Transactions Subject to the Federal Gift Tax

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The federal gift tax was first enacted in 1924, approximately eight years after the adoption of the estate tax. As originally enacted, the tax was largely ineffective because it was computed on an annual basis without regard to gifts made in prior years.

The tax was repealed in 1926, revived in 1932, and has remained in effect since that date. Unlike its predecessor, the 1932 tax was computed on a cumulative basis — that is, the tax rates applicable to a gift were determined by reference to the total amount of taxable gifts made by the donor during his life, rather than by reference only to taxable gifts made in a given year.

**Overlap of Taxes**

The 1932 gift tax was intended to complement the income and estate tax laws by discouraging taxpayers from making inter vivos gifts for the purpose of either reducing their taxable estates, or reducing their taxable incomes, or both. While the gift tax does supplement both the income and estate tax laws, the three taxes overlap to some extent and the treatment accorded a given trans-

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**Editor's Note:** This discussion is drawn from two chapters in the recently published ALI-ABA Handbook, *Federal Taxation of Estates, Gifts, and Trusts*, by Douglas A. Kahn, Earl M. Colson, and George Craven (ALI-ABA Joint Committee on Continuing Legal Education, 4025 Chestnut Street, Philadelphia, Pa., 1970); paperbound, 366 pp., $9.50 (plus 48 cents for postage and handling).
action in the application of the three taxes is not necessarily consistent.

**Initial Questions**

Thus, where a gift is made, the donor must resolve three separate questions:

- Whether the transfer is one on which gift tax is imposed;
- Whether the transferred property will be included in the donor's estate on his death, notwithstanding the inter vivos transfer; and
- Whether the transfer constituted a taxable exchange that is subject to income tax.

A fourth and related question arises when the transfer is made in trust: Whether the income from the transferred property will be included in the taxable income of the donor or whether instead it will be included in the income of the recipient of the property.

It is quite possible that property transferred by a donor will be subjected to a gift tax and also included in the taxable estate of the donor at his death. For example, a transfer in contemplation of death is a taxable gift; yet if the donor should die within three years after making the gift, the transferred property is included in his gross estate. Similarly, a transfer of property in which the donor retains a life interest is subject to both gift and estate taxes.

**Differing Definitions**

The definition of the term "gift" is quite different in the gift and income tax laws. *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947).

Thus, subject to a statutory exception for certain circumstances [*Int. Rev. Code of 1954 hereinafter, IRC* §2516], a husband's transfer of property to his wife in exchange for her relinquishing her marital rights is a taxable gift for gift tax purposes. *Merrill v. Fahs*, 324 U.S. 308 (1954). Nevertheless, such a transfer is not treated as a gift for income tax purposes, and the husband is subject to income tax on any appreciated property so transferred to his wife. *United States v. Davis*, 370 U.S. 65 (1962).

In *Commissioner v. Beck's Estate* [129 F.2d 243, 246 (2d Cir. 1942)], Judge Frank noted the confusion engendered by the independent construction of the three taxes and wryly suggested as a solution that "Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law."

In sum, the treatment of a transaction for income or estate tax purposes is not necessarily consistent.
with the gift tax consequences, and therefore undue reliance should not be placed upon the provisions and interpretations of the other two tax laws when determining gift tax liability.

**Definition of “Gift” under Gift Tax**

The gift tax is imposed on the “transfer of property by gift.” IRC §2501. The term “gift” is not expressly defined either in the Code or in the Regulations.

However, IRC §2512(b), dealing with the valuation of gifts, states that “where property is transferred for less than an adequate and full consideration in money or money’s worth,” the difference between the value of the property transferred and the consideration received constitutes a gift.

Thus, for gift tax purposes, the determination of whether a gift was made does not turn so much on the intent of the transferor as it does on the mechanics of the transfer—that is, whether property was transferred without full and adequate consideration in money and money’s worth, the absence of donative intent is a significant factor in certain circumstances.

The gift tax applies only to transfers by individuals, but a transfer of property by an entity such as a corporation may be attributed to individuals (such as the corporation’s shareholders). See Treas. Reg. §25.2511-1(h)(1).

**Transfer of Property**

Only the transfer of “property” is subject to the gift tax. No gift tax is imposed on account of the contribution of personal services. Cf. Rev. Rul. 56-472, 1956-2 CUM. BULL. 21.

Virtually every kind of property, tangible or intangible, including state and municipal securities that are immune from federal income taxes, is subject to the gift tax. Treas. Reg. §25.2511-1(a).

