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TRANSACTIONS WHICH MAY BE EFFECTED DURING THE OWNER'S LIFETIME

II

GIFTS TO IMPROVE THE FAMILY'S OVER-ALL TAX SITUATION

Sterling Newell, Jr.*

INTRODUCTION

The owner of a family business who finds himself in a high income tax bracket and whose estate will be subject to heavy estate taxes on his death is in effect faced with two choices: (1) he may give his property away, or (2) the Internal Revenue Service will appropriate much of it. This article discusses the possibilities available to individuals who elect the first of these alternatives. The first section examines the tax savings that may be realized by shifting income from high to low bracket taxpayers and by eliminating property from taxpayer's taxable estate. For the purpose of emphasizing the substantial savings that may be realized by gift programs, the tax consequences of two gift programs as applied to a hypothetical family situation are examined. The second section considers questions relating to the choice of the assets to be used in a gift program, examining matters relating to basis and a variety of particular factors involved in making gifts of assets of the type commonly owned by the owners of family businesses. The next article in this symposium examines the various techniques which may be employed in making gifts.¹

THE INTERPLAY OF INCOME, ESTATE, AND GIFT TAXES

As gifts may substantially reduce the burden of income or estate taxes or both, the government naturally imposes a price, in the form of the gift tax, on such transfers. The objective of a gift program must thus be to realize the greatest possible net tax savings. In a discussion of the tax consequences of making gifts generalizations are of little use. Rather, the effect in terms of estate, income, and gift taxes of any contemplated gift must be determined and compared with the consequences of making the gift in another manner, at another time, in another amount, or not at all. It should be particularly noted that the form in which the gift is cast will in large measure determine whether the gift results primarily

* The author acknowledges the assistance rendered by his associate, Richard T. Watson, in the preparation of this article.

1. Hawkins, *Planning the Form of the Gifts*, p. 300 *infra*.

in income tax savings or primarily in estate tax savings. This may best be illustrated by the examination of two relatively simple gift programs as applied to a hypothetical family situation.

Assumed Factual Situation

Mr. Jones, president of the Jones Manufacturing Company is a fifty-five-year-old widower with three children, two daughters and one son, all of whom are married and self-supporting, and ten minor grandchildren. He contributes \$5,000 annually toward the support of his parents, both of whom are eighty-five and would like to make gifts to his grandchildren.

Mr. Jones' estate consists of a \$500,000 portfolio of diversified stocks with an average yield of four per cent and all of the outstanding stock of the Jones Manufacturing Company which has a probable value of \$500,000 and is non-productive. His disposable income after taxes is as follows:

Salary	\$ 50,000.00
Income from Investments	20,000.00
<hr/>	
Total	\$ 70,000.00
Less taxes of	\$ 33,520.00 ²
Less gift to parents	5,000.00
<hr/>	
Disposable Income	\$ 31,480.00

Mr. Jones plans to retire in ten years, at which time his income from the Jones Manufacturing Company will drop to \$20,000 a year, reducing his overall income to \$40,000 per year. The estate tax payable on Mr. Jones' death would be approximately \$290,000.³

A Gift Program to Save Income Taxes

At the outset three things should be noted about Mr. Jones' situation: (1) He has a large current income which is taxed at a high marginal rate but which will decline at a fixed time in the future; (2) he is already making gifts out of his after-tax income and desires to make more gifts; (3) he has income-producing property.

With these factors in mind, consider the following proposal:

Proposal I

Establish a short term reversionary trust for each parent and a short term reversionary trust and a present interest trust under section 2503(c) for each grandchild. The income of the short term trusts for the parents would be payable to the parents and that of the short term trusts for the grandchildren would be payable to their respective present interest trusts.

2. Assuming deductions, exclusions, and exemptions total \$10,000, the marginal tax rate is 78%.

3. This allows for reasonable estate tax deductions.

Transfer \$25,000 in high yield securities to each of the trusts for the parents and \$10,000 of high yield securities to each of the short term trusts for the grandchildren. Create and fund identical short term trusts the following year with similar securities in like amounts. The total value of the securities transferred to the trusts would be \$300,000. The assumed total annual yield on these securities would be \$15,000. These trusts will terminate ten years from the time of their creation or upon the prior death of their respective beneficiaries whereupon the corpus of the trusts will revert to Mr. Jones.

