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

Date: 10-Dec-12

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Pennell & Baskies: Final Words on Gift-by-Promise Technique**

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

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

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

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

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

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

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

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

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

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

Here is their commentary:

EXECUTIVE SUMMARY:

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

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

COMMENT:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Jeff Pennell

Jeff Baskies

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

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

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

Tax Lawyer: Correct, your honor.

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

T: Also correct.

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

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

C: How so — what transfer was there?

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

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

T: I can explain the difference

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