FEATURE:
ESTATE PLANNING & TAXATION

By **Tyson D. Willis**

The Net, Net Gift Revisited

Generate tax savings for older clients

It's a well-known fact that lifetime gifts are more tax-efficient than transfers at death. Many estate-planning strategies for high-net-worth clients seek further tax savings by reducing the amount of the gift for tax purposes. One such strategy that may be useful for older clients is the "net, net gift."[1]

The net, net gift is a variation on a traditional net gift. A traditional net gift is a gift conditioned on the donee paying the donor's gift tax liability. The donee's assumption of the gift tax liability is partial consideration for the property transferred and reduces the amount of the gift for tax purposes. Revenue Ruling 75-72 provides a method for computing the tax on a net gift: first, determine the tentative tax (the tax that would be due on the gross gift); then, compute the true tax using the formula:

True tax = 1/(1+ Tax Rate) * Tentative Tax.[2]

However, the net gift doesn't actually produce a tax benefit over a standard gift. For example, suppose a donor has $10 million and has used up his lifetime estate and gift tax exemption. The donor can give a standard gift of $7,142,857 and use the remaining $2,857,143 (which is also 40 percent of $7,142,857) to pay the gift tax. If instead he gives all $10 million as a net gift, his tentative tax would be $4 million, and his true tax would be $4 million/1.4 = $2,857,143. In either case, the donee receives $7,142,857 after taxes, and the Internal Revenue Service receives the other $2,857,143.

In fact, the income tax consequences could actually be worse for a net gift than a standard gift. A standard gift is a non-recognition event. However, a net gift is treated as a part gift, part sale for income tax purposes. The donor must recognize gain to the extent that the gift tax liability assumed by the donee exceeds the donor's basis.[3]

A net, net gift, on the other hand, may actually reduce gift taxes. The net, net gift goes one step further than a traditional net gift by requiring the donee to pay not only the gift tax associated with the gift, but also any additional estate tax caused by Internal Revenue Code Section 2035(b). IRC Section 2035(b) includes in a decedent's estate all gift taxes paid on gifts made within three years of death. Because the donee is taking on an additional liability (albeit a contingent one), the assumed liability further reduces the amount of the taxable gift.

Court Approval

The courts have twice approved the reduction in a gift for the contingent Section 2035(b) liability. In *Succession of McCord v. Commissioner*,[4] the U.S. Court of Appeals for the Fifth Circuit, reversing a Tax Court decision, held that because the value of the contingent liability could be determined actuarially, it wasn't "too speculative" to be used in calculating the amount of the gift. In the 2015 case *Steinberg v. Comm'r*,[5] the Tax Court, though not bound by the Fifth Circuit's decision in *McCord*, nonetheless agreed that the binding agreement for the donees to assume the contingent estate tax liability reduced the value of the gift. Although the IRS hasn't acquiesced yet, these two cases suggest that the net, net gift will be upheld.

Calculating the Net, Net Gift

The net, net gift involves a circular computation: The contingent Section 2035(b) liability depends on the gift

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tax liability, which depends on the size of the gift, which in turn depends on both the gift tax liability and the Section 2035(b) liability. However, the net, net gift can be computed as follows:[6]

1. Subtract the donor's remaining gift tax exemption and any applicable annual exclusion amounts from the gift. To the extent the gift is covered by the exemption or the annual exclusion, there's no gift tax paid and no possible Section 2035(b) inclusion, so there's no reduction to this portion of the gift.

If the estate tax is repealed, the distinction between a traditional net gift and a net, net gift disappears.

2. Determine the probability of death in each of Years 1, 2 and 3 from the date of the gift using IRS Table 2000CM. For a donor age Y, the probability p_i of death in Year i from the date of the gift is:

$$p_i = \frac{\text{age } [Y + i - 1] \text{ factor} - \text{age } [Y + i] \text{ factor}}{\text{age } Y \text{ factor}} \quad {}^{7}$$

3. Compute the net, net gift using the formula:

$$N = \frac{G}{(1 + t) + t^2\,[p_1/(1+r) + p_2/(1+r)^2 + p_3/(1+r)^3]} \quad {}^{8}$$

where:

N = gift net of both gift tax and contingent Section 2035(b) liability
G = gross gift (in excess of exemption)
t = estate and gift tax rate[9]
p_i = actuarial probability of death in Year i from the date of gift
r = IRC Section 7520 rate (used as a discount rate)

For example, if we assume that a 95-year-old donor made a $10 million gross gift (in excess of any remaining exemption) to his children in May 2017 when the tax rate is 40 percent[10] and the Section 7520 rate is 2.4 percent, the net, net gift would be computed as follows:

1. The gift in excess of the exemption is $10 million.
2. The probability of death in each of the first three years based on Table 2000CM is:

$$p_1 = \frac{\text{age 95 factor} - \text{age 96 factor}}{\text{age 95 factor}} = (6871 - 5315)/6871 = .226459$$

$$p_2 = \frac{\text{age 96 factor} - \text{age 97 factor}}{\text{age 95 factor}} = (5315 - 4016)/6871 = .189055$$

$$p_3 = \frac{\text{age 97 factor} - \text{age 96 factor}}{\text{age 95 factor}} = (4016 - 2959)/6871 = .153835$$

3. Then, using the formula above,

$$N = \frac{\$10{,}000{,}000}{(1 + .4) + .4^2\,[.226459/(1+.024) + .189055/(1+.024)^2 + .153835/(1+.024)^3]}$$

$$N = \frac{\$10000{,}000}{(1.4) + .16\,[.221151 + .180297 + .143267]}$$

$$N = \frac{\$10{,}000{,}000}{1.4 + .087155}$$

N = **$6,724,249**
(a reduction of $3,275,751 from the gross gift)

In addition, 40 percent of the net, net gift, or $2,689,699, represents the gift tax liability, and the remaining $586,052 represents the contingent Section 2035(b) liability discounted to present value, with the total of these three amounts being the $10 million transferred. Under *Steinberg* and *McCord*, this last $586,052 isn't a gift by the donor, but is paid to the donees in exchange for consideration—the donees' acceptance of the risk of additional estate tax under Section 2035(b). After gift taxes, the donor's children have $7,310,301.

Under a standard gift or a net gift (without provision for the contingent Section 2035(b) liability), the gift would be $7,142,857, and the gift tax would

be $2,857,143. By using a net, net gift, the donor can reduce the gift tax by nearly $170,000, which is about 1.7 percent of the assets transferred and about 5.9 percent of the taxes that would be paid on the net gift.

The Downside

However, there's a downside. If the donor in this example dies within three years of the gift (a 57 percent probability under the IRS tables), his estate most likely will pay a higher total tax. First, the $2,689,699 of gift tax paid will be included in the donor's estate under Section 2035(b), causing an additional tax liability of $1,075,880. The donor's children will pay the $1,075,880 under the net, net gift agreement, though they likely would have borne this tax indirectly anyway as the residuary beneficiaries of the estate. Second, and more significantly, the estate's right to have the children pay the tax is probably an additional asset includible in the donor's estate. The courts haven't expressly addressed this question (even though *McCord* noted that the donor did, in fact, die within three years of the gift), but the Tax Court opinion in *Steinberg* contains language suggesting that the liability is includible: "[T]he daughters' contractual assumption of this tax liability gave rise to a new asset that … 'replenished' petitioner's estate."[11] If the contingent liability is includible, there would be an additional $1,075,880 asset in the taxable estate, generating an additional estate tax of $430,352. The donor's children will ultimately bear the burden of this tax as beneficiaries of the residue. The total additional tax due to Section 2035(b) and the children's obligation to pay the tax would be $1,506,232.

If the donor had given a standard gift, there would be an additional $2,857,143 included in the estate under Section 2035(b) and an additional tax liability of $1,142,857, but no further assets to include. The upfront savings of approximately $170,000 from a net, net gift would be outweighed by the additional estate tax of over $360,000.[12] Thus, a net, net gift could backfire if the donor fails to survive for three years following the gift.

Finally, as with a traditional net gift, a net, net gift is likely to be treated as a part-sale, part-gift transaction. A net, net gift is even more likely to trigger capital gains on the transfer, because the donor is deemed to receive more consideration for the transferred property.

Maximizing Tax Savings

The primary factor in determining the potential tax savings from a net, net gift is the donor's age. Older clients can achieve greater tax savings because of the higher actuarial probability of death within three years under the IRS tables, making the contingent Section 2035(b) liability more valuable. For example, a 75-year-old donor would save less than $38,000 of taxes on a gross gift of $10 million by giving the $10 million as a net, net gift, whereas a 95-year-old donor would save over $167,000. Of course, the 95-year-old client typically also has a greater actual (not just actuarial) likelihood of death within three years, which means a greater risk of increasing transfer taxes. Thus, the ideal candidate would be an unusually healthy, older client who'll likely outlive the 3-year period under Section 2035(b).

The net, net gift isn't a one-size-fits-all strategy, but it can generate tax savings for older clients.

