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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2001

Date: 23-Aug-12
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Bramwell and Mullen: Donative Promise Can Use Up Gift Tax Exemption**

"The authors propose a strategy that enables taxpayers to make substantial taxable gifts in 2012 without currently parting with any of their wealth. The strategy is simple: Instead of transferring cash or other property this year, an individual can promise to make gifts to the donees in the future.

If the promise is designed so that it is enforceable under local law, it will be treated as a taxable gift when made and may successfully use up the $5.12 million gift and GST tax exemption amounts while they are still available. The strategy also has nontax benefits that many individuals may find compelling.

Finally, the strategy enables married taxpayers to make gifts in 2012 while avoiding potential "clawback" tax upon the death of the first spouse to die.

For these reasons, many taxpayers who have not yet used the increased gift tax exemption amount should consider doing so this year by making an enforceable promise to make gifts in the future."

Austin Bramwell and **Lisi Mullen** provide members with commentary that is sure to spark interest – if not controversy – among **LISI** members: donative promise gifts as a claw-back management strategy.

LISI provides this commentary – not as an endorsement of the concept – but as "food for thought." The views expressed herein are the authors' own. We'd be interested in reader's input – which you can readily add to **LISI's** COMMENTS BOX by clicking the link at the bottom of this newsletter.

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The authors thank **Jonathan G. Blattmachr** for his helpful comments.

Here is their commentary:

EXECUTIVE SUMMARY:

The authors propose a strategy that enables taxpayers to make substantial taxable gifts in 2012 without actually parting this year with any of their wealth. The strategy is simple: Instead of transferring cash or other property this year, an individual can promise to make gifts to the donees in the future. If the promise is designed so that it is legally enforceable under local law but is not in exchange for consideration in money or money's worth, it will be treated for federal gift tax purposes as a taxable gift when the promise is made (rather than when it is later paid) and will successfully take advantage of the $5.12 million gift and estate tax exemption amount while it is still available.

The strategy also has nontax benefits that many individuals may find compelling.

Finally, the strategy enables married taxpayers to make gifts in 2012 while avoiding potential "clawback" tax upon the death of the first spouse to die.

For these reasons, the authors suggest that many taxpayers who have not yet used up the increased gift tax exemption amount should consider doing so this year by making a legally enforceable promise to make gifts in the future.

FACTS:

The federal gift and estate tax exemption amount, currently $5.12 million, is scheduled to revert to $1 million after this year. The highest estate tax rate, meanwhile, is schedule to increase from 35% to 55% (and, in some cases, up to 60%).

The impending decline in the exemption amount and increase in estate tax rates create a powerful incentive to make taxable gifts this year. Absent further legislation, for example, a taxable estate of $5.12 million, if the decedent made no taxable gifts, will generate $2,111,000 of estate tax in 2013. Taxpayers can potentially avoid that tax entirely by making taxable gifts this year up to the $5.12 million exemption amount.

Unfortunately, not all taxpayers feel that they have the wherewithal to immediately part with $5.12 million of wealth. An individual worth exactly $5.12 million, for example, if he or she has made no prior taxable gifts, would need to give away 100% of his or her assets in order to use up the exemption amount in full this year.

Although the $2,111,000 in potential estate tax savings represents approximately 41% of the individual's wealth, he or she may nonetheless decide that the tax savings at death are not worth the lifestyle compromises required to make substantial taxable gifts this year. Consequently, many individuals, especially the relatively less affluent, will fail to take advantage of the increased exemption amount available in 2012.

COMMENT:

Happily for such taxpayers, we believe there is a strategy whereby they can use up the exemption amount available this year - yet still retain title to and control of all their wealth.

Under this strategy, an individual, instead of giving away cash or other property this year, promises to pay cash or other property to the donees in the future. If the promise (hereinafter, a "donative promise") is legally enforceable under local law, it will be treated as a taxable gift.[i] Although a donative promise will not qualify at the taxpayer's death for

a deduction under Code section 2053(a)(3), it will also not be treated as an adjusted taxable gift under Code section 2001(b). Consequently, a donative promise can save estate tax on the difference between this year's exemption amount and the lower exemption amount that will be available beginning in 2013.

Example: Unmarried Taxpayers

For example, suppose that Ruth, an unmarried individual who has made no prior taxable gifts, has exactly $5.12 million of assets. She makes an enforceable promise to pay her children $5.12 million (plus interest at the applicable federal rate) in five years. The promise will be treated as a taxable gift at the time that it becomes enforceable under local law.[ii] In addition, as discussed in further detail below, the value of the gift can be reported as being equal to the full $5.12 million face amount of the promise. Ruth's donative promise, therefore, uses up all the entire gift tax exemption amount.

Now suppose that Ruth dies in 2013 with exactly $5.12 million of assets. Section 2053(c)(1)(A) of the Code provides that a claim founded on a promise or agreement cannot generally be deducted against the taxable estate - unless it was contracted bona fide and for full and adequate consideration in money or money's worth. Here, Ruth's promise was *not* made for a valuable consideration. Her children's claim against the estate, therefore, will not qualify for a section 2053 deduction. Assuming (for simplicity) that there are no other deductions, Ruth's taxable estate will be $5.12 million.

