
Chapter 8

Gifts of Forestry Assets

Overview

Estate planning frequently focuses on the transfer of property at death; however, lifetime gifts also offer a powerful tool to achieve planning objectives. With a program of giving, the “ability to afford the gift” should be the first consideration. That is, do not give away money or forest land that might someday be needed. Many gifting objectives are personal and do not involve tax saving, but they can be just as—or perhaps more—important than tax and financial considerations. Careful attention to the tax rules permits the donor to stretch the benefits of his (her) gifting program.

Some Reasons for Gifts

The primary reason for a program of gifting is to benefit family members. When most of the assets are owned by one spouse, a substantial gift equalizing the family assets is a statement of trust (in some families, however, a cultural tradition of transferring land only along blood lines complicates this process). Gifts to adult children, especially of forest land, may promote a sense of financial maturity in the donees and motivate them to learn how to manage the forest land. In this way, the donor can see the responsibilities for managing a going concern transferred to the next generation with efficiency and effectiveness. Other beneficial effects that can follow as a result of gifting are discussed in chapters 6 and 9.

Gifts from senior family members who are in higher income tax brackets can reduce the total family income tax burden by moving income-producing property into the hands of family members in lower income tax brackets. Charitable gifts provide an income tax benefit while at the same time benefiting charitable organizations that are personally important to the donor such as churches, colleges, museums, and others. By decreasing the size of the donor’s gross estate, gifting reduces both Federal and State death taxes; it also lowers estate settlement costs and avoids delays and probate fees on the gifted property. In some cases, the transfers can put the property out of reach of creditors.

Because of its power to reshape the donor’s estate, a program of gifting should be pursued cautiously. There also are disadvantages, the most important of which is loss of control of the gifted asset. Gifts of income-producing assets reduce the donor’s income; thus, important business entities

and key parcels of forest land may not be the best candidates for gifts. A gift also transfers the donor’s basis to the donee, with possibly adverse income tax results that would not be the case with a testamentary transfer. Additionally, special use valuation (see chapter 12) is not available for lifetime gifts of forest land.

Gifting Tax Considerations

There is a single, unified tax rate schedule that applies to both lifetime gifts and estates of decedents (see table 3.1). An applicable credit amount for gifts of \$345,800—providing an applicable exclusion amount of \$1 million—was established by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; Public Law 107-16). The gift tax exclusion is not indexed for inflation; once the total of a donor’s taxable lifetime gifts reaches \$1 million, any excess is taxed at rates that currently range from 41 to 45 percent. Under EGTRRA, gift tax liability for years after 2009 will be determined using the same rate schedule as is used for the Federal income tax, with a maximum rate of 35 percent.

The goal of minimizing gift and estate taxes has been made more difficult by recent changes in the tax laws. For example, Clifford and spousal remainder trusts no longer can be used as effective income-splitting devices. These short-term trusts with reversionary interests of income or principal were used to shift income from the grantor to beneficiaries in lower tax brackets; such income now is taxed to the grantor, eliminating the benefit of these types of trusts. The so-called “kiddie tax” affects gifts to children under age 19 because their unearned income over \$1,800 per year (2008, as indexed) is taxed at the parents’ top rate (children 19 years and older with unearned income of \$900 or more (2008)) and claimed as dependents on their parents’ returns are taxed at their own rate). This provides a considerable incentive to increase an older child’s income with income-producing gifts.

Any transfer of property or an interest in property, without adequate and full consideration in money or in kind, may involve a gift.

Incomplete Gifts

Gifts with no strings attached are complete gifts. A complete and bona fide gift requires a competent donor and donee, a clear intent to make a gift, an irrevocable transfer of legal title, the delivery of the gift to the donee, and the donee's acceptance. If a donor retains an interest in or power over the property gifted, it results in the gift being incomplete.

Incomplete gifts are more likely to occur in transfers to trusts than in outright transfers (see chapter 9). If provisions are included in a deed to the effect that, "if I outlive you, the property will become mine again," the gift is called "the possibility of a reverter." The gift is considered complete, but the restriction reduces its value. Along similar lines, a parent who gives the family forest land to the children, but tells them, "I plan to live here and hunt and fish until I die," has made a gift of a remainder (future) interest. Again, the gift is considered complete, but its value has been reduced and it is not eligible for the annual exclusion discussed below.

Gifts of property are valued as of the date of the gift. Any appreciation of the property while in the donee's hands is excluded from the donor's estate. In addition, gift taxes on property transferred more than 3 years before the donor's death are excluded from the donor's gross estate. Probate administration expenses on the value of the gift property and the gift taxes paid will be avoided, income from the gifted property will be excluded from the donor's estate, and State death taxes may be reduced in some States.

Gifts of land and timber rights—The Internal Revenue Service (IRS) treats a gift of underlying land with retention of timber rights by the donor as an incomplete gift. This means that the value of the land will be included in the donor's estate. Revenue Ruling 78-26, 1978-1 CB 286, held that the entire value of forest land given to an individual by a donor who reserved all timber rights for 10 years—which constituted personal property under the law of the State in which the timber was located—with the donor dying during the 10-year period without having removed any timber, was included in the decedent's gross estate. The United States Fourth Circuit Court of Appeals has upheld the IRS position, holding that under South Carolina law, when a decedent transferred her land to a corporation in exchange for shares of its stock, reserving timber rights on a portion of the land for 2 years, she also reserved an interest in the soil necessary to nourish the timber growing on it. The Court ruled that to the extent the transfer to the corporation was not for adequate and full consideration, the forest land was includable in her gross estate as a gift with a retained life estate (*Estate of Graham, M.H. v. United States*, United States Court of Appeals, Fourth Circuit, No. 83-1068, September 30, 1983, 52 AFTR 2d 83-6449).

