

# estate planning



ROGER A. PIES, Esq.,  
partner,  
Cohen and Uretz,  
Washington, D.C.



DANIEL S. GOLDBERG, Esq.,  
associate professor of law,  
University of Maryland School of Law,  
Baltimore, Md.

## Lifetime gifts—a quantitative approach

### Introduction

The Tax Reform Act of 1976 significantly reduced the tax benefits associated with lifetime gifts.<sup>1</sup> Nevertheless, significant tax benefits remain. New planning techniques are required, however, to take full advantage of those benefits which have either been left untouched or modified as a result of the changes made in the estate and gift tax laws.

An understanding of the manner by which wealth transfers are taxed is essential to a consideration of the tax benefits of lifetime gifts. As a result of the '76 Act, a single "unified" wealth transfer tax is imposed on the transfer of property during lifetime and at death. The purpose of the unified transfer tax system is, in general, to impose the same tax whether property is transferred to an individual's heirs during lifetime, or is held until death and subjected to the estate tax.

Under the unified tax system, a gift tax is imposed on the value of property transferred by gift, using the same rates applicable to estates. A unified tax credit is provided against gift tax which, after an initial phase-in period, amounts to \$47,000 for gifts made after Dec. 31, 1980.

<sup>1</sup> For a discussion of the tax benefits of making gifts prior to 1977, see Goldberg and Pies, "Lifetime Gifts in 1976: Planning and Strategy," *TTA*, Dec. 76, p. 716.

Further, the estate tax under the unified estate and gift tax system takes into account both taxable gifts made after Dec. 31, 1976, and property owned by, or otherwise included in the gross estate of, the decedent at the time of his death.

**Computation.** The estate computes its estate tax liability in two steps. First, a "tentative" estate tax is computed on the sum of (i) the taxable estate plus (ii) taxable gifts made after Dec. 31, 1976 (such sum is hereinafter called the "estate tax base"). The tentative estate tax is then reduced by the gift tax payable on gifts made after Dec. 31, 1976 to arrive at the "gross estate tax."<sup>2</sup> The estate tax credit which, after an initial phase-in period, amounts to \$47,000, and any other available tax credits, are then subtracted from the gross estate tax to compute the final estate tax liability.

The method of computing estate tax is illustrated by the following example. Assume that an unmarried individual's taxable estate is \$2,000,000, and the individual has made \$1,000,000 of adjusted taxable gifts after 1976.<sup>3</sup> The tentative estate tax,

<sup>2</sup> Sec. 2001(b). The calculation of the "gross estate tax" under pre-1976 Act law is set forth in Regs. Sec. 20.0-2(b)(4).

<sup>3</sup> Under Sec. 2001(b), "adjusted taxable gifts" are those that are complete for tax purposes and are "taxable gifts" within the meaning of Sec. 2503, and are not includible in the gross estate of the donor by reason of, for example, the provisions of Secs. 2035, 2036, 2037, or 2038.

computed on \$3,000,000, would be \$1,290,800. The gift tax payable on post-1976 gifts is allowed as an offset against the tentative estate tax. The gift tax would be \$298,800, assuming that the individual had not made any pre-1977 taxable gifts and that the full \$47,000 gift tax credit was available. Thus, the gross estate tax would be \$992,000. The gross estate tax is then reduced by the estate tax credit, which would be \$47,000 if the decedent died after 1980.<sup>4</sup> Accordingly, the estate's federal estate tax liability would be \$945,000.<sup>5</sup>

**Classification of gifts.** With this introduction to the wealth transfer tax system, the tax benefits of lifetime gifts may be considered. For purposes of discussion, we believe it is appropriate to classify gifts into two basic categories: gifts without gift tax and gifts that incur gift tax. The tax benefits associated with tax-free gifts are, of course, obvious. The tax benefits associated with gifts that incur gift tax, however, are not. In both cases, a decision on whether to make a lifetime gift, if tax motivated, must be based on a quantitative analysis.<sup>6</sup> As the later portions of this article will show, the quantitative analysis of gifts without gift tax represents a special case of the analysis of gifts that incur gift tax, and the analysis set forth in this article with respect to gifts that incur gift tax is equally applicable to tax-free gifts.

### Gifts without gift tax

**Annual exclusion.** An outright gift made to any individual in an amount not exceeding \$3,000 for any calendar year is not included in determining the amount of taxable gifts made by the donor during that year.<sup>7</sup> Accordingly, a donor may make tax-free gifts of up to \$3,000 to any number of individuals within the calendar year.