The tax consequences of Proposal I are (excluding consideration of possible capital gains)⁴ as follows: Assuming that the appropriate statutory requirements are met,⁵ \$15,000 of dividend income which was formerly received by and taxed to Mr. Jones will be diverted to his parents and grandchildren. While this shift reduces Mr. Jones' pre-tax income by \$15,000, it likewise reduces his annual income tax by approximately \$10,500. Moreover, Mr. Jones may discontinue making his annual gifts to his parents. As a result, his disposable income is actually increased by \$500.00.

	<i>Before Gift</i>	<i>After Gift</i>
Taxable Income -----	\$ 70,000.00	\$ 55,000.00
Income Tax ⁶ -----	33,520.00	23,020.00
Gift to parents -----	5,000.00	
	<hr/>	<hr/>
Disposable Income -----	\$ 31,480.00	\$ 31,980.00

Mr. Jones' parents will still receive \$5,000 annually. As the funds will now come to them from a trust rather than from Mr. Jones, the \$5,000 income will be taxable to them. However, in the light of their exemptions and medical deductions their tax will be nominal or non-existent.

Similarly, the income tax on the income received by each of the grandchildren's present interest trusts would be only \$136 or a total of \$1,360, annually.⁷ Thus, by implementing Proposal I, Mr. Jones will be able to continue to give \$5,000 annually to his parents, to begin giving \$8,640 (\$10,000 dividend income less \$1,360 income tax thereon) annually to his grandchildren, and to increase his own disposable income

4. For a discussion of capital gains problems incident to a short term reversionary trust, see Hawkins, *Planning the Form of the Gifts*, pp. 307-08 *infra*.

5. See Hawkins, *Planning the Form of the Gifts*, pp. 305-08 *infra*. For additional background concerning the taxation of reversionary trusts, see Craven, *Practical Uses and Problems of Short Term Trusts*, N.Y.U. 16TH INST. ON FED. TAX 903 (1958); Kirby, *Current Developments in the Use of Trusts and Estate Planning*, U. SO. CALIF. 1959 TAX INST. 627; Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance*, 60 COLUM. L. REV. 326 (1960); Youhlin, *The Short Term Trust — A Respectable Tax-Saving Device*, 14 TAX L. REV. 109 (1958).

6. This assumes that deductions, exclusions, and exemptions total \$10,000.

7. This assumes that the trusts do not distribute the income received and have no deduction for operating expenses.

by \$500 annually. Total tax savings over a ten-year period would be approximately \$91,400.⁸

No gift tax would be payable on the transfers contemplated in Proposal I as the gifts would all fall within the annual \$3,000 exclusion.⁹ For the purposes of the imposition of the gift tax, the value of the right to receive the income from a reversionary trust is the value of what the donor has given up, that is, the difference between the value of the property placed in trust and the value of the donor's reversionary interest therein.¹⁰ The value, for the purposes of the annual exclusion, of such a gift is the value of the right to receive income from the property for the applicable period.¹¹ So long as the reversionary trust terminates at the end of the applicable period or upon the death of the income beneficiary, whichever is earlier, these values will be identical.¹² Each of the gifts contemplated in Proposal I would be valued for the purposes both of the imposition of the gift tax and the annual exclusion at approximately \$3,000 and would thus not be subject to tax. Until recently there has been some doubt as to whether the right to receive income from a reversionary trust qualifies for the annual exclusion; however, this uncertainty appears to have been resolved in favor of the taxpayer.¹³

A Gift Program to Save Estate Taxes

While Proposal I does result in very substantial income tax savings, it has little or no estate tax consequences as the corpus of the trusts will revert to Mr. Jones after the ten-year period and in the event of his prior death, the value of the reversion is includible in his estate.¹⁴ Thus, nearly one-third of Mr. Jones' estate will be consumed by estate taxes on his death. It should be noted, however, that he owns a substantial amount of non-income producing property which can be given away without reducing the funds available for his support during retirement. With these factors in mind, consider:

