

Estate and Gift Taxation: The Basics

Edward K. Zollars
Phoenix, Arizona

Edward K. Zollars

- Thomas, Zollars & Lynch, Ltd.
- AICPA Tax Practice Improvement Committee
- Podcast at <http://www.edzollarstaxupdate.com>
- CPE Instructors are not authoritative sources for §§6694, 6692, etc.

Today's Course

- Estate and Gift Tax Laws
- Gift Tax Returns
- Preparation of Estate Tax Returns
- IRS Audit Techniques for Estate Tax Returns
- Basic Charitable Gift-Giving Techniques

Today's Course

- Generation Skipping Transfer Tax
- Post Mortem Estate Planning
- Income Tax Return of an Estate Form 1041
- Funding a Decedent's Credit and Marital Trust

Estate and Gift Tax Laws

- ## Module 1

Unified Transfer Tax Rates

If Taxable Transfer is more than:	This Amount	Plus This Rate of Excess Taxable Transfer
\$ 10,000	\$ 1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	41
1,250,000	448,300	43
1,500,000	555,800	45

Section 2010 Credit

- Offset against tax computed
- Now set to offset a specific amount of tax
- “Applicable exclusion amount”
- Gift tax exemption separated from estate tax credit in 2004

Carryover Basis

- Generally have carryover basis (§1014)
- In 2010 we (would) lose carryover basis
 - Step up basis by \$1.3 million
 - Spouse gets additional \$3 million, with total at \$4.3 million
- Seems likely not to become part of law

Summary of Changes

Year	1997 Law	2001 Law Estate Tax	2001 Law Gift Tax
2002-2003	\$675,000	\$1,000,000	\$1,000,000
2004	\$700,000	\$1,500,000	\$1,000,000
2005	\$850,000	\$1,500,000	\$1,000,000
2006 -2008	\$950,000	\$2,000,000	\$1,000,000
2009	\$1,000,000	\$3,500,000	\$1,000,000
2010	\$1,000,000	Estate tax repeal	\$1,000,000
2011	\$1,000,000	\$1,000,000	\$1,000,000

Related Issues

- Gift tax amount left at \$1 million to discourage income tax games
- GST exemption increases along with applicable credit amount
- Automatic allocation of GST amount
- State death tax credit repealed
- Family owned business provision rendered irrelevant

Top Rates

- 45% in 2008–2009
- 35% for gifts only in 2010
- 55% for 2011 forward

Post 2010 Basis Rules

- Joint ownership—only $\frac{1}{2}$ of basis stepped up
- No step up for general power of appointment property
- No step up for transfer within three years of death unless received from spouse
- Transfers to spouse within one year of death not receive step up
- Certain foreign interests not eligible for step up
- Does not appear to change community property rules

Post-2009 Filing Requirements

- Estates with noncash assets in excess of \$1.3 million
- Information to be provided to donee if file gift tax return
 - Donor
 - FMV
 - Basis

Post 2009 Estate Filing

- Information on 706 replacement
- Penalties
 - \$10,000 if fail to file return if assets exceed \$1.3 million
 - \$500 if fail to report gifts received by decedent within three years of death
 - \$50 for failure to report basis to recipients
 - 5% of value of assets if failure to file is intentional

President's Proposals

- Freeze exemption at 2009 level
- Retain 2009 top rate of 45%
- No proposed change to gift taxes (so would still have \$1 million limit there)

Non-Resident Alien

- Rates same as for US citizens, but reduced credit
- No credit against gifts

Example 1-1

EXAMPLE 1-1

An unmarried taxpayer dies during the year with assets valued at date of death of \$500,000. There will be a federal estate tax of \$155,800. However, a credit against the tax of \$155,800 will be allowed and, therefore, no federal estate tax will be due.

Example 1-2

EXAMPLE 1-2

Mr. Smith, a widower, gifts \$200,000 outright to his daughter during the year. The first \$12,000 qualifies for the annual exclusion. The remaining \$188,000 is subject to gift tax. However, since Mr. Smith did not make any prior taxable gifts during his lifetime, there will be no gift taxes due, but a gift tax return will be required. Since Mr. Smith used \$188,000 of his exemption during his lifetime, at his death in 2007, only the first \$1,812,000 (\$2,000,000 - \$188,000) will be distributed federal estate tax-free to his beneficiaries.

Annual Exclusion

- \$12,000 for 2008
- Must be a present interest (Hackl case)

Example 1-3

EXAMPLE 1-3

Ms. Jones has two children, three grandchildren and three friends she desires to make gifts to during the year. She may gift \$12,000 to each individual (for a total of \$96,000), which will be distributed gift tax-free to each of them.

