Deathbed Gifts — A Savings Opportunity for Residents of Decoupled States[1]

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Much has been written about the impact of the movement by many states to “decouple” their death taxes from the federal estate tax system.[2] The bottom line is that while the top federal estate tax rate has dropped since 2001 to 48% for deaths in 2004,[3] the combined state and federal estate tax rates for residents of many states has actually increased from the prior 55% maximum. Residents of decoupled states who die in 2004 are now subject to combined state and federal rates as high as 60%. Most decoupled states, however, do not impose a tax on gifts made during life, even if the gift occurs only an instant before death. This means that residents of decoupled states can achieve significant tax savings by making lifetime gifts, including gifts made shortly before death (referred to going forward as “deathbed” gifts). This Article focuses on the many tax, property and fiduciary issues that must be negotiated in order to achieve those tax savings.

I. The Opportunity

Gifts afford the residents of decoupled states a significant tax savings opportunity because, once made, they completely remove the gifted property from the calculation of the resident’s state estate tax. Decoupled states (in most cases) assess the full pre-2001 state death tax credit, regardless of whether any credit is actually allowed under the revised federal estate tax law. The state death tax credit is based on the decedent’s adjusted taxable estate — generally the assets owned at death plus the value of assets which are the subject of an incomplete transfer or retained interest under Sections 2036 and 2038 of the Internal Revenue Code (“IRC”) but without any adjustment for gifts completed before death. In contrast, the federal estate tax computation takes into account prior completed gifts. It is this difference that generates the tax savings of deathbed gifts.

II. Example of Tax Savings

Set forth below, side by side, are the tax computations for individuals with identical assets who die as residents of a decoupled state in 2004 — the only difference being that one of the individuals makes a deathbed gift and the other does not. A critical assumption underlying the assumptions below is that the individual’s death will trigger an estate tax. In particular, the individual’s estate will not be protected from estate tax by either the marital or charitable deduction. As the example shows, the savings from making a deathbed gift can be significant — for the client in the example, 10.3% of the value of the deathbed gift.[4]

ESTATE TAX CALCULATION - DEATH IN 2004	WITHOUT DEATHBED GIFTS	WITH DEATHBED GIFTS
Estate Assets	$12,000,000	$160
Estate Deductions	$0	$0
Gift Tax Paid on Gifts Within 3 Years of Death	$0	$3,891,840
Taxable Estate	$12,000,000	$3,892,000
Prior Taxable Gifts (assumed made in 2001 and 2004)	$2,000,000	$10,108,000
Total Tax Base for Federal Tax	$14,000,000	$14,000,000
Tentative Federal Estate Tax before credits	$6,540,800	$6,540,800
State Estate Tax (calculated on taxable estate less $60,000)	$1,386,800	$269,168
Tentative Combined State & Federal Estate Tax	$7,927,600	$6,809,968
Less State Tax Credit	-$346,700	-$67,292
Less Unified Credit	-$555,800	-$555,800
Less Gift Tax Paid on All Prior Gifts	-$435,000	-$4,326,840
Total Combined State & Federal Estate Tax	$6,590,100	$1,860,036
Total Gift Tax on Deathbed Gifts made in 2004	$0	$3,891,840
	$6,590,100	$5,751,876
Federal Estate Tax	$5,203,300	$1,590,868
State Estate Tax	$1,386,800	$269,168
Gift Tax (from deathbed gifts)	$0	$3,891,840
Total Estate & Gift Tax	$6,590,100	$5,751,876
Savings from Deathbed Gift		$838,224

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III. No Additional Tax Savings from Donee Paying Gift Tax

The example set forth above contemplates that the donor will give away all of her property other than the funds that will be needed to pay gift taxes the following April.[5] No additional tax savings will be achieved if the donor pays the gift tax before death, or conditions the gift on the donee paying the gift tax,[6] or renders herself insolvent by making a gift of the funds that are otherwise needed to pay gift tax.[7] This is because in all such events, unless the gift was made more than 3 years before death,[8] the gift tax is included as part of the donor's adjusted taxable estate (which is used by most decoupled states to determine the death tax assessed on estate assets).