Further, a gift not in excess of \$3,000 is not included in the donor's estate tax base, since it does not come within the definition of taxable gifts set forth in Sec. 2503. Thus, a gift within the annual exclusion amount is not subject to any transfer

taxes whatsoever, and does not result in any reduction of the donor's gift or estate tax credit.<sup>8</sup>

In addition, in the case of a gift by a husband or wife to a third party, the donor's spouse may elect to treat one-half of the gift as made by that spouse, pursuant to Sec. 2513. This is generally referred to as "gift splitting." The gift-splitting election is made by the consenting spouse signifying his or her consent on the gift tax return filed for the calendar quarter in which the gift is made, and may be made even though a gift is made solely from the property of one of the spouses. Thus, by virtue of the benefits of gift splitting, a husband and wife may each apply their annual exclusion amount to a gift, and thereby may make nontaxable gifts to any person in an amount up to \$6,000 for any year.<sup>9</sup> Gift splitting, where the gift is within the combined annual per-donee exclusion of both spouses, is an effective device for reducing the estate tax base of the wealthier spouse. In effect, if a gift within the combined annual exclusion amounts of the donor and his spouse is made from the assets of the wealthier spouse, and gift splitting is elected, the estate tax base of the wealthier spouse is reduced by an extra \$3,000 with no tax cost to either spouse. Moreover, a gift within the \$3,000 annual exclusion reduces the donor's estate tax base not only by the amount of the gift, but also by the appreciation (i.e., after-tax income plus unrealized increase in value) on the property that would be expected to occur during the donor's life.<sup>10</sup>

**Gifts to spouse.** A second opportunity to make gifts without incurring gift tax is provided by the gift tax marital deduction under Sec. 2523. In general, the donor's gift tax marital deduction is equal to one-half of the value of the gift to his spouse. However, the '76 Act amended Sec. 2523 to permit the first \$100,000 of gifts to a spouse to be made without gift tax. We will refer to the elimination of gift tax

<sup>4</sup> For simplicity, the computation has ignored credits other than the unified credit for gift tax paid.

<sup>5</sup> The apparent allowance of both a \$47,000 gift tax credit and a \$47,000 estate tax credit is an illusion because the gift tax credit reduced the gift tax, which would itself (but for such reduction) have been allowed as an offset against the estate tax by reason of Sec. 2001(b)(2). Thus, the unified gift and estate tax is reduced by only a single \$47,000 credit.

<sup>6</sup> Of course, nontax as well as tax considerations must be weighed in determining whether to make a lifetime gift.

<sup>7</sup> Sec. 2503. To qualify under Sec. 2503, the gift must constitute a "present interest." An outright gift or a gift in trust (with proper planning) may qualify as a "present interest."

<sup>8</sup> Moreover, gifts that are excludible in computing taxable gifts under Sec. 2503(b) are not included in the donor's estate under Sec. 2035 even if the donor dies within three years of the gift, provided that (1) the donor has not made gifts exceeding \$3,000 to the particular donee so that no gift tax return was required under Sec. 6019 with respect to the gift, and (2) the gift involved was not a life insurance policy. Sec. 2035(b), as amended by the Revenue Act of 1978.

<sup>9</sup> A gift tax return is required in order to elect gift splitting. Accordingly, the full amount of a split gift is subject to inclusion in the donor's estate under Sec. 2035 if the donor dies within three years of the date of the gift. See note 8. It might be possible to avoid this result by a \$3,000 gift to a spouse, followed by a gift to the beneficiary which would achieve the benefit of gift splitting without requiring that a gift tax return be filed.

<sup>10</sup> The magnitude of the tax benefit from making a gift within the \$3,000 annual exclusion, taking into account expected appreciation in property, depends on assumptions regarding after-tax income and appreciation in value. These factors are discussed later.

on a gift to a spouse of up to \$100,000 as the "special gift tax marital deduction."<sup>11</sup> The special gift tax marital deduction may be combined with the \$3,000 annual exclusion, thereby permitting a donor to make a gift to his spouse of \$103,000 without incurring any gift tax.

As we discuss below, there are advantages to making a \$100,000 tax-free gift to a spouse using the special gift tax marital deduction. There is also a disadvantage in that the estate tax marital deduction is reduced as a result of making the gift. The reduction in the estate tax marital deduction is required by Sec. 2056(c). Ordinarily, the maximum estate tax marital deduction is equal to the greater of \$250,000 or 50% of the value of the adjusted gross estate. However, as a result of a gift that benefits from the special gift tax marital deduction, the maximum estate tax marital deduction is adjusted by reducing it by one-half of the gift amount for gifts not in excess of \$100,000. Thus, a gift of \$100,000 to a spouse will reduce the donor's available estate tax marital deduction by \$50,000 (i.e., 50% of \$100,000). Gifts in excess of \$100,000 to a spouse will reduce this adjustment of the statutory maximum allowable estate tax marital deduction at the rate of 50% of the amount of the excess of the gift over \$100,000. For example, a gift of \$200,000 would reduce the adjustment by \$50,000, and thus there would not be any net adjustment to the maximum allowable estate tax marital deduction. Similarly, a gift of \$150,000 would reduce the adjustment by \$25,000, and thus there would be a net reduction of \$25,000 (\$50,000 - \$25,000) in the maximum allowable estate tax marital deduction.<sup>12</sup>

