Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2022
Date: 06-Nov-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: Pennell and Baskies: Does the Gift by Promise Plan Work?

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

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

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Here is their commentary:

EXECUTIVE SUMMARY:

In **LISI** Estate Planning Newsletter #2001, **Austin Bramwell** and **Lisi Mullen** posited that a taxpayer can create a state-law enforceable promise, and thereby make a completed gift, by receiving consideration - like a child's promise to send grandchildren to a particular school – that is not money or money's worth. We accept this proposition as true (solely for purposes of this commentary) because our *concern* is the federal wealth transfer tax consequences of the proposition itself. If this technique worked as represented, it would be a boon to any client who would prefer to take advantage of the

$5.12 million exclusion amount without actually transferring assets (or relinquishing the income generated from them).

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

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

FACTS:

The "Gift by Promise" Concept

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

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

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

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

Tax Analysis of Why the Technique Fails

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

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

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

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

No Gift		Gift
$6,000,000	Taxpayer's Net Worth	$6,000,000
0	Enforceable Gift	5,000,000
0	Gift Tax Payable	1,730,800
(0)	Unified Credit Used	(1,730,800)
0	Gift Tax Actually Paid	0
6,000,000	Taxable Estate	6,000,000
0	Adjusted Taxable Gifts	0
6,000,000	Total Amount Taxable	6,000,000
2,940,800	Tax on Total	2,940,800
(0)	Credit for Gift Tax Payable	(2,045,800)
(345,800)	Unified Credit	(345,800)
1,595,000	Tax at Death	550,000

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

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

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

§2001(b) COMPUTATION OF TAX.—The tax imposed by this section shall be the amount equal to the excess (if any) of—

> (1) a tentative tax computed under subsection (c) on the sum of—
>
> > (A) the amount of the taxable estate, and
> >
> > (B) the amount of the adjusted taxable gifts, over
>
> (2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts.
>
> For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

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

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

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

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

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

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

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

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

There are several reasons why the Code uses the word *"payable"* instead of "paid." One is because the taxpayer may die before any gift tax owed actually is paid. The word "payable" is more appropriate if the gift tax is owed but it has not yet been paid. A more important second reason is because Congress anticipated the exact opposite situation of what will occur at the end of 2012. Congress' vision was of the tax rates declining and

the exclusion amount increasing. In which case, Congress did not want a taxpayer who paid gift tax at a higher rate, applicable in the year of an inter vivos transfer, to have a credit that exceeds the estate tax calculated at lower rates in the year of death. The gift tax payable language precludes the taxpayer from applying the excess gift tax paid inter vivos against the estate tax on other wealth that remains includible at death.

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

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

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

The Common Sense Analysis: Substance Over Form

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

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

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

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

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

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

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

COMMENT:

Who *Might* Still Consider the “Gift by Promise” Plan?

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

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

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

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

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

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

Planners Should Properly Set Expectations

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

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

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

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

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