LIFETIME GIFTS IN ESTATE PLANNING UNDER
THE 1976 TAX REFORM ACT

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Prior to 1976, even the most fundamental approach to estate planning involved consideration of lifetime giving as a method of reducing estate taxes. Gift tax rates were twenty-five percent cheaper than the estate tax rates¹ and furthermore, assets which, if held until death, would be taxed in the highest estate tax bracket for the estate, could be transferred during life and taxed in the lowest gift tax brackets.²

Congress, feeling that this tax avoidance method favored the wealthy, since those less affluent could not afford to part with their assets during life, severely limited the tax benefit attainable by this type of tax planning.³ Under the 1976 Tax Reform Act⁴ (Act), several fundamental changes were made in the Internal Revenue Code (Code). These changes essentially merged the gift tax provisions and the estate tax provisions into a single system of taxation of the transfer of wealth, whether during life or at death. It is the purpose of this article to relate and explore the changes and to examine the remaining benefit to be obtained by lifetime transfer of assets.

I. REPEAL OF THE DUAL TAX SYSTEM

A. The Unified Tax Rates

Section 2001 of the Act repealed the dual tax structure by amending sections 2001 and 2502 of the Code, imposing a new unified tax rate table. Prior to the amendment, estate tax rates ranged from 3% to 77%⁵ and the gift tax rates ranged from 2 1/4% to 57 3/4%.⁶ The new section 2001 rate table ranges from 18% to 70% and the same rate table is incorporated by reference into section 2502. Thus, a transfer would theoretically be subject to the same tax rate whether transferred during life or at death.

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2. For example, a $5,000 asset in a total taxable estate of $250,000 would be taxed at 32% under old § 2001. If the asset was transferred by gift and represented the first taxable gift for the taxpayer, the remaining $245,000 estate would still be taxed at 3% to 32%, but the $5,000 asset would be taxed under old § 2052 at 2 1/4%.


6. Id. § 2502.
B. The Unified Tax Base

Section 2001(a) of the Act further amends section 2001 of the Code, eliminating the shifting of assets from one bracket to another by lifetime transfer, by requiring that gifts made after December 31, 1976 be brought back into the estate tax computation at death. This does not mean that all post December 31, 1976 gifts are "recaptured" in the estate in the sense of sections 2035-2038 of the Code, and thus taxed in the estate, but rather that the post December 31, 1976 gifts are simply returned to the computation of the estate tax so that the assets which remained in the estate at death are taxed in the same bracket that they would have been if they had been taxed on top of, or "platformed by," the assets which were transferred during life. The following example illustrates this effect:

EXAMPLE # 1: Taxpayer possessed two assets: Blackacre valued at $500,000 and Whiteacre, valued at $250,000. Under the pre-1976 rules, at taxpayer's death, the first $500,00 of his estate would be taxed at a rate of from 3% to 32%. The second asset, $250,000 would be taxed at 35%. If taxpayer transferred Whiteacre during his life, (assuming no prior gifts and no exemptions or exclusions) the $250,000 would be taxed at only 22½%, and the remaining $500,000 would not be affected by the transfer and thus would still be taxed at 3%-32%.

Under the 1976 Tax Reform Act, the result is much different. If the taxpayer dies without making the transfer, the first $250,000 of his estate will be subjected to a tax of 18% to 32%; the next $250,000 at 34% and the final $250,000 at 37%. If taxpayer transfers Whiteacre, worth $250,000, the value of the gift will be taxed at a rate of 18% to 32% and when he dies, the taxation of his remaining estate will begin where the taxation of his lifetime gifts since December 31, 1976 left off, so that the first $250,000 of his estate will be taxed at 34% and the final $250,000 at 37%.

7. As illustrated in note 2, supra, the lifetime transfer caused the asset to be taxed under old § 2502 while the retained assets were taxed under old § 2001. After the 1976 Tax Reform Act, the lifetime gifts are still taxed under I.R.C. § 2502, but their transfer does not shift the bracket of the remaining assets in the estate. See I.R.C. § 2001(b).

8. I.R.C. § 2001(b) provides:

(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 in accordance with the rate schedule set forth in 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 payable under Chapter 12 with respect to gifts made by the decedent after December 31, 1976.

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.

9. These sections of the Code require that certain lifetime gifts, for instance gifts made within three years of death under I.R.C. § 2035, be taxed as though the decedent had actually retained ownership at death. Thus, the value of such assets are taxed in the decedent's estate even though he legally does not own nor possess them.
C. The Unified Tax Credit

The next step in Congress's overhaul of the Internal Revenue Code was the repeal of the $60,000 specific exemption under section 2052\(^1\) for estates and the repeal of the $30,000 lifetime specific exemption under section 2521\(^1\) for gifts. In lieu of the specific exemptions, Congress provided for a unified credit against estate tax\(^2\) and a unified credit against gift tax,\(^3\) of $47,000, but phased in over a period of years.

For estate tax purposes, the credit is allowed as follows:

<table>
<thead>
<tr>
<th>Estates of Decedents dying in:</th>
<th>The credit is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>$30,000</td>
</tr>
<tr>
<td>1978</td>
<td>34,000</td>
</tr>
<tr>
<td>1979</td>
<td>38,000</td>
</tr>
<tr>
<td>1980</td>
<td>42,500</td>
</tr>
<tr>
<td>1981 and thereafter</td>
<td>47,000(^4)</td>
</tr>
</tbody>
</table>

For gift tax purposes, the credit is the same, but the phase in period is somewhat different:

For gifts made:

<table>
<thead>
<tr>
<th>The credit is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>After 12/31/76 and before 7/1/77</td>
</tr>
<tr>
<td>After 6/30/77 and before 1/1/78</td>
</tr>
<tr>
<td>During 1978</td>
</tr>
<tr>
<td>During 1979</td>
</tr>
<tr>
<td>During 1980</td>
</tr>
<tr>
<td>After 12/31/80</td>
</tr>
</tbody>
</table>

Both the credit against gift tax and the credit against estate tax must be reduced by twenty percent of the amount, if any, claimed as exempt from gift tax under section 2521\(^6\) on gifts made after September 8, 1976, and before January 1, 1977.\(^7\) This is a permanent reduction in the respective credits available to the individual.

