-1976 Act) § 2035, 68A Stat. 381 (1954).

11. See I.R.C. (pre-1976 Act) § 2012, 68A Stat. 375 (1954).

the gift. Since the gift tax was excluded from the estate, but was still available for use as a credit against the estate tax liability, the taxpayer could save taxes on gifts that were included under section 2035. This advantage often resulted in the deliberate making of gifts that would be included in the estate of the donor.¹² In 1976 Congress amended section 2035 to include within the estate all gifts made within three years of death.¹³ The law also was amended to include within the estate the federal gift tax paid on such gifts,¹⁴ thereby further reducing the advantages of gift giving.

B. Other Critical Changes Affecting Gift Giving

In addition to the previously mentioned changes diminishing the value of gift giving, the 1976 Act made a number of other changes in the law that affect decisions to give. There are three such principal changes: (1) the repeal of the \$30,000 lifetime exemption and substitution of a unified credit; (2) the change in the marital gift deduction; and (3) the alteration of section 2040 as it affects interspousal gifts.

1. Replacement of \$30,000 Lifetime Exemption with a Unified Credit

Prior to 1976 there were two separate exemptions, a \$30,000 lifetime exemption for gifts and a \$60,000 exemption for estates.¹⁵ Consequently, estate planners routinely encouraged their clients to make enough inter vivos gifts to exhaust fully the \$30,000 exemption.¹⁶ In 1976 Congress replaced these two exemptions with a single credit of \$47,000 (the equivalent of a \$175,625 exemption), which is applied first against taxable gifts, with the unused balance available for a taxpayer's estate.¹⁷ The larger aggregate exemption provided by the unified credit bars one from categorizing this change as negative for taxpayers. Nonetheless, because any portion of the credit not used against a taxpayer's gift tax liability can be used against his estate tax liability, taxpayers have lost one other incentive to make inter vivos gifts.

2. Change in Marital Gift Deduction

Prior to 1976, under section 2523 one-half of all otherwise taxable gifts to a spouse were not subject to taxation if the gift did not consist of a terminable

12. See, e.g., J. FARR, AN ESTATE PLANNER'S HANDBOOK § 40, at 241 (3d ed. 1966); C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE & GIFT TAXES, § 40.2, at 905 (3d ed. 1974).

13. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1520 (codified at I.R.C. § 2035(a)). All gifts for which a gift tax return was not required to be filed (e.g. gifts of present interests of \$3000 or less) are not included. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1520 (codified at I.R.C. § 2035(b)).

14. See I.R.C. § 2035.

15. I.R.C. (pre-1976 Act) §§ 2052, 2521, 68A Stat. 389 (1954).

16. See, e.g., J. FARR, *supra* note 12, § 39, at 237-38; see generally C. LOWNDES, R. KRAMER & J. MCCORD, *supra* note 12, § 34.1, at 843.

17. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a), 90 Stat. 1520 (codified at I.R.C. §§ 2001 & 2010).

interest described in section 2523(b).¹⁸ The 1976 Act has altered the exemption for interspousal gifts to provide that: (1) the first \$100,000 of these gifts will be exempt from taxation; (2) the second \$100,000 will be completely subject to taxation; and (3) all gifts in excess of \$200,000 will be subject to the old fifty percent exclusion.¹⁹ The old terminable interest rule was also retained, but the 1976 Act did add a decrease in the estate tax marital deduction that is tied to the gift deduction. Under section 2056(c)(1)(B) the maximum allowable estate tax marital deduction is to be reduced to the extent that more than fifty percent of otherwise taxable gifts to a spouse are excluded from taxation under section 2523.²⁰ Estate planners advising programs involving substantial interspousal gift giving must consider that the 1976 liberalization in the interspousal gift deduction has been purchased at the price of a reduction in the donor's maximum estate tax marital deduction.²¹

3. Interspousal Gifts of Jointly Held Property

In general, under section 2040, if a married couple acquires property as joint tenants with rights of survivorship, to avoid inclusion of the full value of the property in the estate of the first to die, the survivor must establish that he contributed a portion of the purchase price. If it can be established that both parties contributed a portion of the purchase price, the amount included in the decedent's estate is the amount of the fair market value proportional to the contribution of the decedent to the total purchase price.²² Prior to 1976 a survivor could not count as his contribution any consideration that was provided by the decedent as a gift. Thus, the creation of a joint tenancy with rights of survivorship could have resulted in a taxable gift to the donee-survivor of a portion of the value of the joint tenancy and later give rise to an inclusion in the estate of the donor-decedent of the full value of the joint tenancy (mitigated by the allowance of a credit for gift taxes paid).

In 1976 the law affecting interspousal gifts of joint property was altered. In general, if an individual now creates a joint tenancy with survivorship

18. I.R.C. (pre-1976 Act) § 2523, 68A Stat. 412 (1954). The gift to a spouse also could qualify for a \$3000 annual exclusion. The one-half exclusion for gifts of a present interest to a spouse was calculated after first subtracting this \$3000 exclusion.

19. I.R.C. § 2523.

20. For example, a \$123,000 gift to a spouse results in a taxable gift of \$20,000 (\$123,000 minus the \$3000 annual exclusion and the \$100,000 marital deduction). The estate tax marital deduction would be tentatively reduced by \$40,000. Assuming that in the next year the same taxpayer made a gift of \$83,000 to his spouse, the taxable gift would be \$80,000, and the previous tentative reduction in the estate tax marital deduction would be expunged. All further gifts would qualify for a 50% deduction and would not affect the estate tax marital deduction.

21. The new § 2056(c)(1)(B) merely effects a dollar-for-dollar reduction in the estate tax marital deduction equal to the amount whereby the post-1976 marital gift deduction resulted in a deduction greater than previously allowed. Moreover, because at its worst § 2056(c)(1)(B) merely reduces the maximum allowable marital deduction by \$1.00 for each \$2.00 transferred free of tax to the spouse, interspousal gift giving should not be avoided simply because of its impact on the marital deduction. If the taxpayer does not wish to transfer a large amount to his spouse and feels he can stretch his gift giving out over several years, use of the \$3000 annual exclusion may be preferred to use of the § 2523 marital deduction.

22. I.R.C. § 2040.

rights with his spouse as the sole co-owner, for purposes of section 2040 each will be deemed to have contributed one-half of the purchase price if two additional requirements are met.²³ First, the creation of a joint interest in personal property must have been a completed gift for gift tax purposes.²⁴ Second, the donor must have elected to treat the creation of a joint tenancy in real property as a taxable event at that time.²⁵

III. REMAINING TAX ADVANTAGES OF GIFT GIVING

Although the 1976 Act has diminished the number of circumstances in which gift giving may result in significant tax savings, it would be wrong to conclude that gift giving cannot play a vital role in a well-conceived estate plan. In this section the principal remaining tax advantages of gift giving will be discussed. Some of these advantages are relatively young, born of the 1976 Act, whereas others are time honored measures whose value has been modestly reduced or left unaffected by the 1976 Act.

A. State Tax Considerations

The issue of state taxes is not dealt with in most treatises on estate planning. This is likely the result of the economic realities of publishing for a national market. The economic realities of the practice of law, however, dictate that the resourceful estate planner devote considerable time and attention to the impact of state gift and death taxes on his client's affairs. Although the diversity of the state tax systems governing gratuitous transfers makes comments about state taxes difficult and dangerous, there are a few common factors amenable to general observation.

First, because only fifteen states and the Commonwealth of Puerto Rico impose gift taxes,²⁶ residents of most of the other states (all but one of which

23. See *id.* § 2040(b).

24. *Id.* § 2040(b)(2)(B)(i).

25. *Id.* § 2040(b)(2)(B)(ii). Section 2515(c) requires the donor to elect the taxable gift. The actual gift tax liability, however, can be reduced or avoided entirely by implementing the following devices provided by the Code: (a) the \$3000 annual exclusion, *id.* § 2503(b), allows a yearly transfer to the spouse of this amount without any gift tax consequences; (b) the marital gift deduction, *id.* § 2523, permits a one-time inter vivos transfer of \$100,000 to the spouse tax free without using any of the unified credit of the donor spouse; and (c) the unified credit, *id.* § 2010, facilitates tax-exempt transfers of property during life or at death up to \$175,625. Inter vivos giving under the last two devices would affect the ultimate tax liability of the donor's estate in the following ways: (1) the marital gift deduction of \$100,000 reduces the estate tax marital deduction, *id.* § 2056, by \$50,000; and (2) once the full amount of the unified credit is applied to taxes on lifetime gifts, it is no longer available to the donor's estate.