The Section 7520 rate also has a moderate effect on the savings from making net, net gifts. If the Section 7520 rate were 6 percent instead of 2.4 percent, the 95-year-old donor's tax savings would fall from $167,000 to about $157,000. The current low interest rates are favorable for net, net gifts, but are less important than the client's age.

Finally, donors should make net, net gifts of high basis assets to minimize income tax consequences. Because the net, net gift will likely be treated as a part sale, part gift, it's possible to trigger capital gains if the donor holds low basis assets such as interests in a family business or depreciable real estate. And, like any gift that removes assets from the donor's estate, a net, net gift will also mean losing a basis step-up at death; the lost step-up is less consequential if basis is already high.

Net, Net Gifts vs. GRATs

One way to obtain a practical measure of the potential

benefit of a net, net gift is to compare it to other estate-planning strategies, such as a grantor retained annuity trust (GRAT). The strategies have some similarities: Both work better when interest rates are low, and both require the donor to live for a certain period to get the tax benefit. But, each has advantages and disadvantages.

The net, net gift has the advantage of removing all appreciation from the estate, whereas the GRAT will remove only the excess appreciation above the Section 7520 rate, and only if the donor survives the GRAT term. Additionally, the donor of a net, net gift must only survive for three years to take advantage of the tax-exclusive nature of gifts, while the portion of the GRAT the donor receives back in the form of annuity payments will start the 3-year clock over for those assets. Also, the net, net gift can shelter appreciation from generation-skipping transfer (GST) tax, but a GRAT can't because of the estate tax inclusion period.[13] Finally, a net, net gift can be given outright, avoiding the ongoing administrative costs of keeping assets in trust.

On the other hand, if the donor dies within the first three years, the net, net gift will result in a higher estate tax than the GRAT if the donee's obligation to pay the Section 2035(b) taxes is includible as an asset of the estate. Also, a GRAT is typically a grantor trust, which permits additional tax savings as the grantor pays the trust's income tax liability without making an additional taxable gift. Finally, even if the donor loses the potential transfer tax savings because he dies during the GRAT term, he'll at least receive a step-up in basis for the assets in the GRAT; he wouldn't obtain this step-up with a net, net gift.

Ultimately, whether a GRAT or a net, net gift performs better will depend on a combination of factors, including the age of the donor, the performance of the gifted assets, whether the donor wishes to make GSTs, the basis of assets transferred and how long the donor lives following the gifts. But in many instances, a net, net gift produces a better tax result (See "Net, Net Gifts vs. Net Gifts vs. GRATs," p. 17).

Estate Tax Repeal

If the estate tax is repealed, the distinction between a traditional net gift and a net, net gift disappears—if there's no Section 2035(b) and no estate tax, there's no contingent liability for additional estate taxes owed. However, any estate tax repeal would likely be temporary, so net, net gifts will still be worth considering.

Additionally, with no estate tax, the traditional net gift may emerge as a hedge against valuation adjustments. Although it would rarely make sense to intentionally pay gift tax if the same assets could be transferred on death with no estate tax, it's possible to end up accidentally owing tax on a gift that was meant to be non-taxable if the IRS increases the value on audit. For example, if a donor with $5 million of remaining exemption makes a gift of what he believes is $5 million worth of property, but the IRS later successfully argues that the value is $8 million, then the donor will bear an unanticipated gift tax liability of $1.2 million (40 percent of the $3 million over the exemption). If the gift were instead a net gift, the donee would be liable for the gift tax of 1/1.4 * $1.2 million = $857,143. The donor can't pay this tax without triggering an additional gift and additional tax, but he could make this amount up with a tax-free bequest, preserving some tax savings.[14]

Further Variations

Finally, there are at least two further refinements on net, net gifts that may expand their benefits or reduce their potential downside. First, the donor should be able to mitigate the potential income tax impact of a net, net gift if the donee assumes the Section 2035(b) liability, but not the gift tax liability. Following on the example above, the donor would give $7,310,301 to the donee, of which the "net, non-net gift" is $6,724,249, and the donor would then pay the gift tax liability of 40 percent of $6,724,249 = $2,689,699. The transfer tax consequences would be the same as for a net, net gift, but the amount of consideration would include only the value of the contingent liability, and not the gift tax liability (for a total of $586,052 as opposed to $3,275,751), and would thus be much less likely to trigger gain.[15]

Second, a donor may be able to amplify the benefits (but also the risks) of a net, net gift if the donee assumes: (1) the gift tax liability, (2) the Section 2035(b) liability, and (3) the additional estate tax liability caused by including the donee's assumption of the Section 2035(b) liability in the donor's estate. Such a gift might be called a "triple-net gift" and would be computed as follows:

$$N = \frac{G\,(1-t)}{1 - t^2 + t^2(1-t)[p_1/(1+r) + p_2/(1+r)^2 + p_3/(1+r)^3]}$$

Net, Net Gifts vs. Net Gifts vs. GRATs

Which produces the best tax result?