Gift Tax Rates, Credits, and Exclusions

As noted above, a tax that currently ranges from 41 to 45 percent applies to lifetime gifts over an applicable exclusion amount of \$1 million. The amount of gift tax payable in any calendar year is calculated by applying the unified transfer tax rate schedule (see table 3.1) against cumulative taxable lifetime gifts. Any tax on previous gifts is then subtracted from this amount, as is any amount remaining of the \$345,800 applicable credit amount for gifts.

Section 2504(e) of the Internal Revenue Code (IRC) sets a 3-year statute of limitations for revaluation of lifetime gifts for gift tax purposes. Under pre-1997 law, most courts permitted the IRS to redetermine the value of a gift for which the statute of limitations had expired, in order to determine the appropriate tax rate bracket and credit amount for the estate tax. Under current law, gifts may not be revalued for estate tax purposes if the statute of limitations for gifts has expired [IRC section 2001(f), as amended by the Taxpayer Relief Act of 1997 (TRA; Public Law 105-34)]. After exhausting all administrative remedies, a donor now may petition the Tax Court for a declaratory judgment as to the value of a gift.

Four gift tax exclusions currently apply: (1) the marital deduction; (2) the charitable deduction; (3) an annual exclusion for gifts to donees other than one's spouse; and (4) exclusions for qualifying payments of tuition and medical expenses.

Marital deduction—The marital gift tax deduction is an unlimited deduction for gifts to a spouse, provided under IRC section 2056(a). To qualify, a gift must satisfy four requirements: (1) the man and woman must be married at the time the gift is made; (2) the donor spouse must be a United States citizen or resident; (3) the donee spouse must be a United States citizen; and (4) the gift cannot be a "nondeductible" terminal interest unless in the form of a qualified terminal interest property (QTIP; see chapters 6 and 9 for discussion of QTIPs and chapter 9 for a discussion of terminal interests). There is no reporting requirement for an outright gift to a spouse.

The gift tax marital deduction is an effective planning tool in the right circumstances, but there is a question as to the extent it should be used. A lifetime transfer saves estate administration and probate expenses if the donor spouse is the first to die, and may permit full utilization of the applicable credit amount if the donee spouse dies first. As with all gifts, however, the donee's basis in the gifted asset is the same as the donor's; there is no "stepped-up" basis as with a transfer at death, which may result in adverse income tax affects. The QTIP election (see chapters 6 and 9) can be used if the donor feels it is necessary to ensure that the

children ultimately receive the property. These decisions should be analyzed carefully with expert counsel and with the family's goals fully in mind.

Charitable deduction—Like the marital deduction, the charitable deduction is an unlimited exclusion for gifts to qualifying charitable organizations, provided under IRC section 2522. Qualifying organizations include units of Federal and State government; units of local government (for gifts used exclusively for public purposes); religious, charitable, scientific, literary, or educational organizations; fraternal societies (for gifts used exclusively for religious, charitable, scientific, literary, or educational purposes); and veterans' organizations incorporated by an act of Congress. Even though they are not taxable, gifts that exceed the annual exclusion for gifts (below) must be reported on IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (see appendix III).

Charitable gifts generally also qualify for a deduction on the donor's Federal income tax return. A Federal gift tax return must be filed, however, in order to deduct any amount of a charitable gift that exceeds the annual exclusion.

Annual exclusion for gifts—An annual exclusion for gifts to donees other than one's spouse is provided under IRC section 2503(b). TRA indexed the exclusion for inflation with adjustments made in \$1,000 increments; it currently (2008) is \$12,000. A donor may make excludable gifts to as many donees as he (she) desires each year, and a married couple may make "split gifts" that combine their individual exclusion amounts, even if only one has income (see below). The value of all gifts given to a donee during the year count against the exclusion amount, with non-cash gifts measured in terms of their fair market value.

To qualify as excludable a gift must be of a present interest; gifts of a future interest are not excludable. As long as a gift is made outright, the annual exclusion should not present a problem. With forest land, however, a qualified appraisal is necessary to verify the fair market value of the transfer.

Example 8.1. Parents have four adult, married children. One parent—in this case the mother—owns 2,000 acres of forest land in fee simple (outright), which has a fair market value of \$1,000 per acre. The annual exclusion for gifts allows the mother (donor) to give each child (donee) \$12,000 in value each year, tax-free. She can do this by giving each child either 12 acres outright or a \$12,000 undivided joint interest in the forest land (see chapter 14), for a total value of \$48,000 per year for all four children. She also can give each child's spouse 12 acres or a \$12,000 undivided joint interest in the forest land each year. The gifts could be made in the form of ownership of 24 acres or a \$24,000 family undivided

joint interest to each child and spouse, for a total value of \$96,000 per year for all four couples. It would take 21 years to transfer the entire holding in this way ($\$2,000,000 \text{ forest land value} \div \$96,000 \text{ gift transfers per year} = 20.83$, or 21 years).

The Hackl case—The present interest requirement recently surfaced in a tree farm gifting case [*Hackl, A.J., Sr. v. Commissioner*, 118 TC 279 (March 27, 2002); affirmed 2003-2 USTC ¶60,465, 335 F3d 664 (CA-7)]. Here the taxpayers gave their children and grandchildren membership units in Treeco, a limited liability company formed to hold and operate tree farming properties. When the properties were first purchased, they had little or no existing merchantable timber, but were bought to provide investment diversification in the form of long-term growth and future income. No timber had yet become merchantable when the gifts were made, and no income distributions were anticipated for many years. The Tax Court agreed with the IRS that because the gifts failed to confer substantial present economic benefits by reason of use, possession or enjoyment of the property, or income from it, they were gifts of a future interest and did not qualify for the annual exclusion.