26. See CAL. REV. & TAX. CODE §§ 15101-16651 (West 1970); COLO. REV. STAT. §§ 39-25-101 to -25-119 (1973 & Cum. Supp. 1978); DEL. CODE ANN. tit. 30, §§ 1401-1406 (1975); LA. REV. STAT. ANN. §§ 47:1201 to :1212 (West 1970 & Cum. Supp. 1980); MINN. STAT. ANN. §§ 292-.01 to -.15 (West 1972 & Cum. Supp. 1980); N.Y. TAX LAW §§ 1000-1009 (McKinney 1975 & Cum. Supp. 1980); N.C. GEN. STAT. §§ 105-188 to -197.1 (1979); OKLA. STAT. ANN. tit. 68, §§ 901-909 (West 1966); OR. REV. STAT. §§ 119.005-.990 (1979); P.R. LAWS ANN. tit. 13, §§ 5201-5223 (1978); R.I. GEN. LAWS §§ 44-24-1 to -24-18 (1971 & Cum. Supp. 1979); S.C. CODE §§ 12-17-10 to -17-310 (1976 & Cum. Supp. 1979); TENN. CODE ANN. §§ 67-2501 to -2526 (1976 & Cum. Supp. 1980); VT. STAT. ANN. tit. 32, §§ 7411-7418 (Cum. Supp. 1979); 1979 Wash. Legis. Serv. ch. 210, at 1621; WIS. STAT. ANN. §§ 75-81 (West 1969 & Cum. Supp. 1980). VA. CODE § 58-218 (Cum. Supp.

impose a state death tax) will often find it beneficial to make inter vivos gifts and thereby completely escape the burden of state taxation on these sums. Inter vivos gifts provide no tax savings in six states that impose only a slack tax (a tax equal to the federal credit)²⁷ and Nevada, which imposes no state gift or death tax. Because the estate tax of these states does not economically burden the taxpayer, avoidance with inter vivos gifts is of no value from a state tax perspective.

Second, because fourteen of the fifteen states that tax gifts do not have a unified transfer tax,²⁸ residents of those fourteen states have the advantage of two separate sets of exemptions and progressive rate structures. Furthermore, in some states there still exists the advantage of a lower rate structure for gifts. Also, the gift tax is often imposed only on the net benefit passing to the donee, whereas the death tax is typically imposed on the gross amount included in the decedent's estate. For example, a resident of North Carolina, which imposes separate gift and inheritance taxes,²⁹ may wish to take advantage of the state's \$3000 per year per donee exemption³⁰ and its \$30,000 lifetime gift tax exemption.³¹ Moreover, he may wish to engage in a more extensive gift-giving program in order to pass a portion of his wealth through the lower end of the gift tax progressive rate structure and the balance through the lower end of the estate tax progressive rate structure. Of course, in so doing he must weigh against the state tax saving the limitations of section 2011, which provides a credit only for state death taxes and not for state gift taxes.

Generalizations beyond those few mentioned above are difficult to make; the resourceful estate planner considering a gift-giving program must, however, consider state tax consequences. Through the remainder of this Article, occasional observations will be made on the impact of state gift and death taxes upon particular situations. The lack of such mention should not be construed as indicating an absence of a state tax advantage or consideration.

B. The \$3000 Exemption

A valuable gift-giving advantage left untouched by the 1976 Act is the \$3000 per donee annual exemption provided by section 2503(b).³² If one's

1980)), provides that no gift tax is to be applied to transfers after January 1, 1980. Oregon apparently does not intend to collect any gift tax after 1986. (OR. REV. STAT. § 119.051 states that the rate for taxation of gifts after 1986 is to be 0%).

27. See ALA. CODE tit. 40, § 15-2 (1975); ALASKA STAT. § 43.31.011 (1971); ARK. STAT. ANN. § 63-103 (1971); FLA. STAT. ANN. § 198.02 (West 1980); GA. CODE ANN. § 91A-5702 (1980); N.M. STAT. ANN. § 7-7-3 (1978).

28. See CAL. REV. & TAX. CODE § 13402 (West Cum. Supp. 1980).

29. N.C. GEN. STAT. § 105-2 to -30 (1979) (inheritance tax); *id.* § 105-188 to -197 (gift tax). If the North Carolina inheritance tax does not result in a state death tax equal to the minimal amount allowed as a credit by I.R.C. § 2011, a slack tax is imposed that produces an aggregate death tax equal to the § 2011 credit. See N.C. GEN. STAT. § 105-7 (1979).

30. N.C. GEN. STAT. § 105-188(d) (1979).

31. *Id.* § 105-188(g). The \$30,000 lifetime specific exemption applies to gifts made to the donor's lineal issue, lineal ancestors, spouse, adopted children, or stepchildren.

32. With the exception of certain gifts to minors and to retirement accounts of a spouse, all such gifts must be gifts of present interests. See I.R.C. § 2503(c) & (d).

spouse "joins" in the gift giving under section 2513,³³ this exemption can be enlarged to \$6000 per year per donee. By employing this exemption with a number of donees over a period of years, it is possible for a taxpayer to reduce substantially his estate tax burden.³⁴ For example, assume that a married taxpayer with a net worth of \$1,000,000 has two children, each of whom is happily married and has two children themselves. If \$6000 is given to each beneficiary (children, their spouses, and issue) for ten years, a total of \$480,000 will have been passed tax free to the donor's grandchildren and their parents, thereby reducing the taxpayer's gross estate to \$520,000. Moreover, if the taxpayer makes ten annual tax-free gifts of \$3000 to his spouse, he will have further reduced his gross estate to \$490,000. By tying this to several other favorable provisions, our taxpayer can reduce his estate tax liability to virtually nothing. For example, by making an additional \$100,000 gift to his spouse, which is free of tax under section 2523, our taxpayer can reduce his gross estate to \$390,000. If he then dies before his spouse and takes the full marital deduction (which is now reduced to \$200,000 because of the prior \$100,000 gift),³⁵ his taxable estate will be reduced to \$190,000. After taking the unified credit his estate tax bill will be \$4,600, or less than one-half of one percent of his initial net worth.

Because of the peculiar wording of section 2035, even if the donor dies within three years of making a gift there will be no estate tax inclusion of the gift if the decedent was not required to file a gift tax return. If a return was required to be filed, then the full amount of the gift is included in the decedent's estate.³⁶ For example, although a gift of \$2500 to one donee will not be included, the full value of a gift of \$3500 to another donee will be. Moreover, because a return must be filed to take advantage of the section 2513 election, the death of the dominant donor spouse will cause inclusion of the full amount of a gift of \$6000 for which the election was made. The death of the electing spouse, however, will not result in an inclusion under section 2035.³⁷

C. Gifts Made Within Three Years of Death

The 1976 Act attempted to remove the advantages of gifts made in proximity of death by automatically including in the estate all gifts within three years of death for which a return must be filed,³⁸ as well as the federal gift tax

33. *Id.* § 2513.

34. The substantial tax saving potential of the \$3000 exemption was one of the features of the estate and gift tax that caused one scholar to characterize these taxes as largely voluntary. *See* G. COOPER, *A VOLUNTARY TAX?* 38-39 (1979).

35. Maximum marital deduction = \$250,000, less excess marital gift deduction of \$50,000 = \$200,000.

36. State law may be somewhat more favorable. For example, in North Carolina gifts made within three years of death are brought back into the estate only to the extent that they exceed \$3000. N.C. GEN. STAT. § 105-2(3) (1979).

37. If the electing spouse dies prior to the time set for filing the return, the executor may make the election under § 2513 for such individual. *See* Rev. Rul. 55-506, 1955-2 C.B. 609.

38. I.R.C. § 2035. The result of this is to include within the estate all gifts in excess of \$3000. Even if the taxpayer's spouse joins in on a larger gift, making it nontaxable (e.g. a \$6000 gift),

on such gifts.³⁹ There are, however, several situations in which the making of these gifts may result in a tax saving. The principal factors making these gifts advantageous are the impact of state death and gift taxes on such transfers, the income, estate, and gift tax treatment accorded gifts to charities, and the exclusion of annual gifts of less than \$3000 from section 2035.