To determine the estate tax due under the calculation procedures of section 2001(b) of the Code, Ruth's executors will need to determine whether any "adjusted taxable gifts" need to be included in the amount subject to estate tax. Normally, a gift that is not included in a decedent's gross estate qualifies as an "adjusted taxable gift." In this case, Ruth's gift is not brought back into the gross estate under one of the "string" sections (i.e., sections 2035 through 2042 of the Code) that can cause property transferred during lifetime to be included in the gross estate. [iii]

Treating a donative promise gift as an adjusted taxable gift, however, would lead to double taxation: The assets used to satisfy the promise would be taxed once as part of the gross estate under section 2033 of the Code (but without a corresponding deduction under section 2053 of the Code) and a second time as an adjusted taxable gift. Public policy, therefore, would seem to demand that a donative promise gift *not* be treated as an adjusted taxable gift to the extent that the promise is not satisfied during lifetime.[iv]

In Rev. Rul. 84-25, the IRS confirmed that a donative promise gift, although it does not qualify for a deduction under section 2053 of the Code, is also not an adjusted taxable gift. Thus, Ruth's $5.12 million gift in 2012 is not added to the estate tax calculation. In other words, a tentative tax will be calculated on the taxable estate of $5.12 million and not on the sum of the taxable estate and Ruth's $5.12 million donative promise gift in 2012.

The next step in the estate tax calculation procedure will be to subtract the gift tax which "would have been payable" on the donative promise gift that Ruth made in 2012. Assuming that the IRS cannot recapture or "claw back" tax on gifts that at the time were under the gift tax exemption amount, the gift tax payable will be $2,111,000. After this amount is subtracted from the tentative tax, the remaining estate tax will be $345,800, which will be equal to the unified credit under section 2010 of the Code. No estate tax will be due at Ruth's death. Thanks to Rev. Rul. 84-25, Ruth's donative promise successfully uses up the $5.12

million exemption amount that was available to her in 2012.

Example: Married Taxpayers

The donative promise strategy also works for married couples who intend to defer the payment of estate taxes until the death of the surviving spouse. To be sure, if the first decedent makes a donative promise gift in 2012, his or her taxable estate may be larger than the estate tax exemption amount that will be available beginning in 2013. At first blush, therefore, it may seem that, contrary to the desire of many married taxpayers, the donative promise strategy will cause estate tax to be paid at the first decedent's death.

In fact, however, the donative promise strategy works as well for married taxpayers as for unmarried taxpayers. For example, suppose that Jake, a married individual with $10 million of assets who has made no prior taxable gifts, makes a $5.12 million donative promise gift to his children in 2012. He dies in 2013 leaving his entire estate, after the payment of debts, to his wife. Jake's executors pay over $5.12 million to Jake's children and the $4.88 million balance to Jake's wife.[v] Jake's estate, therefore, may only take a marital deduction of $4.88 million, which leaves a taxable estate of $5.12 million.

Just as in Ruth's case, Rev. Rul. 84-25 will prevent Jake's donative promise gift from being added to the amount subject to estate tax as an adjusted taxable gift. The gift taxes payable on the gift, meanwhile, will reduce the tentative estate tax to $345,800 (assuming no clawback of tax). Once again, the unified credit will absorb all of the tax and no estate tax will be due.

In short, despite that a donative promise in 2012 may generate a taxable estate that is larger than the exemption amount available after 2012, it will not cause estate tax to be due at the first decedent's death (assuming that clawback, discussed below and not a problem unique to donative promise gifts, does not apply).

Clawback Management

The examples discussed above assume that the gift tax that "would have been payable" on a gift made in 2012 by a decedent who dies in 2013 or later will reduce the amount of estate tax at death, even though no gift tax was actually assessed. As has been discussed in prior **LISI** newsletters,[vi] however, it is not entirely clear that the IRS must permit a reduction of estate tax for a hypothetical tax on gifts that were under the gift tax exemption amount. If the reduction is denied, the IRS could effectively recapture or "claw back" tax on the difference between the (higher) exemption amount available at the time of the gift and the (lower) estate tax exemption amount available at death.

It may be unlikely at this point that the IRS will actually assert the right to recapture tax on gifts that were covered by the exemption amount available at the time of the gifts. For one thing, Congress may eliminate the threat of clawback if the exemption amount is reduced.[vii] Recently published temporary and proposed Treasury Regulations also clearly foreclose the similar threat of clawback that could have arisen where a decedent, by remarrying and surviving a second spouse, lost gift tax exemption he or she had inherited from a prior deceased spouse. [viii] That the IRS does not believe in clawback in the portability context may indicate that the IRS likewise does not believe in clawback in the context of decreasing exemption amounts.

That said, any remaining threat of clawback is especially severe for married couples: If the first decedent's executors are required to pay clawback tax, they may be forced to pay the tax out of the marital share passing to the surviving spouse, which will reduce the marital deduction

available to the estate, which will increase the estate tax, which will further reduce the marital deduction, and so forth in a vicious circle. Suppose, for example, that Marci, a married taxpayer worth $10 million who has made no prior taxable gifts, makes a $5.12 million cash gift in 2012 and dies in 2013 with $4.88 of assets remaining, all of which she attempts to leave outright to her husband. If the IRS successfully claims the power to claw back tax on the $5.12 million gift, Marci's estate will be required to pay $4,691,111.11 of estate tax. Only $188,888.89 will pass to Marci's husband.