Example 1-4

EXAMPLE 1-4

Ms. Jones, a widow, gifts \$25,000 to her grandson, Michael. Since this gift is outright to Michael, the first \$12,000 will qualify for the annual exclusion. However, the remaining \$13,000 will reduce her federal exemption of \$2,000,000. No gift tax is due, but a return is required.

Gift to a Trust

- Will not qualify unless an exception applies
 - Crummey trusts (right to immediate withdrawal, normally for a short period)
 - Trust for minor that must distribute assets when minor turns 21

Example 1-5

EXAMPLE 1-5

Same as above, however, the \$25,000 is gifted to a trust for Michael's benefit. Since the gift is in trust and Michael is over 21 and does not have any withdraw rights, none of the \$25,000 will qualify for the annual exclusion. In addition, the \$25,000 will reduce the \$2,000,000 federal exemption. No gift tax is due, but a return is required. At Mrs. Jones' death, she will have \$1,975,000 ($\$2,000,000 - \$25,000$) remaining that may be distributed estate tax-free to her beneficiaries.

Example 1-5

- Crummey power could have granted annual exclusion
 - Right to demand payment
 - Must give notice to beneficiaries (but can be contingent beneficiaries—see Christofani)
- Required current distribution of income
- Note impact on non-tax issues

529 Plans

- Treated as current gifts, but retain substantial control
- Can elect to include over five year period (§529(c)(B))
- Can change beneficiaries later, but still treated as present interest gift

Split Gifts (§2513)

- Husband and wife can elect to treat gifts $\frac{1}{2}$ made by each
- Election made on gift tax return
 - Consent must be made by later of April 15 or when first spouse files gift tax return
 - May not be sent after notice of deficiency sent to either spouse
- Executor for deceased or incompetent spouse can sign

Split Gifts (§2513)

- Both spouses must file unless meet one of two exceptions
 - Only one spouse made gifts, all less than \$24,000 and all were present interest gifts or
 - Exception 2
 - Only one made gift in excess of \$12,000 but less than \$24,000
 - All gifts by other spouse less than \$12,000
 - All gifts were present interests

Example 1-6

EXAMPLE 1-6

Wanda transfers \$200,000 of real property to her son in 2006. Wanda's husband, Harry, consents to the split-gifts. Therefore, each is deemed to have made a gift of \$100,000 to their son. The first \$12,000 from each of them will qualify for the annual exclusion. The remaining \$88,000 will reduce each of their \$2,000,000 federal exemptions.

Family Owned Business

- Currently only an issue for recapture of prior benefit claimed
- Recapture:

Years	Percentage
1-6	100
7	80
8	60
9	40
10	20

Education and Medical Expenses

- Not deemed to be gifts for gift tax purposes (§2503(c))
- Must be made directly to service provider—cannot reimburse previously paid expense

Example 1-7

EXAMPLE 1-7

During the year, Alice made a tuition payment directly to a university on behalf of Bob. Alice had no legal obligation to make this payment. The university is described in Section 170(b)(1)(A)(ii) of the Code. Alice's tuition payment is exempt from gift tax under Section 2503(e) of the Code. As a reminder, it is for tuition only, not books or room and board.

Example 1-8

EXAMPLE 1-8

Charlie was seriously injured in an automobile accident. Dottie, who is unrelated to Charlie, paid Charlie's various medical expenses by checks made payable to the physician. Dottie also paid the hospital for Charlie's hospital bills. The medical and hospital expenses were types described in Section 213 of the Code and were not reimbursed by insurance or otherwise. Because the medical and hospital bills paid for Charlie were medical expenses within the meaning of Section 213 of the Code, and since they were paid directly by Dottie to the person rendering the medical care, they are not treated as transfers subject to gift tax.

Gift Tax

- Due on April 15 of the following year
- Extensions
 - Form 4868 extends both income tax and gift tax return
 - Form 8892 extends gift tax return only

Revaluation of Prior Gifts

- Prior to 1997, IRS could revalue gifts when 706 was examined
- §2504 now gives ability to close statute on valuation
- Only get closed statute if adequately disclose in accordance with regulations
- IRS does not notify IRS if disclosure inadequate (will be raised with 706)

Adequate Disclosure (Reg §301.6501(c)-1(e))

- Describe property & consideration (if any)
- Identities of transferor and transferee and relationship
- Detailed description of method used to value property including discounts used
- Statement that would apprise IRS of any potential controversy