Once state gift and death taxes are considered these gifts can be advantageous for several reasons. First, if the gift was subject to state gift tax, although the federal gift tax is included in the gross estate for federal estate tax purposes, there is no inclusion under section 2035(c) of the state gift tax paid. Consequently, a taxpayer who makes such a gift will realize a tax saving on his federal estate tax equal to the amount of the state gift tax times his marginal federal estate tax rate.

In addition to the above federal estate tax saving on such gifts, there is also a potential saving on state death taxes that derives from several factors. First, since a number of states employ standards different from those employed by section 2035, a gift that is included under section 2035 might qualify for more liberal treatment under state law. For example, a number of states still employ the old "contemplation of death" standard.⁴⁰ In addition, the operative period in the various states ranges from six months to three years, with several states imposing no cut-off period at all.⁴¹ Moreover, state death taxes that do effect an inclusion of these gifts commonly do not provide for a "gross up" of either the federal or state gift tax.⁴² Even if a state death tax does provide for a "gross up" for gift taxes paid on included gifts, the statutes often are drafted as mirror images of section 2035, requiring a "gross up" only for state gift taxes paid.⁴³

The following example illustrates the potential tax savings available from these features of federal and state death taxes. North Carolina only includes the excess over \$3000 of gifts made in contemplation of death and within three years of death and does not provide for a "gross up" for either the state or federal gift tax.⁴⁴ If a widow residing in North Carolina were to leave all her \$4,000,000 estate to a child, she would incur a combined federal and state estate tax liability of \$1,915,160. If this same taxpayer were to make a death bed gift of \$1,000,000 to the child, her combined federal and state gift and estate tax liability would be \$1,856,747.60. The imperfect state and federal "gross up" and the North Carolina exclusion of the first \$3000 of gifts made in contemplation of death result in a net tax savings of \$58,412.40.

The second situation in which a tax saving may be realized when a gift is included under section 2035 involves a gift to a charity by a taxpayer anxious

since a return must be filed to make the § 2513 election, the full amount of the gift (\$6000) will be included under I.R.C. § 2035.

39. *Id.* § 2035(c).

40. *See, e.g.*, N.C. GEN. STAT. § 105-2(3) (1979).

41. *See Inher., Estate, & Gift Taxes* (CCH State Compilation) ¶ 12.060 (1977).

42. *See, e.g.*, N.C. GEN. STAT. § 105-2(3) (1979).

43. *See, e.g.*, N.Y. TAX LAW § 952(c) (McKinney Cum. Supp. 1979).

44. *See* note 42 and accompanying text *supra*.

to make full use of the marital deduction. A married taxpayer with a large estate who wishes to make a substantial gift to a charity often confronts the dilemma of whether the gift should be made inter vivos or as a bequest. Since inter vivos charitable gifts effectively exclude the gift property from the estate and provide the taxpayer with an income tax deduction, there is a temptation to favor inter vivos giving.⁴⁵ But since the inter vivos gift diminishes the donor's adjusted gross estate, the taxpayer who defers his charitable gift until his death preserves a larger adjusted gross estate and consequently the right to a larger marital deduction. As we shall see, however, this normally will not outweigh the benefits of inter vivos giving.

Assume that a married taxpayer in the fifty percent income tax bracket, who has a net worth of \$1,030,000, wishes to give \$100,000 to a charity and to take maximum advantage of the marital deduction. If he has administration and funeral expenses of \$30,000, leaves \$100,000 to the charity as a bequest, and takes maximum advantage of the marital deduction, he will pay a federal estate tax of \$74,800 on a net taxable estate of \$400,000, resulting in a net benefit to his heirs of \$825,200.⁴⁶

If on the other hand our taxpayer gives the \$100,000 to a charity during his life, retains the income tax saved by the charitable deduction, and dies within three years of making the gift, he will pay a federal estate tax of \$83,300 on a net taxable estate of \$425,000, resulting in a net benefit to his heirs of \$866,700.⁴⁷ If the taxpayer lives for more than three years after making the

45. The income tax saving so realized will, of course, enhance the taxpayer's gross estate.

46. *Computation of Marital Deduction*

\$ 1,030,000 Gross Estate
 — 30,000 Administration and Funeral Expenses
 \$ 1,000,000 Adjusted Gross Estate (AGE)

Maximum Marital Deduction = \$500,000 (50% of AGE)

Computation of Net Taxable Estate and Net Estate Tax

\$ 1,000,000 AGE
 — 500,000 Maximum Marital Deduction
 — 100,000 Charitable Bequest
 \$ 400,000 Net Taxable Estate

Net Tax on \$400,000 after unified credit of \$47,000 = \$74,800.

47. *Computation of Net Worth after Gift*

\$ 1,030,000 original net worth
 — 100,000 amount of gift
 + 50,000 savings on income tax at 50% bracket
 \$ 980,000 Net Worth

Computation of Gross Estate

\$ 980,000 Net Worth
 + 100,000 Inclusion under § 2035
 \$ 1,080,000 Gross Estate

Computation of Marital Deduction

\$ 1,080,000 Gross Estate
 — 30,000 Administration and Funeral Expenses
 \$ 1,050,000 Adjusted Gross Estate

Maximum Marital Deduction = \$525,000 (50% of AGE)

inter vivos charitable gift, he will pay a federal estate tax of \$100,300 on a net taxable estate of \$475,000, resulting in a net benefit to his heirs of \$849,700.⁴⁸

Thus, by making a \$100,000 inter vivos gift to charity within three years of death, our taxpayer will realize a net combined income and estate tax saving of \$41,500 over the tax burden that would have been imposed had the gift been made as a bequest. If the taxpayer lives for more than three years after an inter vivos gift to a charity, he will realize a net combined income and estate tax saving of \$24,500 over the tax burden that would have been imposed had the gift been made as a bequest. Ironically, if the taxpayer dies within three years of the charitable gift, he will realize a net combined income and estate tax saving of \$17,000 over the tax burden that would have been imposed had the gift been an inter vivos gift that was not included under section 2035.⁴⁹

Computation of Net Taxable Estate and Net Estate Tax

\$ 1,050,000 AGE
 — 525,000 Maximum Marital Deduction
 — 100,000 Charitable Bequest Deduction
 \$ 425,000 Net Taxable Estate

Net Tax on \$425,000 after unified credit of \$47,000 = 83,300.

Net Benefit to Heirs

\$ 980,000 Net Worth after inter vivos gift
 — 30,000 Administration and Funeral Expenses
 — 83,300 Federal Estate Tax on \$425,000
 \$ 866,700 Net Benefit to Heirs

48. *Computation of Net Worth after Gift*

\$ 1,030,000 original net worth
 — 100,000 amount of gift
 + 50,000 saving on income tax at 50% bracket
 \$ 980,000 Net Worth

Computation of Marital Deduction

\$ 980,000 Gross Estate
 — 30,000 Administration and Funeral Expenses
 \$ 950,000 Adjusted Gross Estate

Maximum Marital Deduction = \$475,000 (50% of AGE)

Computation of Net Taxable Estate and Net Estate Tax

\$ 950,000 AGE
 — 475,000 Maximum Marital Deduction
 \$ 475,000 Net Taxable Estate

Net Tax on \$475,000 after unified credit of \$47,000 = \$100,300.

Net Benefit to Heirs

\$ 980,000 Net Worth
 — 30,000 Administration & Funeral Expenses
 — 100,300 Federal Estate on Tax on \$475,000
 \$ 849,700 Net Benefit to Heirs

49. It must be kept in mind that the charitable gift that is included under § 2035, as well as the bequest, result in a larger AGE than the charitable gift made more than three years prior to death. This larger AGE allows for a larger marginal deduction, thereby eventually resulting in a larger taxable estate for the surviving spouse. At the death of the survivor a portion of the tax saving will in essence be paid back as the federal estate tax is imposed on this larger estate.