Now suppose instead that Marci gives her children a $5.12 million note enforceable under local law. The note provides that, if it remains outstanding at Marci's death and Marci predeceases her husband, then the amount payable under the note will be reduced to the maximum amount that can be paid to Marci's children without causing estate tax to be due at Marci's death.[ix] Marci once again dies in 2013 survived by her husband. As the maximum amount that can be paid to Marci's children in 2013 without causing estate tax to be due would (if there is clawback) be $1 million, Marci's executors would be required to pay only $1 million to Marci's children. The balance of her assets ($9 million) could then be paid over to Marci's husband. Marci's taxable estate, therefore, would be $1 million, which is exactly equal to the exemption amount available in 2013. A partial cancellation provision that is incorporated into a donative promise gift, in short, can prevent clawback tax at the death of a married taxpayer.[x]

Making the donative promise enforceable

For the donative promise strategy to succeed, it is crucial that the promise be enforceable under local law. If the promise is unenforceable, no taxable gift occurs and no gift tax exemption will be used.[xi] Donors and donees, therefore, should take care that the donative promise is made pursuant to an agreement that satisfies the elements of a contract, i.e., that there be a manifestation of mutual assent and a bargained-for consideration.[xii]

To illustrate, consider the following example:

> Alvina loves her daughter, Vanessa, but privately has reservations about the way Vanessa is raising her own children. In particular, Vanessa has chosen to send her children to an elite private school where they rub elbows with the rich and famous. Alvina believes in supporting the public school system and fears that her grandchildren are learning the "wrong values."
>
> Alvina approaches Vanessa and tells her of the substantial potential estate tax savings from making taxable gifts this year. However, Alvina cannot afford to just give away the money this year. Instead, Alvina says that she will promise to give Vanessa $5.12 million in the future. Vanessa expresses deep gratitude to Alvina for even thinking about saving estate tax at Alvina's death.
>
> Alvina then explains that there is a catch: the promise must be enforceable in order to save estate tax, but the only sure way to make it enforceable is for Vanessa to do something in return for the $5.12 million promise. Alvina confesses that she had always wished that Vanessa had sent her children to public school. As a condition of promising to give her $5.12 million in the future, therefore, Alvina will ask that Vanessa send her children for one year to a local public school. Vanessa says that she will agree.
>
> Alvina and Vanessa then sign an agreement reciting that Alvina wishes to make a taxable gift to Vanessa in order to save estate taxes, and stating that, in consideration for the Alvina's promise to

> pay her $5.12 million, Vanessa will enroll her children in public school. Vanessa enrolls her children in public school in the fall.

Can Vanessa enforce Alvina's promise? In our view, the answer is yes. It is well-established that consideration (i.e., any bargained-for legal detriment, such as an act or forbearance that the promissee has no legal duty to perform [xiii]) need not be adequate in order to be sufficient.[xiv] As one authority has written:

> It is an elementary and oft quoted principle that the law will not inquire into the adequacy of consideration as long as the consideration is otherwise valid or sufficient to support a promise. By this is meant that so long as the requirement of a bargained-for benefit or detriment is satisfied, the fact that the relative value or worth of the exchange is unequal is irrelevant so that anything which fulfills the requirement of consideration will support a promise, regardless of the comparative value of the consideration and of the thing promised. The rule is almost as old as the doctrine of consideration itself.[xv]

Another states:

> The rule is too well settled, even to admit of argument, that consideration in fact bargained for is not required to be adequate in the sense of equality in value. The mere inadequacy, alone, is never sufficient to vitiate a contract or conveyance otherwise valid, and the courts are not disposed to enter upon nice calculations to strike a balance on the one side or the other. Absolute equality is not to be hoped for, and is seldom attained in men's dealings one with the other. Nor is consideration to be measured in terms of dollars and cents alone; convenience, avoidance of troublesome details and efforts are proper elements.[xvi]

Thus, a decedent's promise to pay a friend $5,000 for a canary – an extraordinarily exorbitant price at the time for a bird – was held enforceable against his estate.[xvii] Another promise to pay $5,000 – again, an exorbitant price, especially at the time – in exchange for ministering to the decedent's feet was held to be enforceable.[xviii] In *Hamer v. Sidway*,***[xix]*** the court famously held that refraining from using alcohol or tobacco was sufficient consideration to make a promise enforceable.

The IRS, citing *Hamer*, has itself held that a promise to pay a donee money in exchange for the donee graduating from college was a taxable gift when the donee graduated.[xx] Other considerations that have been held to be legally sufficient include attending the donor's funeral,[xxi] changing one's name, [xxii] quitting one's job[xxiii] or giving a child a certain name.[xxiv] Further examples of inadequate yet legally sufficient consideration abound.[xxv] In like fashion, that Vanessa's promise to enroll her children in public school has no fair market value nor even (compared to the potential estate tax savings) very much value to Alvina is, under traditional contract principles, irrelevant to whether Vanessa's consideration is sufficient.

The principle that the law will not inquire into the adequacy of consideration, however, does not settle whether Alvina's promise is enforceable. The deeper question posed by Vanessa's performance for Alvina's promise is whether it was truly "bargained for." In the "classical" view, consideration is not insufficient merely because "obtaining it was not the motive or a material cause inducing the promissor to make the promise."[xxvi] As an illustration, the Restatement (First) of Contracts offers the following:

> A wishes to make a binding promise to his son B to convey to B Blackacre, which is worth $5000. Being advised that a gratuitous promise is not binding, A writes to B an offer to sell Blackacre for $1. B accepts. B's promise to pay $1 is sufficient consideration. [xxvii]

In other words, a donor may always make a promise enforceable by inducing a nominal consideration, even though both donor and donee know that the motive is simply to make a gift.[xxviii] Thus, that Alvina's primary purpose is to save estate tax by making a taxable gift would not, in the classical view, undermine the sufficiency of Vanessa's consideration.