Tuition and medical expense exclusions—IRC section 2503(e) provides an unlimited exclusion for qualifying gift payments of tuition or medical expenses. The exclusion for tuition applies to tuition paid to a qualifying educational organization. Only gift payments for direct tuition costs are excludable; payments for books, supplies, dormitory fees, board, or other education-related expenses cannot be excluded. The payments must be made directly to the educational organization on behalf of the student, not to the student.

The exclusion for medical expenses applies to payments to a provider of medical care that are not reimbursed—or reimbursable—by insurance. Qualifying expenses include those for diagnosis, cure, mitigation, treatment, or prevention of disease; affecting any structure or function of the body; transportation primarily for and essential to medical care; and medical insurance. Again, the payment must be made directly to the provider of medical care or medical insurance, not to the patient.

The donor need only note gift payments of tuition or medical expenses on their Federal income tax return. There is no other reporting requirement.

Reporting procedures—Except as just noted, a gift tax return, IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (see appendix III), must be filed for transfers of cash or property greater than the annual exclusion for gifts and for split gifts (see below), regardless of value. The gift tax return is due on April 15 (or

as extended) of the year following the year the gift is made, together with the Federal income tax return for the year of the gift.

Other considerations—Only a handful of States still have a gift tax on transfers of property. For donors residing in one of these States, this should be a consideration in making gifts (see chapter 18).

Split Gifts

If both spouses agree, a married couple can make a gift to a child or any other person and treat the transfer as though one-half had been made by the husband and one-half by the wife. The couple can make such a gift even if it comes from income earned or an asset owned entirely by one of them. The gift is “split” for the purposes of computing the gift tax, and thus is taxed at a lower rate than if the entire gift had been given by one spouse. The \$12,000 annual exclusion (2008, as indexed) and applicable credit amount are applied jointly, but the actual donor must file the gift tax return.

Example 8.2. Assume the same facts as in example 8.1, but now the father (who has no ownership in the forest land) agrees to make split gifts to the children. The parents now can give each of the four children up to 24 acres or a \$24,000 undivided joint interest in the forest land each year. They also can make split gifts to each child’s spouse, bringing the total amount gifted to each couple to 48 acres or a \$48,000 undivided joint interest in the forest land each year. This would bring the total amount gifted to \$192,000 per year, requiring just 11 years to transfer the entire holding ($\$2,000,000 \text{ forest land value} \div \$192,000 \text{ gift transfers per year} = 10.42$, or 11 years). One way to make the transfer would be to simply draft a deed for each couple for 48 acres in joint ownership.

Spousal split gifts are allowed only if: (1) both the husband and wife are United States citizens at the time the gift is made; (2) the couple is married at the time; and (3) they agree to split all their gifts for the calendar year.

Basic Gifting Strategies

This section focuses on the economic impact of giving an asset; the effective use of the applicable exclusion amount, annual exclusion, marital deduction, and gift-splitting; and the relative advantages of using cash or its equivalent as the gift property. Forest land is emphasized, but other assets usually found in forested estates are included.

What Type of Property to Give

A gift can take any number of forms, for instance: (1) personal property such as art, cash, business interests, securities (stock), personal effects, cars, or other tangible assets; (2) real estate such as rental property, forest land, timber and hunting leases, personal residences, easements, or other rights in real property; or (3) life insurance, including cash value, cash refunds, or other benefits associated with the policy. Of course, selection of the type of gift should be meshed with the overall estate planning goals.

Here are some basic considerations to bear in mind in choosing gift property.

Low gift value—For lifetime gifts, it makes sense to give property that has low gift tax cost but high potential estate tax cost. Appreciating assets, such as forest land in premerchantable and young-growth timber, fit this category (see the trust example in chapter 9). Forest land with high growth potential is a good candidate for gifts because it can become an estate tax problem for the donor if held.

Appreciated property—Forest land often fits into the appreciated property category. The strategy is to move ownership from an individual in a high income tax bracket to one in a lower bracket. Note, however, that it may be better for income tax purposes to retain appreciated property until the decedent’s death in order to get a stepped-up basis. In making this choice, compare the savings associated with low income tax brackets with the high-bracket estate tax.

High-yield assets—Senior family members in the 35-percent income tax bracket may consider transferring high income-producing assets to children (over 18) who are just getting started in their careers and are in a lower bracket. Alternatively, a retired parent in a lower income tax bracket should consider gifts to middle-aged children of low income-producing assets with good growth potential such as rapidly appreciating young stands in premerchantable and young-growth timber.

Keeper assets—Forest land often is low-basis property that will remain in the family. Senior family members who worry about control of their forest land often consider transferring the land to the children while retaining the timber rights. Since this can cause future estate tax problems, the donor could harvest the mature timber and transfer the cutover bare land. This transfer can be coupled with gifts from liquid resources to cover the cost of reforestation. In this case, it is important to make sure the donees have the resources to handle the management costs and carrying charges associated with the property before the timber grows to merchantable size.

Problem property—If forest property with growth potential will cause problems for the donor’s executor if retained because it is difficult to value, sell, or divide, the owner should gift it during his (her) lifetime. The family home, the lake property, or the vacation cottage typically fall into this category, as do art, antique guns and clocks, and jewelry.

Jointly held property—If forest land is held jointly, it may be advantageous to retitle the property to make it easier to handle for testamentary disposition. For example, if a parent and child own forest land jointly, the parent may wish to gift his (her) interest to the child. This avoids the problem of having the property fully valued in the estate of the first to die due to inadequate records for proof of proportionate contributions.