If our mythical taxpayer had no charitable impulses and left his entire estate to his family, they would have received a net benefit of \$891,200 after taxes and expenses. Thus, the \$100,000 gift to a charity will only cost our taxpayer: (1) \$24,500 if he makes it as an inter vivos gift and

Given the proper set of circumstances it is possible for a taxpayer to profit from a cash gift to a charity that is included in his estate. For example, a taxpayer in the seventy percent income tax bracket with a net worth of \$12,000,000, who desires to take maximum advantage of the marital deduction, will leave his heirs an after-tax net of \$8,796,200 if no charitable gift is made.⁵⁰ If the same taxpayer makes an inter vivos deathbed gift of \$100,000 to a charity, after income and estate taxes his happy heirs (who will not seek to avail themselves of a mortmain statute) will have a net of \$8,811,700, or \$15,500 more than they would have had if the taxpayer had made no charitable gift.⁵¹ modest aggregate after

The third situation in which deliberate gifts within three years of death would prove beneficial involves gifts covered by the \$3000 annual exclusion. Since no returns need be filed for such gifts, they will not be covered by section 2035. For example, a taxpayer with a spouse, two children, two-in-laws, and four grandchildren can transfer \$27,000 free of all tax at the very moment of death.

dies within three years; (2) \$41,500 if he makes it as an inter vivos gift and dies more than three years after the gift; and (3) \$66,000 if he makes it as a bequest.

50. Maximum Marital Deduction = \$6,000,000 (50% of AGE)

Computation of Net Taxable Estate and Net Estate Tax

\$ 12,000,000 AGE
 - 6,000,000 Maximum Marital Deduction
 \$ 6,000,000 Net Taxable Estate

Net Tax on \$6,000,000 after unified credit of \$47,000 = \$3,203,800.

51. *Computation of Net Worth After Gift*

\$ 12,000,000 original net worth
 - 100,000 amount of gift
 + 70,000 savings on income tax at 70% bracket
 \$ 11,970,000 Net Worth

Computation of Marital Deduction

\$ 11,970,000 Net Worth
 + 100,000 Inclusion under § 2035
 12,070,000 Adjusted Gross Estate

Maximum Marital Deduction = \$6,035,000 (50% of AGE)

Computation of Net Taxable Estate and Net Estate Tax

\$ 12,070,000 AGE
 - 6,035,000 Maximum Marital Deduction
 - 100,000 Charitable Bequest Deduction
 \$ 5,935,000 Net Taxable Estate

Net Tax on \$5,935,000 after unified credit of \$47,000 = \$3,158,000.

Net Benefit to Heirs

\$ 11,970,000 Net Worth after inter vivos gift
 - 3,158,300 Federal Estate Tax
 \$ 8,811,700 Net Benefit to Heirs

This particular tax saving is realized by allowing a greater portion of the taxpayer's net worth to pass under the marital deduction to the surviving spouse. The properly discounted value of this device will vary from estate to estate depending on a variety of factors such as the age of the surviving spouse, the after tax yield on the spouse's investments, and the ages of the heirs who will receive the balance of the decedent's estate. In some circumstances, despite the initial tax benefit, it might eventually result in a modest aggregate after-tax cost.

In conclusion, it should be observed that although section 2035 as amended has removed much of the incentive to make gifts within three years of death, in select circumstances modest but meaningful tax savings can be realized on gifts made within three years of death.

D. Getting the Tax Out of the Estate

As previously mentioned, the base of the gift tax is the net amount transferred to the donee, whereas the base of the estate tax is the net amount transferred by the donor at death and includes both the amount transferred to the donee and the amount transferred to the tax authorities as payment of federal estate taxes. Since this particular advantage of gift giving is based on escaping "the tax on the tax" imposed under the existing estate tax regime, its value increases geometrically as the size of the taxpayer's net worth increases. For example, if an unmarried taxpayer with a net worth of \$1,000,000 makes a gift of all his assets less the tax due on the gift, he will pass a net of \$785,877.70 to his donee.⁵² If the entire \$1,000,000 were left in his estate, he would pass a net of \$701,200 to his donee.⁵³ If he were to make a taxable gift of \$500,000 to a donee and leave the balance after tax in his estate, the aggregate amount passing to his donee would be \$744,802.⁵⁴ If the taxpayer had a net worth of \$4,000,000, a gift of all his assets less the tax due on the gift would pass a net of \$2,841,692.80 to his donee.⁵⁵ If the entire \$4,000,000 were left in his estate, he would pass a net of \$2,166,200 to his donee.⁵⁶ If he were to make a taxable gift of \$2,000,000 to a donee and leave the balance after tax in his estate, the aggregate net amount passing to his donee both as a gift and bequest would be \$2,606,176.⁵⁷

Finally, it should be noted that although there is a lower effective rate for gift giving produced by the method for computing the gift tax, its principal beneficiaries will be quite well-to-do taxpayers whose wealth allows them to engage in an extensive gift-giving program involving large taxable gifts.

E. Spousal Splitting of the Estate

When one spouse possesses the lion's share of the wealth owned by the married couple and the poorer spouse dies first, the latter's unified credit may be wasted. Moreover, a higher total estate tax is likely because the larger estate cannot be split into two estates under the marital deduction with each half

52. A gift of \$785,877.70 will result in a net gift tax of \$214,122.30.

53. A \$1,000,000 estate will be liable for a net estate tax of \$298,800 leaving a net distributable estate of \$701,200.

54. A gift of \$503,000 will result in a gift tax of \$108,800 leaving a taxable estate of \$388,200 on which a tax of \$146,398 is due, resulting in a net distributable estate of \$241,802.

55. A gift of \$2,841,692.80 will result in a net gift tax of \$1,158,307.20.

56. A \$4,000,000 estate will be liable for a net estate tax of \$1,833,800, resulting in a net distributable estate of \$2,166,200.

57. A gift of \$2,003,000 will result in a gift tax of \$733,800, leaving a taxable estate of \$1,263,200 on which an estate tax of \$660,024 is due, resulting in a net distributable estate of \$603,126.

being taxed at the lower end of the progressive rate structure at the death of each spouse.

There are two procedures that can be employed to avoid the occurrence of these losses. First, the wealthy spouse may take advantage of section 2503 to transfer \$3000 tax free each year to the poorer spouse. In addition, the wealthy spouse may use the section 2535 marital deduction to transfer free of tax \$100,000 to the poorer spouse. Although this latter transfer will reduce the estate tax marital deduction by \$50,000, this should not be of concern since the purpose of the stratagem is to provide for the contingency of the poorer spouse dying first. Moreover, if he or she does not die first, the reduction does not seem too high a price to pay since it has resulted in a tax-free transfer to the survivor of twice its size.

Second, the wealthy taxpayer might wish to commence an extensive gift-giving program. The poorer spouse then could elect under section 2513 to treat one-half of the gift as given by each spouse. If sufficiently extensive, such a program will consume the unified credit of both spouses and will take advantage of the lower end of the progressive rate structure for both spouses.⁵⁸ Even if the "electing" spouse dies within three years of the gift by the wealthy spouse, there will be no inclusion of "his portion" of the gift under section 2035.⁵⁹ Unfortunately, however, if the wealthy spouse dies within three years of any such gift, there will be an inclusion of the full amount of the gift.⁶⁰ Moreover, the unified credit of the electing spouse will not be restored, thereby resulting in a wasting of that portion of the unified credit originally used.⁶¹ This latter factor warrants considerable care in using section 2513 to consume the unified credit. Of course, if the electing spouse already has used his unified credit or will have little or no taxable estate, such a consideration will not be very important.

F. Assignment of Income

High bracket taxpayers often make gifts of property to low bracket donees for the purpose of assigning income. These gifts commonly take the form of income producing assets or of appreciated property ripe for sale. Donors who seek to take advantage of this opportunity for tax saving must be careful to abide by certain relatively well-established rules for assigning income.⁶²

58. Section 2513 provides that the election is to be treated as a gift only "for the purposes of this chapter." I.R.C. § 2513. The effect of this exclusive application to Chapter 12 of the I.R.C. is that § 2035, found in Chapter 11, does not apply to the consent of the electing spouse. It should be recalled that if the electing spouse dies prior to the filing of the return on which the election is to be made, his or her executor can consent to the election. See Rev. Rul. 55-506, 1955-2 C.B. 609.

59. See I.R.C. § 2001(e).

60. This is so because § 2513(a) indicates that the election operates only "for the purposes of this chapter" (*i.e.* chapter 12) and § 2035 is to be found in chapter 11 of the Code.

