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Estate Planning for Gifting: What's Taxable?

INSIGHTSARTICLE

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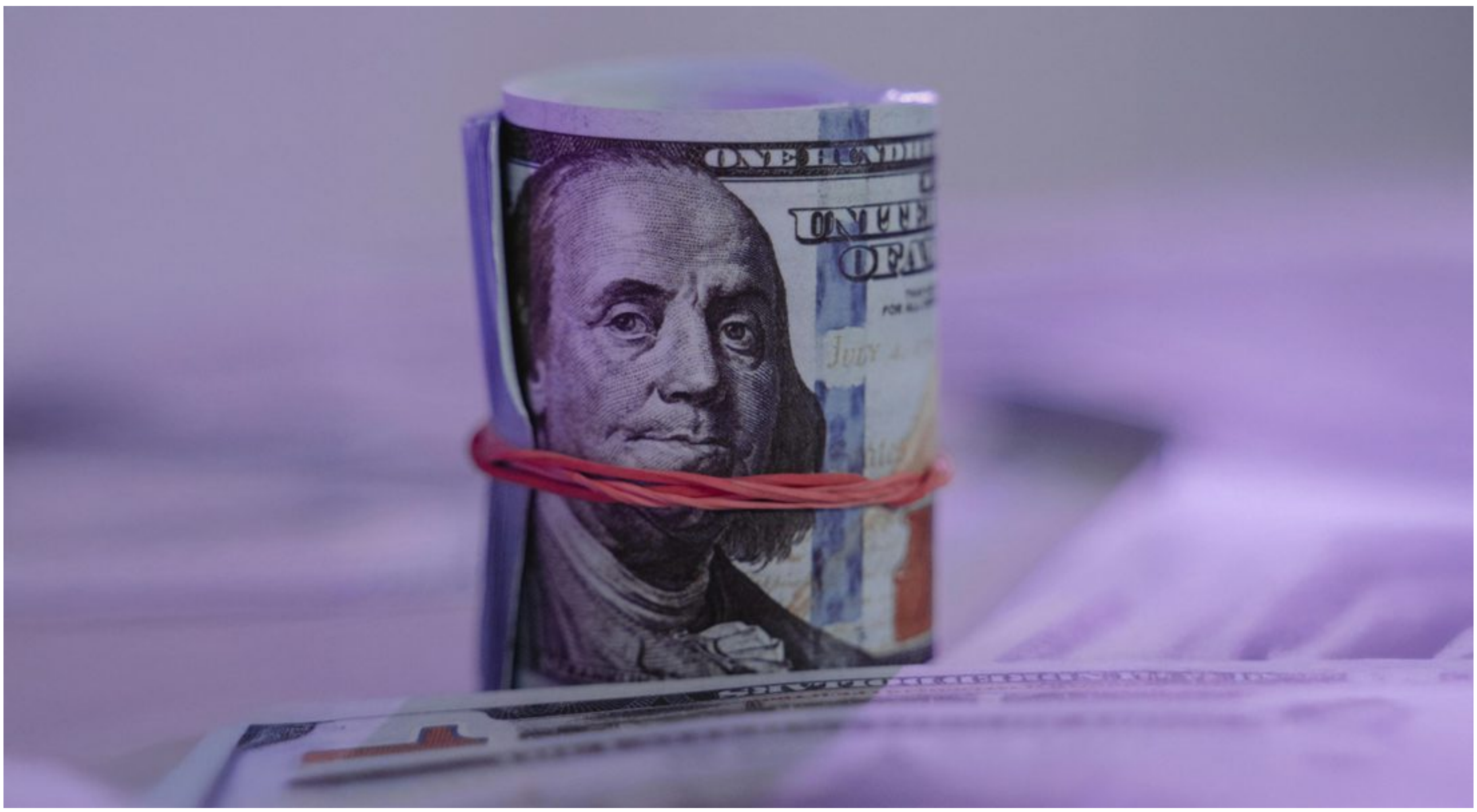

Gifting is a common estate planning strategy to reduce the taxable estate and minimize estate taxes. However, the Internal Revenue Code (IRC) contains provisions that "pull back" certain gifts made during a decedent's lifetime into the taxable estate.

These provisions are understandable, since they intend to prevent individuals from reducing their estates through last-minute gifts made shortly before death. Specifically, the rules are governed by **26 U.S.C. § 2035** and related provisions.