Taxable Estate

- Any assets that pass at death
 - Probate estate
 - Assets that pass by operation of law
 - Joint tenancy
 - Retirement accounts
 - Life insurance (if policy owned by decedent)
 - Living trusts
- Clients often don't understand this

Gross Estate

- Real estate
- Stocks, bonds, mutual funds
- Cash, notes and mortgages receivable
- Jointly held property
- Tangible personal property

Gross Estate

- Partnership interests
- Income tax refunds (including rebates)
- Pensions and annuities
- General powers of appointment (§2041)

Gross Estate

- Transfer with retained life estate, including implied life estate (§2036)
- Transfers taking place at death (§2037)
- Transfers with retained power to alter, amend, revoke or terminate (§2038—but note doesn't bring in §529 plans)

Joint Interests

- Spouses
 - 100% for property acquired before 1977
 - 50% for later acquisitions
- For all others, 100% inclusion presumption (must show contribution by others to exclude portion)

Deductions

- Reasonable funeral expenses
- Administrative expenses (§2053)--but note may elect to claim on 1041 and exclude from 706
- Debts of decedent at date of death including
 - Taxes
 - Debts attributable to non-probate property
 - Medical expenses of final illness (or may instead claim on final 1040)

Deductions

- Certain losses (§2054) due to casualty or theft during administration
- Marital deduction (§2056)
- Charitable deduction (§2055)

Determining the Tax

- Calculate per schedule
- Due nine months after the date of death
- Potential extensions under §§6161 or 6166

State Death Taxes

- Previously a credit per table
- Now only a deduction is offered for state death taxes
- Was the funding mechanism for first few years of federal estate tax reduction
- However, old credit table still used by some states (see table in manual)

Gift Tax Returns

- ## Module 2

Gift Tax

- Excise tax
- Transfer of property between two parties
- Less than adequate consideration received

Gift Defined

- Donor intends to make a gift
- Donor competent to make a gift
- Donee capable of receiving and possessing the gift
- Donee must have actual and constructive receipt of gift
- Donee must accept the gift

Gift Tax

- Normally paid by donor
- Can require donee to pay
- If not paid
 - Lien attaches to the gifted property
 - Donee liable up to value of property

Value

- Fair market value
 - Willing buyer/willing seller test
 - As of date of gift
- Key issue (and major area of dispute with IRS)

Valuation Issues

- Publicly traded stock
- Real estate (appraisals)
- Jointly owned assets (discount issue)
 - Family limited partnerships a technique to access discounts
 - Case law emphasizes doing this one right (Strangi case vs. Kelly case)

Basis

- §1015 governs
- $FMV >$ donor's basis, get donor's basis plus allocable share of gift tax
- $FMV <$ donor's basis, dual basis
 - Losses computed using donor's basis
 - Gains computed using FMV
 - Broad area where will have neither gain nor loss
- Key area of difference with assets passing at death

Example 2-1

EXAMPLE 2-1

Jennifer gifts Shay stock with a basis of \$30,000 and a fair market value at the time of the gift of \$25,000.

1. If Shay sells the stock for \$31,000, Shay will have a \$1,000 gain (\$31,000 - \$30,000).
2. If Shay sells the stock for \$28,000, no gain or loss is recognized.
3. If Shay sells the stock for \$22,000, Shay will recognize a \$3,000 loss (\$22,000 - \$25,000).

Example 2-2

EXAMPLE 2-2

Liz gave Eric land worth \$100,000. Later that year she gave Beth land worth \$50,000. At the time of the first gift, Liz has already used \$980,000 of her life time giving exclusion.

1. The total gift tax paid is:
 - a. Remaining unified credit = $\$1,000,000 - \$980,000 = \$20,000$.
 - b.

Total Gifts	\$150,000
Less remaining unified credit	<u>20,000</u>
Taxable Gift	<u>\$130,000</u>
 - c.

Tax	\$130,000
Tax rate	<u>x.41</u>
Total Tax	<u>\$ 53,300</u>

Example 2-2

2. Allocation of the tax to basis:

a.	Gift to Eric	\$100,000
	Remaining unified credit	<u>20,000</u>
	Taxable gift	\$ 80,000
	Beth's gift	<u>50,000</u>
	Total gifts	<u><u>\$130,000</u></u>

b. Allocation to Eric's gift
 $= (\$80,000 / \$130,000) \times \$53,300 = \$32,800$

c. Allocation to Beth's gift
 $= (\$50,000 / \$130,000) \times \$53,300 = \$20,500$

Gift Splitting

- All or nothing proposition
- Less needed in community property states

Bargain Transfers

- Below market value sales not made in ordinary course of business
- Deemed interest on below market loans

Gifts to 529 Plans

- Qualified Tuition Programs
- Considered completed gift of present interest even though donor retains control

5 Year Election

- Make election by checking box at top of Schedule A and attaching statement
 - Total amount contributed per individual beneficiary
 - Amount for which election is made
 - Name of individual for whom contribution made
- Sample statement at back of this module

Gift Tax Return Example

Eric Sample made two gifts during 2007.