8. Jones' annual income tax before gift		\$33,520.00
Less: Jones' income tax after gift	\$23,020.00	
Grandchildren's trust total annual tax	1,360.00	24,380.00
Annual tax Savings		\$ 9,140.00
		X 10 years
Total income tax saving over 10-year period		\$91,400.00

9. INT. REV. CODE OF 1954, § 2503(b) [hereinafter cited as CODE §].

10. Treas. Reg. § 25.2512-5 (1958) [hereinafter cited as Reg. §].

11. Rev. Rul. 54-344, 1954-2 CUM. BULL. 319.

12. See Formulas 14.1 and 14.2 in U.S. Treasury Dept. Publication No. 11 Rev. 5-59. *Actuarial Values for Estate and Gift Tax*, p. 31.

13. See Hawkins, *Planning the Form of the Gifts*, p. 306 *infra*.

14. Reg. § 20.2031.7 (1958).

Proposal II

Mr. Jones gives property valued at \$10,000 to each child and annually thereafter gives property valued at \$3,000 to each child, spouse of a child, and grandchild. The total value of property given over a period of, for example, six years, would be \$318,000.

Although Proposal II contemplates the transfer of assets of a value comparable to that involved in Proposal I, its consequences are quite different.

While implementation of Proposal I would have no effect on the estate tax to be imposed on Mr. Jones' death, the gifts in Proposal II, which contemplates the elimination of property of the value of \$318,000 from Mr. Jones' taxable estate, would reduce the estate tax by approximately \$115,000.¹⁵ To the extent that the property given away under Proposal II produces income, income tax savings would be realized to the extent of the difference in the marginal tax rates of Mr. Jones and his donees. However, if non-productive stock such as that of Jones Manufacturing Company were given, no income tax savings would be realized. As will be discussed subsequently, if the stock given has a market value in excess of its basis in Mr. Jones' hands, the gift may have adverse tax consequences in the event of the subsequent sale of the stock by the donee.

No gift tax would be payable in connection with Proposal II as all gifts would fall within the lifetime exemption or the annual exclusion.¹⁶

Summary of the Two Proposals

Thus, in brief, while each proposal contemplates the transfer of approximately \$300,000 of securities, Proposal I will lead to income tax savings of \$91,000 over a ten-year period but no estate tax savings. On the other hand, Proposal II will reduce the potential estate tax liability by \$115,000 but result in little or no immediate income tax savings. Neither proposal would result in the imposition of a gift tax. Moreover, Mr. Jones could make the gifts contemplated by Proposal I at ages fifty-five and fifty-six and the gifts contemplated by Proposal II during the six years thereafter, thus realizing both the income and the estate tax savings, and still incur no gift tax.

From the foregoing analysis, it should be apparent that very substantial net tax savings can be realized through a gift program and that whether these savings take the form of a reduction of income or estate tax primarily depends on the form in which the gift is cast. However, while it might appear that the tax consequences of a gift program can be stated with relative certainty, this is not the case. In the above discussion, for

15. The property transferred would otherwise be taxable at an approximate average rate of 36%.

16. CODE §§ 2503(b), 2521.

example, the effect of gifts of stock in Proposal II on the tax payable on the eventual sale of the securities involved was, for the purposes of simplicity, ignored. In actuality, this effect, along with other considerations relating to the specific assets given rather than to the family tax situation generally, may be of great importance. The second portion of this article examines these considerations which center about the specific assets to be used in a gift program. Because of the wide variety of considerations involved, the discussion in the second portion of the article is in the abstract rather than with reference to Mr. Jones.