More recent authorities, however, retreat from the Restatement (First) of Contract's flat assertion that motive is irrelevant. Restatement (Second) of Contracts instead warns that a "mere pretense of bargain does not suffice." As an illustration, it gives the following:

> A desires to make a binding promise to give $1000 to his son B. Being advised that a gratuitous promise is not binding, A offers to buy from B for $1000 a book worth less than $1. B accepts the offer knowing that the purchase of the book is a mere pretense. There is no consideration for A's promise to pay $1000.[xxix]

The Restatement (Second) acknowledges that "[e]ven where both parties know that a transaction is in part a bargain and in part a gift, the element of bargain may nevertheless furnish consideration for the entire transaction."[xxx] The Restatement (Second) also generally endorses the well-settled rule that a promissor's motivation for inducing a consideration is normally irrelevant to whether it was actually bargained for.[xxxi] Nonetheless, it clearly raises the possibility that, even though the donor and donee both wish to make donor's promise legally enforceable, a donative promise will be held unenforceable if they both know that the donor's motive in seeking consideration from the donee is to make a gift. In Alvina's case, since her overwhelming motive is to save estate tax by making a taxable gift, it is unclear whether Vanessa's act of enrolling her children in public school was truly bargained for.

The Restatement (Second)'s about-face on nominal consideration for a promise to make a gift has been widely criticized.[xxxii] As Samuel Williston remarked, "It is something, it seems to me, that a person ought to be able to do, if he wishes to do it—to create a legal obligation to make a gift. Why not? . . . I don't see why a man should not be able to make himself liable if he wishes to do so."[xxxiii] Unfortunately, there does not appear to any case law to settle which Restatement's position is correct.[xxxiv]

That said, in the our view, even under the Restatement (Second)'s position, Alvina's promise is enforceable. While Alvina's primary motive is to save estate tax, she also genuinely desires to see her grandchildren enrolled in public school. Even the Restatement (Second) allows that presence of some non-donative motive for seeking consideration suffices to make it legally sufficient.[xxxv] As there is at least some element of bargain in Vanessa's agreement to enroll her children in public school, therefore, Alvina's promise should be enforceable.[xxxvi]

As a general matter, it seems that the more strongly the donor actually desires the performance or forbearance furnished as consideration, the more likely the promise is to be upheld as enforceable. Planners recommending the donative promise strategy, therefore, should review carefully with the donor what lifestyle concessions he or she wishes to extract from the donees. The more meaningful to the concession (and the more reluctant the donees to make it), the more likely the strategy is to succeed. The requirement that a promise must be supported by consideration in order to use up gift tax exemption turns out to be a significant non-tax benefit: In order to make a taxable gift of a promise to pay money in the future, a donor simply has no choice but to demand, on the advice of counsel, that the donees take actions that they might otherwise be reluctant to perform.

Must the promise be bona fide?

Just because an instrument is enforceable under local law does not mean that it will always be respected for tax purposes. For example, the IRS

has ruled, controversially, that if a taxpayer sells property for a note that he or she does not intend to enforce, the note will be disregarded in determining the value of the gift.[xxxvii] The IRS's attack on notes that are not bona fide in the context of installment sales may cause some concern that the IRS will similarly attack a donative promise gift on the grounds that the donors and donees did not intend to enforce the terms of the gift nor the donor and donee to honor it. Some might worry, in other words, that, contrary its usual practice, the IRS will actively seek to *prevent* taxpayers from reporting transactions as taxable gifts.

Needless to say, no individual should make a donative promise gift unless he or she fully intends to honor the terms of the promise. For taxpayers concerned that the IRS will question their intentions, however, it is comforting to observe that the *intent* of the parties is irrelevant to determining whether a transaction constitutes a taxable gift.[xxxviii] On the contrary, "application of the [gift] tax is based on the objective facts of the transfer and the circumstances in which it is made, rather than the subjective motives of the donor."[xxxix] In Rev. Rul. 79-384, for example, a child sued a parent to enforce a promise to pay money upon the child's graduating from college. Despite the parent's evident lack of intent to honor the promise, the IRS held that the parent made a taxable gift on the date the child graduated and the promise became enforceable under local law.

Consistent with the notion that subjective intent is irrelevant to whether a transfer is a taxable gift, Rev. Rul. 84-25 holds that the "gratuitous transfer of a *legally binding* promissory note is a completed gift." The ruling says nothing about whether the promissees intended to enforce the note or the whether the taxpayer intended to satisfy it. Therefore, so long as the promise is legally enforceable and the consideration received has no value in money or money's worth, the promise will be a taxable gift.

In any case, taxpayers can foreclose any "risk" that the IRS will attempt to void donative promise gifts by adequately disclosing them on their gift tax return. Once a donative gift is adequately disclosed and the period for assessment of gift tax lapses, any argument by the IRS that the gift was not bona fide would be precluded under Code section 2001 (f). The gift tax assessment period will begin to run so long as the gift is adequately disclosed and reported as a completed gift, even if the gift is ultimately determined to have been incomplete.[xl] Thus, if a donative promise is reported as a taxable gift and the gift tax assessment period lapses, the IRS must treat the promise as a taxable gift when calculating estate tax at death.

Is there a downside?

Suppose that, despite the unbroken line of authority supporting the proposition that an enforceable promise is a taxable gifts,[xli] the IRS nonetheless seeks to void a donative promise gift made in 2012. If the IRS succeeds, the donor will simply have failed to have made a taxable gift and his or her estate will not be able to subtract from the amount of estate tax due the gift taxes that "would have been payable" on the donative promise gift. The same result would have obtained had the donor made no taxable gifts at all. For taxpayers who do not have the means to make conventional taxable gifts this year, therefore, there is no gift or estate tax downside to making a donative promise gift.[xlii]

Valuing the promise

In general, the value of property for gift tax purposes is the price at which it would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both being reasonably apprised of the relevant facts.

This general rule, however, is subject to a number of specific rules governing the valuation of various types of property. In particular, the value of a promissory note "is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value."[xliii] Under this rule, it seems that a taxpayer may report the value of a note as being equal to the amount due, even though the value of the note could in theory be discounted (such as for lack of security, insolvency of the borrower, date of maturity, etc.). Indeed, as the Treasury Regulations only permit the *donor* (not the IRS) to establish a lower value, it may be (although it is not certain) that the IRS is precluded from challenging a taxpayer's position that the value of a note is equal to the principal required to be paid.