<sup>11</sup> The value of gifts to a spouse in excess of \$100,000, and not exceeding \$200,000, however, receive no benefit from the gift tax marital deduction. Gifts to a spouse in excess of \$200,000 result in a gift tax marital deduction equal to one-half of the value of the gifts. The effect of the special gift tax marital deduction and the elimination of any marital deduction on gifts between \$100,000 and \$200,000 is that the allowable gift tax marital deduction for gifts to a spouse of more than \$200,000 equals a gift tax marital deduction of one-half of the value of the gift.

<sup>12</sup> In addition, prior to the 1978 Revenue Act, it was arguable that a gift within the \$3,000 exclusion of Sec. 2503(b) also reduced any adjustment to the statutory maximum marital deduction under Sec. 2056(c). This result was altered by §702 of the 1978 Act which amended Sec. 2056 to provide, in effect, that the adjustment to estate tax marital deduction is reduced only for gifts required to be included in a gift tax return. A gift of up to \$3,000 would not be required to be included in a gift tax return and would, therefore, not reduce the adjustment to the marital deduction. It is, however, unclear whether after the donor has made gifts of \$100,000 to his spouse, an additional gift of \$3,002 to his spouse would have the effect of reducing by \$1,501 the adjustment to the maximum estate tax marital deduction. This result may be possible under the statute because the full amount of the gift, \$3,002, is required to be included in a gift tax return, even though only the excess over \$3,000 is subject to gift tax.

Larger estates. The reduction in the estate tax marital deduction that results from the use of the special gift tax marital deduction is, in general, designed to place the donor in the same tax position that he would have been in if a gift had not been made. For example, assume that a donor with an estate of \$600,000 makes a \$100,000 gift to his spouse, thereby reducing his estate tax base to \$500,000. His estate at his death will be entitled to a maximum marital deduction of \$200,000. This is determined pursuant to Sec. 2056(c) as follows. The maximum marital deduction is equal to the greater of (i) one-half of the adjusted gross estate (\$250,000 in this case) or (ii) \$250,000, both reduced, pursuant to Sec. 2056(c), by one-half of the gift benefiting from the special gift tax marital deduction. Thus, a total of \$300,000, \$100,000 by gift and \$200,000 from the estate, will be permitted to pass between spouses free of transfer tax. Absent the gift, the maximum estate tax marital deduction would have been \$300,000, i.e., \$300,000 would have been permitted to pass free of estate tax. Thus, in larger estates (\$600,000 or more) the special gift tax marital deduction does not provide a means of increasing the maximum amount that may be transferred from one spouse to the other without incurring a gift or estate tax.

Smaller estates. For smaller estates, however, by taking advantage of the special gift tax marital deduction the decedent may actually increase the maximum amount that otherwise could be passed to a spouse without transfer tax. For example, a taxpayer with \$500,000 in assets would be entitled to a maximum estate tax marital deduction of \$250,000, resulting in an estate tax base of \$250,000, absent any gift. If, however, the taxpayer made a \$100,000 tax-free gift to his spouse, his estate would be reduced to \$400,000. The maximum marital deduction allowed his estate would be \$200,000 instead of \$250,000, i.e., an amount equal to the greater of (i) one-half the adjusted gross estate (\$200,000) or (ii) \$250,000, such amount reduced by one-half of the gift that benefited from the special gift tax marital deduction (\$50,000). Accordingly, the donor's taxable estate would be \$200,000 if he took advantage of the maximum estate tax marital deduction. The net result of the \$100,000 marital gift, therefore, would be to permit \$300,000, instead of the \$250,000 maximum amount that would have been available absent the gift, to be transferred tax-free to the donor's spouse; that is, \$100,000 during the donor's life and \$200,000 at his death.<sup>13</sup> The

<sup>13</sup> Although the taxpayer has passed a greater amount of property to his spouse under this procedure, the overall estate taxes imposed on the estates of the donor and his spouse may be increased. Thus, if the donor, instead of making a gift,

\$100,000 gift, which benefits from the special gift tax marital deduction, has increased by \$50,000 the amount available to be passed from the decedent to his spouse without transfer taxes.<sup>14</sup>

Other advantages. Even if a \$100,000 gift to a spouse results in a full reduction of the estate tax marital deduction, as discussed above, there are still significant tax advantages in making such a gift to a spouse. The most significant advantage is that a tax-free marital gift insures that the donor will at least benefit from a portion of the marital deduction, even if his spouse predeceases him. In effect, the wealthier spouse receives a kind of insurance against the possibility that the estate tax marital deduction will be lost by virtue of his outliving his spouse. In addition, the \$100,000 tax-free gift reduces the donor's estate and helps to assure that the donee spouse will receive at least some benefit from the \$47,000 estate tax credit and the progressive rates in the event such spouse predeceases the wealthier spouse.