For example, transfers of royalty rights, life insurance, partnership interests, and checks or notes of third parties are subject to the gift tax.

**Transfers Subject to Tax**

The gift tax applies to transfers of property without full and adequate consideration in money or money’s worth regardless of the manner in which made. Among others, the tax applies to indirect transfers, to transfers in trust, and to gifts of future interests. However, an interest-free loan does not constitute a gift of the amount of interest that could have been charged.

*Illustration a.* $100,000 to his son, S, upon S’s promise to pay X, his sister, a comparable annuity. F has made an indirect gift of the annuity.
to $X$. If, however, $F$ made the gift to $S$ with no obligation; and $S$, on his own initiative, made a comparable gift to $X$, there are two gifts: $F$'s gift to $S$ and $S$'s gift to $X$, both of which are taxable events.

**Illustration b.** If an heir or beneficiary of an estate refuses to accept his interest in an estate, he has made a taxable gift if under the local law he could not prevent the passage of title to himself by renouncing. Treas. Reg. §25.2511-1(c); William L. Maxwell, 17 T.C. 1589 (1952).

(Ex should be noted that some states, by statute, permit an heir to renounce his interest in an estate, but many states do not permit renunciation by heirs.) Even where a beneficiary is permitted to renounce his interest in an estate, he must do so within a reasonable time after learning of the transfer to avoid gift tax liability. Treas. Reg. §25.2511-1(c).

**Illustration c.** $F$ made a bona fide loan of $200,000 to each of his children. There was an agreement by each debtor to repay the principal amount, without interest, on demand. The interest-free loan does not constitute a gift to the children of the interest that $F$ might have charged. *Johnson v. United States*, 254 F.Supp. 73 (N.D. Tex. 1966). However, the decision in *Johnson* may yet be repudiated, and considerable caution is warranted.

Generally, the gift tax applies only to transfer of property, and therefore the performance of services without compensation does not constitute a gift. However, once personal services have been converted into a property right for compensation, the forgiveness of the debt will constitute a gift.

**Illustration d.** A fiduciary who waives his right to statutory commissions after performing services may be deemed to have made a gift to the beneficiaries involved. Rev. Rul. 64-225, 1964-2 CUM. BULL. 15. However, there is no gift where the fiduciary waives his right to commissions either:

- **Before** commencing his services [Rev. Rul. 56-472, 1956-2 CUM. BULL. 21; and see Rev. Rul. 70-237, 1970 INT. REV. BULL. NO. 20, at 7]; or

- Within a reasonable time after commencing to serve and where all the executor’s actions are consistent with a gratuitous performance of services [Rev. Rul. 66-167, 1966-1 CUM. BULL. 20].

**Illustration e.** Forgiving a debt may constitute a gift. *Selsor*


Illustration f. A owned a life insurance policy on the life of B and designated X as beneficiary of the policy. A retained the power to change the beneficiary of the policy.

Upon the death of B, the owner of the policy, A, is deemed to have made a gift to X, the beneficiary, of the proceeds of the policy. *Goodman v. Commissioner*, 156 F.2d 218 (2d Cir. 1946). If, however, A had irrevocably designated X as the beneficiary and had retained no other beneficial interest in the policy (that is, the power to surrender the policy or to borrow against the cash value), the designation of beneficiary would constitute a completed gift of an amount equal to the replacement value of the policy at the time of designation.

Illustration g. A transferred property to T in trust to pay the income to himself for life, remainder to X. The remainder interest (determined by deducting the value of A's income rights) is a completed gift subject to the gift tax. The value of A's income rights at the date of transfer is determined under tables set forth in Treas. Reg. §25.2512-5(f). [On July 3, 1970, the Treasury proposed new regulations (P-H Estate & Gift Taxes ¶142,231) that would substitute more modern tables for valuing income interests, remainders, reversions, terms for years, and similar interests.]

**Application of Tax to Various Transactions**

**Transfers for Business Purposes**

Transfers for inadequate consideration are not necessarily taxed as gifts. In particular, those transfers made in the ordinary course of business are not deemed gifts, despite the lack of full and adequate consideration. Treas. Reg. §25.2512-8.

The regulations define a business transaction as one that is "bona fide, at arm's length, and free from any donative intent." Accordingly, the gift tax is not imposed on the sale of property for less than its market value where the seller makes an error in business judgment. *Carl E. Weller*, 38
Also, where a bargain sale to an employee is motivated by business judgment, the transfer is not subject to the gift tax. *Estate of Monroe D. Anderson*, 8 T.C. 706 (1947). Where a transfer of property is made for profit motives or for the purpose of making a bona fide economic settlement of a claim against the transferor, the gift tax is not usually applicable. See *Catherine S. Beveridge*, 10 T.C. 915 (1948).