The first was a 9.6% interest in his family limited partnership. This was made to his son. Eric obtained an appraisal from a well known and well respected appraiser. The appraiser took a 15% lack of control discount and an 18% lack of marketability discount. The fact that we have taken a discount is disclosed on page 2. We attached a copy of the appraisal to the return.

Gift Tax Return Example

The second gift was to fund a Section 529 plan for his grandson. He used 5 years of gifting. He is required to report the gift in the current year and sign the attached election. He only reports 1/5 of the total amount in the current year. If he does not make any additional gifts next year, he will not have to file a gift tax return to report that year's portion.

Gift Tax Return Example

In addition to the gifts, Eric, made a charitable gift to the Arizona Community Foundation of over \$12,000. Since he was required to file a gift tax return, he was required to include this amount in his return.

Finally, Eric helped his daughter. She had her identity stolen. This destroyed her credit rating and she was not able to obtain a mortgage. Eric obtained the mortgage in his name, but Elizabeth made all the payments. We have included this item to document that Eric has not made a gift to his daughter and to begin the running of the statute of limitations.

Preparation of Estate Tax Returns

- ## Module 3

Form 706

- Page one – summary of information for the return
- Confirm social security number—don't rely on death certificate
- Alternate valuation date
 - Must serve to decrease estate tax
 - Testing date 6 months after date of death
 - Kohler regulations now in place—must be market conditions and not other post death matters

Form 706

- Consider submitting 2848 along with signing Part IV to authorize other members of the firm
- Small bequests below \$5,000 do not have to be detailed, but may wish to include if amount is substantial
- Review prior two years individual income tax returns looking for omitted assets
- Get an engagement letter

Form 706

- Organizing workpapers—may want to consider ring binder with items by schedule
- Organize the 706 so that the IRS can find information in the return

What Agents Look For (per IRS)

- Look at first three pages of 706
- Is executor related to the taxpayer?
- How old was decedent?
- What generates large deductions
- Prior taxable gifts

What Agents Look For (per IRS)

- Existence of difficult to value assets
- Election of either special use valuation or election to postpone payment of tax will get return sent to field
- Have discounts been taken (as a practical matter, right now this is the single issue)

What Agents Look For (per IRS)

- Any yes answers in Part 4 will generate an additional inquiry

Schedule A—Real Estate

- Real estate owned outside a trust and not jointly owned with another party
- Fully identify property, including parcel numbers
- Value reduced by nonrecourse debt here
- Recourse debt, entire value listed on Schedule A and debt on Schedule K, Part 2

Schedule A—Real Estate

- Valuation
 - Appraisal
 - Sale shortly after death normally accepted to value property
- Rents
 - Unpaid rents listed on Schedule A
 - Prepaid rents are a liability listed on Schedule K

Schedule B—Stocks and Bonds

- List details or attach as schedule
 - Include CUSIPs
 - Bonds should include maturity dates and interest rates
- Accrued interest and dividends should be shown here

Schedule B—Stocks and Bonds

- For traded stock: average high/low price on date of death
- Closely held stock
 - CPA needs to be aware of SSVS No. 1 if client asks to value
 - However, also consider SSTS No. 1 if client gives value

Schedule C—Mortgages, Notes and Cash

- Cash on hand listed here
- Consider valuation of notes—face may not be valid measure
- Accrued interest

Schedule D—Insurance on Decedent's Life

- From Form 712, included as an attachment
 - Name & address of insurance company
 - Policy number
 - Face amount
 - Beneficiary
- If left to specific beneficiary, be sure to list on page 2

Schedule D—Insurance on Decedent's Life

- Insurance Trust
 - Even if excluded from estate, must list here
 - Value shown as zero
 - Attach trust document
 - Attach evidence of exclusion

Schedule E—Jointly Owned Property

- Two parts
 - Top part is for property jointly owned with spouse, $\frac{1}{2}$ included in estate
 - Part two, property owned with someone other than spouse
- Owned with nonspouse
 - Presumption—all included in estate of decedent
 - Must show evidence contribution of other owner(s)
 - Major issue for nontraditional families