61. See STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 528 (1976); see also Anne E. Norair, 65 T.C. 942 (1976).

62. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 1.05, 2.06, 3.17, 7.21, 11.03, 11.62 (4th ed. 1979 & Supp. 1980); J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §§ 18.01-.15 (rev. ed. 1974 & Supp. 1980); Eus-

While it is not the intention of this author to discuss thoroughly all the various concerns of a donor who wishes to assign income, one problem produced by the 1976 Act is of widespread concern and, therefore, is worthy of special note. Under section 644, as amended in 1976,⁶³ all pre-gift appreciation in value of property given in trust will be taxed at the rates applicable to the donor (if higher) if the property is sold within two years of the gift. Consequently, donors desiring to assign income by making a gift of appreciated property ripe for sale will have to consider the implications of making a gift in trust of the property. Many donors will recoil at the thought of making substantial gifts to minors without the protection of a trust. The impact of section 644 may be to cause these donors to withdraw from the contemplated gift, to make it accepting taxation, or to bar any sale within two years. If donors decide to go ahead and make the gift to the minor without employing a trust, the gift will have to be made to a custodian under a gifts to minors act or to a guardian of the property who is appointed to receive a gift, a generally undesirable and expensive procedure.⁶⁴ The Uniform Gifts to Minors Act provides only for gifts of annuity contracts, life insurance, securities, and cash,⁶⁵ and leaves uncovered a cornucopia of valuable property rights such as tangible personal property, realty, mineral interests, and intangibles such as patents and copyrights. Therefore, if a sale within two years is contemplated, in many cases guardianship is the only device left open to the donor. Because of the change in section 644 wrought by the 1976 Act and the limited utility of the Uniform Gifts to Minors Act, it would not be surprising if states amended their respective Gifts to Minors Acts to broaden appreciably the category of assets covered.

G. *Qualifying the Estate*

Preferential treatment is accorded estates under several sections of the Code if a given portion of the estate consists of certain types of assets. By engaging in a program of gift giving designed to qualify an estate under these various sections, a taxpayer may obtain a lower valuation of his remaining assets under section 2032A, allow his estate to engage in an advantageous delayed payment of the estate tax under either section 6166 or section 6166A, or permit his estate to employ a highly advantageous redemption under section 303.

tice, *Contract Rights, Capital Gain and Assignment of Income—The Ferrer Case*, 20 TAX L. REV. 1 (1964).

63. Tax Reform Act of 1976, Pub. L. No. 94-455, § 701(e)(1), 90 Stat. 1520 (codified at I.R.C. § 644).

64. See generally R. MACKEY, *THE LAW OF GUARDIANSHIP* ch. 2 (3d ed. 1980); *Symposium: Guardianship*, 45 IOWA L. REV. 209-413 (1960).

65. UNIFORM GIFTS TO MINORS ACT, Preface. The various state versions of the Uniform Gifts to Minors Act typically cover only a narrow class of assets. See, e.g., CAL. CIV. CODE §§ 1154-1165 (West Cum. Supp. 1980) (securities, money, life or endowment insurance policies, and annuity contracts); N.Y. EST., POWERS & TRUSTS LAW §§ 7-4.1 to -4.9 (McKinney Cum. Supp. 1979) (securities, life insurance policies, annuity contracts, and money); N.C. GEN. STAT. §§ 33-68 to -77 (Cum. Supp. 1979) (securities, money, and life insurance).

1. Qualificaton for Section 2032A Valuation

Under section 2032A, certain "qualified" real property⁶⁶ used in farming or in a trade or business can be valued for estate tax purposes at its present use value rather than at its best use or fair market value.⁶⁷ Since the methods prescribed for determining present use values, particularly those prescribed for farms, are generally quite favorable,⁶⁸ qualification under section 2032A will often provide the taxpayer with a substantial tax saving.

In general, to qualify for present use valuation: (1) fifty percent or more of the adjusted value⁶⁹ of the gross estate must consist of qualified realty and personalty; and (2) twenty-five percent or more of the adjusted value of the gross estate must consist of qualified realty.⁷⁰ The total reduction in value from the fair market value of these assets cannot exceed \$500,000.⁷¹ Given the proper set of circumstances, a taxpayer whose holdings do not qualify for section 2032A treatment could, through a well-conceived program of gift giving, qualify his estate for section 2032A treatment, thereby reducing his taxable estate by as much as \$500,000. For example, assume that an unmarried taxpayer possesses two assets: (1) a farm worth \$800,000 for speculative purposes and worth \$300,000 for farming purposes; and (2) \$900,000 of securities. By giving away \$100,000 of securities (much more is recommended to provide a cushion), the taxpayer, as a result of qualifying for the lower valuation, can effectively remove \$500,000 from his taxable estate, thereby reducing his estate tax bill by \$219,230.⁷²

66. I.R.C. § 2032A(b) generally requires that realty, in order to be deemed "qualified," (1) be located in the United States; (2) be passed from the decedent to an heir who is a member of the decedent's family; (3) be used for farming purposes or in a trade or business; (4) in five of the last eight years must have been used by the decedent or a member of his family in farming activities or in pursuit of a trade or business involving material participation by the decedent or a member of his family; and (5) that the qualified assets consist of certain percentages of the gross estate of the decedent.

67. *Id.* § 2032A. A full discussion of the highly technical requirements for qualification under § 2032A is beyond the scope of this Article. For thorough discussion of this section, see Carter, *The Application of Section 2032A to the Valuation of Timberland for Federal Estate Tax Purposes*, 29 S.C. L. REV. 577 (1978); Cox, *Estate Planning for Farmers after the Reform Act of 1976*, 14 WAKE FOREST L. REV. 577 (1978); Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609 (1978); Comment, *The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code*, 1977 B.Y.U. L. REV. 353 (1977).

68. See I.R.C. § 2032A(e)(7) & (8). Farmland is principally valued by capitalizing the average annual gross cash rental of comparable land (less real property taxes). The value of farmland consists of: (1) its immediate income potential; (2) its speculative value for farm purposes; (3) its speculative value for non-farm purposes. To derive the true value of land for farm purposes one should exclude only the third factor. By also excluding the second factor, § 2032A(e)(7) results in an understatement of the real farm value of land. Moreover, an executor not satisfied with the result of § 2032A(e)(7) can elect the valuation produced by § 2032A(e)(8) if that more open-ended method produces a more favorable result.

69. *Id.* § 2032A(b)(3) defines adjusted value as the gross estate less any debts allowed as a deduction under § 2053(a)(4).

70. *Id.* § 2032A(b)(1)(A) & (B).

71. *Id.* § 2032A(a)(2).

72. *Computation of Net Tax Absent Gift*

\$ 800,000 Farm
 900,000 Securities

Estate planners seeking to qualify an estate for section 2032A benefits should keep several factors in mind. First, it is highly advisable to err on the side of caution and insure that both percentage tests of section 2032A are satisfied with substantial margins for error. Because of fluctuations in values and difficulties in assigning accurate values to many assets, objective outside appraisers should often be employed to insure that the estate more than marginally qualifies for section 2032A. Curiously enough, executors may confront situations in which auditing agents, for the purpose of barring use of section 2032A, insist on lower fair market values for qualified realty and personalty than those shown on the return. Second, because of the automatic nature of section 2035 there is no place for last minute gift-giving programs aimed at qualifying for section 2032A or at correcting for value changes in assets in the estate—one additional reason for erring on the side of caution. Finally, just as a well-conceived gift-giving program can result in an estate qualifying for section 2032A benefits, an ill-conceived gift-giving program can result in disqualifying a previously qualified estate.

2. Qualification for Sections 6166 and 6166A Delayed Payment

Under sections 6166 or 6166A, an estate may qualify for favorable delayed payment of estate taxes if certain types of assets held by the estate constitute prescribed portions of the estate.⁷³ Qualification for deferred payment under section 6166 is contingent on the value of an "interest in a closely held business"⁷⁴ consisting of more than sixty-five percent of the value of the

\$ 1,700,000 Net Taxable Estate

Net tax on \$1,700,000 after unified credit of \$47,000 = \$598,800.

Computation of Net Estate Tax After Gift of \$100,000 of Securities

Gift tax on taxable gift of \$97,000 (\$100,000—\$3000 annual exemption) after unified credit of \$47,000 = \$0.

\$ 300,000 Farm (§ 2032A value)

800,000 Securities after gift

\$ 1,100,000 Net Taxable Estate

\$ 1,100,000 Net Taxable Estate

97,000 Adjusted Taxable Gifts

\$ 1,197,000 Base

Net tax on Base after unified credit of \$47,000 = \$379,570.