EXAMPLE # 2: Taxpayer made a gift of $18,000 on October 31, 1976 and claimed $15,000 as a specific exemption under section 2521 (the remaining $3,000 was exempt under section 2503). If taxpayer makes gifts during 1978, the maximum credit allowable will be $34,000 less (20% × $15,000) $3,000 = $31,000.

The computation of gift tax remains cumulative and the credit is likewise cumulative.\(^8\) Thus, the maximum credit is determined by the time of the gift.

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13. Id. § 2505.
14. Id. § 2505.
15. Id. § 2505.
17. I.R.C. §§ 2010(c), 2505(c).
18. The allowable credit under § 2505(a)(1) is reduced by "the sum of the amounts allowable as a credit ... for all preceding quarters." Id. § 2505(a)(2).
This credit is then reduced by the amount of the adjustment, if any, under section 2505(c)\(^{19}\) and is further reduced by the amount of credit previously claimed.\(^{20}\) Thus, if the taxpayer in example #2 claimed the maximum credit allowable to him in 1978, $31,000, and made a subsequent gift in 1981, the credit allowable would be $47,000 less $3,000 (section 2505) less $31,000 (previously claimed) leaving $13,000. If taxpayer claims the full remaining credit ($13,000), he will have reached the maximum and no further credit for gifts will be allowable.

The allowance of this unified credit under sections 2010 and 2505 for both gift tax purposes and for estate tax purposes makes it appear that there are two credits allowable, totaling $94,000. However, that appearance fades in the computation of estate tax under section 2001(b). The tax imposed on the estate is determined by computing a “tentative tax” on the total value of the estate assets plus the value of all taxable gifts made after December 31, 1976, and deducting from the tentative tax, the tax payable on the prior gifts. The term used in section 2001(b)(1)(B) is “adjusted taxable gifts” which term is defined as taxable gifts within the meaning of section 2503. Consequently, the term does not include gifts which were exempt from tax under section 2503 (i.e., present interest gifts under $3,000 per donee) but does include gifts which were subject to tax even though no tax was paid due to the allowable credit under section 2505. The effect of this is that the computation of the tentative tax will include a tax on the prior transfers. If the tax on prior transfers was previously paid (i.e., the credit did not offset the tax), then the tax computed on the prior transfer is deducted at death and the remaining tax on the estate assets will be reduced by the full credit.\(^{21}\) If the tax on the prior transfer was not paid, (i.e., was offset by the credit), then there will be no corresponding reduction in the tentative tax with the result that at death, the tax paid will reflect the tax on the prior transfer.\(^{22}\) This total tentative tax is then reduced by the credit against estate tax.\(^{23}\) The effect of the computation is to require “repayment” of any credit claimed during life, and the allowance of a single credit at death.

II. THE “GROSS-UP” PROVISION—SECTION 2035

A traditional benefit of lifetime giving was the removal of the amount paid as gift tax from the estate of the donor. Whereas money used to pay the estate tax was itself subject to estate tax, money used to pay gift tax was subject to neither gift tax nor estate tax. This benefit was available even though the lifetime gift might fail to avoid the recapture provisions of sections 2035-2038, for although the value of the gifted asset might be recaptured in the estate, the

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\(^{19}\) The adjustment as a result of the old § 2521 exclusion claimed on gifts after September 8, 1976. *Id.* § 2505(c).

\(^{20}\) *Id.* § 2505(a)(2).

\(^{21}\) The tentative tax, computed under § 2001(b)(1), is reduced by the tax payable on the prior gift. *Id.* §§ 2001(b)(2), 2012; see id. § 2010.

\(^{22}\) Because the amount subtracted, under § 2001(b)(2), will be less, the estate tax computed under § 2001(b) will be greater.

\(^{23}\) I.R.C. § 2010.
gift tax paid on the prior transfer was not subject to recapture and thus did not increase the estate even though it was allowed as a credit against the estate tax by section 2012. In effect then, the taxpayer had accomplished a deduction from the estate for estate taxes to the extent that estate taxes were “paid” in the form of gift tax. Frequently, this benefit was the “solace” that remained after an abortive attempt to remove assets from the estate by a lifetime gift which had run afoul of one of the recapture sections.

There were at least two commonly used “planned failures.” First, a failure was designed where the planning analysis revealed that maximum benefit could be obtained by redirection of income during life, but returned to the estate for estate tax purposes at death in order for the heirs to have a stepped-up basis.24 Thus, a carefully designed transfer was made which resulted in a taxable gift under section 2501 and an effective redirection of income under sections 671-678 but with the retention of sufficient powers or interests by or in favor of the donor to require inclusion of the gifted property in the donor’s estate at his death.

The usefulness of this device after the Tax Reform Act is somewhat unclear. Obviously, the benefit to be obtained in the “planned failure” situation was dependent on the credit against estate tax allowed by section 2012. However, section 2001(a)(3) of the Act amended section 2012 by adding:

(e) Section inapplicable to gifts made after December 31, 1976.—No credit shall be allowed under this section with respect to the amount of any tax paid under chapter 12 on any gift made after December 31, 1976.