Life insurance—It may be beneficial to transfer ownership of a life insurance policy to a junior family member or to a life insurance trust (see chapter 10). The transfer may trigger a gift tax based on the replacement value of the policy, but will prevent the policy’s full face value from entering the donor’s estate.

Income Tax Basis

A donee’s basis in gifted property is the donor’s basis, plus any gift tax paid on the net appreciated value of the gift while owned by the donor. For this reason, highly appreciated property often should be held, so the donee can benefit from the step-up in basis that occurs with a transfer at death. This strategy, however, must be balanced against the potential for further appreciation in the value of the property.

Installment Sales and Gifting of Installment Notes

The strategy of selling property to a relative such as a child under an installment contract and then forgiving all or part of the payments as they come due should be used with considerable caution. This strategy runs the risk of having the sale re-characterized as a gift. A possible solution is to accept the payments—treating them as income for tax purposes—then make gifts of cash to the child, who can deposit the gifts into a separate account from that used to make the payments (see chapter 11).

Gifts to Minors

Gifts within families are the most common type of lifetime gifts, such as gifts from parents to children and from grandparents to grandchildren. Many gifts to minors are made without much thought to the legal or

tax consequences. As long as such gifts are small, there generally is no serious problem.

As gifts increase in value, however, the so-called “kiddie tax” (discussed above) can have an impact on minors under the age of 19. State law often is concerned about protection of a minor’s rights and their legal capacity to own, manage, and sell property. Many States require a guardian for a minor who owns real property, place restrictions on a minor’s power to make contracts, and otherwise restrict a minor’s ability to conduct business on his (her) own behalf. These constraints complicate gifting to minor children, especially gifting of real property such as forest land. Vehicles such as trusts, custodianships, and guardianships are used to protect the interests of minors. These differ in important ways, and their advantages and disadvantages should be understood before starting a substantial gifting program involving minors.

Two pieces of legislation have been widely adopted which make the process of gifting to minors more uniform across States. The Uniform Gifts to Minors Acts (UGMA) and more recently the Uniform Transfer to Minors Acts (UTMA) have made it easier and safer from a legal standpoint to make gifts of all types of property to minors.

When making gifts to minors, the legal, tax, and practical management aspects of the transfer all should be considered, particularly where forest land is concerned. Recent tax acts have increased the spread between the lowest and highest noncorporate income tax brackets, which has perhaps increased the motivation for tax shifting. State income taxes also need to be considered.

Example 8.3. Assume that a parent who is in the 35-percent marginal income tax bracket gives a child who is over age 18 and in the 10-percent bracket an interest in forest land that is under a long-term lease to a forest products company. The interest provides an income of \$10,000 per year, which is treated as ordinary income for income tax purposes. Assuming the child has enough additional unearned income from other sources to use the standard deduction, the family has saved \$2,500 in income taxes [$(\$10,000 \times 0.35) - (\$10,000 \times 0.10)$].

Parental obligations, however, must be taken into account. The legal obligation of support makes the child’s income attributable to support taxable at the parent’s rate; in addition, trust income actually applied to the support of a beneficiary whom the grantor is legally obligated to support is taxable to the grantor (IRC section 677). The IRS treats custodial accounts similarly, and many State laws treat a guardianship as a trust, which would subject it to treatment under IRC section 677. The definition of support under

State law should be considered carefully, since expenses for private schools, a college education, and in some cases, a graduate education may be required as proof of support.

Custodianship

Under the UGMA and UTMA laws for transferring property to minors, custodians have the same power over the property that an unmarried adult exercises over his (her) own property. These laws permit all types of property to be transferred, including forest land, and the custodian can enter into business transactions that are needed to manage the property. Such actions, however, are subject to the laws governing fiduciary obligations.

State statutes should be checked for the specific requirements concerning transfers, for the exact responsibilities of the custodian and for the age of majority. The custodial control of a minor's property usually is given over to the full control of the donee at the age of majority, but the applicable State law should be reviewed.

Estate tax—If the minor child dies before the custodial account is transferred to his (her) control, the property is includable in his (her) estate. It also may be included in the donor's estate if the donor is the custodian and dies before the child reaches the age of majority. It is, therefore, not a good idea for the donor to serve as custodian and risk having the assets included in his (her) estate, especially if the value is large. There are similar problems with the donor's spouse serving as custodian—a reliable aunt, uncle, or cousin might be a better choice.

Gift tax—Gifts under the UGMA and UTMA laws qualify for the annual gift tax exclusion of \$12,000 (\$24,000 for split gifts). Parent-donors, however, should not be custodians because there is a risk that the transfer to the child-donee at majority could be treated as a release of a general power of appointment and, therefore, taxable to the parents.

Guardianships

A legal guardian takes custody of and manages a minor's property. A guardian has fiduciary responsibility similar to a trustee; however, the guardian does not hold legal title to the property as does a trustee. The guardian can receive gifts for a minor.

Example 8.4. Assume the same facts as in example 8.3. The parent is appointed as the child's guardian and, in addition, is legally obligated for his (her) support. If used for the child's support, the \$10,000 annual lease income would continue to be taxed at the parent's 35-percent marginal tax rate even though it is now the property of the child. Any portion not used for the

child's support, but for his (her) benefit in other ways, is taxable to the child. The guardian files the income tax return for the child.

For estate purposes, the property that is given to the child is removed from the donor's estate, subject to the provisions for gifts within 3 years of death, discussed below.

A guardianship—which includes bonding, accounting, and court supervision—provides the greatest protection for the child's property rights. This extra measure of security for the child often means added operating costs and constraints on the flexibility of operations, as compared to a custodial or trust arrangement. Potential disadvantages include termination at majority, which may be earlier than is in the best interests of the child's welfare, and adverse estate tax consequences if the child dies within the term of the guardianship.