In the context of the donative promise strategy, the presumption that a note is equal to its face value is helpful in a number of ways:

First, the donor need not engage an appraiser to value a donative promise gift; instead, he or she may simply report the face value of the promise as its value for gift tax purposes.

Second, the donor, to use up his or her exemption amount, need not increase the face value of the promise in order to make up for any discount.

Third, if the value of the promise is equal to its face value, there will generally not be any mismatch between the value of the gift in 2012 -- which will determine the amount of gift taxes which "would have been payable" under section 2001(b) of the Code -- and the amount that the taxpayer's executors will actually be required to pay to the donees at death -- which may (such as in the case of a married donor who plans to defer estate taxes until the death of the surviving spouse) determine the size the taxable estate.

Finally, for married taxpayers, the ability to report the value of a donative promise as being equal to the full amount of principal can help manage the risk of clawback tax. As discussed above, a married donor should consider including a partial self-cancellation provision that, if the donor predeceases his or her spouse, will automatically reduce the amount required to be paid under the note to the maximum amount that can be paid without causing estate tax to be due at the donor's death.

The presumption that a note is equal to its face value seems to permit the donor to take the position that there is no discount in virtue of the self-cancellation feature. That is, rather than attempt to determine what the discount would be based on such uncertain factors as whether the law permits the IRS to claw back tax or the probability that Congress will not act to prevent a decrease in the exemption amounts, it seems that the donor can report the value of the note as being equal to the full principal amount, without taking the partial cancellation clause into account.[xliv]

Is payment of the promise taxable income?

Donees who enter into a donative promise gift agreement with the donor should consider whether any payment to them is taxable income rather than a gift excludable from gross income under section 102(a) of the Code. Just because a transaction is a taxable gift for gift tax purposes does not mean that it is a gift for income tax purposes.[xlv] In particular, whereas a taxable gift is generally any completed transfer (other than in the ordinary course of business) for less than full and adequate consideration in money or money's worth, regardless of motive, a taxable gift for income tax purposes generally requires, in the words of the *Duberstein v. Comm'r*,[xlvi] a "detached and disinterested generosity . . out of affection, respect, admiration, charity or like impulses." Unless the donees can establish that that the payment by the

donor was made with the requisite motive, therefore, the payment could conceivably be treated as taxable income earned by the donees.[xlvii]

That said, while there is no authority directly on point, it should not be difficult to establish that the donor was indeed motivated by a "detached and disinterested generosity." The donor's very purpose in making a donative promise gift is to cause more wealth to pass tax-free to the donees. Any payment to the donees, therefore, should be treated as a gift excludable from the donees' income.

In addition, courts have held where an individual deliberately overpays for property or services, the overpayment constitutes a gift.[xlviii] In making a donative promise, the donor deliberately agrees to overpay for the value of the donees' consideration. Consequently, the overpayment should be excluded from the donees' income just as in the case of a gift made for no consideration.

Finally, when the donor and the donee are intimately associated, courts have typically treated a payment to the donee, even if in exchange for some kind of benefit, as a gift.[xlix] As a donative promise will typically be made to family members, the donor's natural affection for the donees will tend to establish that the payment to the donees was a gift.

Careful planning can in any case minimize the risk that the donees will have taxable income:

First, wherever possible, the donor, rather than the donees, should initiate discussion of making a donative promise gift.

Second, the documents implementing the donative promise gift should emphasize the donor's wish to pass wealth to the donees. The donative promise documents can even recite that the donor has asked the donees to furnish consideration so as to enable the donor to make gifts to them in a tax-efficient manner.

Third, the donees of the donative promise gift should be the same as the beneficiaries named in the donor's will or other testamentary documents.

Finally, the donor should demand consideration that he or she genuinely believes will be beneficial to the donees. Good candidates may be an agreement to enroll minors in a particular school, to travel to a particular location, to release claims in order to resolve intra-family strife or to engage in some meaningful and significant life-improving activity.

Income and GST tax structuring

In almost all cases, the donative promise should be made to an irrevocable trust that is structured as a "grantor trust" for income tax purposes.[l] Making a donative promise gift to a grantor trust has several advantages:

First, as transactions between the donor and a grantor trust are ignored for income tax purposes, neither the donor nor the trust should be taxed on any interest on the note.[li]

Second, it should be possible for the donor to allocate exemption from generation-skipping transfer ("GST") tax to the trust so as to reduce to zero the GST tax rate that may apply.[lii]

Third, the donor's spouse can be included in the class of beneficiaries, thereby ensuring that all property of the donor will pass to or be held for the benefit of the spouse if he or she survives the donor.

Fourth, if the donative promise is satisfied during the donor's lifetime, it does not appear that the payment to the trust can be treated as taxable compensation income to the donees, as both the promise and the satisfaction of the promise would be ignored for income tax purposes under Rev. Rul. 85-13.[liii]

Finally, even if the promise is not satisfied until after grantor trust status is terminated (such as at the grantor's death), the creation of a private express trust, a traditional device for passing on family wealth, supports a finding that the donor was primarily motivated by "detached generosity" and thereby should lessen any risk that satisfaction of the promise will be treated as compensation income to the donees.

TECHNICAL EDITOR'S COMMENT

Will the IRS argue that the note was not a legitimate, enforceable obligation? The odds of this adverse result diminish if payments start to be made immediately.