If a gift is made, and gift tax paid, and the gift is subsequently recaptured in the estate under section 2037, for instance, it would be little comfort to know that the gift tax itself would not be recaptured if no credit is allowed to offset the subsequent estate tax on the gifted property. The problem appears to be solved by the mechanics of the computation of estate tax under section 2001(b). Under that section, the tentative tax computed on the computed tax base would include a tax on the prior transfer (as being a part of the “taxable estate” under 2001(b)(1)(A)) and would be reduced by the tax previously paid by virtue of section 2001(b)(2). The legislative history to section 2001 of the Act specifically discusses this point and indicates the congressional intent that this type of tax saving device remain allowable except with regard to section 2035 transfers.25

The second “planned failure” was a more flagrant abuse. Under section 2035 of the Code, prior to the 1976 Tax Reform Act, a transfer made within three years of death was presumed to be in contemplation of death and thus includible in the donor’s estate. However, as previously discussed, only the transfer itself was recaptured, not the tax paid. Therefore, a taxpayer, even on

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24. See division VIII A, infra, for a discussion of basis.
his deathbed, was advised to make substantial transfers, obviously in contemplation of death and pay the gift tax thereon. When the taxpayer died, his estate received credit for the gift tax paid without having to include the amount of gift tax in the valuation of his estate.

Congress recognized the latter device as an "abuse" and responded with new section 2035 which in effect provides:

(a) Gifts within three years of death are includible in the decedent's estate. Note that this eliminates the question of whether the gift was or was not "in contemplation of death." Under the new law, neither the old rebuttable presumption nor the "life motives" are now relevant.

(b) The gift tax paid on a transfer made within three years of death is also includible in the decedent's estate. Due to the foregoing amendment, removal of amounts paid as gift tax on "deathbed gifts" is no longer possible.

III. THE ANNUAL EXCLUSION—SECTION 2503

The $3,000 per year per donee exclusion for gifts of present interests under section 2503 is retained. Amendments to two other sections, however, significantly enhance the use of the section 2503 exclusion.

First, perhaps as a slight amelioration of the "strict inclusion" rule under amended section 2035, Congress provided that gifts within three years of death and excludable in computing taxable gifts by section 2503 would not be includible in a decedent's estate by virtue of section 2035. (This is not to say that such gifts might not otherwise be recaptured, for instance under section 2038 if revocable.) A renowned commentator has observed that a skillfully planned estate would now involve the calling of all relatives to gather around the deathbed to receive $3,000 gratuities, noting that not only would the decedent's taxable estate and his life ebb simultaneously, but that this should enhance the attention of his heirs to his departing. As macabre as it sounds, significant tax savings are available as a result of this exception to section 2035.

A second amendment with impact on section 2503 is the amendment to the "throwback rules" for distributions from trusts which accumulate income. Section 701(b) of the Act amends the section 665 definition of accumulation distributions to exclude from that definition amounts distributed from a trust where the accumulation was for the period prior to the beneficiary attaining the

26. I.R.C. § 2035(c). Section 2035(b) also provides an exception for gifts under $3,000. This exception is discussed in division III, infra.
27. Id. § 2035(b)(2).
29. The "throwback rules" of I.R.C. §§ 665 et seq. were designed to prevent tax avoidance by having a trust, in relatively low brackets, accumulate income for a high bracket taxpayer, then distribute the income tax-free at a later date. Under the throwback rules, a tax is imposed upon distribution of the accumulated income, equal to the difference between the tax actually paid by the trust on the income when received and the tax that would have been paid if the beneficiary had been taxed on the income in the year it was received by the trust. Id. § 667.
age of twenty-one. Thus, the latitude to accumulate income, allowed under section 2503(c), is no longer impacted by the application of the throwback rules.

Furthermore, the unification of lifetime gifts and estate assets as a single taxable base under section 2001, excludes gifts which are exempt under section 2503. The unifying formula under section 2001 only takes into account “adjusted taxable gifts.” Thus gifts which are exempt under section 2503, like gifts which are exempt under the marital deduction, do not augment the estate to “platform” the estate assets into a higher tax bracket.30

IV. THE MARITAL DEDUCTION—SECTIONS 2056 AND 2523

With the repeal of the estate tax exemption ($60,000 under section 2052) and the enactment of the unified credit, which is an exemption equivalent of approximately $175,000, the concept of equalizing the estates of married persons is more viable than ever. The great benefit of equalization, where neither spouse would have an estate in excess of the equivalent exemption, is that the order of death will not affect the estate taxes payable. Consequently, expanded use of inter-spouse gifts is predictable.

Prior to the 1976 Tax Reform Act, the marital deduction for gifts to the spouse of the taxpayer, under section 2523(a), was one-half the value of the gift. Consequently, the other one-half might be subject to gift tax. In order to facilitate ease in making estate-equalizing gifts between spouses, Congress amended section 2523 to provide that the first $100,000 in gifts made after December 31, 1976 between spouses will be exempt; the next $100,000 will be taxed and gifts over $200,000 will be subject to the old fifty percent exclusion.31 Thus, up to $100,000 (regardless of gifts to the spouse made prior to 1976) may be transferred to the spouse free from the gift tax, without depleting the taxpayer’s unified credit. In addition, the gift will not be includible in the term “adjusted taxable gifts” under section 2001(b)(1)(B) and thus will not “platform” the estate into a higher tax bracket.