**Gifts within the gift tax credit.** A third opportunity to make gifts without current gift tax is provided by the unified credit against gift tax.<sup>15</sup> The gift tax credit, which will increase to \$47,000 for gifts made after 1980, permits a donor who has not previously made taxable lifetime gifts to give up to \$175,625 of taxable gifts (lesser amounts of gifts made before 1981 and for donors who have previously made lifetime gifts) without being liable for gift tax. We refer to these tax-free gifts as "gifts within credit." If the donor's spouse consents to split the gift for gift tax purposes, a donor can make up to \$351,250 of gifts within credit, that is "taxable

---

simply transferred one-half of his estate to his spouse at death, and his spouse's estate consisted solely of such amount, the overall estate tax imposed on both spouses, after the applicable \$47,000 estate tax credit, would be \$47,600. On the other hand, if the donor passed \$300,000 to his spouse using the special gift tax marital deduction and the maximum estate tax marital deduction, the combined estate tax will be \$48,600. This "overfunding" of the marital deduction may or may not be desirable. For a discussion of some of the advantages and disadvantages see Halstead, "Marital Deduction Planning Under The Tax Reform Act of 1976: Does Your Old Formula Still Fit?," 30 *U. So. Cal. Tax Institute* 801 (1978).

<sup>14</sup> Prior to the Revenue Act of 1978, there was a potentially significant detriment to giving \$100,000 to a spouse. That is, even if the gift was includible in the donor's estate, for example by reason of Sec. 2035, the donor's estate tax marital deduction was reduced under Sec. 2056. The '78 Act partially corrected this problem by amending Sec. 2056 to provide for no reduction in the estate tax marital deduction where the gift that benefits from the gift tax marital deduction is included in the donor's estate under Sec. 2035. There is no similar provision in the event that the gift to a spouse is includible in the donor's estate pursuant to Secs. 2036, 2037, or 2038.

<sup>15</sup> Sec. 2505.

gifts," without either spouse being liable for gift tax (lesser amounts for gifts made before 1981 and for consenting spouses who have previously made lifetime gifts).

Gifts within credit, unlike gifts within the \$3,000 annual exclusion, or gifts that are free of gift tax as a result of the special gift tax marital deduction, will be aggregated with the donor's taxable estate in computing the federal estate tax.<sup>16</sup> As a result, the estate tax base is the same as if the gift within credit had not been made, except that the technique of making lifetime gifts within credit permits a donor to remove future appreciation from his estate. Assuming the gift is made to a member of a younger generation, the donor has succeeded in substantially postponing estate tax on any future appreciation.<sup>17</sup>

In order to determine the magnitude of the potential tax benefit of a lifetime gift within credit, some assumptions regarding after-tax income and future appreciation in value of property must be made. The future appreciation of property depends on two factors: the donor's life expectancy and the rate of increase in value of the property. For purposes of our discussion, we will assume a 4% annual expected appreciation of property (i.e., after-tax income plus unrealized increase in value). This assumed appreciation, when combined with the donor's life expectancy, may be expressed as a factor which we call the "future value factor." The future value factor is a number that, when multiplied by the present value of the gift, will produce the expected future value of the gift property (plus after-tax income) at the expected date of the donor's death, as actuarially determined. The future value factor can be determined from tables which are readily available. For example, a donor age 68 has a life expectancy of approximately 12 years. If his assets appreciate at the rate of 4% per year, after 12 years they will be worth 160% of their present value. The donor's "future value factor" in this case is 1.6.

Since the effect of the gift is to remove the future appreciation in the property from the donor's estate tax base, the tax saving from a gift within credit (determined as of the date of the donor's death) is equal to the additional estate tax that would have been payable by the donor if the future appreciation of the gift property had been included in the

---

<sup>16</sup> The full estate tax credit, of course, will be available as a credit against estate tax liability.

<sup>17</sup> There is, of course, a potential detriment to making gifts within credit, since the property may decline in value after the gift. If property declines in value after the gift is made, the gift is included in the donor's estate tax computation under Sec. 2001(b) using its value at the date of the gift. Thus, in such a case, the transfer taxes would be imposed on a greater amount than if no gifts were made.

donor's estate and taxed at the donor's highest anticipated marginal estate tax rate.<sup>18</sup> Based on the assumptions made regarding future appreciation and the donor's life expectancy, i.e., the donor's future value factor, it is possible to calculate the donor's estate tax savings resulting from a gift within credit.