Trusts for Minors

Trusts can provide a very flexible means of making large gifts. The general applicability of trusts as an estate planning tool is addressed in chapter 9; certain specific issues related to gifts to minors are discussed here. The grantor of a trust has considerable freedom to design the trust instrument to meet his (her) objectives. A trust can be established to distribute income to a minor during its term, accumulate income for the minor, or both. The grantor can establish the term of the trust, select the trustee (and the successor trustee), specify when and how the principal will be distributed, and fulfill other functions discussed in chapter 9. If the size of a gift warrants the expense of setting up and operating a trust, it probably is the most effective way to transfer the gift to a minor.

Two basic types of trusts commonly are used to make gifts to minors. Trusts written to conform to the provisions of IRC section 2503(b) make use of the annual exclusion for gifts possible, since the transfer is a gift of a present interest. This type of trust requires current distribution of income, but does not require distribution of the principal when the beneficiary reaches age 21. Trusts written in accordance with IRC section 2503(c) also permit use of the annual exclusion for gifts. In this case current distribution of income is not required, but distribution of the principal and accumulated income is required when the beneficiary reaches age 21—or sooner if specified in the trust instrument. The annual exclusion also is available if the beneficiary "may" use the income before he (she) reaches age 21, with the principal paid at 21. If the beneficiary dies before reaching age 21, the principal is paid to his (her) estate [*Gall v. U.S.*, DC Tex., 75-1 USTC ¶ 13,067 affirmed 75-2 USTC ¶ 13,107 (CA-5), 521 F2d 878 (1975)]. With these types of trusts, the income portion is considered a gift of a present interest and the

principal portion a gift of a future interest; the income tax treatment for the beneficiary is as discussed above.

A trust written under the provisions of the previous IRC section 2503(c) is a separate taxable entity. The income tax treatment of trusts is discussed in chapter 9. The trust property generally will not be included in the donor's estate.

Trusts have considerable flexibility as tools for making gifts to minors, but they require careful attention to draftsmanship in order to ensure they qualify for the annual exclusion for gifts and also make practical sense for management of property such as forest land. A qualified estate planner should be consulted.

Gifts within 3 Years of Death

The value of a gift made within 3 years of death generally is not includible in the donor's estate. Such gifts are valued on the effective date of transfer, and the appreciation in value after that date is not subject to the Federal estate tax.

There are certain exceptions to this rule, however, which apply whether or not a gift tax return is required. The value of a life insurance policy transferred by the decedent within 3 years of death is included in the gross estate (IRC section 2036). In addition, all gift transfers within 3 years of death are included in the calculation of estate value for purposes of determining whether the estate qualifies for special use valuation under IRC section 2032A (see chapter 12), deferral and extension of tax payments under IRC section 6166 (see chapter 13), and qualification for special stock redemptions (IRC section 303). Such gifts do not, however, assist in meeting the statutory percentage requirements under these statutes. In addition, gift taxes paid on gifts within 3 years of death are includable in the donor's estate.

Despite these restrictions, there still are good reasons for proceeding with a gifting program within 3 years of death. As noted above, the appreciation after the gift's transfer is not taxable to the donor; therefore, properties with high appreciation potential such as plantations of premerchantable and young-growth timber (see discussion in chapter 2) are good candidates for gifts. Similarly, income generated from the gift once it is made is not includable in the donor's estate. For spouses, the unlimited marital deduction may be used without incurring a gift tax. Gifts to donees in lower income tax brackets may save on income taxes if they are not subject to the "kiddie tax." In States with a gift tax, the State gift taxes paid are deductible on the Federal estate tax return.

Certain negative factors must be considered in making gifts within 3 years of death. One is the gross-up provision,

which takes all previous taxable transfers into account when computing the transfer tax. Also, as discussed above, the gift does not get a stepped-up basis as does a testamentary transfer. This is disadvantageous particularly for forest land because timber is a long-term investment and the basis for most timber assets held for a long period is low.

Charitable Gifts

Overview

After one's spouse and children are adequately provided for, a plan for charitable giving of additional assets can bring great personal satisfaction. A donor can benefit his (her) family and the charity in a variety of ways. The affordability of the gift depends on its after-tax cost, which is affected by the donor's filing status, taxable income and the sum of Federal, State, and local taxes, as adjusted.

Charitable Income Tax Deduction

Taxpayers generally can deduct contributions to religious, charitable, educational, scientific, and other organizations from income taxes. Tax effects depend on *when* assets are given, *how* they are given, *how much* is given, and to *whom* they are given. For substantial gifts, the donor should understand the different categories of charitable giving, which include: (1) public charities such as churches, universities, hospitals, and foundations that receive considerable public support; (2) semipublic charities such as veterans' organizations, nonprofit cemetery associations, and others that do not fit into a the public charity category; (3) private charities such as private, nonoperating, or distributing foundations; (4) contributions for the use of a charity (rather than "to" a charity); and (5) capital gain property—that is, highly appreciated property.

Churches and units of government are automatically viewed as charitable, but private organizations must meet the requirements of IRC section 501(c)(3) and have on file an "exemption letter" from the IRS to prove their status in order to assure a tax deductible contribution.

The percentage limitations on charitable contributions deductions are based on the category of the organization and the nature of the gift. The charitable contribution deduction for the tax year is limited to a percentage of the donor's "contribution base," defined as his (her) adjusted gross income without regard to any net operating loss carry back.