But as Congress giveth, Congress taketh away. To the extent that the marital deduction claimed for gifts after December 31, 1976 exceeds fifty percent of the value of the gifts, the maximum estate tax marital deduction allowance will be reduced.32 Section 2056 was amended by the Act to provide that the maximum marital deduction for estate tax purposes would be the greater of (A) $250,000 or (B) fifty percent of the adjusted gross estate. Section 2056 (c)(1)(B) provides that the maximum allowable marital deduction shall be reduced by the excess, if any, of the amount claimed as a gift tax marital deduction for gifts made after December 31, 1976 over fifty percent of the value of such gifts.

30. See division I B, supra.
32. Id. § 2056(c)(1)(B).
EXAMPLE # 3—Taxpayer made gifts of $120,000 to his spouse after December 31, 1976. The first $100,000 was free from tax under section 2523, and the next $20,000 was fully taxed (disregard section 2503). Upon taxpayer's death, the maximum marital deduction allowable to his estate will be the greater of (A) $210,000 ($250,000 less the excess of $100,000 over 50% of $120,000 = $40,000) or (B) fifty percent of his adjusted gross estate, less $40,000. (Note that this adjustment merely reduces the maximum allowable amount, it does not reduce the amount which may be claimed if less than the adjusted maximum.)

V. SPLIT GIFT PROVISION—SECTION 2513

The splitting of gifts so that one-half is considered to have been given each by husband and wife is unaffected by the Act. Therefore, by the election provided in section 2513, up to $6,000 may be given tax free to each donee under section 2503. In addition, both the husband's and the wife's unified credits against gift tax provided by section 2505 may be used even though only one spouse made gifts. 33

VI. EFFECT OF LIFETIME GIFT ON ESTATE TAX—REMAINING BENEFIT

A. Is Anything Removed From the Estate?

As noted above, the value of lifetime transfers made after December 31, 1976 is now used to "augment" the estate at death in order to determine the rate of tax to be applied to those assets remaining in the estate. Thus, both the assets previously transferred and the assets retained are ostensibly subjected to the same tax that they would be if all the assets had been retained until death. However, only the value of a gifted asset at the time of the gift is brought back into the computation of estate tax, not the value at date of death. 34 Whereas if the asset were retained in the estate, the value to be included in the estate tax computation would be the full fair market value at date of death. Consequently, if an asset is transferred during life, the appreciation in value of the asset is effectively removed from the estate and is not taxed to the donor at all. Furthermore, the remaining assets are taxed at a lower rate than that which would have applied had the appreciation occurred in the estate.

A further advantage is gained if a tax is paid on the lifetime transfer. The amount paid is removed from the estate entirely, thus producing an additional tax savings. If the asset is retained in the estate, the tax on the transfer of the asset may be the same (assuming constant value), but in addition, the money used to pay the estate tax on the asset will itself be subject to estate tax. The money used to pay the gift tax is subject to neither gift nor estate tax.

33. Id. § 2513(a)(1). This section treats the gifts as made one-half by each spouse. Therefore, if either spouse made gifts and if either gift was taxable, then both spouses would be entitled to their respective § 2505 credits.
34. I.R.C. § 2001(b)(1)(B) refers to the "amount of adjusted taxable gifts." The amount of the gift is determined at the date of gift. However, the value at the date of death is included for any gift recaptured under §§ 2035-2038.
The foregoing discussion is applied in the following example:

EXAMPLE # 4: Molly Widow has an estate consisting of $500,000 in cash and $500,000 in other assets which are likely to appreciate to $800,000 by the date of her death. If Molly makes no lifetime transfers and dies with a taxable estate of $1,300,000, her estate tax will be $469,800 before credits. If, on the other hand, Molly makes a lifetime transfer of one-half ($250,000) of the non-cash assets in August, 1977 and pays gift tax of $39,840, then upon her death, she will have cash of $460,160 plus the remaining one-half of the non-cash assets, now worth $400,000, for a total of $860,160. Under section 2001, her estate tax will be $349,835 before the credit. Therefore, she will have paid a total of $389,735, less her estate tax credit, to transfer her estate if the lifetime transfer is made, compared to a total tax of $469,800, before the credit, to transfer the same estate entirely at death.

B. The Section 2505 Credit—Must It Be Claimed?

In the foregoing example (#4), the assumption was made that the donor claimed her allowable credit against the gift tax as authorized by section 2505. This credit is provided, in part, as a replacement for the specific exemption previously allowed by section 2521, which has been repealed with respect to gifts made after 1976. At least one commentator has suggested that while "use of the gift tax exemption . . . is elective rather than mandatory (Reg. Sec. 25.2521-1) . . . the credit under the new law is automatic, not elective."  

A comparison of old section 2521, which was clearly elective, as noted in the quoted article and as indicated in the cited regulation, and the new section 2505, raises some doubts concerning the accuracy of the foregoing conclusion. Both sections use identical language:

"§2521. Specific exemption
In computing taxable gifts for a calendar quarter, there shall be allowed as a deduction . . . an exemption of $30,000 . . . ."

"§2505. Unified credit against gift tax
(a) General rule.—In the case of a citizen or resident of the

35. I.R.C. § 2001. The tax on an estate of $1,300,000 is $448,300 plus 43% of the excess over $1,250,000, or 43% × $50,000 = $21,500. $448,300 + $21,500 = $469,800.  
36. Assuming no prior gifts and $3,000 exempt under I.R.C. § 2503, the tax on $247,000 would be $69,840 under I.R.C. § 2502, less the credit of $30,000 under I.R.C. § 2505, leaving tax payable of $39,840.  
37. The tentative tax under I.R.C. § 2001 will be computed on the sum of the taxable estate, $860,160, plus the taxable gifts, $247,000. This totals $1,107,160 and the tentative tax is $345,800 plus 41% of the amount in excess of $1,000,000, for a total tentative tax of $389,735. This figure is then reduced under I.R.C. § 2001(b)(2) by the tax on the prior transfer, $39,840, leaving a balance of $349,895.  
38. The credit allowable under § 2505 for gifts between July 1, 1977 and January 1, 1978 is $30,000.  
39. See division II C, supra.  
41. INT. REV. CODE OF 1954 AS AMENDED THROUGH JULY 9, 1975, § 2521 (emphasis added).
United States, \textit{there shall be allowed as a credit} against the tax imposed by section 2501 . . .