IV. Magnitude of Tax Savings

The savings that can be achieved by using deathbed gifts to avoid state death tax peaks this year when the state death tax credit is only 25% of what it would have been in 2001,[9] but the deduction for state death taxes is zero — that deduction not being available until 2005. In general, a resident facing the highest combined (state and federal) estate tax rate in a decoupled state will pay 12% more than a resident with the same size estate in a pick-up state in 2004 and 8.5% more in 2005. (The savings increases slightly to 8.6% in 2006 and 8.8% in 2007-2009 as the top federal tax rate drops.)

	Total	Federal*	State
2001 Year			
Pick-up State	55%	39%	16%
Decoupled State	55%	39%	16%
2002 Year			
Pick-up State	50%	38%	12%
Decoupled State	54%	38%	16%
2003 Year			
Pick-up State	49%	41%	8%
Decoupled State	57%	41%	16%
2004 Year			
Pick-up State	48%	44%	4%
Decoupled State	60%	44%	16%
2005 Year			
Pick-up State	47%	47%	0%
Decoupled State	55.5%	39.5%	16%

* The federal rate shown takes into account the allowable state death tax credit or deduction for that year.

V. Selection of Gift Property

One potential disadvantage of making deathbed gifts is that the donor's cost basis in the gift property will not be fully stepped-up, as would be the case for transfers made at the donor's death. This means that, in addition to having to pay tax on any gain that accrues between the date of the gift and the sale of the asset (which also applies to testamentary gifts), the donee of a lifetime gift of appreciated property will be responsible for paying tax on a portion of the difference between the fair market value of the property on the date of the gift and the donor's cost basis in that property that is remaining when the asset is sold. Thus, a gift of

appreciated assets made immediately before death is worth less to the donee than the same gift would be if it was made upon the donor's death.

The carryover basis rule for gifts is partially mitigated when the transfer generates a gift tax. The cost basis of gift property is increased by the amount of gift tax attributable to the donor's unrealized gain on the gift property as of the date of the gift.[10] The magnitude of the step-up available is tied to the estate tax rate in effect when the gift is made.

> Example: A donor makes a gift of an asset with a fair market value of $5 million and a cost basis of $0. The donor pays gift tax of $2,400,000 ($5 million times 48%) the following April. The donee's basis in the gifted asset is stepped-up pursuant to the following formula: Stepped up basis equals (appreciation divided by asset value) times gift tax paid. In this example, the stepped up basis is $2.4 million (($5 million divided by $5 million) times $2.4 million). If the donor sells the asset immediately, her federal capital gains tax will be $390,000 ($2.6 million times 15%). The estate tax savings from making the gift is $600,000 ($5 million times 12%). After paying the capital gains tax, the donee's overall tax savings is reduced to $210,000 — fully 65% of the contemplated estate tax savings has been lost because the gift consisted of appreciated property.

In contrast, compared to a transfer at death, there is actually an advantage to using depreciated property (*e.g.* property with a current fair market value less than its basis) for lifetime gifts. IRC Section 1015(a) directs that if property transferred by gift has a basis greater than the current fair market value of the gift property, the donee's basis in the property for loss purposes will be equal to its fair market value on the date of the transfer. The effect of this rule is to preclude the donor from shifting loss to the donee when that loss is attributable to the time when a donor owned the gift property. However, for gain purposes, the donee can use the higher basis attributable to the donor — unlike the rule for transfers occurring at death which eliminates the decedent's higher basis for gain purposes as well as for computing losses. The implication of these rules is that if the client has depreciated property and can use the loss, consideration should be given to selling the depreciated property and using the cash proceeds for the gift. If the donor cannot use the loss, it will be preferable to use the depreciated property for the lifetime gift because any loss that is unrealized at the donor's death will be unavailable to the donor's heirs after death whereas a gift of the depreciated property at least will allow a higher basis to be used by the donee in a future sale if the value of the gift property exceeds the donor's basis.