**Illustration of tax benefits of gifts within credit.** If a donor makes a gift of \$178,625 in 1981, no gift tax is payable since the amount of the gift is reduced by the \$3,000 annual exclusion<sup>19</sup> in computing "taxable gifts," and, as so reduced, the gift tax is fully offset by the donor's \$47,000 gift tax credit. The donor saves no estate tax on \$175,625 (the gift amount less the annual exclusion amount) since that amount is included in his estate tax base as an adjusted taxable gift. However, if the donor's future value factor is 1.6 (i.e., a life expectancy of approximately 12 years), the gift within credit results in the donor's estate tax base being smaller than it would otherwise have been. The amount by which the estate tax base is reduced is equal to the sum of (1) the annual exclusion amount (\$3,000) multiplied by the future value factor (1.6) plus (2) the taxable portion of the gift (\$175,625) multiplied by .6, the excess of the future value factor over 1.0. Thus, in the above situation, the donor's estate tax base would be reduced by \$110,175 (\$4,800 + \$105,375). The resulting estate tax saving is computed at the donor's highest marginal estate tax rate.

**Tax benefits of split gifts within credit.** There may also be tax benefits from making split gifts within credit.<sup>20</sup> A lifetime gift within credit, where gift splitting is elected, in much the same manner as the \$100,000 gift to a spouse discussed above, serves as a kind of insurance against the possibility that the estate tax marital deduction will be lost

as a result of the donor predeceasing his spouse. A split gift, in effect, serves to divide the donor's estate by causing the amount of the taxable gift deemed to be the spouse's portion to be taken into account in computing the spouse's estate tax liability pursuant to Sec. 2001(b).<sup>21</sup> In addition, a split gift also assures that a portion of the spouse's estate tax credit will be used. Thus, the result of a split gift within the credit is that the estate of the donor is reduced without current cost, while the consenting spouse is assured of having an estate tax base sufficient to use at least a portion of the \$47,000 estate tax credit.

### Gifts that incur gift tax

Gifts that do not require current payment of gift tax have evident advantages as demonstrated above. However, a gift that is not within the \$3,000 exclusion, or the \$100,000 marital deduction, and that incurs gift tax in excess of the applicable gift tax credit, may appear to start on a different footing. Such a gift requires current payment of gift tax, and the donor loses the benefit during his lifetime of the funds used to pay that tax. The gift tax payment itself, however, will constitute an offset to the estate tax payable at the donor's death. This offset for gift tax, therefore, will serve to satisfy partially the donor's wealth transfer tax at death. The incurring of gift tax in excess of the gift tax credit merely accelerates the payment of the wealth transfer tax, essentially from the estate tax payment date after the donor's death, to the gift tax payment date, which is shortly after the date of the inter vivos transfer. Thus, the gift tax is in essence a prepayment of the estate tax. Therefore, it is only the use of the gift tax payment during the donor's life and not the payment itself that represents the tax "cost" of the gift.

In order for such a gift to provide a tax benefit, the tax advantage of making the gift must outweigh the detriment involved in the loss of the use of the gift tax payment during lifetime. There are two principal tax advantages to be considered in con-

<sup>18</sup> Moreover, a gift that qualifies for the \$3,000 annual exclusion, in addition to avoiding gift and estate tax, as discussed above, also reduces the donor's estate tax base by the amount of the gift multiplied by the donor's future value factor.

<sup>19</sup> This assumes that at least \$3,000 of the gift constitutes a present interest. See note 7.

<sup>20</sup> If the entire gift is made from the property of one spouse, that spouse reduces his estate tax base by (1) the amount that qualifies for the donor's and his spouse's \$3,000 exemption (maximum of \$6,000) multiplied by the donor's future value factor, plus (2) the amount of the gift in excess of the annual exclusions multiplied by the excess of the donor's future value factor over 1. Offsetting this reduction in the donor's estate tax base is the increase in the consenting spouse's estate tax base by one-half of the value of the gift, less the amount that qualifies for the donor's spouse's \$3,000 annual exclusion. Whether there is any additional tax saving as a result of reducing the donor's estate tax base by making split gifts within credit, accordingly, depends on the estate tax rates applicable to the spouses.