A 50-percent limitation on charitable deductions applies jointly to so-called "50-percent" charities, which include several organizational categories, public and private. The limitation is applied first to public charities, then to private

charities, with any excess contributions carried over for five succeeding tax years. There is a 30-percent limitation on deductions to private charities classified as so-called “30-percent” charities as well as on contributions “for the use of” charities. Examples of the former include fraternal orders and veterans’ organizations. Deductions for contributions of capital gain property to semipublic and private charities are limited to 20 percent of the donor’s contribution base. There also is a special 30-percent limit on certain capital gain property given to a public charity, and there are further limitations based on the ratios among the various categories.

Valuation of contributions—A deduction for donated property is measured by its fair market value, subject to certain reductions for appreciated property as discussed below. No problems exist for securities that are publicly traded; for large gifts of real estate or forested property, however, a qualified appraisal must be obtained and a summary of it attached to the tax return (IRS Form 8283, Noncash Charitable Contributions, Section B) if the value of the property exceeds \$5,000 (\$10,000 for non-publicly traded property). The appraisal must be made within 60 days prior to the date of the gift and the appraiser must be qualified to make appraisals of the type of property being gifted. For example, forest land should be appraised by a person who meets the Federal appraisal standards. The appraiser must sign the form, must not be related to the donor, and must not work on a percentage basis. There are penalties for overvaluation of property. If an audit determines the reported value to be 200 percent more than the correct value, a 20-percent penalty can be imposed. Additional penalties can be levied for more blatant overvaluation.

Appreciated property—The charitable deduction depends on the property’s fair market value, the type of property (real or personal), the holding period, the character of the charity, and the use of the property. Capital gain property and ordinary income property retain their different characters for charitable purposes.

Capital gain property held by the donor for more than 1 year is given favorable tax treatment; the donor gets a deduction of fair market value and does not have to pay tax on the appreciation, subject to the alternative minimum tax (AMT). For real estate, including forest land, the donor is entitled to a deduction based on the property’s fair market value on the date of the contribution. The deduction generally is limited to 30 percent of the donor’s contribution base, as noted above, if made to a public charity such as a church or university. If the contribution goes to a semipublic charity the limitation drops to 20 percent. Contributions of capital gain property to certain private foundations that do not make distributions may be limited to the property’s basis.

There also is a special rule on contributions of appreciated property that permits the donor to deduct up to 50 percent of his (her) contribution base if an election is made to reduce the value of the contribution by the amount of the appreciation. The decision whether to make this election should be based on the amount of the appreciation (forest land often has a very low basis and may not be a good choice), the importance of a deduction greater than the 30-percent limit, and the donor’s exposure to the AMT provisions of the Federal income tax. Value appreciation is a preference item that is included in the base of AMT taxable income.

Charitable Estate Tax Deduction

Lifetime charitable contributions generate not only an income tax deduction but also an estate tax deduction that depends on the marginal estate tax rate. At the estate’s current taxable threshold (that is, over \$2 million in taxable value) the saving would be 45 percent of the value of the charitable contribution. If the transfer is a testamentary bequest or is includable in the donor’s estate by virtue of a retained interest, only the estate tax deduction will be available.

Gifts with Retained Interest—Charitable Remainders

A forest landowner may be thinking of giving a particular property to a charity, but may need the income from the property. The transfer could be made at death, but there may be a spouse or other family member who might need the benefit of the income after the donor is gone. For example, many parents who own forest land in rural, often remote areas of the country have children who live in distant cities and often have little interest in the forest land. The children, however, may feel that they might need the income from the property for educating their own children or for some other reason.

Landowners in this situation can make a present gift to a charity of a future interest, known as a charitable remainder. If the gift is money or liquid assets, the transfer should be in trust. For real property, however, the remainder interest can be created without using a trust. The remainder can be constructed to take effect at the end of a set term of years, at the donor’s death, on the death of the surviving spouse, or on the death of other persons. There are, of course, some strict limitations.

The present value of the remainder interest is deductible for Federal income and gift tax purposes, if given to a qualified charity. The amount of the gift is the fair market value of the property, less the value of the retained “life interest,” as determined from actuarial tables.

Charitable remainder trusts—The donor can get an income, estate, or gift tax deduction for a charitable contribution to a charitable remainder trust that has one or more non-charitable beneficiaries only if the trust qualifies as an annuity trust or a unitrust under the IRC. An annuity trust provides a “fixed annuity payment” to the income beneficiaries, while a unitrust provides a “variable annuity payment” based on a percentage of the trust’s earnings. Both types of trusts can be established during a donor’s lifetime or by the donor’s will. The donor is required to set aside certain assets with payments—either fixed or variable—made for either a fixed term (not to exceed 20 years) or for the life of the donor-grantor, his (her) spouse, or other named person(s) with the remainder to go to a qualified charity. Distributions to the beneficiaries must be made at least annually, and the principal must not be used for the beneficiaries’ benefit except in accordance with specific payout requirements in the trust.

Both the annuity trust and the unitrust require a payment rate of at least 5 percent. The payment under an annuity trust is calculated on the basis of the initial fair market value of the trust assets, updated annually. With a unitrust, the beneficiaries have a variable annuity. For example, if the assets are forest land, the payments may fluctuate with the cyclical nature of the timber market. With a unitrust, the instrument may—but is not required to—have a provision permitting use of the principal if the annual income is insufficient. Furthermore, additional contributions can be made to a unitrust during the grantor’s life or by the grantor’s will under specified terms and conditions [Treasury Regulation 1.664-3(b)]. With an annuity trust, once the payment schedule is established, the annual payments are made from principal if current earnings are insufficient, and no additions to the trust are accepted. If the payment rate is set too high for an annuity trust, the remainderman—the charity—may get a smaller gift than expected or none at all. This situation has been noted as an opportunity that invites abuse and thus has merited IRS and congressional attention.