If the client does not have high basis assets or cash that can be used for deathbed gifts, then consideration should be given to using the donor's low basis assets as collateral for borrowing cash to use for deathbed gifts. After death, when the bases of those low basis assets have been stepped-up, they can be sold without triggering capital gains taxes and the proceeds used to repay the loans. Note that the benefit of the reduced state death tax in a decoupled state is the same whether the adjusted taxable estate is reduced due to a simple gift of the donor's assets or by a loan (producing a deductible debt) followed by a gift of the loan proceeds. If a loan is contemplated, it may be advisable to put into place stand by credit arrangements with the donor's financial institution so that such a loan and gift transaction could be quickly implemented if a sudden change in the donor's health makes the immediate implementation of deathbed planning necessary.

VI. Estate Tax Exceeds Estate Assets

As is the case with gift taxes, donees are liable as transferees for any estate tax not paid by the donor's estate. IRC Section 6324(a)(2) provides that if the estate tax imposed by Chapter 11 is not paid when due, then a transferee (which includes a donee of a lifetime gift) is liable to the extent of the value of the subject property as of the date of the decedent's death.[11] The IRS also can proceed against the donees under state laws related to fraudulent transfers.[12] IRC Section 6901 sets forth a procedure for collecting tax from a transferee which can be enforced whether the claim is brought under state or federal law.

Despite the existence of transferee liability, an insolvent estate may create a challenge for an executor who is responsible for making sure that taxes are paid. In addition, a trustee of a trust that receives a deathbed gift can be found personally liable for unpaid estate tax if the trust made a distribution of the trust property to a trust beneficiary.[13] Accordingly, any deathbed gift planning should include consideration of ways to facilitate the future payment of estate tax and the protection of the client's fiduciaries.

One important step will be to inform, and emphasize to, the donees that a portion of the gift property may need to be refunded in the future for estate taxes. Possibly, outright gifts should be made to newly created agency accounts that segregate the assets

from the donee's other funds and that, by virtue of that segregation, help focus the donee on the fact that those funds should not be freely consumed until the donor's estate tax liabilities are fully known and paid (*e.g.* after audit). Making the deathbed gifts in trust is another option for insuring that all or a portion of the gift property is preserved until after the estate taxes have been paid.

Consideration should also be given to whether the donees should sign a refunding agreement. The primary reason for signing such an agreement is less to impose liability (since the recipients already will be legally liable for the estate taxes due to transferee liability) than it is to put the recipients on notice that a refund may need to be paid. The primary disadvantage to using a refunding agreement is that by giving the estate (rather than the IRS) an enforceable claim against the donees for the estate tax monies, the donor may be creating a taxable interest in the gifted assets that will be subject to estate tax at the donor's death and undermine the very reason for the making the deathbed gift. It seems clear that IRC Section 6324(a)(2) transferee liability by itself does not cause inclusion of those assets.[14]

VII. Client Capacity for Making Gifts

Clients for whom deathbed gifts are appropriate will, in many cases, be physically or mentally unable to sign the paperwork necessary to make such gifts. In these situations, there will need to be clear and unambiguous authorization to carry out such planning on the client's behalf.

Powers of Attorney: If the client's property is held in his individual name, the key question will be whether the client's power of attorney authorizes his agent to make large lifetime gifts of the client's property. In the best case, the prospect of gifting will have been considered prior to the client's infirmity or incapacity and the power of attorney will specifically address the issue. The question of whether a general grant of broad authority in a power of attorney extends to gifts has been widely litigated and has produced varying results among the many states. In general, if a client wishes to authorize his agent to make gifts, that grant should be both expressly and specifically set forth in the power of attorney.[15]