SELECTING THE PROPERTY TO BE GIVEN: BASIS AND RELATED CONSIDERATIONS

To evaluate the effect of a gift program on the tax consequences attendant to the eventual sale of the assets involved, the statutory provisions governing the basis of property acquired by gift must be compared with the provisions governing the basis of property acquired by bequest or devise. For the purposes of determining gain upon the sale or exchange of property received by gift, a donee takes the donor's basis, increased (but not above market at the time of the gift) by the gift tax paid in respect of the gift. For the purpose of determining loss, the donee takes as his basis the lower of the donor's basis (adjusted for gift tax paid as above) or market value at the time of the gift.¹⁷ In contrast, a legatee takes as his basis the market value of the assets as of the date of death of the decedent from whom the assets were acquired unless an estate tax return is filed and the alternative valuation date is elected in which event the values on the latter date control.¹⁸ Thus, while in the case of non-appreciated property it makes little difference whether property is acquired by bequest or gift, in the case of appreciated property receipt of the property by bequest will result in a stepped up basis while receipt by gift will not. This might appear to suggest that it is always wise to give non-appreciated assets rather than appreciated assets. However, any such decision must be taken in light of the consequences of the possible future growth of the assets to be given.

The gift of an asset which, subsequent to its transfer, substantially increases in value will shift the appreciation to the donee whereas retention of assets likely to appreciate in value will operate to increase the estate taxes payable on their owner's death. This might appear to suggest that it is always wise to give assets with growth potential rather than those without.

The difficulty with such general statements is that the same factors

17. CODE § 1015.

18. CODE § 1014.

which have led to an asset's past appreciation in value (and hence its relatively low basis and desirability for retention in the donor's estate) are likely to be factors that will lead to continued appreciation in value (and hence desirability for current gifts). Confronted with this dilemma, or its reverse in the form of high-basis, non-growth assets, other factors assume increased importance.

If a choice must be made between a gift of an appreciated growth stock or of a high basis preferred, the income produced by the security should be considered. Where there is a substantial disparity between the marginal tax rates of the donor and the donee, it is normally preferable to give high rather than low income property so that additional income tax savings can be realized even in a program primarily concerned with reducing estate taxes.

Another factor of importance is whether or not the asset will be sold and, if so, when. For example, if a high-bracket taxpayer contemplates both making a gift to a low-bracket donee and selling some highly appreciated property, it is wise to give the appreciated asset to the donee and to have the donee make the sale, thereby having the gains taxed at a lower rate. If, on the other hand, the donor contemplates a gift and the sale of property whose basis exceeds market, the donor should sell the property himself and give the proceeds to his donee. Otherwise, the capital loss deduction will be lost.

In the case of a donor of advanced age who holds a substantial block of highly appreciated securities which his children will wish to sell for purposes of diversification, it may be wise for those securities to be retained by the donor until his death in order that they may obtain a stepped up basis irrespective of the fact that this may result in a slight increase in estate tax as a result of further appreciation. In contrast, highly appreciated securities of the family business may be used for current gifts irrespective of basis considerations if disposal of the family business in a taxable transaction is not contemplated.

Finally, the impact of charitable giving must not be ignored. A taxpayer in the seventy-five per cent bracket contemplating the sale of \$10,000 worth of securities with a zero basis and a gift of the proceeds to his son could give the securities to a charity and give the \$7,500 tax savings resulting from the charitable deduction to his son, thus turning a \$7,500 gift into a \$17,500 gift at no additional cost to himself.¹⁹

Consideration of the factors discussed above: basis, growth, income, and probability of sale, will cover the most significant tax consequences of the giving of many of the assets likely to be possessed by the owner of a family business such as common and preferred stock, notes, and similar intangible assets.

19. Rev. Rul. 55-410, 1955-1 CUM. BULL. 297.

However, the use of certain assets to shift the income from the family business requires particular care. To the extent that gifts of these assets are non-reversionary, the basis and other factors discussed above are of importance. In addition, however, attention must be given to problems peculiar to the assets involved. As illustrations of the problems involved, consider three assets: patents, real estate, and Subchapter S stock.