(1) $47,000 . . . ."^{42}$

Section 38, which provides for investment credit, and section 37, which provides for the credit for the elderly (previously called retirement income credit) also use the same language, \textquote{there shall be allowed}, and neither section is mandatory nor automatic. Based on the identical language used in these sections, it would seem then that the section 2505 credit, like the previously allowable exemption, should be elective rather than mandatory or automatic. However, the nature of the beast created by Congress requires further examination before any conclusion can be drawn.

At the time of death, section 2001 of the Code requires the application of the unified rate structure to a tax base which consists of the value of the estate assets plus the value of the post December 31, 1976 taxable transfers.\textsuperscript{43} The tax arrived at on this sum is the \textquote{tentative tax} and is reduced by the \textquote{aggregate amount of tax payable} under chapter 12 with respect to gifts made by the decedent after December 31, 1976."\textsuperscript{44} If the term \textquote{amount of tax payable} is interpreted to mean the tax imposed by chapter 12, section 2502, less the \textit{allowable} credit under section 2505, then the computation under section 2001 would not be reduced by the gift tax which was actually paid on a lifetime transfer (where the credit was not claimed) but rather, would be reduced by the amount that would have been paid if the credit had been claimed. The effect then would be that the lifetime gift would be taxed twice. If, on the other hand, the term \textquote{amount of tax payable} means simply the tax payable under chapter 12 depending upon whether or not the credit has been claimed, then the section 2001 computation would mesh with the section 2502/2505 computation and the lifetime gift would be taxed only once. Therefore, resolution of the problem appears to rest on the meaning of the phrase \textquote{aggregate amount of tax payable under chapter 12} contained in section 2001.

The computation most similar to the new section 2001 computation is that for computing the tax on gifts, which likewise is a cumulative computation.\textsuperscript{45} But in order to make allowance for changes in the rate structure over the years, the computation uses the term \textquote{tax, computed . . ., on the aggregate sum.}"\textsuperscript{46} There is nothing in the report of the conference committee which answers this question, but hopefully the regulations to be promulgated by the Commissioner will resolve the issue in the way most favorable to the taxpayer. In hopes that the regulations will resolve the issue in favor of the taxpayer or that such result will be established by litigation, consideration will now be given to the effect of

\begin{itemize}
\item \textsuperscript{42} \textit{I.R.C. § 2505} (emphasis added).
\item \textit{Id. § 2001(b)(1)}.
\item \textit{Id. § 2001(b)(2)}.
\item \textit{See id. § 2502(a)(1)}.
\item \textit{Id. § 2502(a)(2)}.
\end{itemize}
electing not to claim the credit.\textsuperscript{47}

If, in Example \#4, Molly Widow had not claimed the credit, she would have paid a gift tax in the amount of $69,840 at the time of the gift. Thus, when she died, she would have had $430,160 in cash and $400,000 in non-cash assets. The tax on her estate would be $307,596, before the credit.\textsuperscript{48} Thus, she would have paid a total of $377,436 in taxes to transfer her assets if the gift tax credit was not claimed, compared to a total of $389,735, if the credit had been claimed. By not claiming the credit, she (or rather, her heirs) has saved $12,299. Obviously, a complete analysis must include the fact that she loses the use of $30,000 from the date of the payment of the gift tax until her death. However, the analysis must also consider that the tax savings represents a guaranteed and tax-free return on the $30,000 and that an alternative investment of the funds which yields equal results may not be available.

\section{VII. \textbf{Transfers to Qualify the Estate}}

There are several sections of the Internal Revenue Code which provide various types of relief to estates but only if certain conditions exist. For example, section 303 is intended to provide relief to the estate which is caught between a large estate tax bill due to the inclusion of stock in a family corporation and the economic reality that although the stock represents a high value in the estate, it is not readily convertible to cash or would disrupt the family business if sold to outsiders. Under normal circumstances, any attempted "redemption" of the stock by the family corporation could fail under section 302, resulting in dividend treatment of the "redemption" distribution. If section 303 is applicable, the corporation can redeem stock equal in value to the death taxes and administration expenses without the risk of dividend treatment to the redeeming stockholder. Therefore, the distribution is taxed only to the extent of gain and at the favorable capital gains rate.\textsuperscript{49} However, in order for section 303 to be available to an estate, the value of the closely held stock in the estate must exceed fifty percent of the value of the adjusted gross estate.\textsuperscript{50}