Tax Saving Due to Gift

\$ 598,800 Net Estate Tax Absent Gift

379,570 Net Estate Tax After Gift

\$ 219,230 Tax Saving

73. I.R.C. §§ 6166, 6166A. For a good recent discussion of the deferred payment provisions, see Blum & Bienemann, *Federal Estate Tax Deferral: New Challenges for Fiduciaries*, May 1980 TRUSTS & EST. 54.

74. In general, under I.R.C. § 6166(b)(1) the following interests in trades or businesses will qualify for classification as an "interest in a closely held business" under § 6166: (1) an interest in a proprietorship; (2) an interest in a partnership if 20% or more of the total capital interest in such partnership is included in the decedent's gross estate or if the partnership has 15 or fewer partners; or (3) an interest in a corporation if 20% or more of the total voting stock in such corporation is included in the decedent's gross estate or if the corporation has 15 or fewer shareholders.

adjusted gross estate. Executors of qualifying estates may elect to defer payment of the estate tax attributable to the closely held business for up to five years from the due date of the estate tax return.⁷⁵ Thereafter, pursuant to the executor's original election, the unpaid tax must be repaid in from two to ten equal annual installments. The deferred estate tax attributable to the first \$1,000,000 in value of a closely held business is subject to a bargain four percent per annum simple interest,⁷⁶ and the balance is subject to the moderately favorable regular rate for interest on deferred payments.⁷⁷

Qualification for delayed payment under section 6166A is contingent on the value of the estate's "interest in a closely held business"⁷⁸ exceeding either thirty-five percent of the gross estate or fifty percent of the taxable estate. Payment of the estate tax attributable to the interest in a closely held business⁷⁹ may then be made in as much as ten equal annual installments, the first of which must be made when the federal estate tax return is due.⁸⁰ The bargain four percent interest rate under section 6166 is not applicable to these deferred payments, which, however, do qualify for the moderately favorable regular rate for interest on deferred payments.⁸¹

The executor of an estate qualifying under these sections may elect under section 642(g) to treat the interest as an income tax deduction on the estate's tax return or as a deductible administration expense under section 2053(a)(2).⁸² Consequently, the estate that qualifies for deferred payment will enjoy not only the advantageous terms and interest rates that are available, but also will discover that payment of the interest called for by these sections itself may result in a lower estate tax than that otherwise due.⁸³ Since election of deferred payment treatment under either section will, however, result in a reduction in the adjusted gross estate, executors must be aware of the potential effect of this election on the marital deduction and on bequests affected by this decision, such as residuary bequests or bequests that are fractional portions of the adjusted gross estate.

A well-conceived gift-giving plan can play a vital role in securing the benefits of either section 6166 or section 6166A for taxpayers whose existing holdings fail to satisfy the percentage tests applicable to these two sections. As has been noted in the discussion of section 2032A above, caution warrants that the

75. The amount of the total tax qualifying for deferred payment is that percent of the total tax that the value of the closely held business bears to the adjusted gross estate. *See* I.R.C. § 6166(a)(2).

76. *Id.* §§ 6166(j)(4) & 6601(j).

77. *Id.* § 6621.

78. With one exception, the definition of "interest in a closely held business" employed in § 6166A is the same as the definition of that term in § 6166, discussed in note 74 *supra*. The single basic difference between the various definitions is that § 6166A employs a partner and shareholder numerical limitation of 10 rather than 15.

79. The amount of the total tax qualifying for deferred payment is that percent of the total tax that the value of the closely held business bears to the gross estate. I.R.C. § 6166A(b).

80. *Id.* § 6166A(e).

81. *Id.* § 6621.

82. *See* Estate of Bahr, 68 T.C. 74 (1977), *acq.* Rev. Rul. 78-125, 1978-1 C.B. 292.

83. *See* Blum & Bienemann, *supra* note 73.

percentage tests be satisfied with a comfortable cushion, that the gift-giving program not be put off until the waning years of the taxpayer's life, and that gift-giving programs undertaken for other purposes be scrutinized so that they do not encumber subsequent potential attempts to qualify the estate.

3. Qualification for Section 303 Redemption

Under section 303 the redemption of certain stock included in the gross estate can qualify for treatment as a sale of the stock. The amount that can so qualify is limited to the federal and state death taxes and funeral and administration expenses of the estate.⁸⁴ Redemption of the stock that most often qualifies for section 303 treatment would, under other circumstances, generally result in treatment of the proceeds of the redemption as dividend income. Given the return of the stepped-up basis rules of section 1014, an estate planner who can qualify an estate for section 303 treatment is providing his client with an opportunity to remove earnings from a corporation at no tax cost whatsoever.⁸⁵ Consequently, if a client possesses the requisite stock in a corporation with sufficient retained earnings that it is anxious to distribute, most estate planners will wish to do all in their power to take advantage of this section.

Qualification for section 303 treatment is contingent upon: (1) the value of the stock of the distributor-corporation included in the estate exceeding fifty percent of the adjusted gross estate; or (2) the value of the stock of two or more corporations (one of which is the distributor) included in the estate exceeding fifty percent of the adjusted gross estate, and the estate possessing more than seventy-five percent in value of the outstanding stock of all such corporations.⁸⁶ As with sections 2032A, 6166, and 6166A, a well-conceived gift-giving program can provide a means whereby an estate can qualify for the highly advantageous treatment accorded by section 303. Also applicable here are the same cautions that were voiced previously about the timing of the gift-giving program, the establishment of a substantial margin for error, and the need to avoid gift giving that runs the risk of encumbering future attempts to qualify an estate. Finally, it should be noted that, although sections 303 and 2032A are, practically speaking, mutually exclusive, an estate can qualify for both section 303 treatment and for section 6166 or section 6166A deferred payment.⁸⁷ Similarly, it is possible for certain estates to qualify for both section 2032A valuation and section 6166 or section 6166A deferred payment.

84. I.R.C. § 303(a).

85. Assuming that the redeeming corporation possesses sufficient earnings and profits, the shareholder generally is confronted with qualifying for either ordinary income treatment or sale or exchange treatment. In the latter case, a portion of the proceeds equal to the shareholder's basis will be a nontaxable return of capital and the balance will be treated as a capital gain. Section 303 generally will result in a totally nontaxable return of capital to the shareholder because of the § 1014 step-up in basis.

86. *Id.* § 303(b)(2).

87. See Rev. Rul. 72-188, 1972-1 C.B. 383.

H. Transferring Appreciating Assets

By transferring assets likely to appreciate and by retaining assets whose value is likely to remain static, taxpayers can realize significant tax savings. There is a dual benefit in transferring a rapidly increasing asset as an inter vivos gift. First, since the gift tax calculation is based on a lower value, a lower tax is paid. Second, the taxpayer avoids "bracket creep" by transferring appreciating assets before they place him in a higher estate tax bracket. The present inflationary environment intensifies concern with this latter factor.

The principal difficulty in putting such a plan into effect comes in identifying those assets that are most likely to appreciate in value. Short of explaining to a client the moderately unreliable general rules of thumb in this area, the attorney can be expected to provide the client with little real guidance. It is true that the virtually nonexistent, proverbial ignorant widow may benefit from an explanation that antiques, common stock, and land could generally be expected to appreciate more rapidly than bonds or preferred stock. In general, however, those who have succeeded in amassing sizeable estates are the most appropriate judges of the worthiness of their various investments for such purposes. There is often little the attorney can do to assist these clients in identifying assets fit for gift giving and retention. It is possible, however, that these clients might benefit from the estate planner's calling to their attention the availability of a recapitalization to freeze the value of some assets suitable for retention and to create a highly leveraged group of assets that are likely to appreciate rapidly and that are suitable subjects for gift giving.⁸⁸ In brief, however, this is an area in which an attorney, after explaining the basic advantage to his client, must largely defer to that individual's judgment.

I. Interest-Free Loans

In *Lester Crown v. Commissioner*,⁸⁹ a donor succeeded in establishing that there is no gift of imputed interest on non-interest bearing demand loans. The case has given rise to a substantial increase in the use of interest-free loans by estate planners. The desired advantages are threefold. First, the lender transfers something of value to the debtor without paying any gift tax. Second, if all goes well, at termination of the loan the subject matter of the loan will be returned to the lender. Third, the income on the loaned funds will be taxed to the debtor.

