When Gift Planning Goes Awry

Thomas E. Simmons
When gift planning goes awry

Advisors to gift recipients need to be aware of the possibility of gifts with attached transferee liability.

Thomas E. Simmons
SPECIAL TO THE NATIONAL LAW JOURNAL

SOMETIMES, A GIFT comes with unintended consequences. Imagine the following telephone conversation between a lawyer and a client:

Lawyer: I've got good news and bad news. Client: Give me the good news first. Lawyer: Your rich uncle deposited $40,000 worth of small cap stocks in your investment account as a birthday gift.

Client: Wooppeee! Lawyer: The bad news is that the stocks are now worthless.

Client: (after a long pause) Well, easy come, easy go. Lawyer: It's also time to look at though you're going to be stuck with the gift tax bill of about $20grand.

Client: (after a longer pause) How does that work? Wealth managers and estate planners know the many benefits of lifetime gifts. Donors who make inter vivos transfers to their loved ones can take advantage of the annual exclusion (which is currently $11,000 per donee per year), achieve the benefit of transferring appreciating and income-producing assets earlier rather than later, and experience the joy of seeing the appreciation of the recipients of the gifts.

When transferee liability for gift taxes applies, however, a gift can come with an unanticipated liability. Advisors to gift recipients need to be aware of the possibility of gifts with attached transferee liability. In a worst-case scenario, the amount of tax can exceed the value of the gift when interest and penalties are added. 26 U.S.C. 6601.

When a donor makes a taxable gift, the effect of gift taxes always needs to be considered. The donor has the primary responsibility to pay any gift tax. A gift tax will be assessed whenever a donor's lifetime gifts in excess of the annual exclusion amount have consumed the donor's $1 million gift tax credit. When credit has been exhausted, gift tax is due on subsequent lifetime gifts that exceed the annual exclusion. Transfers to spouses or charities are free from gift taxation under current law.

For example, a father who makes a gift of $1,011,000 to his son in 2004 would have consumed his $1 million credit. (The first $11,000 escapes taxation under the annual exclusion rule.) No gift taxes are owed. The father follows up with a $20,000 gift in 2005, resulting in a gift tax in the amount of $4,050 (45% of the $9,000 in excess of the $11,000 exclusion). The tax will be due in April of 2006. If the father neglects to pay the tax, the son becomes liable under the "transferee liability" found in the Internal Revenue Code. 26 U.S.C. 6324(b). The transferee liabiltiy situation is almost always unforseen.

Thomas E. Simmons is an associate at Rapid City, S.D.-based Gunderson, Palmer, Goodale & Nelson. He practices in the areas of trusts, property and elder law.
Donors can be liable for donor's tax

'Gift tax' from page 13

The ability of the Internal Revenue Service (IRS) to charge donors with gift tax is limited by rules "to the extent the value of such gift." Thus, in the example above, the son ought to be liable for up to $20,000 when his dad fails to pay the tax.

But how can the son be liable for $20,000 when the gift to him generated only $4,050 in gift tax? Because courts have held that a donor can be liable not only for the gift tax assessed on the gift he receives, but also for taxes on gifts resulting from other donor-recipient arrangements. See, e.g., Commissioner v. Rys, 85 F.2d 917 (3d Cir. 1938), cert. denied, 109 S. Ct. 1743 (1989). This is known as the collateral gift rule. If Dad makes additional taxable gifts to other children, his son can, in principle, be held liable for the tax on those gifts as well, up to the full value of the gift that he personally received.

Liability even after gift vanishes

The value is at its worst when assets with volatile values have been gifted. Say, for instance, that the $20,000 gift was a hedge fund that became worthless the day after it was gifted. The gift tax is no longer payable, unless the fund is sold at a loss. Most importantly, however, once the asset value falls, so will the value of the $20,000 gift.

"Gift tax liability can extend to gifts made to other donors."

Gift tax liability can extend to gifts made to other donors.

begin to accrue, even against an unwarned donor. Interest and penalties may eventually amount to the value of the gift itself.

Courts have imposed liability upon two recipients for non-payment of tax on unpaid gift tax. See, e.g., United States v. Bartlett, 136 F. Supp. 2d 875 (W.D. N.Y. 2002). This liability has been extended above and beyond the value of the gift actually received. While this conclusion would seem to contradict the statutory limitation of liability tied to the value of the gift, this is of little comfort to liable transferees stuck with paying the bill.

The gift tax liability applies not only to the initial transferee but to subsequent transferees as well. The liability is a variety of estate and gift tax to which the next generation may not have been subject. The same gift was given to the daughter in 1933, and the son in 1934.

Court has held that, even though the statute of limitations precludes collection of the gift tax from the donor, it does not mean that the tax cannot be collected from the donees. See, e.g., Moore v. Commissioner, 146 F.2d 824 (2d Cir. 1945). The IRS can pursue a donee up to one year after the expiration of the statute of limitations on unpaid taxes against the donor.

The courts have held that a donee can be held responsible for gift tax even when the donee's gift did not contribute to the total value of the gift. See, e.g., Commissioner v. Willard, 280 F.2d 777 (2d Cir. 1960); but see Estate of Mandella v. Commissioner, 292 F.2d 183 (2d Cir. 1960) (donee not liable when IRS fails to establish value of property transferred to donee).