Assume you have a client who's a 95-year-old donor. Let's compare the outcomes for: (1) a net, net gift, (2) a net gift (or a standard gift), and (3) a 3-year grantor retained annuity trust (GRAT) followed by a gift at the end of Year 3 (if the donor lives through Year 3) of any amounts received as annuities over the life of the GRAT. Here's the amount the donee(s) would have eight years following the gift based on when the donor died and the rate of annual appreciation. The data also assumes that the donees are the residuary beneficiaries of the donor's estate, so any increase in estate taxes will ultimately be borne by the donees.

	3% Annual Appreciation	10% Annual Appreciation	25% Annual Appreciation
Donor dies at end of Year 2	Net, net gift: $7,461,951 **Net gift: $7,683,727** 3-year GRAT: $7,600,620	Net, net gift: $13,001,897 **Net gift: $13,286,708** 3-year GRAT: $12,861,533	Net, net gift: $37,826,969 **Net gift: $38,215,092** 3-year GRAT: $35,762,787
Donor dies at end of Year 5	**Net, net gift: $9,260,470** Net gift: $9,048,358 3-year GRAT: $8,321,005	**Net, net gift: $15,670,278** Net gift: $15,311,349 3-year GRAT: $14,415,086	Net, net gift: $43,572,787 Net gift: $42,574,746 **3-year GRAT: $45,362,161**
Donor dies at end of Year 8	**Net, net gift: $9,260,470** Net gift: $9,048,358 3-year GRAT: $9,092,587	Net, net gift: $15,670,278 Net gift: $15,311,349 **3-year GRAT: $16,159,385**	Net, net gift: $43,572,787 Net gift: $42,574,746 **3-year GRAT: $48,265,088**

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The triple-net gift could also be combined with the net, non-net gift concept to minimize income tax consequences. In that case, the donee would assume the Section 2035(b) liability and the additional estate tax from the Section 2035(b) liability being included as an estate asset, but not the original gift tax liability.

A triple-net gift would increase the risk and reward over a net, net gift by providing a greater upfront discount on the gift, but an even higher estate tax bill if the donor doesn't survive at least three years. For example, for a $10 million gross gift by a 95-year-old donor, the triple-net gift is only $6,471,410, causing gift tax of $2,588,564 (compared to $2,689,699 for a net, net gift and $2,857,143 on a net gift). However, if the donor dies within three years of the gift, the estate inclusion will be even higher, causing total additional estate taxes of $1,725,709 (compared to $1,506,232 for a net, net gift, and $1,142,857 for a net gift).

The triple-net gift hasn't been tested in the courts, but should nonetheless be permissible because the third-tier liability, like the contingent Section 2035(b) liability, has an actuarially determinable value. However, the triple-net gift depends on the assumption that the donee's obligation to pay the Section 2035(b) liability is an asset of the estate, and although this assumption makes sense, no authority exists on the issue. Once the question of whether the Section 2035(b) liability is includible in the donor's estate is settled, either a net, net gift should reduce gift taxes without the risk of increasing estate taxes or a triple-net gift should be possible. Either answer leaves something for the taxpayer.

Generate Tax Savings

The net, net gift isn't a one-size-fits-all strategy, but it can generate tax savings for older clients. Additionally, the net, net gift can avoid the complexity and ongoing administrative costs of trusts, especially because the client's children will often be old enough that the client is comfortable giving them assets outright.