<sup>21</sup> Prior to the '78 Act, if a split gift was required to be included in the estate of the donor, there could have been unfavorable tax consequences. That is, the decedent's spouse was required to include the amount of the taxable gift deemed to be such spouse's portion by virtue of the gift-splitting election in computing the tentative estate tax at death, even though the gift was fully taxed in the decedent's estate at an earlier time. This problem was partially eliminated by the amendment of Sec. 2001 by the '78 Act to exclude the split gift from the estate tax computation with respect to the donor's spouse in the event that the gift is included in the donor's estate by reason of Sec. 2035 (relating to gifts made within three years of the donor's death). No similar adjustment is made if the gift is included in the donor's estate by reason of Secs. 2036, 2037, or 2038.

nection with gifts that incur current gift tax. First, the gift tax (and any appreciation thereof) is removed from the donor's estate tax base. The fact that the donor has incurred a current gift tax, and, therefore, has forgone the use during his life of the funds used to pay the gift tax, means that his estate tax base is reduced by the gift tax paid on the gift. Thus, his estate tax is lower than it would have been if no gift had been made.

Second, appreciation in value of the property that is the subject of the gift is removed from the donor's estate tax base.<sup>22</sup>

Both the gift tax computation with respect to the gift and the estate tax computation necessitated by the inclusion of the gift in the estate tax base as an "adjusted taxable gift," will be made using the value of the gift determined at the time the gift is made. On the other hand, if no gift were made the property would be included in the estate at its value at the donor's death. Thus, the appreciation in value of the gift property from the time of the gift to the donor's death is completely removed from the donor's wealth transfer tax computation by virtue of the gift.

These advantages are discussed below, and a procedure will then be illustrated by which the potential estate tax reduction can be compared with the lifetime tax detriment suffered by the donor.

#### **Benefits and detriments of gifts that incur tax.**

The amount of the reduction in estate taxes resulting from a gift that incurs gift tax is equal to the donor's maximum marginal estate tax rate (which we represent by the symbol "e") multiplied by the sum of (i) the anticipated appreciation in the value of the gift ("Expected Gift Appreciation") and (ii) the anticipated value of the gift tax paid ("Expected Gift Tax Value").

The Expected Gift Appreciation can be determined by multiplying the donor's future value factor (which we represent by the symbol "f") by the present value of the gift (which we represent by the symbol "G"), and then subtracting the present

value of the gift in order to isolate the appreciation. Thus, the Expected Gift Appreciation is equal to  $fG - G$ . The Expected Gift Tax Value is equal to the gift tax (which we represent by the symbol "T") multiplied by the donor's future value factor and, therefore, would be represented as  $fT$ .

Thus, the full tax benefit of a lifetime gift that incurs a current gift tax, viewed at the time of the donor's death, is equal to  $e(fG - G + fT)$ .

Recall, now, that the tax cost of making the gift, viewed at the time of the donor's death, is the loss of use of the gift tax payment. That cost is determined by subtracting from the future worth of the gift tax paid ( $fT$ ) the gift tax itself (T) which is allowed as an offset against the donor's estate tax. The tax cost of the gift, therefore, may be expressed as  $fT - T$ . The net tax saving of making the gift, then, is the excess of the two tax benefits over the tax cost.

Summarizing, the computation of the Net Tax Saving, viewed as of the time of the donor's death, can be expressed algebraically in the following manner:

$$\begin{aligned} \text{Gross Future Tax Benefit} &= e(fG - G + fT) \\ \text{Future Tax Cost} &= fT - T \\ \text{Net Future Tax Savings} &= \text{Gross Future Tax} \\ &\quad \text{Benefit} - \text{Future Tax Cost} \\ &= e(fG - G + fT) \\ &\quad - fT + T \end{aligned}$$

A simple example may serve to clarify these concepts. If, for purposes of analysis, we assume that the donor's future value factor is equal to 1, that is, that none of the donor's property or money involved will appreciate, then the advantage of making a lifetime gift that incurs a current gift tax, pursuant to the discussion above, is equal to  $eT$ . Under this assumption, there is no tax cost to the donor in making the lifetime gift since the future worth of the gift tax paid is zero. Thus, the net tax benefit of making a gift, determined as of the date of the donor's death and assuming that the donor's future value factor is 1, would be the donor's estate tax marginal rate that would have been applicable to the gift property multiplied by the gift tax paid; that is,  $eT$ .<sup>23</sup>

Based on these concepts, it is possible to express the net tax saving of gifts within credit, discussed above, as follows:  $e(fG - G)$ . That is, the net tax saving of making a gift within credit is equal to the estate tax that is saved by eliminating the fu-

<sup>22</sup> If the donor dies within three years of making the gift, however, under Sec. 2035 the donor's gross estate will include the value of the gift property, except under certain limited circumstances. Because the property is valued at the date of the donor's death for purposes of the inclusion in the gross estate under Sec. 2035, the actual increase in the value of property after the date of the gift and until the donor's death is also part of the donor's estate tax base. The donor's adjusted taxable gifts are reduced by the value of the property at the time of the gift under Sec. 2001(b) to avoid double counting. In addition, under Sec. 2035(c), the donor's gross estate will also include the amount of gift tax paid by him in respect of those gifts. Appreciation on the gift tax paid and earnings (as contrasted with the actual increase in value) with respect to the gift property after the date of the gift and before the decedent's death, however, are excluded from the donor's estate.