Patents

Gift planning involving the use of patents is a particularly uncertain undertaking. It is difficult to value a patent at the time it is secured and even more difficult to predict the value of the patent over the years to come because of the inherent vulnerability of a patent to attack or to technical obsolescence. Care must be used to insure that the transfer of a patent involves a gift of income producing property rather than an assignment of income and that the inventor has parted with substantial control of the patent. While it is now reasonably clear that the gift by an inventor to members of his family of a patent license agreement with a third party is effective to shift income, the extent to which this can be said with regard to license agreements involving a family business remains unclear.²⁰

Further, the effect of the gift of a patent or license agreement on possible capital gains treatment of the proceeds from sale or license of the patent requires attention.²¹ Finally, in the case of patents developed by the owner of the family business while working for his corporation the question of shop rights — the right of the corporation-employer to claim an implied license to use the patent — must be examined.²²

However, under circumstances which render the several uncertainties above minimal or at least of minor relative importance, gifts of patents can be quite valuable in gift programs designed to shift income, as a patent will normally generate a substantial amount of income relative to its value for gift tax purposes. On the other hand, because of its comparatively short life and attendant normal decline in value over its life span, a patent is usually undesirable for use in programs designed to reduce estate taxes.

20. Compare *Commissioner v. Sunnen*, 333 U.S. 591 (1948); *Heim v. Fitzpatrick*, 262 F.2d 887 (2d Cir. 1959); *Commissioner v. Reece*, 233 F.2d 30 (1st Cir. 1956), *non acq. withdrawn*, 1960-1 CUM. BULL. 5, and *John T. Potter*, 27 T.C. 200 (1956), *acq.* 1957-2 CUM. BULL. 6.

21. See generally, Griswold, *Disposition of Inventions (Patented and Unpatented)*, 12 WEST. RES. L. REV. 338 (1961).

22. 35 AM. JUR. *Master & Servant* § 95 (1941).

Real Estate

Gifts of real property also may afford the opportunity of shifting income and may, under certain circumstances, offer the opportunity for shifting substantial growth potential to the hands of the donees.²³ However, as is the case with patents, the donor must be alert to the possibility that the gift will be characterized as an assignment of income.

The owner of property in the path of urban expansion may, for example, give his property to his donees. Thus, in addition to eliminating the value of the property from the donor's estate, the donor will have shifted the anticipated increase in the value of the property to his donees. This same shifting of anticipated growth to the donees may be accomplished by the donor's incorporating the property and taking back preferred stock or notes in an amount equal to the value of the property, together with common stock which would carry negligible value for gift tax purposes. Gifts of the common stock to his donees would transfer the appreciation to them. However, where, in contrast to the above examples, the gifts are used primarily to shift income, considerable care must be exercised. For example, the gift by a lessor of a lease to a ten-year reversionary trust which provided that the trustee was forbidden to assign or transfer the lease was ruled to be ineffective to shift income.²⁴

However, gift and leaseback arrangements involving independent trustees and reasonable rentals have been held effective although contrary results have also been reached.²⁵ In the case of a donor who owns real estate needed by the donor's corporation a successful leaseback will lead to the result that the corporation, secures a rental deduction and the rental income is taxed to the donees. As a variant on this technique, the donor-lessee, having secured an advantageous lease and contemplating a profitable sublease of the property might successfully shift the profit by making a gift of the leasehold.

Completely apart from possible tax savings, gifts of real property may greatly simplify the administration of the donor's estate and provide for the orderly devolution of interests in the real estate involved. A piece of real estate owned in varying undivided interests by a multitude of individuals is an awkward asset. If the owners of the undivided interests seek to simplify the situation by transferring their undivided interests to a trustee and taking back beneficial interests in the trust the problem of an association taxable as a corporation is likely to arise.²⁶ However, if

23. See generally, Vogeler, *Tax Problems Incident to Planning With Real Estate*, 11 WEST. RES. L. REV. 258 (1960).

24. Rev. Rul. 58-337, 1958-2 CUM. BULL. 13.

25. See, e.g., *Potter Electric Signal & Mfg. Co. v. Commissioner*, 286 F.2d 200 (9th Cir. 1961); *W. H. Armston v. Commissioner*, 188 F.2d 531 (5th Cir. 1951); *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948).

26. See *Morrissey v. Commissioner*, 296 U.S. 344 (1935).