The unitrust may be created with an income-only or makeup option. Under this arrangement, the trustee pays the beneficiary only the current income, but as earnings increase in future years any deficit in previous payment amounts is made up [IRC section 664(d)(3)].

Tax consequences—For tax purposes, the remainder interest under an annuity trust is the net fair market value of the trust property, less the present value of the annuity. If two or more beneficiaries are involved, the computations are based on the life expectancies of each. The present values are computed using the IRS tables in IRC section 7520 and are based on a floating interest rate equal to 120 percent of the midterm Applicable Federal Rate. Examples of the procedure can be found in IRS Publication 1458, Actuarial Values.

The annuity trust and the unitrust are exempt from Federal income taxes except for unrelated business taxable income. Distributions to trust beneficiaries are taxed first as ordinary income, then as a capital gain to the extent of the trust’s undistributed capital gains. For estate tax purposes, the trust property’s value will be included in the grantor’s estate if he (she) is the sole beneficiary.

Pooled income fund—This is an IRS-designated vehicle for charitable contributions that meets a donor’s needs and provides him (her) with a tax deduction, while operating within safe guidelines for valuation of the contributions and for the protection of the government and the charity. Whereas the annuity trust and unitrust are private endeavors, pooled income funds pull together several contributors to benefit both the charity and the individual contributors. In a word, a pooled income fund is a public trust that is controlled by the charity. Most of the provisions are similar to the annuity trust and the unitrust; however, with pooled income funds, the property of all donors is commingled. A pooled income trust cannot receive or invest in tax-exempt securities. The income tax deduction is based on the present value of the remainder interest to the charity.

A charitable lead trust—This is the reverse of the charitable remainder annuity trust. Property is left to create “income” for the charity, with the remainder interests passing to the family. A charitable lead trust reduces death tax liability; however, there may be a gift tax on the present value of the remainder interest when the trust is created.

Charitable remainder in a personal residence or farm—Generally, a donor can obtain a charitable contribution deduction for a gift of a future interest in property only through a charitable remainder trust or a pooled income fund. The IRC makes an exception, however, for a gift of a farm or personal residence [IRC section 170(f)(3)(B)]. Under these circumstances, a donor can contribute the property to a charity, but reserve the right to live on it or use it for the rest of his (her) life and the life of the surviving spouse, if applicable. The gift must be irrevocable.

The personal residence can be a second home or cooperative apartment. A “farm” means land improvements used by the donor or tenant to produce crops, fruits, or other agricultural products of livestock or poultry [Treasury Regulation 1.170A-7(f)(4)]. The regulation does not explicitly include or exclude forest land, so if a taxpayer is considering using this provision for forest land, it would be prudent to obtain a private letter ruling (see chapter 5) from the IRS. If this fails, other alternatives should be considered. For example, this type of asset can be transferred by deed during life or by will at death, with the surviving spouse having income and right of possession for life, and the property then passing to the charitable organization at his (her) death.

Qualified Conservation Contribution

A charitable contribution of an interest in property that is less than the donor's entire interest does not qualify for a deduction unless it is an undivided part of the donor's entire interest, or a gift of a partial interest in property that would have been deducted if it had been in trust.

A charitable contribution of an open space easement in gross and in perpetuity is treated as a contribution of an undivided portion of the donor's entire interest in the property [Treasury Regulation 1.170A-7(b)(1)(ii)]. An easement in gross is defined as a personal interest in, or right to use, the land of another. A deduction is allowed for the value of a restrictive easement gratuitously conveyed to a qualified charitable organization (see below) in perpetuity. Special rules apply to easements and remainder interests for conservation purposes.

Gifts of partial interests in real property generally do not qualify for a charitable contribution deduction; a qualified conservation contribution, however, is an exception [IRC section 170(f)(3)(B)(iii)]. A qualified conservation contribution is defined as a qualified real property interest donated to a qualified conservation organization exclusively for conservation purposes [IRC section 170(h)]. A qualified real property interest is defined as the entire interest of the donor other than a qualified mineral interest, a remainder interest, or a restriction granted in perpetuity on the use that may be made of the real property. The term "conservation purpose" is defined to include any one (or more) of four objectives: (1) the conservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the conservation of open space (including farmland and forest land) where such conservation will yield a significant public benefit and either (a) is for the scenic enjoyment of the general public, or (b) is pursuant to a clearly delineated Federal, State, or local governmental conservation policy; or (4) the conservation of a historically important land area or a certified historic structure.

The conservation purpose must be protected in perpetuity. Qualified organizations are limited to government and publicly supported charities or organizations they control. The value of the conservation easement is based on the sales of similar easements if such records exist. If such records do not exist, the conservation easement is based on the difference between the fair market value of the property before and after the easement. Thus, valuation of the charitable deduction of a conservation easement generally is accomplished by subtracting the value of the property as encumbered by the real property interest from the value of the property determined without regard to the transfer

of the qualified real property interest [Treasury Regulation 1.170A-14(h)(3), Revenue Ruling 73-339, 1973-2 C.B. 68]. After the conservation easement is made, the donor must reduce the basis of the retained property by the proportional part of the basis allowable to the easement.

In connection with the exclusivity requirement, the regulations also provide that a deduction will not be allowed if the contribution would in fact accomplish one of the enumerated conservation purposes, but would additionally permit destruction of other significant conservation interests. This requirement is not intended to prohibit uses of the property such as selective timber harvesting or selective farming, if under the circumstances, those uses do not impair significant conservation interests [Treasury Regulation 1.170A-14(e)(2)].