Schedule F—Other Miscellaneous Property

- Catch-all schedule
- Questions at top of page
 - Take care with these questions
 - Be sure to include any required appraisals
- If beneficiary of QTIP, those assets are listed here

Schedule F—Other Miscellaneous Property

- Insurance owned on life of another (page 2 of Form 712)
- Refunds received due to death
- Prepayments of liabilities (such as escrow accounts)

Schedule G—Transfers During Decedent's Life

- Include assets held in revocable trust
 - True even though assets appear should be listed elsewhere
 - Be sure to include all required information
- Gift taxes paid within three years of death are brought back in here

Schedule H—Powers of Appointment

- Includes 5x5 power that has not lapsed in year of death
- Include limited power of appointment over trust corpus even though trust will not be included in the estate

Schedule I—Annuities

- Pensions, IRAs and annuities listed here
 - Some are income stream for life
 - Others are for period of years
- Same information required for investments in IRA as if held elsewhere
- Example calculation in appendix

Schedule J—Funeral and Expenses in Administering Estate

- Funeral expenses
 - Limited to a reasonable amount (Estate of Davenport, TC Memo 2006–15)
 - Expenses of the funeral
 - Travel only for one person to accompany the body
 - Burial plot issues
- VA death benefits reduce funeral deduction
- Social Security payment to surviving spouse does not

Schedule J—Funeral and Expenses in Administering Estate

- Prepaid funeral
 - Not an asset of estate
 - No deduction for amount prepaid
- Administrative expenses
 - §2053(a)(2) allows deduction
 - In alternative, may elect to deduct on Form 1041 under §642(g)

Schedule J—Funeral and Expenses in Administering Estate

- Administrative Expenses
 - Attorney's Fees
 - Reasonable
 - Enforcable under local law
 - Accountants Fees

Schedule J—Funeral and Expenses in Administering Estate

- Administrative Expenses
 - Executor Fees
 - Must be paid or expected to be paid—if never paid not deductible
 - If will provides amount will be allowed so long as not in violation of local law
 - Specific bequest to executor in lieu of commissions are not deductible
 - Trustee Fees
 - Incurred for property subject to claims
 - Services normally performed by executor

Example

EXAMPLE

In 1940, the decedent made an irrevocable transfer of property to the M&I Trust Company, as trustee. The instrument of transfer provided that the trustee should pay the income from the property to the decedent for the duration of his life, and, upon his death, distribute the corpus of the trust among designated beneficiaries. The property was included in the decedent's gross estate under the provisions of Section 2036. Three months after the date of death, the trustee distributed the trust corpus among the beneficiaries, except for \$6,000 which it withheld. The amount withheld represented \$5,000 which it retained as trustee's commissions in connection with the termination of the trust and \$1,000 which it had paid to an attorney for representing it in connection with the termination. Both the trustee's commissions and the attorney's fees were allowable under the law of the jurisdiction in which the trust was being administered, were reasonable in amount, and were in accord with local custom. Under these circumstances, the estate is allowed a deduction of \$6,000.

Schedule J—Funeral and Expenses in Administering Estate

- Administrative Expenses
 - Miscellaneous Administrative Expenses
 - Shipping bequests
 - Court filing fees
 - Appraisal fees
 - Actuary fees
 - Special guararians

Schedule J—Funeral and Expenses in Administering Estate

- Administrative Expenses
 - Miscellaneous Administrative Expenses
 - Investment counsel
 - Bondsmen
 - Witness fees paid in litigation
 - Etc.
 - Test for Administrative Expenses
 - 2nd, 5th and 9th Circuits use own standard
 - 6th and 7th give considerable weight to state probate courts
 - IRS agrees with first position, but will follow second in those circuits that have ruled
 - Expenses Incurred for Probate Assets Limited to Net Probate Assets

Schedule J—Funeral and Expenses in Administering Estate

- Administrative Expenses
 - Post death interest expense
 - Selling expenses
 - Brokers Commissions reduced the value
 - Expenses associated with assets held in trust are deducted on Schedule L

Schedule J—Funeral and Expenses in Administering Estate

- Excise Taxes incurred in selling property deductible if sale is:
 - Necessary to pay decedent's debts, expense of administration or taxes
 - Preserve the estate or
 - Effect a distribution
- Goal to have all expenses paid or agreed upon rather than estimated on 706

Schedule K—Deduction for Claims Against the Estate

- Legitimate personal claims against decedent are generally deductible
- If use alternate valuation date, only accrued interest at DOD is counted
- Generally don't allow a mere promise or agreement to pay (charitable exception)

Schedule K—Deduction for Claims Against the Estate

- Form
 - Date of death liabilities listed on top half of form
 - Liens against the assets are listed in the bottom half
- Personal debt
- Partnership liability