If a client does want to authorize her agent to make gifts, careful thought will need to be given to how that grant of authority will be phrased. Giving an agent the ability to make lifetime gifts carries not only the risk that the agent will intentionally abuse the power, but also the risk that the agent will simply misjudge how the principal would have wanted his property distributed. One way to minimize both risks is for the power of attorney to require that the gifts follow the same format in terms of amounts, recipients and terms of trusts as is set forth in the principal's estate plan. Another way is require the agent to consult with other beneficiaries of the principal's estate plan before embarking on any gift giving — for example, if a child is named as agent, the power of attorney could require the child to consult with or obtain the written consent of all of his siblings prior to making any gift. Or, if such consultation is likely to be too time consuming or otherwise onerous, the power of attorney could require that all gifts be made among the donor's descendants on a per stirpital basis. The principal may also want to require that notice be given to him if the agent decides to exercise the gift giving power or that the power only be exercisable if designated persons (other than the agent) have determined that the principal is disabled.

In many cases, the agent that the client authorizes to make gifts will be a family member or another person to whom the client wants to make gifts. It is unclear whether giving an agent the power to make gifts to himself results in the agent having a general power of appointment. IRC Sections 2041 and 2514 dealing with powers of appointment provide that if a power is exercisable only in conjunction with the creator of the power, it is not a general power of appointment. Since the principal can revoke the power of attorney, arguably any gifts made pursuant to its authority are being made with the principal's consent. In addition, since the gifts will be taxable gifts to the donor when made and any other property subject to the power of attorney will be taxable in the donor's estate at death, the property is not escaping transfer tax. On the other hand, an argument can be made that, just as in the case of an irrevocable trust, the power to make unlimited gifts to oneself under another's power of attorney does constitute a general power of appointment on the basis that the power to revoke or amend a document does not equate to the requirement of consent (particularly in situations when the principal is disabled). One way to guard against this argument is to require the agent to act with another person who also has an interest in the property.[16]

Trustee or Gift Agent: If the client's property is held in a revocable trust, then the gift authority will need to be set forth in the trust instrument.[17] The same considerations and possible limitations on the authority discussed in connection with powers of attorney are relevant to gift powers set forth in trust instruments. It will, however, be easier for the gift power to require that lifetime gifts follow the format of the client's testamentary gifts if the authority is contained in the trust instrument along with the

terms of the client's estate plan. Likewise, it will be easier to condition the power on the client being disabled if the trust instrument already sets forth a mechanism for declaring the client being disabled.

Court Appointed Guardian: In those cases where a client becomes incompetent before any gift authority provisions can be included in the client's power of attorney or trust instrument, a family who wants to have gifts made on behalf of the client will need to request a court appointed guardian. Many states authorize their guardianship courts to direct and approve gifts of a ward's property for estate or tax planning reasons. The Guardianship and Protective Proceedings Act (UGPPA) which amended the Uniform Probate Code gives a guardian, among other powers, the power to make gifts of the principal's property, create revocable and irrevocable trusts on behalf of the principal, and make beneficiary designations if the court determines that such transfers would be in the best interests of the ward. In some jurisdictions, the court will require evidence that the disabled person would have made such a transfer himself if he were not disabled. This is called the doctrine of "substituted judgment." In other jurisdictions, the court will only require a showing that a prudent person would have made the transfer.[18]

The evidentiary requirements are just one downside to having to resort to a guardianship court to make deathbed gifts. Other disadvantages include the expense of having a guardian appointed, the public nature of guardianship proceedings, and the delay that will almost certainly result from having to make application to the court. Still, there may be instances involving contentious heirs and beneficiaries when a court proceeding is preferable even if a power of attorney or revocable trust separately grants gift giving power. In these cases, however, the applicable state law should be reviewed to determine if the appointment of a guardian will automatically render a power of attorney ineffective. If such a result will occur, the benefits of the tax planning will need to be weighted against the disadvantage of losing the flexibility generally provided by the power of attorney in terms of managing the donor's assets.

VIII. Conclusion

Deathbed gift planning poses many challenges. One of the greatest challenges is working with a client and family members who are coping with the emotional issues of terminal illness. For this reason, it will often be appropriate to discuss deathbed giving with clients when they are still healthy. Even when such advance planning has not occurred, most advisers will feel a responsibility to discuss the tax savings that could be realized if the client makes large lifetime gifts when a client's death seems imminent. In the author's experience, despite the difficulty of the circumstances, the client and family recognize the need for planning and appreciate the adviser's advice. Indeed, for better or worse, some families find the focus on tax planning and the opportunity to take constructive action a welcome relief from a situation where they otherwise feel entirely helpless.