Will the promissory note actually be enforceable under state law? If so, will it be enforceable to the extent of the note's full principal, or perhaps a reduced amount? These questions, of course, are something each attorney will need to research for his or her own state.

And, of course, it is absolutely essential that the parties act in good faith and honor their agreement and that the note be actually repaid.

Being conservative, I would tend to recommend this approach only if the client had no other assets to give, had short-term liquidity needs, and had a long-term plan for raising the money to repay the loan – and an intention to do so.

That's just my preliminary approach to this idea; each **LISI** reader should decide when this strategy is the most appropriate one to use under the circumstances.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

Lisi Mullen

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[i] A donative promise, as the term is used in this article, is "donative" in the sense that, if it is enforceable under local law, it will be treated as taxable gift for federal gift tax purposes. See, e.g., Rev. Rul. 79-384; Rev. Rul. 84-25. As discussed further in the text, however, a promise must generally be supported by some consideration, even if not adequate in dollar terms, in order to be enforceable under local law.

[ii] Rev. Rul. 79-384; Rev. Rul. 84-25; *Comm'r v. Copley's Estate*, 194 F.2d 364 (7th Cir. 1952), acq. 1965-2 C.B. 4; *Rosenthal v. Comm'r*, 205 F.2d 505 (2d Cir. 1953); *Harris v. Comm'r*, 178 F.2d 861 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950); cf. *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981) ("The critical inquiry is whether the parties to the agreement intended to give the donees the right to enforce the [donor's] obligation to make the . . . payments").

[iii] The Line 4 Worksheet for adjusted taxable sheets in the IRS's Instructions for Form 706 seems to assume that a post-1976 gift cannot be excluded from adjusted taxable gifts unless the transferred property is included in the gross estate under one of the "string" sections. As discussed in the text, however, a donative promise gift, although not included in the gross estate under one of such sections, is also not an adjusted taxable gift.

[iv] The Second Circuit recognized the potential for double taxation of donative promise gifts in *Estate of Flandreau v. Comm'r*, 994 F. 2d 91 (2d Cir. 1993). There, the court held that deductions for donative promise claims against the estate were rightly denied under section 2053(c)(1)(A) of the Code. The court went on to note, however, that, to prevent double taxation of the donative promise gifts, which were made before 1977, the estate should have claimed a credit for gift taxes paid under section 2012 of the Code.

[v] It is assumed here that no interest is payable on the $5.12 million promise at death. To avoid accrued interest from increasing the amount taxable at death (thereby increasing the first decedent's taxable estate and potentially generating estate tax), it may be prudent for a married donor to make regular interest payments on the donative promise. Alternatively, the donor could make a donative promise gift by giving a zero-interest note to a grantor trust for the benefit of the donees. No income tax liability for foregone interest would be generated under section 7872(a) of the Code, as any transactions between the donor and the trust would be ignored for income tax purposes. Rev. Rul. 85-13. Any deemed transfer of foregone interest from the trust to the donor under section 7872 of the Code would be harmless for gift tax purposes, as the gift tax applies to individuals and not to trusts. Internal Revenue Code ("IRC") § 2501(a).

[vi] M. Jones, *Grasping Clawback's Applicability & Opportunities*, LISI Estate Planning Newsletter #1925 (February 16, 2012); D. Evans, *Clawback Has No Teeth*, LISI Estate Planning Newsletter #1929 (February 23, 2012).

[vii] See, e.g., U.S. Senate. 112th Congress. 2d Session. *Middle Class Tax Cut Act*. S. 3393 (July 17, 2012) ("If the taxpayer made a taxable gift in an applicable preceding calendar period, the amount of tax computed under subsection (a) shall be reduced by the amount of tax which would have been payable under chapter 12 for such applicable preceding calendar period if the applicable exclusion amount in effect for such preceding calendar period had been the applicable exclusion amount in effect for the calendar year for which the tax is being computed and the modifications described in subsection (g) had been applicable for such preceding calendar period."). As all lifetime taxable gifts, not just "adjusted taxable gifts," can generate a reduction of estate tax for the gift taxes that "would have been payable," a clawback cure will be just as helpful for decedents who made donative promise gifts (or other taxable gifts that are not adjusted taxable gifts, such as a gift to a personal residence trust where the grantor died during the fixed term) as decedents who made conventional gifts of cash or other property.

[viii] See Treas. Reg. § 20.2010-3T(b); Treas. Reg. § 25.2505-2T(c).

[ix] To ensure that the donative promise gift is complete for gift tax purposes, care should be taken that the donor does not retain any power to affect the amount due under the note. For example, the note should provide that the maximum amount that can transferred free of estate tax is determined as if all property included in the donor's gross estate will qualify for an estate tax deduction, regardless of whether it actually so qualifies.

[x] The partial self-cancelling feature should not be void under *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). That case held as void as against public policy a provision that purported to automatically cancel a transfer of stock if it was determined to be subject to gift tax. The court in *Procter* gave three grounds for disregarding the provision: First, it would discourage the collection of taxes; second, it would frustrate the judicial process by rendering moot any determination by a court that the transfer was a taxable gift; third, the provision, if upheld, would be a condition subsequent that would render any judicial opinion a mere declaratory judgment. Recent cases have cast doubt on the first rationale by holding that the "Commissioner's role is to enforce the tax laws," not merely to maximize receipts. *Estate of Christiansen v. Comm'r,* 586 F.3d 1061 (8th Cir. 2009). As for the second two rationales in *Procter*, a partial self-cancelling provision would not purport to undo *post hoc* the effects of a judicial decision as to whether the IRS can clawback tax on lifetime gifts. On the contrary, the amount payable under the note would in principle be determinable as of the moment of death. Recent cases have held that where an amount transferred is constant, even if unknown, *Procter* is not applicable. See *Petter v. Comm'r*, 653 F.3d 1012, 1023 (9th Cir. 2011); *Wandry v. Comm'r*, T.C. Memo 2012-88. A self-partial cancellation provision would simply fine-tune the decedent's taxable estate so that it is no greater than the exemption amount available at death. The IRS has approved similar clauses in its own regulations. See Treas. Reg. § 25.2518-3(d) Example 19.