<sup>23</sup> Another way of illustrating the same point is to note that an estate of \$10,000,000 would be subject to \$6,003,800 in estate taxes. On the other hand, if the individual made a lifetime gift of \$6,468,353 and incurred gift tax of \$3,531,647 (the \$3,000 annual exclusion has been disregarded), there would be no tax at the time of his death and the total wealth transfer tax would be reduced from \$6,003,800 to \$3,531,647. The estate tax saving is equal to 70% of the gift tax paid; that is,  $eT$ .

ture appreciation in the gift property from the donor's estate.

At any given level of a prospective donor's wealth, one can determine how much the donor could save in transfer taxes, by making a gift and incurring gift tax, based on the assumptions used regarding appreciation in assets and the cost of losing the use of the gift tax payment during lifetime.

**Computation of net tax benefit.** In order for the tax adviser to compute the tax benefit from making a lifetime gift that involves a current payment of gift tax, it is necessary to compute the tax benefit and the tax detriment taking into account the expected appreciation in the donor's assets during lifetime. This may be done by following a suggested procedure which we will apply to a set of hypothetical facts.

**Procedure.** The suggested procedure includes the following steps:

- Determine the value of the proposed gift ("G") and the amount of gift tax that would be payable ("T").
- Compute the donor's future value factor ("f") based on his life expectancy, his expected yield on investments after income tax, and other adjustments deemed appropriate by the donor and the tax adviser.
- Determine the donor's estimated marginal estate tax rate ("e").
- Determine the net future tax savings using the formula:  $\text{Net Future Tax Saving} = e(fG - G + fT) - fT + T$ . This is the amount the donor would save based on the "future value" of the amounts involved. The present value of the net future tax savings can be determined by dividing the net future tax saving, computed as set forth above, by the donor's future value factor.

**Example.** To illustrate the recommended procedure, assume that the donor is a 68-year-old man, in good health, married, with one adult child whom he wishes to be the beneficiary<sup>24</sup> of his and his wife's estates. He and his wife each have a life expectancy of 12 years, and it is assumed that they will live for the period of their life expectancy and that the donor will predecease his wife. Further assume that the donor's taxable estate, after 12 years, will be \$2,000,000 absent any taxable gifts,<sup>25</sup> and that the donor's net worth increases at

<sup>24</sup> For purposes of this analysis, we use the term beneficiary to represent the class of donees, beneficiaries, or heirs to whom the donor's wealth will be passed both during his life and at his death.

<sup>25</sup> It is assumed that all of the assets of the donee as well as the donor will increase in value at the rate of 4% per year.

the rate of 4% per year<sup>26</sup> over his life expectancy.<sup>27</sup> It is assumed that the wife has at present, and will have at her death, a zero net worth, except for property received from her husband's estate (which will consist only of the maximum allowable marital deduction amount). It is also assumed that the donor and his wife elect the benefits of gift splitting.

A determination of the gross tax benefit that would result if the donor were to make a gift of \$500,000 in year one may be made in the following manner:

- Determine the gift tax that would be payable as a result of the gift, using the gift tax table set forth in Sec. 2001(c). A gift of \$500,000 split between husband and wife, neither of whom have made previous taxable gifts, results in combined gift tax of \$47,600 after applicable gift tax credits.
- Determine the donor's future value factor. In our example the donor's future value factor is 1.6.
- Determine the donor's expected marginal estate tax bracket (e) which would be applicable to the Expected Gift Appreciation and Expected Gift Tax Value.

In our example, the marginal estate tax bracket rate will be 39% since the donor's taxable estate absent the gift, and after taking the marital deduction into account, will be \$1,000,000. Thus, each dollar reduction in his estate tax base by virtue of a proposed inter vivos gift will reduce his taxable estate by \$0.50, after taking into account the resulting reduced marital deduction, and reduce the taxable estate his surviving spouse would otherwise have by \$0.50. Thus, both the donor and his spouse will each save \$0.19½ for each dollar reduction in the donor's estate tax base, for a total saving of \$0.39 per dollar of reduction of the donor's gross estate. This rate of tax saving will continue until the sum of the Expected Gift Appreciation and Expected Gift Tax Value exceeds \$500,000.<sup>28</sup> In our example

<sup>26</sup> Under these assumptions, the donor's present net worth is approximately \$1,300,000.