Subsequent transfers by conservation organization

The instrument of conveyance must prohibit the donee from subsequently transferring the qualified real property interest (the easement) unless the subsequent transferee is itself a qualified organization and the donor requires its transferee to carry out the conservation purpose. If unexpected changes in the condition of the area surrounding the property make the continuation of the conservation purpose impossible or impractical, the qualified real property interest may be sold if the proceeds of sale are used by the donee in a manner consistent with the conservation purpose of the original transfer.

Income tax deduction rules—The income tax deduction rules for charitable contributions discussed earlier in this chapter also generally apply to gifts of conservation easements. Current law, however, provides additional incentives for qualified conservation easement contributions. The Federal income tax deduction for such contributions is increased from 30 percent to 100 percent of adjusted gross income (AGI) for qualifying farmers and ranchers, and to 50 percent of AGI for other individual taxpayers. In addition, the carryover period for unused contributions is extended from 5 years to 15 years for both groups. Qualifying farmers and ranchers are those whose gross income from farming or ranching exceeds 50 percent of their total gross income. These provisions were provided initially by the Pension Protection Act of 2006 (Public Law 109-280) for 2006 and 2007, but were extended to 2008 and 2009 by the Food, Conservation, and Energy Act of 2008 (Public Law 110-246). As of this writing, they are scheduled to expire after December 31, 2009.

Example 8.5. Tall Pine owns a 200-acre parcel of forest land in the path of a suburban leapfrog development. The property has been in the family since the original land grant, and Pine's objective is to keep the property in the family and in timber production. The use value

of the property for timber production is \$400,000 including the current growing stock which has been well managed for timber and wildlife. The fair market value in the “highest and best use” is \$900,000.

In 2007, Pine gave the U.S. Department of Agriculture Forest Service a permanent conservation easement subject to the restrictions that the property be managed on a sustainable basis, with no more than 20 percent of the timber harvested in any 5-year period and harvested areas regenerated within 2 years. The \$500,000 (\$900,000 – \$400,000) charitable contribution is subject to the income tax rules discussed above; the income tax charitable deduction is limited to 50 percent of adjusted gross income. Since Pine’s adjusted gross income is \$250,000, the current income tax deduction is \$125,000 ($\$250,000 \times 0.50$). With a 15-year carry-forward period for excess contributions, Pine will deduct the remaining \$375,000 from future income, which in all likelihood will absorb the excess deductions. The estate’s value will be reduced by the \$500,000 encumbrance on the property. Pine’s appraisal was made by a qualified general appraiser and registered forester who works for a reputable consulting forestry firm.

Estate tax exclusion—Under TRA, the executor of an estate is allowed to exclude from the gross estate up to 40 percent of the value of any “land subject to a qualified conservation easement” [IRC section 2031(c)(1), as amended by TRA]. The exclusion is subject to certain limitations. If the value of the easement, reduced by the value of any retained development rights, is less than 30 percent of the value of the land without the easement, the 40 percent exclusion is reduced by two percentage points for each point that the ratio falls below 30 percent. For example, if the value of a conservation easement is 25 percent of the value of the land before the easement, reduced by the value of retained development rights, the exclusion percentage is 30 percent $\{40 \text{ percent} - [2 \times (30 \text{ percent} - 25 \text{ percent})]\}$. Under these rules, if the value of the easement is 10 percent or less of the value of the land before the easement, reduced by the value of retained development rights, the exclusion percentage equals 0. The exclusion limitation is \$500,000. The conservation easement may be in place before the donor’s death or it may be put in place after death by the estate executor with the approval of all heirs/legatees.

For debt-financed property, the exclusion only applies to the extent of the donor’s net equity in the property [IRC section 2031(c)(4)(A)]. Also, the exclusion does not apply to the value of any development rights retained by the donor in the conveyance of the qualified conservation easement. If, however, every person who has an interest in the land executes an agreement to extinguish permanently some or all of the development rights retained by the donor on or before the date for filing the estate tax return, any estate tax due is reduced accordingly; the agreement(s) must be filed with the estate tax return. An additional tax, in the amount of the tax that would have been due on the retained development rights subject to the agreement, will be imposed on any failure to implement the agreement not later than the earlier of: the date that is 2 years after the date of the decedent’s death, or the date of the sale of the land subject to the easement. For these purposes, the term “development right” means any right to use the land subject to the easement in which the right is retained for any commercial purpose that does not directly support use of the land as a farm for farming purposes, defined to include timber production.

Exclusion election—The election to exclude from the gross estate the value of land subject to a qualified conservation easement is made on the estate tax return. Once made, the election is irrevocable [IRC section 2031(c)(6)]. The term “land subject to a qualified conservation easement” means land that is located in the United States or a U.S. possession. The land must have been owned at all times by the decedent or a member of his (her) family during the 3 year period ending on the date of the decedent’s death [IRC section 2031(c)(8)(A)(ii)]. A member of the decedent’s family is defined as an ancestor; spouse; lineal descendent of the decedent or the decedent’s spouse, or of a parent of the decedent; or the spouse of any lineal descendent described above. The definition of “qualified conservation easement” generally is the same as that for a qualified conservation contribution for estate and gift tax deduction purposes, discussed above, with two exceptions: (1) the preservation of a historically important land area or a certified structure does not qualify, and (2) a perpetual restriction on the use of real property must include, for purposes of the estate tax exclusion, a prohibition on more than a de minimus use for commercial recreational activity. The exclusion applies to interests in partnerships, corporations, and trusts, if at least 30 percent of the entity is owned by the decedent [IRC section 2031(c)(9)]. To the extent that the value of land subject to a qualified conservation easement is excluded from the gross estate, the basis of the land acquired at death is its basis in the hands of the decedent; that is, the basis is carried over, not stepped up.