The Tax Court recently threw some cold water on the interest-free loan device in *Estate of Meyer E. Berkman*.⁹⁰ This case involved several low interest term loans for which the donor-lender received notes that, because of the stipulated low interest rates, had a fair market value of less than the money

88. See generally Coleman, *Preferred Stock Freeze*, 182 N.Y.L.J. 1 (1979); Ehrlich, *Corporate Recapitalization as an Estate Planning Business Retention Tool*, 34 N.Y.U. INST. FED. TAX. 1661 (1976); Williams, *Using a Recapitalization to Reallocate Equity Interests and Perpetuate Closely Held Status*, 32 N.Y.U. INST. FED. TAX., 715 (1974).

89. 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (7th Cir. 1978).

90. 48 T.C.M. 185 (P-H 1979).

loaned. Judge Fay held that there existed a taxable gift equal to the difference between the value of the loaned funds and the fair market value of the notes. He distinguished *Crown* on the ground that it involved demand rather than term loans and because the issue of the difference in value between loaned funds and the value of the notes had not been raised in *Crown*.⁹¹ It remains to be seen what the impact of *Berkman* will be on the gift tax treatment of interest-free loans. It is entirely possible that only demand loans will ultimately pass muster under *Crown*.⁹²

Assuming that the taxpayer's victory in *Crown* holds up, there are two principal subsidiary tax problems that lenders may confront in such circumstances. First, a taxable gift will occur if the loan is canceled or if the lender does not collect on the loan when due and allows the statute of limitations to run on collection.⁹³ Second, despite the hopes of taxpayers, there is a possibility that the lender may be taxed on the imputed interest income on the interest-free loan. The first of these subsidiary problems can be dealt with relatively easily by not allowing the statute of limitations to run on a debt. The second problem, however, admits of no such simple solution.

A number of scholars have dealt at length with the likelihood of the imputed income from an interest-free loan being taxed to the lender.⁹⁴ These authors suggest three possible lines of attack for the Service. First, through an expanded definition of the term "organization," section 482 might be applied to impute interest income to the lender. Second, the "substance over form" doctrine might be employed to cause the loan arrangement to be treated as a trust, thereby making the grantor trust rules⁹⁵ applicable to many such loans, especially demand loans and, assuming *Berkman* was decided incorrectly, term loans of a period of not more than ten years. Third, the assignment of income doctrine might be judicially expanded to tax the income from the principal of the loan to the lender.

Despite the positive assessment made by several authorities of the unlikelihood of the Service's succeeding in taxing the lender on the imputed interest

91. *Id.* at 188 n.2. See also Letter Rul. 7905090 (Nov. 2, 1978) (holding that a term loan at a bargain interest rate gives rise to a gift equal to the difference in value between the notes given by the debtor to the creditor and the amount of loan). Since payment of a demand loan can always be requested at any time, at the time the loan is made it will have a face value equal to its fair market value.

92. In *Berkman* the taxpayer died after making the low interest term loans, and his executor successfully sought to include only the fair market value of the note in the estate. Had the executor also succeeded in excluding the economic value of the low interest loans from the category of taxable gift, it would have been relatively easy to employ low interest term loans to reduce the taxable estate without making taxable gifts. Demand loans do not admit of such relatively easy manipulation of the taxable estate since they will be included in the estate at the face amount of the loan.

93. See *Estate of Grace E. Lang v. Comm'r*, 613 F.2d 770 (9th Cir. 1980).

94. See, e.g., Frazier, *Interest-Free Loans Between Family Members: What Practitioners Can Expect After Crown*, 48 J. TAX. 28 (1978); Roth, *Can Lender Be Charged with Receiving Taxable Income as a Result of an Interest-Free Loan?* 52 J. TAX. 136 (1980); Comment, *Income and Gift Tax Implications of Interest-Free Loans Between Relatives*, 1978 B.Y.U. L. REV. 155 (1978).

95. See I.R.C. §§ 671-678.

from these loans,⁹⁶ one should proceed with some caution in this area. It is most likely that, either by judicial opinion or by legislation, the imputed income will be taxed to the lender. Not to do so would amount to a de facto wholesale repeal of much of the grantor trust legislation. Nonetheless, high bracket taxpayers who wish to retain effective control over assets, but who also wish to see the income from the assets placed in the hands of others in a lower tax bracket, seem to have everything to gain and nothing to lose by structuring their transactions as interest-free demand loans.

J. Jointly Held Property and Marrieds

It is a basic truism of estate planning that it generally is unadvisable for a taxpayer to create a joint tenancy with the right of survivorship. Under section 2040 the full value of such property will be included in the estate of the first to die unless the executor can establish the portion of the original purchase consideration provided by the decedent and the survivor. If this can be established, the amount included will be the portion of the value of the property that the consideration provided by the decedent is of the original cost of the property.⁹⁷ Prior to 1976, for purposes of determining what consideration was provided by the survivor, a gift by the decedent to the survivor was disregarded, and the decedent was deemed to have also provided that portion of the original purchase price represented by the gift.⁹⁸ As mentioned previously, section 2040(b) now has been amended so that if one spouse furnishes the other with his or her portion of the purchase price, that amount may be counted as purchase price consideration provided by the recipient if certain requirements are met.⁹⁹

Despite the general unadvisability of creating joint tenancies with rights of survivorship, in some circumstances creation of these interests is highly justified.¹⁰⁰ When such a situation exists and the subject matter of the gift is likely to appreciate in value, spouses may find it desirable to take advantage of section 2040(b) so that only one-half of the joint property will become subject to estate tax upon the death of one of the spouses. Because of section 2056(c)(1)(B), however, such a gift will diminish the marital deduction potentially available to the donor. Therefore, section 2040(b) should be used only after giving this factor due consideration. Because of the \$3000 annual exclusion and the method in which section 2056(c)(1)(B) operates, in most cases this provision will produce considerably less than a dollar-for-dollar reduction in the maximum marital deduction. Moreover, if the joint tenancy does appreciate substantially in value, the negative impact of the section 2056(c)(1)(B) re-

96. See Letter Rul. 7731007 (Apr. 29, 1977), in which the Internal Revenue Service conceded that the judiciary has long held that there is no income recognized to the lender in an interest-free loan.

97. See I.R.C. § 2040.

98. I.R.C. (pre-1976 Act) § 2040, 68A Stat. 385 (1954).

99. See notes 23-25 and accompanying text *supra*.

100. See Rowder & Frazier, *Joint Tenancies in Estate Planning*, 3 NOTRE DAME EST. PLAN. INST. 353, 374-78 (1979).

duction in the marital deduction will be substantially outweighed by the reduction in the taxable estate that is effected. In closing, it should be observed that for post-1976 tenancies by the entireties in realty for which the gift election was not made, it is possible for taxpayers to take advantage of section 2040(b) by terminating and then recreating the tenancy by the entirety and electing to treat the re-creation as a gift.

K. Disposing of Taxable Strings

A taxpayer may own or control various rights with respect to property that will cause the property to be included in his estate at death under sections 2036-2042. If the rights giving rise to the inclusion are relatively modest when compared to the value to be included in the estate at death, a substantial tax saving can be realized by making a gift of the taxable string. For example, assume that years ago a taxpayer created a trust under which he retained the right to income¹⁰¹ and that the trust is now worth \$250,000. If the taxpayer, a seventy-six year old male, were to give away his income interest to his child, this would result in a taxable gift of \$78,902.50, which could effectively remove upwards of \$250,000 from the taxpayer's estate.¹⁰² One thing that must be borne in mind in these circumstances is the impact of the change in section 2035. Because of the automatic inclusion for all gifts within three years of death, severance of taxable strings is best attended to in other than the waning years.