Deathbed giving is best suited for circumstances when the client is not expected to live longer than a year and can be maximized when the client has access to other assets that will not be included in his/her estate (such as irrevocable trusts created for the client by another family member over which the client has no taxable powers). It is, of course, distasteful and often very difficult to predict how long a terminally ill client will live; and that will limit the cases where large gifting is appropriate or at least force a delay until death is truly imminent. In cases where the client's life expectancy is uncertain, the chance that changes in the federal and state estate tax laws might undermine the benefit of making (taxable) deathbed gifts should not be ignored. Still, in many cases, deathbed gifts will be a powerful way to save estate taxes.

For Further Information

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Endnotes

[1] This paper is based on the article "Deathbed Gifts: A Savings Opportunity for Residents of Decoupled States" written by our colleague, Debra L. Stetter, and published in the June 2004 issue of Estate Planning Magazine.

[2] Our colleague, Skip Fox, has written widely about the issue of the phase-out of the federal state death tax credit in general. See, *e.g.* Fox, IV, Charles D., Pomeroy, Robert C., Abbott, Susan L., and O'Donell, Laurie L., "Ramifications for Estate Planners of the Phase Out of the Federal State Death Tax Credit: Boom, Bust, or Unknown?" 29 ACTEC Journal 26 (Summer 2003); ALI-ABA 170 (September 2003); Proceedings of the 2003 Notre Dame Tax and Estate Planning Institute (September 2003); Proceedings of the 38th Annual University of Miami Law School Heckerling Institute on Estate Planning, Chapter 16 (January 2004); and ABA Trust & Investments (January/February 2004), p. 37; See also Bart, Susan T. "This is Me Leaving You: Illinois Departs from the Federal Estate Tax Scheme," 92 Ill. Bar. Journal 20 (January 2004); Woods, Anthony, "Decoupling's Dilemma," Trusts & Estates (April 2004).

[3] This reduction in the top federal estate tax rate is one of the changes enacted by the 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). EGTRRA changed the way in which the federal estate tax is calculated in three significant ways: (i) it reduced the top federal estate tax (before application of the state death tax credit) in uneven stages from 55% in 2001 to 45% in 2007, (ii) it increased the applicable exclusion amount in uneven increments between 2001 and 2009 to $3.5 million with there being no estate tax in 2010, and (iii) it phased out the state death tax credit by 4% a year from 16% in 2001 to 4% in 2005 when a state death tax deduction is added. In 2011 when the federal estate tax is reinstated, the pre-EGTRRA state death tax credit is restored at its original rate of 16%.

[4] Number crunching should be a part of any evaluation of deathbed gift planning for a client as the savings for any actual client will depend upon the size of the client's estate, the value of the client's prior taxable gifts, and the year in which the deathbed gift is made.

[5] A donor is liable for any gift tax generated by a gift. IRC Section 2502(c).

[6] The law is clear that gift taxes paid by the donee are included in the donor's estate if he dies within three years of making the gift. See Estate of Sachs v. C.I.R., 856 F.2d 1158 (8th Cir. 1988), aff'g in part and rev'g in part, 88 T.C. 769 (1987). This is true regardless of whether the donee pays the gift tax pursuant to a private agreement with the donor or pursuant to transferee liability. In addition, having the donee pay the gift tax does not reduce the value of the gift for purposes of the gift tax due. The value of a gift will be reduced by the amount of gift tax payable if there is a binding agreement that the donee pay the tax on behalf of the donor. Cf. Moore v. C.I.R., 146 F.2d 824 (2nd Cir. 1945), aff'g 1 T.C. 14 (1942) to Harrison v. C.I.R., 17 T.C. 1350 (1952) and Rev. Rul. 75-72, 1975-1 C.B. 310. However, if there is a reduction in value for gift tax paid, the reduction will be equal to the actual gift tax liability assumed. If the donor had unified credit available at the time of the gift, that credit will be taken into account in determining the amount of the gift. Rev. Rul. 81-223, 1981-2 C.B. 189. Thus, the value of a net gift will be identical to the value of the gift if the donor pays the tax himself. If the donee pays the gift tax and that tax exceeds the donor's basis in the property, then the donor will realize income to the extent of the excess. Diedrich v. C.I.R., 457 U.S. 191 (1982).