### Involuntary Transfers

The gift tax applies only to voluntary transfers of property. For example, a payment made under the compulsion of a tort judgment does not constitute a gift. Cf. *Harris v. Commissioner*, 340 U.S. 106 (1950).

Possibly, such settlements can be analyzed with similar results under the Regulations defining business transactions. Treas. Reg. §25.2512-8.

### Transfers for Consideration

A transfer of property is not removed from the reach of the gift tax merely because it was made for consideration. To be exempt from the tax, the consideration received must be equal in value to the property transferred and must be received "in money or money's worth." Moral consideration, past consideration, or consideration in the form of a detriment to the transferee that does not benefit the transferor will not bar the imposition of the tax.

Illustration. A transferred $100,000 to X, a widow, upon her promise to marry him. X's remarriage would result in her forfeiting a $100,000 interest in a trust established by her first husband, and consequently A gave her the $100,000 to compensate her for this loss.

There is a gift from A to X. X's promise to marry A is not sufficient consideration, because it cannot be valued in money or money's worth. Although X's loss of interest in the trust is a detriment to her, it does not constitute a benefit to A. Thus, there is a gift tax on A's transfer. *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

### Relinquishment of Marital Rights

Under the estate tax statutes, the relinquishment of marital rights (including dower, curtesy, and statutory estates in lieu thereof) does not constitute consideration in money or money's worth. IRC §2043(b).
The Supreme Court has applied this estate tax provision to the gift tax on the ground that the two taxes are in pari materia. Merrill v. Fahl, 324 U.S. 308 (1945). Accordingly, a husband's transfer of property in exchange for his wife's relinquishment of her marital rights constitutes a taxable gift to the wife.

However, under IRC §2516, a transfer of property from one spouse to the other pursuant to a written agreement relative to their marital and property rights shall be deemed to have been made for "full and adequate consideration in money or money's worth," provided that the spouses are divorced within two years after the execution of the agreement.

While every effort should be made to comply with IRC §2516 where applicable, if for some reason the terms of the statute are not satisfied (for example, if the divorce occurs more than two years after the agreement), the transferor may contend that a transfer in anticipation of a divorce is not voluntarily made and therefore is exempt from the tax. The Supreme Court's decision in Harris v. Commissioner [340 U.S. 106 (1950)] provides substantial support for that contention. See Rosenthal v. Commissioner, 205 F.2d 505 (2d Cir. 1953).

Right to Support


While there are two court decisions involving estate taxes to the contrary [Meyer's Estate v. Commissioner, 110 F.2d 367 (2d Cir. 1940); Estate of Robert Manning McKeon, 25 T.C. 697, 706-07 (1965), acquiesced in, 1958-2 Cum. Bull. 6], the administrative position of the Service, as evidenced by its rulings, and the more recent court decisions clearly establish that the wife's support rights qualify as money's worth consideration. See Estate of Hubert Keller, 44 T.C. 851 (1965); and Estate of Morrison T. O'Nan, 47 T.C. 648 (1967), acquiesced in, 1967-2 Cum. Bull. 3.

A transfer in satisfaction of the right to support of the minor children of the transferor is made for money's worth. Estate of Robert Manning McKeon, above.

Support payments to indigent adult children that are required to be made by state law were held to be gifts in Commissioner v. Greene [119 F.2d 383 (9th Cir. 1941), cert. denied, 314 U.S. 641 (1941)]. However, Greene was decided by a divided Court, and the result is difficult to rationalize.
Complete and Incomplete Transfers

A transfer of property is not subject to the gift tax unless it is complete and irrevocable. A transfer that may be revoked by the donor alone or in conjunction with any party or parties who do not have a substantial adverse interest in the revocation is not a completed gift for tax purposes. *Burnet v. Guggenheim*, 288 U.S. 280 (1933).

Similarly, where the donor has retained the power (either alone or in conjunction with others who do not have a substantial adverse interest) to change the beneficiaries of the gift, the transfer is not complete for gift tax purposes. *Sanford's Estate v. Commissioner*, 308 U.S. 39 (1939).

Illustration a. A transferred property to T in trust for A for life, remainder to B. This is a completed gift of the remainder interest, because the donor has relinquished all control over that interest. However, if A had retained the power to revoke the whole trust, there is no gift. If A can revoke only with the consent of T, who does not have a substantial adverse interest, there is no completed gift. If A can revoke only with B's consent, then the gift is complete.