\begin{footnotesize}
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\textsuperscript{47} The resolution of this issue has less impact if the gift is made before July 1, 1977. Under I.R.C. § 2505, the credit allowable for gifts made prior to that date is only $6,000. After June 30, 1977, the credit jumps to $30,000.
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\begin{footnote}
\textsuperscript{48} Under I.R.C. § 2001, the tentative tax would be computed on the sum of $830,160 plus $247,000 = $1,077,160. The tentative tax would be $345,800 plus 41\% of $77,160 = $377,436. This sum is then reduced by the prior payment of $69,840, leaving a balance of $307,596.
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\begin{footnote}
\textsuperscript{49} I.R.C. § 303(a). Some of the benefit of this provision was lost with the advent of the carryover basis under I.R.C. § 1023. Prior to the Tax Reform Act of 1976, the stock would have received a stepped-up bases to fair market value at death under old § 1014, and little, if any, gain would have to be recognized upon the distribution in redemption. Under the new law, the decedent's basis is carried over so that the redemption will probably result in gain subject to taxation. \textit{See id.} § 1023.
\end{footnote}
\begin{footnote}
\textsuperscript{50} \textit{Id.} § 303(b)(2)(A). Prior to the 1976 amendments, the value of the stock had to exceed either 35\% of the gross estate or 50\% of the taxable estate. \textit{Int. Rev. Code of 1954 as Amended Through July 9, 1975}, § 303.
\end{footnote}
\end{footnotesize}
Assume the following facts with regard to the estate of D:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock in D Family Corporation</td>
<td>$250,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>450,000</td>
</tr>
<tr>
<td>Gross estate</td>
<td>700,000</td>
</tr>
<tr>
<td>Expenses &amp; Debts (sections 2053 &amp; 2054)</td>
<td>$120,000</td>
</tr>
<tr>
<td>Adjusted gross estate</td>
<td>$580,000</td>
</tr>
</tbody>
</table>

In this situation, D's estate would not be entitled to rely on section 303 because the value of the D Corporation stock in the estate does not exceed fifty percent of the value of the adjusted gross estate. If section 303 is desired, either to provide a source of liquidity for the payment of taxes and administrative expenses, or simply to seize the opportunity to remove funds from the family corporation at the favorable capital gain tax rate, lifetime giving may provide the only answer.

By making an inter vivos gift of $90,000 out of the other assets in the estate, section 303 can be made available without the imposition of any additional tax. The adjusted gross estate will now be $490,000 and the value of the D Corporation stock, $250,000, will exceed fifty percent. Thus, section 303 is available.

However, the analysis must be carried further to determine the effect on estate taxes vis-a-vis the marital deduction. If the taxpayer is unmarried, and therefore not relying on the estate marital deduction, or if the estate is less than $500,000 (before the gift), then the lifetime transfer will have no effect on total taxes in this regard. However, if the estate exceeds $500,000, so that the maximum marital deduction is determined by the value of the adjusted gross estate, a gift as herein described can result in additional tax. In the foregoing example, the estate without the gift was $700,000 and after deduction of $120,000 in debts and expenses, the adjusted gross estate was $580,000. The marital deduction under section 2056 would be $290,000, and thus, the taxable estate would be $290,000. Assuming no gifts after December 31, 1976, the estate tax would be $84,400 before the credits.

If the $90,000 lifetime gift was made to someone other than the spouse, the computation would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross estate</td>
<td>$610,000</td>
</tr>
<tr>
<td>Debts &amp; expenses</td>
<td>120,000</td>
</tr>
<tr>
<td>Adjusted gross estate</td>
<td>490,000</td>
</tr>
<tr>
<td>Marital deduction</td>
<td>250,000</td>
</tr>
<tr>
<td>Taxable estate</td>
<td>$240,000</td>
</tr>
</tbody>
</table>

51. There is no requirement under I.R.C. § 303 that the funds received in the redemption be used to satisfy estate taxes or expenses, nor that the estate demonstrate a need for the funds in that regard.
52. There will probably be no gift tax paid on the gift since it is well within the $2505 credit. Even if gift tax is paid, it will be no more than the estate tax would have been if the $90,000 had been retained in the estate.
53. I.R.C. § 2056 provides for a maximum marital deduction of 50% of the adjusted gross estate or $250,000, whichever is higher.
The estate tax payable, assuming no tax was paid on the lifetime gift because of the gift tax unified credit, would be the tax on $240,000 plus $87,000.\textsuperscript{54} Thus the estate tax is increased to $96,980 before the credits. If the gift is made to the spouse however, the result is different. The adjusted gross estate would still be $490,000 but the marital deduction would be only $205,000.\textsuperscript{55} Thus, the taxable estate is $285,000. However, since the lifetime gift was not a taxable gift, it does not enter into the computation of the estate tax. The tax, before credits, on the $285,000 estate is $82,700, which is less than the tax would have been if the gift had not been made at all. Applying this analysis to estates of various sizes reveals that in any case where the lifetime gift is made to the spouse of the taxpayer and the marital deduction is used for both the gift and for estate tax purposes, there will be no increase in total taxes.

The use of lifetime giving in order to “qualify” the estate may also be relied upon with regard to the special farm valuation formula under section 2032A, and the provision for extended installment payment of estate taxes under sections 6166 and 6166A.

VIII. SELECTION OF ASSETS TO BE TRANSFERRED INTER VIVOS

A. Basis Considerations

Prior to the 1976 Tax Reform Act, one of the primary considerations with regard to the choice between passing an asset at death and making a lifetime gift of the asset was the basis of the asset in the hands of the donee/legatee. Under the prior law, the heir who received property through an estate received a “stepped-up” basis in the property equal to the fair market value of the asset as determined for estate tax purposes.\textsuperscript{56} Thus, on subsequent disposition of the asset by the heir, there would be little or no gain subjected to income tax. A lifetime gift of the same asset to the same person as donee rather than inheritor would result in a carryover of the donor’s basis,\textsuperscript{57} perhaps very low, and thus the loss of a significant income tax advantage. The estate planner was faced with a disadvantage one way or the other.

Perhaps out of sympathy for the estate planner’s dilemma, Congress removed the disparity, not by removing the disadvantage, but rather by eliminating the advantage. The 1976 Tax Reform Act added section 1023\textsuperscript{58} to the

\textsuperscript{54} This assumes a single $3,000 exclusion under I.R.C. § 2503(b).