Here are the major ways in which gifts may be included in the gross estate for tax purposes, focusing on considering gifts made within three years of death, gift tax paid within three years of death, and other related considerations:

Gifts made within three years of death

The basic rule provides that any gift made during the three years preceding the decedent's death will be included in the gross estate if it would have been includable had the decedent retained the interest or power over the property at the time of death.

Special rules for inclusion in the gross estate

There is automatic inclusion in the gross estate of a decedent if a "certain transfer" occurs within three years of death. The term "certain transfer" includes transfers with retained powers or interests and transfers of life insurance policies where the decedent either transferred the benefit or relinquished ownership. In addition to the value of the gifts the decedent made, any gift tax paid by the decedent or their estate on gifts made during the final three years will also be included in the gross estate. This rule applies even if the gift tax is paid by the person who receives the gift or if it is part of a net gift, where the receiver is responsible for the gift tax payment. A net gift occurs when the donor gives a gift but conditions that the receiver will pay the gift tax. In such cases, if the gift is made within three years of death, the amount of the gift tax paid by the receiver is included in the decedent's gross estate, even if the decedent did not personally pay the gift tax.

If the decedent dies exactly three years after making the gift, no inclusion occurs under this rule. Also, if spouses split the gift and gift taxes are paid, those taxes will be included in the first spouse's estate.

Constructive payment of gift tax

When the surviving spouse makes a gift shortly after the decedent's death, and the surviving spouse pays gift tax on it, this may result in the inclusion of the gift tax in the decedent's estate. This is known as **constructive payment** of gift tax. To prevent this outcome, it may be prudent to establish trusts that qualify for the marital deduction, which can help defer the estate tax liability until the surviving spouse's death.

Life insurance

Life insurance can be a significant asset in the gross estate. Suppose the descendant purchased a life insurance policy and transferred the policy to another party (including an irrevocable life insurance trust or ILIT) within three years of death. In that case, the full value of the policy will be included in the gross estate. If there is a taxable estate, consider placing life insurance policies in an irrevocable life insurance trust (ILIT) from inception to avoid inclusion in the estate.

Indirect transfers

When a decedent transfers property to an entity they control, any assets transferred to the entity within three years of death are included in the decedent's gross estate. This rule prevents the manipulation of ownership to avoid estate taxes. Courts have ruled that the value of assets transferred to an entity during this period is measured at the time of transfer, not the time of death.

Revocable trusts

Any transfers from a **revocable trust** are treated as if made directly by the decedent. This means that if the decedent transfers property to a trust that they retain control over (such as a revocable living trust), the value of that property will be included in the gross estate, just as if the decedent had made the transfer directly.

Other key considerations and exceptions

Gifts made in contemplation of death. Historically, transfers made in contemplation of death were included in the gross estate. This rule captures gifts intended to take effect at or after death. This principle prevents a decedent from reducing their taxable estate through deathbed gifts. However, the court clarified the application of this rule, ensuring that only gifts made with a specific intent to avoid estate taxes are included. Courts have addressed this issue, noting that if the decedent made gifts with the knowledge of their impending death, these gifts could still be included in the estate as part of the decedent's efforts to avoid estate taxes.

Adjusted taxable gifts. Adjusted taxable gifts, such as gifts made after 1976 that have been taxed under the gift tax rules, are added to the gross estate for estate tax purposes, provided they were not already included in the gross estate.

Valuation of gifts. The value of a gift for estate tax purposes is typically determined as the value that was assessed when the gift was made for gift tax purposes. If the statute of limitations for assessing the gift tax has expired, that final valuation will generally carry over when calculating the gross estate.

Tips for estate planning

Timing is crucial. For clients seeking to minimize estate taxes through gifts, it is important to be aware of the three-year rule. Gifting made close to death can result in unexpected estate tax inclusion.

Life insurance strategies. Clients who own significant life insurance policies should consider creating an ILIT. The trust must have owned the policy since its inception or at least three years prior to the decedent's death to avoid inclusion in the gross estate.

Net gifts and gift tax payments. When making a "net gift" (where the gift receiver pays the gift tax), consider how those payments might affect the decedent's estate. The gift tax paid within three years will be included in the decedent's estate.

The rules governing gifts, gift taxes, and transfers of life insurance policies must be understood and strategically addressed to ensure the decedent's wishes are honored without incurring excessive estate tax liability. Working with an experienced estate planner can help ensure that gifts are made in a tax-efficient manner and in accordance with federal regulations. If you have any questions about gift transfers or any other estate planning questions, please contact any member of the Saxton & Stump Trusts and Estates Group.

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