[xi] Rev. Rul. 67-396; *Alexander v. U.S.*, 640 F.2d 1250 (Ct. Cl. 1981).

[xii] Restatement (Second) of Contracts § 17(1). It is also possible that the promise would be enforceable based on a theory of promissory estoppel. See Restatement (Second) of Contracts § 90. Promissory estoppel, however, should be treated, at most, as a fallback theory. The safest course is to make the donative promise pursuant to a binding contract.

[xiii] Restatement (Second) of Contracts § 71.

[xiv] Restatement (Second) of Contracts § 79(b).

[xv] Williston on Contracts § 7:21 (4th ed.).

[xvi] Corbin on Contracts (Revised Edition) § 5.14 (quoting *Marcrum v. Embry*, 291 Ala. 400, 406 (1973).

[xvii] *In re Todd's Estate*, 47 Misc. 35 (Sur. Ct. 1905).

[xviii] *Yarwood v. Trusts & Guarantee Co*., 94 A.D. 47, 87 N.Y.S. 947 (4th Dep't 1904).

[xix] 27 N.E. 256 (N.Y. 1891).

[xx] Rev. Rul. 79-384.

[xxi] *Earle v. Angell*, 157 Mass. 294 (1892).

[xxii] *Babcock v. Chase*, 36 N.Y.S. 879, 880-81 (N.Y. Gen. Term 1895).

[xxiii] *Brearton v. DeWitt*, 252 N.Y. 495, 499-500 (1930).

[xxiv] *Schumm by Whyner v. Berg*, 37 Cal. 2d 174 (1951).

[xxv] *In re Cole's Estate*, 195 N.Y.S. 541, 548-50 (N.Y. App. Div. 1922) (abandoning practice of medicine); *Werner v. Werner*, 154 N.Y.S. 570 (N.Y. App. Div. 1915) (refraining from attempting to join police force); *Lindell v. Rokes*, 60 Mo. 249 (1875) (abstaining from liquor); *Halliwell v. Gordon*, 878 N.Y.S.2d 137, 139 (N.Y. App. Div. 2009) (refraining from leaving employment); *Delisi v. Ficarrota*, 135 N.Y.S. 653, 655 (N.Y. App. Term 1912) (abandoning right to bid on property); *Farrar v. Young*, 216 S.E.2d 575 (1975) (providing maintenance and support).

[xxvi] Restatement (First) of Contracts § 84.

[xxvii] Restatement (First) of Contracts § 84 Illustration 1.

[xxviii] Of *Dementas v. Estate of Tallas*, 764 P.2d 628 (Utah Ct. App. 1988), where the decedent seems to have used every device possible to make his promise enforceable other than to demand consideration, E. Allan Farnsworth wrote that "[a] peppercorn would have sufficed, but there was none." *Promises to Make Gifts*, 43 Am. J. Comp. L. 359, 372 (1995).

[xxix] Restatement (Second) of Contracts § 71 comment b, Illustration 1; see also Restatement (Second) of Contracts § 81 comment b ("Disparity in value, with or without other circumstances, sometimes indicates that the purported consideration was not in fact bargained for but was a mere formality or pretense.")

[xxx] Restatement (Second) of Contracts § 71 comment c.

[xxxi] Restatement (Second) of Contracts § 81 comment b ("Unless both parties know that the purported consideration is mere pretense, it is immaterial that the promissor's desire for the consideration is incidental to other objectives and even that the other party knows this to be so."); see also Williston on Contracts (4th ed.) § 7:17 ("[T]he law . . . does not require that the cause or motive of the promissor actually induce the making of the promise or that the promissee in rendering its performance or in making its return promise actually be induced or motivated by the promissor's promise; rather, it is enough that one party manifests an intention to induce the other's response and to be induced by it and that other response in accordance with the inducement"); Corbin on Contracts (Revised Edition) § 7:17 ("[T]he consideration need not be the actual inducing cause of the contract").

[xxxii] See Comment, 97 Nw. U. L. Rev. 1809 (2003); Richard A. Posner, Economic Analysis of Law 99 (6th ed. 2003) ("The real mystery . . . is why the law doesn't simply make available a form for making binding promises without requiring consideration . . . Promises made under seal were enforceable without consideration. This was, seemingly, a useful device; its disappearance is a puzzle."); Melvin A. Eisenberg, *The Principles of Consideration*, 67 Cornell L. Rev. 640, 660-61 (1982) ("Should the law then recognize some new formality to play the role once played by the seal? An obvious candidate is nominal consideration—that is, the form of a bargain—because it can be safely assumed that parties who falsely cast a nonbargain promise as a bargain do so for the express purpose of making the promise legally enforceable. A rule that promises in this form were enforceable would have obvious substantive advantages . . . ."); E. Allan Farnsworth, *Promises to Make Gifts*, 43 Am. J. Comp. L. 359, 373 (1995) ("Should no formality [be] available to give legal effect to [the donor's] intention?").

[xxxiii] Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings 194 (1925). Williston drafted a Uniform Written Obligations Act that provided that a written promise would be binding if it contained an express statement that the signer intends to be legally bound. Today, only Pennsylvania has adopted it. 33 P.S. § 6.