\textsuperscript{55} Under I.R.C. § 2056(c)(1)(B), the maximum marital deduction is reduced because of the use of the gift tax marital deduction in excess of fifty percent of the value of the gift.

\textsuperscript{56} INT. REV. CODE OF 1954 AS AMENDED THROUGH JUNE 9, 1975, § 1014.

\textsuperscript{57} Id. § 1015.

\textsuperscript{58} The Tax Reform Act of 1976 redesignated I.R.C. § 1023 as § 1024 and added a new § 1023. Tax Reform Act of 1976, § 2005(a)(2), Pub. L. No. 94-455, 90 Stat. 1520, 1872. The Act also amended § 1014(d) to exclude from that section property which is covered by § 1023. Id. § 2005(a)(1). Section 1015(d) was amended by adding paragraph (6) which limits the adjustment to basis for gift tax paid on gifts after 1976 to that portion of the gift tax which is allocable to appreciation. Id. § 2005(c), at 1877.
Code so that now the inheritor of a decedent's property takes the decedent's basis in the property and thus is in much the same position that he would have been had he acquired the property by gift rather than inheritance. Section 1023 does, however, provide for certain adjustments to basis in the hands of a decedent's successors. Under section 1023(c) the basis is adjusted by the estate tax attributable to appreciation in the property (which is similar to the adjustment provided by section 1015(d)(6) for property acquired by gift) and under section 1023(d) there is provision for a minimum carryover basis.

However, the more important provision is section 1023(h). Under this provision, known as the "fresh-start provision," if decedent died possessing assets acquired prior to December 31, 1976 and the value of those assets in the estate exceeds the decedent's basis, the basis is adjusted to the extent of appreciation which occurred prior to December 31, 1976. The true value of the asset on December 31, 1976, other than for listed securities, is not relevant. The basis adjustment is arrived at by an allocation, on a daily basis, of the difference between estate value and the decedent's basis, with the amount allocated to the holding period up to December 31, 1976 being the amount added to the basis in the hands of the successor. The following illustration demonstrates the application of section 1023(h):

**EXAMPLE # 5:** D acquired an asset on January 1, 1966 at a cost of $300X. D dies on January 1, 1981 when the asset is worth $900X. Under section 1023(h), the appreciation, $600X, is allocated over the holding period of the asset so that:

\[
\begin{align*}
3,650 & \quad (# \text{ days held by } D \text{ prior to } 1/1/77) \\
5,475 & \quad (\text{total } # \text{ days held by } D) \\
\end{align*}
\]

Thus, 2/3 of the appreciation, or $400X, is allocated to the period ending on December 31, 1976 and is added to the decedent's basis of $300X. The basis of the asset in the successor's hands, under section 1023(h) would be $700X.

There is no counterpart to the foregoing adjustment with regard to property acquired by gift. Therefore, if the taxpayer owns property which was acquired before December 31, 1976 and which has appreciated in value, the loss of an adjustment to basis in the event that the property is transferred by lifetime gift must be considered. With regard to property acquired since January 1, 1977, there is no adjustment under 1023(h).

A similar analysis must be made with regard to property which has declined in value since acquisition by the taxpayer. Under section 1015(a), the basis of property acquired by gift, for the purposes of determining loss on disposition by the transferee, shall not exceed the fair market value of the property at the date of gift. Thus, any loss in value occurring between the date of acquisition by the donor and the date of the gift is not deducted by either the donor.

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59. This means the value at which the asset is included in the estate. Thus, if the valuation of the asset was under § 2032A, only the difference between the decedent's basis and the § 2032A value would be allocated and used to adjust the carryover basis.
or the transferee. However, if the property is acquired from a decedent under section 1023, the basis of the decedent is carried over without any limitation based on fair market value at date of death. Therefore, the unrealized loss of the decedent is preserved to the heir. Thus, if the taxpayer owns property in which there is an unrealized loss, it may be advisable to retain the property in the estate rather than make a lifetime disposition.

B. Cash v. Non-cash Gifts

Assume that a taxpayer is in the fifty percent income tax bracket, and that his daughter, to whom he wishes to make a present gift of $100,000, is in a thirty percent bracket. Further assume that the taxpayer’s estate, when taxpayer dies, will reach into the thirty-nine percent estate tax bracket under the unified rate table. Taxpayer must consider whether to make a cash or non-cash gift. Two possible assets are being considered:

(A) 100 shares of X stock, non-income producing, but with a steady growth rate of five percent per year. The stock is presently worth $100,000 and in five years, when taxpayer dies (based on life expectancy) will be worth $125,000.

(B) $100,000 in cash. This sum yields five percent per year in income, but the income is taxed at fifty percent so that at the end of five years, the total dollar value of the account will be only $112,500.

A gift of either asset will result in a taxable gift of $100,000 (assume section 2503 is not applicable), so the gift tax is not affected by which asset is given. If the stock is transferred, there will be no difference in the income tax consequences during the five year period, but the estate tax will be reduced by thirty-nine percent of $25,000 (the $100,000 value will still be included in the estate tax computation, but the appreciation since the date of gift will not). Therefore, the estate taxes are reduced by $9,750.

If the cash is given, there will be an income tax savings over the five years in the amount of $5,000 due to the daughter’s lower income tax rate, and the estate will be reduced by the $12,500 that the taxpayer would have accumulated if he had retained the cash. This results in an estate tax savings, at thirty-nine percent, of $4,875. Therefore, the total tax savings is $9,875, only $125.00 more than the savings in the case of transfer of the stock. However, there remains a significant difference. If the cash is transferred, the daughter ends up with the $100,000 plus the $17,750 after tax accumulation, and presumably, plus the $4,875 estate tax savings. Thus, she has $122,675 and that sum is not subject to any further tax. If the stock were transferred, she would have the $125,000 value, plus the estate tax savings, but the $125,000 is still subject to income tax on the unrealized appreciation. This income tax liability may be increased by the fact that a possible section 1023 increase in basis was lost.

