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Another Reason to be Cautious in Making Big Gifts

-by Neil E. Harl

In recent issues of the Digest, we have focused attention on the issue of major gifts prompted by perceived tax advantages. The prospect of a new income tax basis at death (and other reasons for not making big gifts during life) have generally trumped the arguments for gifting property during life, at least for heavily appreciated property. Another reason to go easy on major gifts during life is that such gifts could affect special use valuation in the donor’s estate if death of the donor occurs less than three years after the date of the gift.

General rule on gifts within three years of death

Since the 1981 amendments to the provision on gifts in contemplation of death, with four exceptions, property gifted within three years of death is not included in the gross estates of decedents dying after 1981. Those four exceptions are – (1) the decedent retained a life estate in the property; (2) the transfer is to take effect at death; (3) the transfer is revocable; and (4) the transfer involves life insurance policies. These are exceptions to the general rule that property transfers within three years of death are not included in the gross estate.

The additional rule for gifts within three years of death

For three additional situations, gifts within three years of death are included in the donor’s gross estate for the limited purpose of determining eligibility for distributions in redemption of stock to pay death taxes, special use valuation of land for federal estate tax purposes and installment payment of federal estate tax.

Pre-death gifts to achieve eligibility. At the time of enactment, it was thought that, without inclusion of these amounts in the gross estate for purposes of determining eligibility for these provisions, individuals facing imminent death could make gifts of property on a selective basis before death to assure eligibility.

Example: Lawrence Webber, terminally ill, was advised in early 2013 that farmland rented to a son under a crop-share lease should meet the qualifications as an interest in a closely-held business for purposes of special use valuation but that the farmland and farm personal property totaled only 40 percent of the adjusted value of the decedent’s gross estate. However, the statute requires that the value of the real and personal property...
must consist of at least 50 percent of the adjusted value of the gross estate. If gifts within three years of death were not included in the gross estate, Webber could make a late pre-death gift of sufficient non-business property to raise the percentage of the adjusted gross estate to exceed 50 percent as required. The rule, in effect, counts gifts within three years of death in determining whether Webber has met the qualification requirements for special use valuation. Gifts within three years of death augment the gross estate only for purposes of determining eligibility for the three provisions.

Pre-death gifts that are included in the estate and achieve eligibility. A 1985 private letter ruling confirms and extends this analysis in a manner that can be helpful to the estate. In that ruling, the decedent gifted pasture land to his spouse in 1982 which would have been eligible for special use valuation. Upon his death in 1984, the decedent owned real and personal property used for farming purposes but not enough to meet the percentage limitations for a special use valuation election. The ruling allowed the decedent’s estate to take into account the real property that was transferred to his spouse within three years of death only for purposes of qualifying the property owned by the decedent until death to be eligible for special use valuation. In this case, the requirement benefitted the taxpayer.

Similarly, in Rev. Rul. 87-122, the ruling makes it clear that the primary purpose of the three-year rule was to disqualify estates when the decedent transferred assets shortly before death in an attempt to qualify otherwise disqualified property, but the rule by its terms includes not only non-qualifying property but also qualifying property if transferred within three years of death. Thus, the rule can operate to allow a special use valuation election where such an election would not have been possible otherwise.

Estate of Slater

In the 1989 case of Estate of Slater, the decedent transferred stock in a farm corporation to his two sons shortly before his death. Upon his death, the estate included all of the stock in the decedent’s gross estate and valued the stock under special use valuation. The Tax Court, however, held that the shares of stock gifted to the sons were included in the gross estate only for purposes of determining whether the decedent’s remaining stock qualified for special use valuation. The court stated that the sons’ shares of stock in the corporation, which were included in the gross estate of the decedent, had to be listed as “adjusted taxable gifts” and were not themselves eligible for special use valuation. Thus, the three-year rule cannot be used to make the gifted property eligible for special use valuation.

In conclusion

The rules in I.R.C. § 2035(c)(1) should be taken into account any time a major gift could cause unexpected and unwanted consequences because of the required inclusion of the gift in the donor’s gross estate.

ENDNOTES

2 See I.R.C. § 2014(a)(1) (basis becomes the fair market value at the date of the decedent’s death).
3 I.R.C. § 2035(c)(1)(B) (value of transfers by gift included in gross estate if made within three years of death for purposes of special use valuation).
5 See 5 Harl, Agricultural Law § 43.02[6][d] (2013).
6 I.R.C. § 2035(a)(2).
7 Id.
8 Id.
9 Id.
10 I.R.C. §§ 2035(c)(1)(A), 303.
11 I.R.C. §§ 2035(c)(1)(B), 2032A.
12 I.R.C. §§ 2035(c)(1)(C), 6166.
13 See 5 Harl, Agricultural Law § 43.02[6][d] (2013).
16 Id.
18 Id.
20 Id.
21 Id.