<sup>27</sup> For purposes of this analysis, we have ignored administration and similar expenses, and state and foreign death taxes. In addition, we have used a simplifying assumption that any gift tax incurred as a result of a lifetime gift is payable at the time of the gift, rather than at the time the gift tax return is due, and that any estate tax is payable at the time of the decedent's death. Further, we have assumed that all proposed transactions take place after 1980, when the full \$47,000 gift tax credit is available.

<sup>28</sup> Since it is assumed that the donor would pass one-half of the value of the property to his spouse using the estate tax marital deduction, the removal of the Expected Gift Appreciation and Expected Gift Tax Value will reduce the donor's estate tax base from a maximum of \$1,000,000 toward the next lower estate tax bracket (\$750,000) at the rate of \$.50 for each \$1.00 of Expected Gift Appreciation and Expected Gift Tax Value. Until the estate tax base is reduced below \$750,000, the marginal estate tax rate is .39.

that sum clearly will not exceed \$500,000. Thus, the net tax benefit will be:

$$.39 ((1.6 \times \$500,000) - \$500,000 + (1.6 \times \$47,600)) - (1.6 \times \$47,600) + \$47,600 = \$118,142.$$

This amount may be reduced to present value by dividing by the donor's future value factor. The present value of the net future tax savings would, therefore, be approximately \$73,839.

Analysis. Based on the formula stated above, we can make some additional observations. First, there will always be a net tax saving resulting from a lifetime gift. This principle can be demonstrated as follows. In our basic formula for computing net future tax savings, set forth above, we may substitute for the gift tax (T), the expression  $gG$ , where  $g$  is the average gift tax rate payable with respect to gift  $G$ . The formula, as so modified, becomes  $e(fG - G + fgG) - fgG + gG$ . Finally, the formula for net tax savings may be reduced to  $(f - 1)(G)(e - g) + fegG$ .

It is easy to show that this formula results in a net tax saving regardless of the donor's future value factor (assuming it is greater than 1) and regardless of the amount of the gift. The proof of this principle is accomplished by showing that  $(f - 1)(G)(e - g) + fegG$  is positive. This will be true if the component  $fegG$  is positive and each other component is positive, or at least non-negative. Thus, the proof of this principle is as follows:

- $f-1$  is positive because under normal economic circumstances there is always a time value of money; that is, a dollar today is worth more than a dollar tomorrow;
- $G$  is positive, since the value of the gift is greater than zero;
- $e-g$  cannot be negative since the estate tax and gift tax rates are progressive and the tax-

payer's gift tax rate cannot exceed the estate tax rate; and

- $fegG$  is positive since each of its parts is positive.

Summarizing, there will always be a net tax saving associated with a lifetime gift provided the donor survives the gift by at least three years and thereby avoids application of Sec. 2035.

Our second principle is that the longer the life expectancy of the donor, the greater will be his net future tax saving resulting from a lifetime gift. The proof of this rule is also quite simple. As stated above, the net future tax saving from a gift is equal to  $(f - 1)(G)(e - g) + fegG$ . This may also be expressed as  $f(G(e - g) + egG) - G(e - g)$ . Since  $e$  is equal to or greater than  $g$ , and  $e, g, f,$  and  $G$  are all greater than zero, it follows that  $G(e - g) + egG$  is greater than zero. Thus, the greater the value of  $f$ , the greater will be the value of the entire expression and, therefore, the donor's net future tax saving.

Since  $f$  increases as the life expectancy of the donor increases, the longer the life expectancy of the donor, the greater will be his net future tax saving resulting from a lifetime gift. Said another way, a donor will derive a greater future tax benefit from lifetime gifts if he makes them while he is young.

## Conclusion

Tax benefits of lifetime gifts remain although in a modified and somewhat curtailed form as a result of the '76 Act. Lifetime gifts therefore continue to be a part of the tax planner's alternatives. We have presented in this article a review of tax benefits associated with lifetime gifts and a method of analysis that the tax or financial planner may use to determine the tax benefits of a gift program. **ttt**

**Are you profiting  
from these  
valuable AICPA  
tax guides?**

American Institute of CPAs  
1211 Avenue of the Americas  
New York, N. Y. 10036

## AICPA STUDIES IN FEDERAL TAXATION

- 1. Tax Guide for Incorporating a Closely Held Business**  
\$13.50 Discount price to AICPA members \$10.80
- 3. Guide to Federal Tax Elections**  
\$12.50 Discount price to AICPA members \$10.00
- 4. Tax Practice Management**  
\$42.50 Discount price to AICPA members \$34.00
- 5. Tax Research Techniques**  
\$8.50 Discount price to AICPA members \$6.80
- 6. U.S. Tax Aspects of Doing Business Abroad**  
\$13.50 Discount price to AICPA members \$10.80