Endnotes

1. *See* Michael S. Arlein and William H. Frazier, "The Net, Net Gift," *Trusts & Estates* (August 2008), at pp. 1-8.
2. This is the formula for the tax when the entire gift is subject to a single tax bracket, which is effectively the case given current exemption levels. Revenue Ruling 75-72 also provides a more complex formula for a gift spanning multiple brackets.
3. *Diedrich v. Commissioner*, 457 U.S. 191, 199-200 (1982). *Diedrich* was overruled by Section 1026 of the Deficit Reduction Act of 1984, Pub.L. No. 98-369 for gifts made before 1982, but applies to gifts made after 1982.
4. *Succession of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006).
5. *Steinberg v. Comm'r*, 145 T.C. 184 (2015).
6. William H. Frazier, the appraiser in both *Steinberg* and *McCord*, performed the calculation iteratively—that is, by computing the tentative Internal Revenue Code Section 2035(b) liability, then recomputing the net gift, then recomputing the IRC Section 2035(b) liability and so on. *See supra* note 1. The method presented here derives from the method used by Frazier, but has the advantage of using a set of equations that can be done with a hand calculator or simple spreadsheet.
7. This formula comes from multiplying the probability of living up to Year i – 1 from the gift (age [Y + i – 1] factor/age Y factor) by the probability of dying in Year i given survival to Year i – 1 from the gift (1 – {age [Y + i] factor/age [Y + i – 1] factor}) and then simplifying.
8. This formula is derived from the fact that the net, net gift = gross gift – gift tax paid – contingent Section 2035(b) liability, or N = G – T – CL. Both the gift tax paid and the contingent liability can be expressed in terms of the net, net gift, and the resulting equation can then be solved for N algebraically.
9. This assumes that the estate tax rate won't change across the three years, which current law provides. The mere possibility of future rate changes is ignored for valuation purposes (*see McCord, supra* note 4), but rate changes that have been enacted for a future effective date should be considered. The formula could be modified to account for scheduled rate changes as follows:

$$N = \frac{G}{(1 + t) + t\,[p_1 * t_1/(1+r) + p_2 * t_2/(1+r)^2 + p_3 * t_3/(1+r)^3]},$$

where:
t = tax rate at the time of the gift
t_i = scheduled estate tax rate for year i from the date of gift
p_i = actuarial probability of death in year i from the date of gift
r = Section 7520 rate (used as a discount rate)

Even this formula, however, fails to account for the fact that if the donor makes the gift in the middle of the year, the *i*th year from the date of the gift will span two calendar years and thus be subject to two different rates depending on when during the *i*th year the donor dies.

10. This only includes the federal estate tax rate. For clients in New York and other states that have an estate tax with a 3-year clawback for lifetime gifts, the potential tax savings and risks from a net, net gift are even greater.
11. *Steinberg, supra* note 5, at p. 198. *See also* Steve R. Akers, "*Steinberg v. Commissioner.* 'Net, Net Gift'; Tax Court Allows Gift Offset for Donee's Assumption of Potential Estate Tax Liability Under § 2035(b) Attributable to Gift if Donor Dies Within Three Years" (Bessemer Trust, September 2015).
12. Of course, if the contingent liability created by a net, net gift isn't included in the donor's estate, then the donor of a net, net gift would have additional tax savings at death within three years, with no downside. Using the same 95-year-old donor and the same $10 million gift, the donor of a net, net gift would have an estate tax liability of $1,074,954 under Section 2035(b), whereas the donor of a standard gift would pay additional estate taxes of $1,142,857 from the Section 2035(b) inclusion.
13. IRC Section 2642(f). The donor (or the executor of the donor's estate) can allocate generation-skipping transfer (GST) tax exemption at the close of the estate tax inclusion period (typically the end of the grantor retained annuity trust (GRAT) term), but allocating to the GRAT remainder isn't a leveraged use of GST tax exemption.
14. Another alternative to a net gift in this situation would be a *Wandry*-type defined value provision. In *Wandry v. Comm'r*, T.C. Memo. 2012-88, the donor made a gift of "a sufficient number of [LLC units] so that the value of such Units for federal gift tax purposes shall be" a specified dollar amount. The Internal Revenue Service increased the value per LLC unit on audit and argued that the gift was correspondingly higher. The Tax Court held that the adjustment to the per-unit value changed only the number of units transferred and that the value of the gift was fixed. Thus, the amount of the gift was exactly as reported by the donor. The IRS appealed, then later withdrew the appeal but filed a notice of nonacquiescence. 2012-46 I.R.B. 543 (IRS ACQ).

It's also possible that the IRS would raise similar objections to those it raised in *Wandry* and in its nonacquiescence, namely, that the donor has retained an interest contingent on an event outside his control (the IRS audit). *See, e.g., Smith v. Shaughnessy*, 318 U.S. 176, 181 (1943). It's not clear how the courts would decide. In any case, a net gift would claim less of a reduction in gift tax liability than a *Wandry* clause.

15. Gain could also be avoided if the gift is made to a grantor trust. However, one of the advantages of a net, net gift is that trusts aren't required, so the net, net gift can save administrative costs. By gifting to a grantor trust, the donor loses the potential simplicity of outright gifts.