L. Controlling Valuation

There are two distinct situations in which gift giving can be advantageously employed to obtain a lower tax liability than would result if the asset to be transferred were left in the estate. First, the donor-taxpayer can select the precise moment when a gift is made, thereby timing his gift to take advantage of market fluctuations that result in the lowest anticipated taxable amount. Second, the gift tax is imposed on the value transferred to the individual donee on a given day, whereas the estate tax is imposed on the full value transferred at death. Although the law in this area is not thoroughly developed, this basically piecemeal valuation of the estate for gift tax purposes and aggregate valuation of the estate for estate tax purposes seemingly provides the taxpayer with an opportunity to decide to give away or retain individual assets solely for the purpose of making the disposition most likely to result in the lowest taxable amount. For example, a taxpayer who owns a substantial tract of land worth \$200,000 and who gives away one-fourth of it to each of four different children can rightly claim that each undivided quarter is worth substantially less than \$50,000.¹⁰³ The claim for a lower valuation

101. See I.R.C. § 2036.

102. The amount "effectively" removed from the estate depends on whether the gift predated the 1976 Act, the amount originally treated as a taxable gift when the trust was created, and the tax paid on it. See *id.* § 2001.

103. See, e.g., *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962).

would be based on the special value attributable to the larger tract, the cost of severance proceedings, and the limited market for the undivided interest. Of course, if the same child were the beneficiary of all four gifts, each in a different year, and the child retained the gift property, although a valuation less than \$50,000 would be justified for the first gift, higher valuations probably would be justified for subsequent gifts since each such gift would properly be worth something more to the donee, thereby resulting in an aggregate gift of about \$200,000. Moreover, in addition to selecting different donees for each such interest given, to avoid the Service's contention that the totality of gifts in a given quarter is the proper base for determining gift tax liability, it probably would be wise to make separate gifts in different quarters.

On the other hand, large blocks of assets such as securities, which would qualify for blockage discount, generally should be left in the estate in order to take advantage of this discount. An exception to this, of course, is a large block of stock that is to be given to a single donee. In such a case, blockage discount would be available to the donor on the gift. When, however, the block is to be given to a number of beneficiaries, blockage discount would be maximized by leaving the stock in the estate.

IV. ADDITIONAL CONSIDERATIONS

The various advantages of gift giving mentioned above might, by themselves, be sufficient to cause a taxpayer to embark on a gift-giving campaign. Such a decision, however, should not be made without evaluating a number of tax and nontax considerations, all of which must be individually explored with great care. There are at least four important tax and numerous nontax considerations that must be weighed carefully in deciding to make a gift. From a tax standpoint one must consider at least the following: (1) the impact of a gift on the marital deduction; (2) the negative impact of a gift on certain estates; (3) the impact of a gift on the income tax liability of the donor and donee; and (4) the lack of a credit for state gift taxes.

Since most gifts that escape the reaches of section 2035 place property outside of the gross estate of the decedent, they quite expectedly will reduce the maximum amount allowable as a marital deduction under section 2056.¹⁰⁴ Assuming that the taxpayer wishes to make maximum use of the marital deduction, the tax consequences of a lesser portion of the taxpayer's net worth qualifying for the marital deduction due to a gift being made must be weighed against the financial benefit secured by the gift. Since the marital deduction often results in little more than a deferral and a splitting of estate tax liability, dollar-for-dollar comparisons will be of little use unless such figures are dis-

104. I.R.C. § 2056. Of special note are gifts to the spouse that qualify for the § 2523 deduction. Because these gifts can effect a reduction in the marital deduction under § 2056(c)(1)(B), they appear at first blush to be matters of prime concern. Because, however, a reduction effected is merely compensating for only a portion of the property transferred to a spouse free of tax, one ought not allow § 2056(c)(1)(B) to deter one from making an otherwise desirable gift since the additional tax imposed by the section's reduction in the marital deduction will be more than compensated for by the tax saved by the § 2523 deduction.

counted properly. Often enough, the other tax savings produced by the gift will more than compensate for the reduction in the maximum marital deduction produced by the gift. For example, although gifts that allow an estate to qualify for a section 303 redemption result in a diminution of the dollar amount of the maximum marital deduction allowed to the estate, the resulting saving in income taxes provided by section 303 may substantially exceed the discounted value of the projected additional aggregate gift and estate tax. Moreover, if the gift is to a spouse and qualifies for the gift tax marital deduction, the benefit of that deduction and other benefits such as the \$3000 annual exclusion will often equal or outweigh any negative impact of a gift on the estate tax marital deduction. Finally, the potential negative impact of gifts on the marital deduction is of no concern to widows and other unmarried taxpayers and to married taxpayers who, for valid tax and nontax considerations, do not wish to make maximum use of the marital deduction.

Also to be considered is the potential negative impact on the estate tax occasioned by gifts affecting benefits other than the marital deduction. Gifts that disqualify the estate for special treatment under sections 303, 2032A, 6166, or 6166A or under blockage discount valuation principles are the chief types of transfers that come within this category. For example, a taxpayer who attempts to affect valuation by giving away undivided interests in farmland to various donees (with all parts valued at less than the whole) may discover that his aggregate tax bill has been increased because: (1) the farmland given cannot now qualify for section 2032A valuation; or (2) the section 2032A assets retained are now an insufficient portion of the estate to allow the estate to qualify for the lower valuation.

Just as income tax and not estate and gift tax considerations sometimes mandate that a gift be made, they also on other occasions demand that a taxpayer not make a gift. The two most common situations involving gifts that probably should not be made because of income tax considerations are: (1) gifts of income producing property, or of appreciated property ripe for sale, to donees in tax brackets substantially higher than that of the donor; and (2) gifts of property that, because of the differing basis rules of sections 1014 and 1015, should be retained by the donor for sale or inclusion in his estate. The recent total reinstatement of section 1014 has restored the old general rules of thumb that: (1) vastly appreciated property generally should be retained in the estate to allow the heirs to take advantage of the stepped-up basis; (2) property that has declined in value should be sold by the donor if he can avail himself of the loss;¹⁰⁵ and (3) to the extent possible, gifts should be made in the form of cash or assets whose adjusted basis closely approximates their fair market value. Of course, an accurate appraisal of whether a particular asset should be given

105. If the donor cannot take advantage of the loss, a gift of this property is preferable to leaving it in the estate. Although § 1015 provides that the donee must use as his basis, for the purpose of determining loss, the fair market value of property when at the time of the gift that value was less than the donor's basis, if the property subsequently rises in value the donee will be allowed to use all or a portion of the donor's basis when to do so will result in no loss or a gain. See Treas. Reg. § 1.1015-1(a)(2) (1964).

to a donee should be made only after a thorough analysis and weighing of the gift, estate, and income tax consequences to donor and donee.

The last remaining major tax consideration that must be evaluated in determining whether a gift is called for is the lack of a credit for state gift taxes that is parallel to the credit for state death taxes provided by section 2011. This factor, of course, is only of concern in those fifteen states that impose a gift tax. This absence of a credit for state gift taxes means that in states with a gift tax the net combined state and federal after-tax cost of gifts actually will be somewhat higher than it would appear to be at first blush. The loss of a credit, however, in most cases probably will not be sufficient to cause one to abandon an otherwise financially beneficial gift-giving program so that the assets can be left in the estate to take advantage of the section 2011 credit for state death taxes. Nonetheless, the impact of the absence of a credit for state gift taxes is a factor that must be considered in reaching a decision to embark on a gift-giving program.

Although it is not the purpose of this Article to explore nontax advantages and considerations involved in gift giving, one particular nontax consideration—the importance of preserving estate liquidity—should be noted because of its interrelationship with various tax considerations. Because of the need to provide for medical, funeral, and administration expenses as well as state and federal death taxes, it is highly desirable that a substantial portion of the estate consist of liquid assets that can be used to satisfy these needs. Highly liquid assets, however, are often the most logical candidates for gift giving. For example, cash and listed securities provide the least complicated means whereby a donor can: (1) undertake a widespread gift-giving campaign taking advantage of the \$3000 per donee annual exclusion; or (2) qualify the estate for favored treatment under sections 303, 2032A, 6166, or 6166A. In a nice turn of events for the taxpayer, his need for liquidity is reduced to the extent his gift results in a substantial reduction in estate taxes or qualifies the estate for special treatment.

V. CONCLUSION

The Tax Reform Act of 1976 has had a substantial negative impact on the extensive role that gift giving had played in estate planning. A well-conceived program of estate planning can, nonetheless, in certain situations still result in substantial tax savings to donor and donee. Although gift giving will only result in modest tax savings in most estates, in certain specific situations the opportunities for saving are substantial. A critical function of the estate planner will be to recognize these situations for his client and to develop a gift-giving program that produces the minimum tax burden for his client consistent with the client's basic gratuitous intentions.