[xxxiv] See Comment, 97 Nw. U. L. Rev. 1809 (2003) ("At what point would the consideration rise to the level of mixed bargain and gift? The case law on this question is sparse.").

[xxxv] Restatement (Second) of Contracts § 71 comment c ("[T]he distinction between bargain and gift may be a fine one, depending on the motives manifested by the parties.") It may be noted that the main rationale offered for frustrating a donor's ability to make binding gratuitous promises – namely, to protect donors from promises they might later regret – does not apply to Alvina. Alvina's primary goal, after all, is not so much to make a gift (Alvina intends to hold onto her wealth, after all) but to save estate tax. The paternalist rationale for protecting would-be donors from themselves, therefore, arguably does not apply to Alvina.

[xxxvi] In theory, to take a controversial example from the literature on this topic, reading *Atlas Shrugged* in exchange for a promise to pay $5.12 million would make the promise enforceable, provided that the donor genuinely desires to induce the donees to read Ayn Rand's (notoriously long and, to many, tedious) novel. Bramwell, *Donative Promise Can Lock In Gift Tax Exemption*, 39 Estate Planning 8 at 9 (August 2012). As noted, however, planners recommending the donative promise strategy should attempt to establish as strong a nondonative motive for inducing the donees' consideration as possible.

[xxxvii] Rev. Rul. 77-299; but see *Haygood v. Comm'r*, 42 T.C. 936 (1964), acq. in result, 1965-1 C.B. 4, nonacq., 1977-2 C.B. 2; *Estate of Kelly v. Comm'r*, 63 T.C. 321, 325 (1974) nonacq., 1977-2 C.B. 2.

[xxxviii] See, e.g., *Comm'r v. Wemyss*, 324 U.S. 303 (1945).

[xxxix] Treas. Reg. § 25.2511-1(g)(1).

[xl] Treas. Reg. § 301.6501-1(f)(5).

[xli] Not to mention the public policy reasons favoring donative promise gifts: While

there is no indication that, in creating such strong incentives to make taxable gifts this year, Congress preferred one form of taxable gift over another, because donative promise gifts are ideally suited for the very class of taxpayers to which Congress meant to provide relief when it increased the exemption amounts – namely, taxpayers of modest but not extravagant wealth – the donative promise is, if anything, the form of taxable gift that is most favored by public policy.

[xlii] One exception may be that a married taxpayer could end up having made a promise enforceable against his or her estate that is nonetheless disregarded for estate tax calculation purposes. In that "worst case" scenario, the promise could generate estate taxes even though a decedent bequeaths all his or her property to the surviving spouse. As discussed in the text, however, it seems that the promise can have a partial self-cancellation feature that can prevent any estate tax from being payable at the death of the first spouse to die.

[xliii] Treas. Reg. § 25.2512-4; see also Prop. Reg. § 25.2512-4.

[xliv] Careful readers of Rev. Rul. 84-25 will find the curious statement that a donative promise gift becomes complete on "the date on which [the donor's] promise was legally binding *and determinable in value*." (Emphasis added.) The requirement that the promise be "determinable in value" in order to constitute a completed gift appears to allude to the IRS's position at the time that, under the so-called "open transaction" doctrine, a gift does not become complete until the amount transferred is susceptible of valuation. The open transaction doctrine was rejected in *Estate of DiMarco v. Comm'r*, 87 T.C. 653 (1986) and the IRS subsequently revoked the ruling that adopted it. Rev. Rul. 92-68 (revoking Rev. Rul. 81-31). Consequently, it appears that the requirement in Rev. Rul. 84-25 that a donative promise be "determinable in value" in order to constitute a gift is no longer viable. See generally M. Gans, *Valuation Difficulties and Gift Completion*, 58 Notre Dame L. Rev. 3 (1983).

[xlv] *Farid-Es-Sultaneh v. Comm'r*, 160 F.2d 812 (2d. Cir. 1947).

[xlvi] 363 U.S. 285-86 (1960).

[xlvii] If the donor makes the donative promise to a trust for the benefit of the donees, the payment to the trust could be treated as taxable income earned by the donees under the assignment of income doctrine. Cf. Rev. Rul. 74-32.

[xlviii] See, e.g., *Veterans of Foreign Wars, Dep't of Mich. v. Comm'r*, 89 T.C. 7 (1987); *Romero v. Comm'r*, T.C. Memo 1967-157; *Johnson v. Comm'r*, 48 T.C. 636 (1967); see also *Peters v. Smith*, 221 F.2d 721 (3rd Cit. 1955).

[xlix] *Starks v. Comm'r*, T.C. Memo. 1966-134; *Libby v. Comm'r*, T.C. Memo. 1969-184; *Pascarelli v. Comm'r*, 55 T.C. 1082, 1090-1091 (1971), aff'd 485 F.2d 681 (3d Cir. 1973); *Reis v. Comm'r*, T.C. Memo. 1974-287; *Reynolds v. Comm'r*, TC Memo 1999-62.

[l] Even if the donor is legally obligated to deliver the note to the trustee, the donor should still be considered the grantor of the trust for income tax purposes so long as the note is not delivered for fair market value. Treas. Reg. § 1.671-2(e)(2).

[li] Rev. Rul. 85-13.

[lii] For further discussion of whether GST exemption may be allocated to the trust, see Bramwell, *Donative Promise Can Lock In Gift Tax Exemption*, 39 Estate Planning 8 at 11-12 (August 2012).

[liii] On the other hand, even if the promise is satisfied while the trust is a grantor trust, perhaps it is possible that the donees will be treated as having taxable compensation income when grantor trust status ends. Cf. Rev. Rul. 1977-402.

0 Comments Posted re. *Bramwell and Mullen: Donative Promise Can Use Up Gift Tax Exemption*

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