The mere delivery without consideration of a personal check or note of the transferor himself does not constitute a completed gift because no enforceable obligation is incurred. The Service has stated that the transfer of a personal check becomes complete and therefore taxable when it is paid, certified, or accepted by the drawee, or is negotiated for value to a third person.


Completed Transfers

Where the donor's power to alter or revoke the transfer can be exercised only with the consent of a party with a substantially adverse interest, the transfer is complete for gift tax purposes. *Commissioner v. Prouty*, 115 F.2d 331 (1st Cir. 1940).

Illustration b. A transferred
property to \( T \) in trust for \( C \) for life, remainder to \( D \), and \( A \) reserved the power to alter or amend the trust as he sees fit. The transfer is not complete, so there is no taxable gift.

If, however, \( A \) later amends the trust so that he can exercise the power of further amendment only with the consent of \( C \), there will then be a complete transfer and a taxable gift on \( C \)'s life estate, but not as to \( D \)'s remainder interest. The gift of \( C \)'s life estate is effected on the date that the amendment was made. \( C \) does not have an adverse interest as to \( A \)'s alteration of the remainder interest in the trust, so the requirement that \( C \) consent to such alterations does not render complete the transfer of the remainder interest in the trust.

Where the donor's reserved power to alter a transfer can effect only the time when the transferred property will be received by the beneficiaries, there is a completed gift at the date of the transfer. Treas. Reg. §25.2511-2(d).

Illustration c. \( A \) transferred property to \( T \) in trust to pay the income annually to \( B \) for 20 years, and at the end of that period, to distribute the corpus to \( B \) or to \( B \)'s estate. \( A \) retained the power to direct \( T \) to accumulate the income in any year and to distribute it together with the corpus after the expiration of the 20-year period. \( B \)'s interest in the trust is vested and only the timing of enjoyment is subject to change. Therefore, \( A \) has made a completed gift, which is subject to the gift tax.

It should be noted that when the grantor has a power to revoke subject to the approval of an adverse party, or when he has the power to affect the timing of enjoyment of the transfer, the property is includible in the gross estate of the donor at his death under IRC §2038, even though the transfer is treated as a completed gift.

Relinquishment of Power

Where a donor retains a power (such as the power to revoke) preventing a transfer from constituting a completed gift, the subsequent relinquishment of that power by the grantor creates a gift at the date of relinquishment. Treas. Reg. §25.2511-2(f).

Similarly, where income from an incomplete transfer is paid to a beneficiary and thus placed beyond the control of the donor, there is a completed gift of the income at the date of payment.

Illustration d. \( A \) declared himself trustee of certain properties owned by him. Under the declaration of trust, the trustee
is to distribute the income quarterly between B and C in such proportions as the trustee shall determine in his discretion. Upon the death of the survivor of B and C, the trust corpus is to be distributed to X or his estate. The trust is irrevocable.

Since A retained the power as trustee to change the proportionate interests of B and C, the gift of the income interests was incomplete and consequently A incurred no gift tax liability therefor. However, the gift of the remainder interest to X was complete.

Subsequently, A resigned, and T was appointed as trustee in A's place. Since A's power over the income interest was terminated by his resignation, the gift of the income interest became complete at that date. Prior to the resignation of A, any income that was actually distributed to B or C was placed beyond A's power of control, and consequently there was a completed gift of distributed income on the date of distribution from the trust.

Joint Bank Accounts

One of the most commonly recurring examples of an incomplete transfer is the creation of a joint bank account. Since the grantor alone may withdraw any or all of the funds from the joint account, he has retained a power of revocation and there is no completed gift.

However, when the donee actually withdraws funds from the account and thereby removes those funds from the control of the grantor, there is a gift of the funds in question at the date of withdrawal. Treas. Reg. §25.2511-1(h)(4).

Of course, if local law required the donee to return the withdrawn funds upon the donor's demand, the gift would not be complete on withdrawal. But if the donor fails to demand return of the funds, at some subsequent date the donor's inaction may be deemed his acquiescence in the withdrawal, which will then be a completed gift.

Similarly, if A purchases a United States savings bond registered as payable to "A or B," there is no gift to B unless and until B surrenders the bond for cash. Treas. Reg. §25.2511-1(h)(4).

Retained Interests

Reversionary Interests and Life Estates

Transfers of property in which the donor retains a reversionary interest are subject to the gift tax. Smith v. Shaughnessy, 318 U.S. 176 (1943).