Schedule K—Deduction for Claims Against the Estate

- Prorata share of joint and several liabilities unless show other joint debtor unable to pay
- Related party debt deductible—but be ready to defend its validity

Schedule K—Deduction for Claims Against the Estate

- Enforceable claims against estate
 - Must be enforceable (unenforceable gambling debt not allowed)
 - Valid claims released after date of death, split in circuits
 - Claims barred by statute of limitations not allowed

Schedule K—Deduction for Claims Against the Estate

- Charitable pledge or subscription
- Taxes
 - Generally needs to be taxes accrued at death
 - Property taxes—accrued and enforceable as a claim under local law
 - State gift taxes
 - Income taxes of the decedent (see formula of joint liability)

Schedule K—Deduction for Claims Against the Estate

- Unpaid mortgages

EXAMPLE:

Decedent owned as a tenant-in-common a parcel of real estate. His estate was entitled to a deduction of one-half of the mortgage outstanding at the time of death.

- Promise or agreement

Schedule L—Net Losses During Administration

- Losses from casualties if did not waive right to take under §642(g)
- Claims, debts and taxes
 - Unpaid mortgages
 - Accrued property taxes
 - Expenses non-probate property
 - Divorce claims
 - Medical expenses

Schedule M—Bequests Left to Surviving Spouse

- Describe property left to surviving spouse
- Two boxes to list assets
 - QTIP assets
 - All other assets

Schedule O—Charitable, Public, and Other Gifts and Bequests

- CRT
 - Assets listed on asset schedule
 - Remainder on Schedule O
- Charity as residual beneficiary
- Calculations included as an attachments

Schedule Q—Credit for Taxes on Prior Transfers

- Property previously inherited and estate tax paid on that property
 - Beginning ten years before decedent's death
 - Ending two years after decedent's death
- Can take even if assets no longer in decedent's estate
- Also can come from income stream from credit shelter trust

Credit Phase Out

Period of Time		Percentage Allowable
Exceeding	Not Exceeding	
-----	2 years	100
2 years	4 years	80
4 years	6 years	60
6 years	8 years	40
8 years	10 years	20
10 years	-----	none

Schedule R—Generation-Skipping Transfer Tax

- 3 Parts to the Form
- Part One—Summary of GST and Allocation to Current Trusts
 - Trust inclusion ratio portion subject to GST
 - Prefer either 1.0 or 0.0 trusts
 - Don't include both skip and nonskip individuals
 - Disclosure to indicate would be pushed back to zero

Schedule R—Generation-Skipping Transfer Tax

- Part Two—List of Direct Skips
- Part Three—Form GST trust uses to pay its tax

Example Annuity (p. 3-58)

Estate of _____
 Form 706 _____
 SSN _____
 Schedule I, Item _____

Valuation of an Annuity Payable for a Term of Years
 Valuation Date: 2/14/2006

Frequency and timing of Payments ANNUALLY

1. Annual Payment	\$7,500
2. Annuity factor for a term of years (Table B using the Section 7520 rate)	<u>7.6473</u>
3. Unadjusted value of annuity (line 1x Line 2,)	\$57,354.75
4. Adjustment factor for annuities payable on an annual, semiannual, quarterly, monthly or weekly period	
a. If payment is at the end of the period, enter factor from Table K, corresponding to the Section 7520 rate for the period	<u>n/a</u>
b. If payment is at the beginning of the period, enter the factor from Table J, corresponding to the Section 7520 rate for the period	<u>1.052</u>
5. Value of annuity (line 3 x line 4a or line 4b)	<u>\$60,337.20</u>

IRS Audit Techniques for Estate Tax Returns

- ## Module 4

General

- IRS Estate Tax Examiners Handbook
http://www.irs.gov/irm/part4/irm_04-025-001.html
- Strict Time Limits (§6501(c)(4))

Time Limits

- Generally tax must be assessed within three years
- Exceptions
 - False or fraudulent return with intent to evade tax (§6501(c)(1)) assessment may be made
 - Willful attempt to defeat or evade tax—no statute (§6501(c)(2))
 - No return filed, no statute (§6501(c)(3))
 - Omission exceeds 25% of gross estate—6 year statute (§6501(e)(2))

Time Limits

- Exceptions
 - Additional one year to proceed against transferee (§6901(c))

Executor Liability

- Has personal liability
- Can shorten period by requesting shorter period via Reg. §20.2204-1(a)
 - Reduces to nine months after later of
 - Filing return
 - Filing request
 - Does not impact transferee liability for assets that passed to executor