60. There is an exception, under I.R.C. § 1023(a)(2), for personal and household effects.
Clearly an exact computation of the different tax consequences is impossible given the uncertainty of a donor's life span, tax rate, return on investment, etc., but an analysis in each individual's situation may yield convincing information and should not be overlooked.

C. Section 2032A Assets

If the assets being examined as the possible subject of lifetime gifts include a farm or closely held business, the impact of section 2032A, added by the 1976 Tax Reform Act, must be considered. Under this provision, such an asset may qualify for a special valuation formula based on "use" rather than "highest and best use." This is particularly relevant to the family farm. The valuation of the farm under section 2032A for estate tax purposes may be made under a very narrow and ostensibly beneficial formula based on average rental value for agricultural use, capitalized at a rate equal to the average interest rate for loans from the Federal Land Bank. The "relief" provided by Congress in the enactment of this section is, however, severely limited by the restrictions contained therein. Such restrictions include the limitation on subsequent use or disposition of the property and the imposition of a continuing lien for the amount of estate tax saved by use of the special valuation formula. Furthermore, the availability of section 2032A should not preclude consideration of alternate solutions such as lifetime gift or the use of buy-sell agreements.

If, after due consideration of alternatives, section 2032A is to be relied upon, then the farm cannot be the subject of a lifetime gift because the special valuation allowed by this section only applies to property passing through the estate of a decedent. It is also worth noting that not only will the "use" valuation not apply for purposes of determining the value subject to the gift tax, but it also will not apply for determining the "platform" effect of including the value of the farm gift in the section 2001 estate tax computation.

IX. The Form of the Gift

Other than a technical amendment to section 2038 to conform the language therein to the new language of section 2035, there were only two amendments to the recapture rules under sections 2035-2038. Section 2035 was totally rewritten as noted hereinafter, and section 2036 was amended to provide that retention of voting rights in stock transferred by gift will be includible in the

61. Under I.R.C. § 2032A(c)(1)(B), some or all of the estate tax saved by the special valuation must be repaid if the "qualified use" of the property does not continue for fifteen years after the decedent's death.
62. I.R.C. § 6324B.
64. There is no counterpart to I.R.C. § 2032A contained in the gift tax law. See I.R.C. ch. 12.
65. See division II, supra.
estate of the donor. Obviously, if the benefit to be derived by making a lifetime gift requires non-inclusion in the estate, the recapture rules must be avoided.

The traditional factors determining the likely identity of the donee remain much the same (for instance with regard to marital deduction, attribution rules, etc.) with one notable exception. If the potential donee is a minor child of the donor, and will be an orphan upon donor's death, and the donor will not leave a spouse, new Code section 2057 allows for a deductible bequest to such minor child in the amount of $5,000 for each year of age under twenty-one of the child at the decedent's death. There is no gift tax counterpart for this section, and it is conceivable that circumstances could dictate waiting until the taxpayer's death to pass assets to the child.

Another significant feature of the 1976 Tax Reform Act is the tax on "generation-skipping transfers", under new Code sections 2601-2621. Basically, this tax applies to distributions from trusts in which there are beneficiaries from more than one generation which is younger than the generation of the donor. There is an exception of up to $250,000 per child of the donor. This means that the traditional "skip generation trust" has been limited in its usefulness, but certainly not eliminated. The examination of the new rules in this regard would be far too expansive to be undertaken here.

X. Taxing the Lifetime Gift

The computation of gift tax, albeit under a new rate schedule, and with the modification in exclusion and allowance of a credit as noted hereinabove, remains much the same as it was prior to the Act. One comment is worthy of mention, however. Although only post December 31, 1976 gifts are accumulated for purposes of the section 2001 estate tax computation, the gift tax computation under section 2502 requires that gifts continue to be accumulated since June 6, 1932. To account for the difference in rates the computation now requires that a "tentative tax" be computed under the new rate schedule for the accumulated total of taxable gifts since June 6, 1932. The "tentative tax" is then reduced by the amount of tax computed under the same rate table for the accumulated total prior to the instant gift. Thus, the tax that was actually paid on the prior gifts does not enter into the computation.

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66. Tax Reform Act of 1976, § 2009(a), Pub. L. No. 94-455, 90 Stat. 1520, 1893. This amendment to § 2036 is the so-called "anti-Byrum" rule, referring to United States v. Byrum, 408 U.S. 125 (1972), which had held that retention of voting rights was not sufficient retention to cause inclusion in the donor's estate under § 2036. The section as amended appears to have been incorrectly worded in that it refers to retention of voting rights "in retained stock," when it obviously was intended to cover the retention of voting rights in the transferred stock.
67. Id. § 2006(a), at 1879.
68. See division I, supra.
69. I.R.C. § 2502(a)(1).
70. Id. § 2502(a)(2).
One final change to be noted is the amended filing requirements. Section 6075 is amended so that quarterly gift tax returns need not be filed until the total taxable gifts for the year exceed $25,000. If that total is not reached during any calendar quarter for the year, then a return for the entire year must be filed by the fifteenth day of the second month following the close of the taxable year. (February 15th for a calendar year taxpayer).

XI. CONCLUSION

Although the 1976 Tax Reform Act has limited the benefit to be derived from lifetime gifts, the importance of such gifts is undiminished. The planning must be more meticulous and the analysis more comparative, but the lifetime gift remains an essential element of estate planning.