[7] Section 6324(b) makes a donee of a gift liable for the unpaid gift taxes of the donor and imposes a lien upon the gift to secure payment of the tax, and to the extent that the tax is not paid, personal liability on the donee to the extent of the gift. There are three requirements for the assertion of liability under Section 6324(b): (i) the donor must have made a gift to the donee, (ii) the donor must have incurred gift tax liability, and (iii) the donor must have failed to pay the tax when it was due. La Fortune v. C.I.R., 29 T.C. 479 (1957), aff'd 263 F.2d 186 (10th Cir. 1958) (holding that the liability of a donee as a transferee for unpaid gift tax does not depend on the solvency or insolvency of the donor).

[8] It is the date of the gift and not the date of payment of the gift tax that is relevant for purposes of Section 2035(b) of the Internal Revenue Code.

[9] See Footnote 3.

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[10] IRC Section 1015(d)(6).

[11] Armstrong v. C.I.R., 114 T.C. 94 (2000).

[12] A transferee is liable in equity if the transfer can be shown to be a fraudulent transfer under applicable state law. See Uniform Fraudulent Transfer Act (providing that a transfer by a debtor is fraudulent if the transfer was made with the actual intent to hinder, delay or defraud a creditor of the transferor).

[13] The Code does not define who constitutes a "transferee" for purposes of Section 6324(a)(2). There is case law that holds that a trustee can be held personally liable as a transferee despite the fact that the trustee had acted in good faith in distributing the property at issue to a trust beneficiary. See Estate of Govern v. C.I.R., T.C. Memo 1996-434 (1996)(holding a trustee personally liable for estate tax to the extent of the property held as of the date of death that was subsequently distributed to trust beneficiaries). On the other hand, it has been held that a beneficiary of a trust that received property from the decedent's estate is not a "transferee" for purposes of Section 6324(a)(2). See Englert v. C.I.R., 32 T.C. 1008 (1959). This means that a transferee of a transferee is not liable under Section 6324(a)(2) although they may be under state law.

[14] Armstrong v. C.I.R., 114 T.C. 94 (2000).

[15] See *e.g.* Kunewa v. Joshua, 83 Haw. 65, 924 P.2d 559 (Haw. 1996) (holding that a power of attorney must expressly authorize gift giving), LeCraw. V. LeCraw, 261 Ga. 98, 401 S.E.2d 697 (1991) (holding that a broad grant of general authority in a power of attorney did authorize certain gifts). See also TAMS 9231003 (July 31, 1992), 9342003 (October 22, 1993) and 9403004 (January 21, 1994) (all holding that a power of attorney does not authorize gifts unless it contains specific language granting that power). See also Cal. Prob. Code 4264, Mo. Stat. 404.710, Wash. Stat. 11.94.050 (each requiring the power to make gifts to be expressly set forth in a power of attorney).

[16] IRC Section 2514(c)(3) provides that a power created after October 21, 1942 is not considered a general power of appointment if its holder may only exercise it with the consent of the creator of the power or a person who has a substantial adverse interest in the property subject to the power.

[17] Since 1997, gifts can be made from revocable trust without triggering the 3-year rule. See IRC Section 2035(e).

[18] See Clark, Elizabeth, "Substituted Judgment: Medical and Financial Decisions by Guardians," 24 Est. Plan. 66 (February 1997); Edge and Hutchinson, "Tax Savings on Gifts on Behalf of Wealthy Incompetents," 17 Ga. St. B.J. 22 (1980).