Reasons for Audit

- Discounts (major issue as of today)
- Sloppy or obvious errors
- Addition errors
- Valuation issues

Reasons for Audit

- Inconsistencies in the return
- Incomplete information
- Failure to attach exhibits
- Controversial or technical issues that are subject of litigation

Reasons for Audit

- Decedent involved in “cash type” business
- Large amount of cash found in safe deposit box

IRS Methodology

- Returns selected for review forwarded to local office
- Manager options
 - Perfection
 - Survey before assignment
 - Survey after assignment
 - Limited scope audit
 - Regular field audit

Estate Tax Examiners Handbook

- Notice of audit
 - Letter 1028
 - Name of examining agent
 - Request for information
 - Preprinted options (checkbox)
 - Other information

Other Documents Requested

- Power of Attorney
- Decedent's final 3 income tax returns
- Checks from checking account for 3 years prior to death
- Estate checking account
- Safe deposit box inventory

Other Documents Requested

- Records used to support estate tax return
- Decedent's insurance policies
- Real estate appraisals
- Closely held business appraisals

Other Documents Requested

- Art and other valuable tangible property appraisals
- Support for claims and debts of estate
- Gift tax returns of surviving spouse
- Consider obtaining information prior to filing estate tax return to avoid surprises

Real Estate—Schedule A

- Appraisal is a matter of judgment
- Sale shortly after death will tend to fix value unless there is a significant intervening event
- May ask for all appraisals made in five years prior to date of death (though in current economy may not be as valuable)

Stocks and Bonds—Schedule B

- Publicly traded stock—generally market price
- Nonpublicly trade stock more problematical
 - Minority discounts
 - Marketability discounts
 - Blockage discounts
- SSVS No.1 and professional liability if CPA does a valuation to “save client money”

Stocks and Bonds—Schedule B

- Agent to ask for
 - Sales or offerings of stock in recent past
 - Rejected offers to purchase the stock by any party
 - Corporate tax returns for prior 5 years
 - Corporate by-laws

Stocks and Bonds—Schedule B

- Agent to ask for
 - Financial statements for last 5 years
 - Shareholder agreements and buy-sell agreements
 - Changes in officers
 - Stock certificate book

Mortgages, Notes and Cash— Schedule C

- Unusual withdrawals
- Cash on hand and in safe deposit box
 - “Discrete” inquiry
 - Cash in safe deposit box presumed to belong to decedent

Mortgages, Notes and Cash— Schedule C

- Discounted notes
 - Consider interest rate in discount
 - If callable, should be no discount
 - Notes to family members
 - Suspicious if no indication of repayment, nor any gift tax return
 - Very skeptical of claim of worthlessness

Mortgages, Notes and Cash— Schedule C

- Contracts for sale of real estate
 - Generally set the value
 - If to “object of affection” may be scrutinized for disguised sale
 - Discounts may be appropriate
- Credit balance in brokerage account

Mortgages, Notes and Cash— Schedule C

- Other cash accounts
 - Cash in name of rental agents
 - Partnership/proprietorship bank accounts
 - Unpaid salary/expense accounts
 - Uncollected fees and commissions
 - Claims for damages, rights of action, accounts receivable

Mortgages, Notes and Cash— Schedule C

- Other cash accounts
 - Accounts receivable in hands of collection agency
 - Cash advances to decedent's business organization
 - Federal and state income tax refunds
 - Income cash in “agency” accounts with trust companies

Life Insurance—Schedule D

- Check Form 712 with amounts on return
- If claimed decedent did not own the policy:
 - Inquire as to reason for omission
 - Review 3 year rule
 - Verify assignment claims with insurance company
 - Review all incidents of ownership of decedent

Life Insurance—Schedule D

- If claimed decedent did not own the policy:
 - Accident or double indemnity provisions if accidental death
 - Review checking account for payment of life insurance premiums
 - Investigate requests for large number of death certificates

Jointly Owned Property—Schedule E

- Investigation for additional joint property
 - Inquiry of executor
 - Review income tax returns
 - Expected heir left out of will—and did not contest the matter
- If 100% included, agent told to investigate whether it's a basis ploy

Miscellaneous Property Interests— Schedule F

- Lack of consistency with decedent's standard of living
- Provides agents with techniques
 - Social standing in community
 - Residence and furnishings
 - Review submitted appraisals
 - Personal property tax returns

Miscellaneous Property Interests— Schedule F

- Provides agents with techniques
 - Insurance policy schedules
 - Cancelled checks
 - Press coverage of house and furnishings
 - Objects mentioned in decedent's will
 - Review of probate court files