Illustration a. F transferred property to T in trust for X for life, remainder to X's children who are living at X's death. There is a valid gift of the remainder even though X might
not have children at the time of the transfer, and if there are children, they might not survive $X$, thus creating the possibility that the property may revert to $F$ on $X$'s death.

In this event, the value of the donor's reversionary interest must be deducted from the property transferred in order to determine the value of the gift. The donor has the burden of proving the value of his retained interest; and if his interest is so speculative as to have no ascertainable value under recognized actuarial methods, the amount of the gift is treated as equal to the entire value of the property transferred. *Robinette v. Helvering*, 318 U.S. 184 (1943).

Similarly, if the donor retains a life estate in the transferred property, the gift tax will be imposed on the value of the remainder. *Id.*

It should be noted that the retention of a life estate will cause the inclusion of the transferred property in the gross estate of the donor upon his death, notwithstanding that the transfer was previously taxed under the gift tax laws. IRC §2036.

*Power of Third Party To Invade on Behalf of Donor*

Where the donor has transferred property in trust and where a nonadverse third party (for example, an independent trustee) has the discretionary power to make distributions of principal or income to the donor, the gift tax consequences will depend upon the extent of the third party's discretion.

If the discretionary power of the third party to make distributions to the grantor is limited by an external standard, then the donor's contingent interest must be valued as of the date of transfer; and the amount of the completed gift is deemed to be the value of the property transferred in trust less the value of the donor's contingent interest. Rev. Rul. 54-538, 1954-2 CUM. BULL. 316.

Where the external standards are so encompassing that there is no limit on the amount of trust corpus that might be distributed to the donor, the gift will be treated as incomplete. See *Estate of Leon Holtz*, 38 T.C. 37 (1962), acquiesced in, 1962-2 CUM. BULL. 4; and *Commissioner v. Vander Weele*, 254 F.2d 895 (6th Cir. 1958), affg 27 T.C. 340, acquiesced in, 1962-2 CUM. BULL. 4. See also Rev. Rul. 62-13, 1962-1 CUM. BULL. 181.

The Service has ruled that where a third party is given very broad discretion to make distributions of principal or income to the donor (including transfers where the third party's power to invade is not limited by external standards) so that there is no assurance at the time of transfer that anything of value will pass to a beneficiary of
the trust, the gift is not complete for gift tax purposes. Rev. Rul. 62-13, above. But see Herzog v. Commissioner, 116 F.2d 591 (2d Cir. 1941).

Voidable and Void Transfers

If the transferor of property is incompetent, his attempted transfer is void and no gift tax is imposed. However, a gift tax will be imposed upon a gift made by an incompetent's lawfully appointed guardian who was authorized to make the gift on behalf of the incompetent. Rev. Rul. 67-280, 1967-2 CUM. BULL. 349.

If the transferor of property is under a temporary disability (such as infancy), and if the transferor can affirm or rescind the transfer when the disability has been removed, there is no gift at the time of transfer, but a gift will be deemed to have been made when the transferor's disability is removed and he does not rescind the transfer within a reasonable time. Commissioner v. Allen, 108 F.2d 961 (3d Cir. 1939), cert. denied, 309 U.S. 680 (1940).

It is not clear whether a transfer that is voidable for reasons other than disability, as for example, a transfer voidable under the Statute of Frauds, is subject to the gift tax when made.

Nonresident Aliens

For 1967 and succeeding years, a nonresident who is not a citizen is exempt from the gift tax on transfers of intangible property [IRC §2501(a)]; but this exemption from gift tax may not apply to gifts made by a donor within 10 years after having lost his American citizenship [IRC §2501(a)(3)].

However, the gift tax does apply to transfers by a nonresident not a citizen of real property and tangible personal property located in the United States. A resident is a person who was domiciled in the United States at the time of the gift. Treas. Reg. §25.2501-1(b).

Annuity Benefits

If an annuitant acquires an annuity for himself that contains a provision for a survivorship annuity or for a refund upon the death of the annuitant, a taxable gift from the annuitant to the beneficiary entitled to survivorship or refund benefits is made on the date that the designation of such beneficiary becomes irrevocable. See Treas. Reg. §25.2512-6, Ex. (5); I.T. 3322, 1939-2 CUM. BULL. 177; and Wagner v. United States, 387 F.2d 966 (Ct. Cl. 1967).

However, no gift tax is imposed where an irrevocable designation of the beneficiary is made by an employee entitled to an annuity under certain qualified deferred compensation plans, except to the extent that the value of the annuity is attributable to contributions of the employee. IRC §2517.