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When Gift Planning Goes Awry

Thomas E. Simmons

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WEALTH MANAGEMENT

When gift planning goes awry

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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: Whoopee!

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 starting to look as though you're going to be stuck with the gift tax bill of about 20 grand.

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 even 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 that 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 rule" found in the Internal Revenue Code. 26 U.S.C. 6324(b).

The transferee liability situation is almost always un-

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Thomas E. Simmons is an associate at Rapid City, S.D.-based Gunderson, Palmer, Goodsell & Nelson. He practices in the areas of trusts, property and elder law.

WEALTH MANAGEMENT

Donees can be liable for donor's tax

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planned. Gifts are notoriously easy to carry out and often occur without the benefit of legal or tax counsel.

The ability of the Internal Revenue Service (IRS) to charge donees with gift tax is limited by statute "to the extent of the value of such gift." Thus, in the example above, the son ought to be liable for no more than $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 tax? Because courts have held that a donee can be liable not only for the gift tax assessed on the gift he or she receives, but also for taxes on gifts made to other donees. See, e.g., *Poinier v. Commissioner*, 858 F.2d 917 (3d Cir. 1988), cert. denied, 109 S. Ct. 1743 (1989). This is known as the collateral gifts rule. If Dad makes additional taxable gifts to other children, his son can legitimately 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 transferee liability trap is at its worst when assets with volatile values have been gifted. Say that the $20,000 gift Dad made was a hedge fund that became worthless the day after it was gifted. The gift itself has essentially vanished by virtue of its value being depleted. Yet the liability remains. If Dad fails to pay the tax (perhaps because the rest of his investments suffered a similar fate), he may have gifted to his son nothing more than a liability to the worst creditor anyone could have—the IRS.

The IRS has at its disposal a wide selection of collection remedies showcased in the federal tax lien. Few creditors have access to such powerful devices.

Donor insolvency is a common fact

Donee may not even be aware of gift tax until it is overdue.

pattern in a transferee liability scenario, but the insolvency of the donor is not a precondition to the imposition of liability on the donee.

The situation can also be complicated by gifts of future interests. Say that Dad, instead of gifting a hedge fund, made a gift of his home, retaining a life estate. While the future interest in the home has value (and thus incurs a tax), the son would have a very difficult time converting that interest into funds with which to satisfy transferee liability taxes.

Courts have 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 donee. 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.

Courts have also held that a donee can be held responsible for gift tax even when the donee's gift did not contribute to any gift tax whatsoever. See, e.g., *Want v. Commissioner*, 280 F.2d 777 (2d Cir. 1960); but see *Estate of Mandels v. Commissioner*, 64 TC 61 (1975) (donee not liable when IRS fails to establish value of property transferred to donee).

For example, if a donee received a total of $5,000 in gifts during a calendar year, this amount is completely excluded from taxation under the $11,000 annual exclusion rule. Nevertheless, this donee could conceivably be required to pay the full $5,000 back to the Internal Revenue Service on account of taxable gifts that the donor made to other individuals that same year.

Transferee gift tax liability is especially troubling since the transferee may not even be aware of the gift tax until it has already been long overdue. The donee's liability for gift taxes accrues on the date the gift tax is first due—April 15 of the year following the gift. After that date has passed, interest and penalties can

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

begin to accrue, even against an unaware donee. Interest and penalties may eventually exceed the amount of the original tax liability.

Courts have imposed liability upon gift recipients for accrued interest due on unpaid gift tax. See, e.g., *United States v. Bartlett*, 186 F. Supp. 2d 875 (C.D. Ill. 2002). This liability has even 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.

Transferee liability applies not only to the initial transferee but to subsequent transferees as well. The liability is a variety of joint and several liability. If the son in our example has since gifted the gift on to his daughter when he hears word of the gift tax liability, both son and granddaughter may witness the collection powers of the IRS.

Cautious wealth managers and estate planners with clients who receive generous gifts should make their clients aware of the potential minefields of transferee liability. Unfortunately, however, little in terms of constructive counsel can usually be given. The grateful donee is not likely to be probing his or her generous donee as to whether a timely gift tax return has been filed, whether valuation on gifted property has been adequately documented, whether the donee has already consumed the available gift tax credit or whether the donee even intends to pay any gift tax assessed.

Many taxable gifts occur that do not make it onto timely filed form 709 gift tax returns. The difficulty the IRS has in tracking gifts seems to lull taxpayers into a false sense of security. Another difficulty lies in inadequately documented form 709s.

When difficult-to-value assets such as real property or shares in a family corporation have been gifted, donors often rely on county property tax assessments or book values in arriving at valuations. When insufficient documentation accompanies the tax return, the potential liability can lie dormant for years, even when no audit is immediately forthcoming. The less detailed the valuation documentation provided to the IRS, the more likely the IRS can argue that limitations periods should be suspended. Meanwhile, interest and penalties can be accruing.

Perhaps the only practical guidepost that can be offered to gift recipients is the importance of a prudent investment philosophy and asset protection, especially with regard to assets received by gift. In the event the IRS later comes rapping on the door, the recipient will be grateful for having avoided undue risk that the assets could have dissipated through market losses, divorce or involuntary creditors.

The reason so little is known about transferee liability probably relates to the fact that there is so little in the way of advance planning that can actually be done. Nevertheless, the potential of a client's transferee liability should not be underestimated. When it arrives on a client's doorstep, it is almost always a worst-case scenario.

Transferee liability arises only when the donor has failed to pay gift tax. The tax may be long overdue by the time a problem is identified; interest and penalties may have accrued. The problem is exacerbated if the original donee has since dissipated the transferred property or transferred it down the line to an expanding circle of potential liable donees.

The 'Winton' precedent

The case of *Winton v. Reynolds*, 57 F. Supp. 565 (D. Minn. 1944), illustrates the destructive power of transferee gift tax liability. Imagine the seeds of marital disharmony that would be sown under these facts: In 1935, David J. Winton began making annual exclusion gifts ($11,000 under today's law) to three trusts for the benefit of his minor children. The gifts were repeated in 1936 and in 1937. In 1937, Winton also made a similar-sized outright gift to his wife.

In 1941, the U.S. Supreme Court issued a decision that changed the way in which gifts to minors' trusts were treated for gift tax purposes. Essentially, the court held that Winton's gifts to his trusts could not be considered excluded under the annual exclusion rule.

Accordingly, the IRS proceeded to re-audit Winton's gift tax returns and assessed a deficiency close to the total gift his wife had so happily received. Winton, represented by savvy counsel, refused to pay, pointing out that the period within which assessment could be made against him as the donor had expired.

Therefore, the IRS approached his wife for payment. She also was represented by resourceful and articulate counsel who argued that no collections could proceed against her without proof of the insolvency of her donor/husband. The Minnesota District Court considered, then rejected the argument: "For purposes of this case it may be conceded that solvency of the donor precludes liability in equity on the part of the donee, but I cannot escape the conclusion that there is liability at law," said the court.

So his wife paid the tax.

Perhaps the only bright spot in the area of transferee gift tax liability is the fact that attorney fees expended by a donee in contesting liability may be deductible on his or her income tax returns. Whether this benefit was adequate to calm the seething Mrs. Winton in 1944, however, is doubtful; and it seems unlikely to relieve the sting of transferee liability in individuals who experience it firsthand. NLJ