WRMarketplace
An AALU Washington Report

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TOPIC: Something Old, Something New: Steinberg v. Commissioner – Is It Time for Net, Net Gift Valuation Discounts?

MARKET TREND: While the IRS targets valuation discounts, the Tax Court seems to head in another direction in the Steinberg case by approving a reduction in the value of a gift due to the recipient's assumption of the donor's potential estate tax liability.

SYNOPSIS: The Tax Court approved a valuation discount of a gift based on the recipients' assumption of a potential estate tax liability under IRC § 2035(b) (should the donor die within three years of the gift), deeming the assumption a benefit to the donor that a hypothetical willing buyer and willing seller would consider when valuing the asset. This is, in effect, an expansion of the so-called "net gift" planning concept.

TAKE AWAYS: Tax Court approval of this valuation discount and methodology could facilitate net, net gift planning, but clients and their advisors should still exercise caution, as the IRS is likely to continue targeting the discount and/or the methodology for its determination. Net, net gift planning also may have limited practical application, as its use by younger donors will produce minimal discounts, while use by donors in bad health poses a greater risk that the gift recipient will be required to pay the liability, which could far exceed the value of the discount. Thus, this approach is likely best considered in planning for older clients who are in good health who are making large gifts.

MAJOR REFERENCES: *Steinberg v. Commissioner, 145 T.C. No. 7 (Sept. 16, 2015); IRC § 2035(b).*

Generally, a donor is liable and must pay gift taxes on his or her taxable gifts.[1] It has long been recognized by the IRS and the courts, however, that if the gift recipient ("**donee**") is required to assume the liability for payment of gift taxes as a condition of the gift, the value of the gift is reduced by the gift taxes paid (so-called "**net gifts**").[2] When a net gift occurs, the donor is deemed to receive consideration for part of the gift in an amount equal to the applicable gift tax, and the gift tax liability is calculated by reducing the net fair market value of the gift by the amount of tax due.

> *Example 1*: In 2016, Jane, age 90, agrees to give $25 million to her son, Jack, but only if Jack pays all gift taxes due on the gift (he agrees).[3] The federal gift tax due is $5,591,429 (assuming use of Jane's available $5,450,000 lifetime gift tax exclusion). Since Jack pays the gift tax of $5,591,429, Jane reports a taxable gift of only $19,408,572.

In a recent case, *Steinberg v. Commissioner*,[4] the Tax Court was asked to extend the net gift concept by addressing whether the value of a gift <u>also should be reduced</u> by the donees' assumption of a <u>contingent estate tax liability</u> under IRC § 2035(b) (the "**2035(b) estate tax**") – a tax that may <u>never</u> actually have to be paid. In *Steinberg*, the assumption of the potential 2035(b) estate tax was in addition to the assumption of the gift tax liability, making the gift a so-called "**net, net gift**." Holding for the taxpayer, the Tax Court recognized that a willing buyer and willing seller would consider the potential 2035(b) estate tax when arriving at a value of the asset, opening the door for a new estate planning tool, <u>in the right circumstances</u>.

<u>STEINBERG IMPACT</u>: THE BEFORE & AFTER

The chart below compares the difference in the net value of a gift and the gift taxes due in the following scenarios, using the fact from Example 1 above: (1) a net gift (as illustrated in Example 1), (2) a net-net gift, where the donee also agrees to assume any 2035(b) estate tax as a condition of the gift, and (3) no assumption of any gift tax liabilities.

	No Net Gift	Net Gift (Assume Only	Net, Net Gift (Assume Both Gift &

		Gift Tax)	2035(b) Estate Taxes)
Gift's Fair Market Value	$25,000,000	$25,000,000	$25,000,000
Assumed Discount for Assumption of 2035(b) Estate Tax	N/A	N/A	$1,250,000
Tentative Gift Tax Base	$25,000,000	$19,408,572	$18,515,714
Net Gift Tax Paid (After $5.45 million Exclusion)	$7,828,000	$5,591,429	$5,234,286
Net Amount to Donee	$25,000,000	$19,408,572	$19,765,714

THE "GROSS-UP" PROVISIONS OF IRC § 2035(b).

IRC § 2035(b) is a "gross-up" provision that pulls back into a decedent's gross estate the amount of any gift tax paid by the decedent or his or her estate on any gift made by the decedent within three years before death.

The gift tax regime is "tax exclusive," which means that the tax is imposed only on the property that passes to the donee. The property used to pay the gift tax is not itself subject to the tax. The estate tax regime, on the other hand, is "tax inclusive," which means that the tax is imposed on the entire estate, including the portion that is used to pay the estate tax. Due to the difference in how gift and estate taxes are assessed, it often can make more sense to make lifetime taxable gifts rather than pay estate taxes at death. Congress enacted IRC § 2035(b) as part of an effort to mitigate this disparity. The provision eliminates the incentive to make deathbed transfers by bringing any gift taxes paid on gifts made within three years of a decedent's death back into his or her estate – in effect, making it tax inclusive. The taxpayer in *Steinberg* used the assumption of this potential estate tax liability by the donees to reduce the value of the taxpayer's gift.

WHAT STEINBERG SAID

Facts. On April 17, 2007, after several months of negotiation through separate counsel, Jean Steinberg, age 89, and her four daughters entered into a binding gift agreement whereby Mrs. Steinberg agreed to transfer property having a fair market value of $109,449,307 equally to her daughters. In return, her daughters agreed to: (1) assume and pay any federal gift tax liability imposed as a result of the gift and (2) assume and pay any 2035(b) estate tax liability (including any state estate tax liability) should Mrs. Steinberg die within three years of the gift (making the transfer a "net, net gift"). Concurrently with the gift and execution of the gift agreement, the four daughters transferred $40,000,000 to an escrow account.

In part, an appraiser determined that the value of the gift was: (1) the fair market value of the assets conveyed by Mrs. Steinberg less (2) the gift tax liability plus an amount representing the value of the Section 2035(b) estate tax liability.

Mrs. Steinberg filed a gift tax return reporting the net value of the gift to her four daughters as $71,598,056 and a total gift tax due of $32,034,311. The funds in the escrow account were used to pay the gift taxes and the balance remained in escrow pending the three-year "pull-back" period under IRC § 2035(b). The IRS accepted the discount taken for gift taxes paid by the daughters, but disallowed the discount Mrs. Steinberg had taken for her daughters' assumption of the potential 2035(b) estate tax and increased the net value of the gift to $75,608,963, thereby increasing the gift tax due by $1,804,908.

Consideration of Assumed Liabilities in Gift Valuation: Willing Buyer & Willing Seller. The fundamental question posed by *Steinberg* is the fair market value of an asset transferred under the gift agreement. Fair market value is generally the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[5] The "willing buyer/willing seller" test is the foundation of transfer tax valuation. It requires an examination of the property rights that are being transferred and the price a hypothetical willing buyer and willing seller would agree for that asset. The fair market value must take into account any restrictions or conditions limiting the property's marketability, including those imposed by a donor. The Tax Court concluded that the assumption of the 2035(b) estate tax liability can be considered in valuing the gift under the willing buyer/willing seller analysis as there is a detriment to the donee and a benefit to the donor that would be considered by a willing buyer and willing seller in arriving at a value for the asset.

PRACTICAL APPLICATION OF THE NET, NET GIFT VALUATION DISCOUNT

A donee's assumption of a donor's gift and potential 2035(b) estate tax liability is not a common occurrence. Although the Tax Court approved the concept of the net, net gift and the procedure for valuing the reduction, this planning approach may only be practical for some clients.

- For younger clients, there will be little reduction in the gift's value from assumption of the potential 2035(b) estate tax (as there is a low risk of death within three years of the gift).
- For much older donors and/or those with special health issues, the risk that the donor may die within three years of the gift and that the donee may have to pay the 2035(b) estate tax may be too high. <u>The potential estate tax liability may far outweigh the discount in the value of the gift.</u> For example, if Mrs. Steinberg had actually passed away within three years of the gift to her daughters, their liability to pay the estate taxes would have been $12,813,724 ($32,034,311 x 0.40) whereas the reduction in the value of the gift for the assumption of that estate tax liability was merely $5,838,540.
- Use of the net, net gift valuation discount strategy could create a valuable asset in the form of the donee's obligation to pay the additional estate tax, that would be included in the donor's estate should the donor die within three years of the gift.

The net, net gift valuation discount strategy is likely optimal for older, healthier clients who are considering large gifts. In such situations, the donee could obtain short-term life insurance on the donor to cover the estate tax liability should the donor die within the three year period.

TAKE AWAYS

- Tax Court approval of this valuation discount and methodology could facilitate net, net gift planning, but clients and their advisors should still exercise caution, as the IRS is likely to continue targeting the discount and/or the methodology for its determination.
- Net, net gift planning also may have limited practical application, as its use by younger donors will produce minimal discounts, while use by donors in bad health poses a greater risk that the donee will be required to pay the liability, which could far exceed the value of the discount. Thus, this approach is likely best considered in planning for older clients who are in good health who are making large gifts.

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[1] IRC § 2502(c).
[2] Rev. Rul. 75-72, 1975-1 C.B. 310 (gift tax paid by the donee may be deducted from the value of transferred property where it is expressly shown or implied that payment of tax by the donee or from the property itself is a condition of the transfer). See also *Harrison v. Commissioner*, 17 T.C. 1350, 1357 (1952).
[3] Assume Jane lives in a state that does not have a gift tax, and Jane has not made any prior taxable gifts.
[4] *Steinberg v. Commissioner*, 145 T.C. No. 7 (Sept. 16, 2015).
[5] Treas. Regs. § 25.2512-1.