Miscellaneous Property Interests— Schedule F

- Provides agents with techniques
 - Review 1040s for gifts to charities
 - If own property near water, look for boat
 - Jewelry
 - Personal property > \$3,000 must have appraisal
 - Art referred to Art Advisory Panel

Transfers—Schedule G

- Look for life insurance transfers within three years of death
- Consider if gifts made while incompetent or without mental capacity
- Validity of gifts under power of attorney
- Compare signatures in suspicious circumstances
- Look for retained life estates

Powers of Appointment—Schedule H

- Review the following
 - Decedent's will
 - Probate court records
 - Decedent's income tax returns
 - Insurance policies
 - Previous estate may reveal power of appointment

Survivorship Annuities—Schedule I

- If no annuities reported, check if retired or employed
- If yes, consider inquiring about existence of annuities

Administration Expenses—Schedule J

- Agent told to start with this schedule
- Should be easy to confirm
- Review 1041 and 1040 for double deductions
- Determine if attorney fees are reasonable
- Check into accounting fees

Debts and Claims—Schedules K and L

- Obligations that existed at the date of death
- Special scrutiny paid to claimed debts due to relatives
- Auditor told to check for double deductions (medical expenses claimed both as debt and on final 1040)

Marital Deduction—Schedule M

- Check validity of will or trust
- Who is responsible to pay expenses?
- Actual funding of the marital deduction took place
- Be sure QTIP does not have disqualifying provisions
- Check to see if life insurance really payable to spouse per Form 712

Charitable Deductions—Schedule O

- Must be made by decedent, not by heirs or estate
- Pledge only deductible if enforceable against the estate
- Check Publication 78 for organization
- Deduction issues for certain organizations (social or fraternal organization, private cemetery association)

Charitable Deductions—Schedule O

- Check probate to see if contest has arise that will block contribution
- Be sure is actually paid to the charity and/or charity has been notified

Prior Gifts

- Can revalue prior gifts
 - Not blocked if only statute for assessing tax has run
 - However, if full disclosure regulations complied with, cannot revalue after 3 years
- Evidence of undisclosed gifts

Prior Gifts

- Look for disguised gifts
 - Bargain sales
 - Distributions from living trusts
- Review split gifts

Civil Penalties

- IRC §7269 Penalty
 - Up to \$500 plus costs
 - Failure to produce information in person's possession
- IRC §6651(a)(1)
 - Failure to file
 - 5% per month/maximum 25%
 - Fraudulent: 15% per month, maximum 75%

Civil Penalties

- IRC §6651(a)(2)
 - Failure to pay
 - 0.5% per month/maximum 25%
 - Failure to file reduced by failure to pay

- **Reasonable Cause**
 - Mailed timely to reach IRS within legal period
 - Filed timely, but in wrong district
 - Erroneous IRS information
 - Death or serious illness in taxpayer's family
 - Unavoidable absence

- **Reasonable Cause**
 - Fire or casualty destroy records or place of business
 - Application for forms not provided by due date
 - Visited office of District Director and unable to see representative

- **Not Reasonable Cause**
 - Forgetting to file
 - Ignorance of law
 - However misunderstanding due to reasonable doubt may be
 - Reliance on agent not reasonable cause
 - Malpractice issue for CPA

Civil Penalties

- IRC §6662(b)(5)
 - Tax underpaid by $> \$5,000$
 - Value on return from 65% to 40% of correct value, penalty of 20%
 - Less than 40%, gross understatement and penalty rises to 40%
 - Reasonable cause does not apply to gross understatement

Civil Penalties

-
- IRC §6663
 - Civil fraud penalty
 - Bad faith
 - Intent to evade tax
 - 75% of the underpayment
 - Precludes substantial understatement penalty

Civil Penalties

- Preparer penalties §6694
 - Now applies to estate tax returns
 - Level for §6694(a) recently moved down to substantial authority

• Criminal Penalties

- Conceal assets
- Conceal records
- Intentional failure to disclose inter vivos transfers of decedent
- Deliberate false valuation
- Deliberate unsupported deduction claims

- **Criminal Penalties**
 - Conceal facts related to contemplation of death questions
 - Deliberate false statement on contribution to joint property
 - Deliberate false statements as to attorney's fees or executor's commissions

• Criminal Penalties

- Evasion on supplying requested information
- Concealment of valuable jewelry or art collections
- Deliberate failure to answer questions on return
- Unexplained inconsistencies

• Criminal Penalties

- Disputes among executor, decedent's spouse and heirs
- Suspicious change of attorneys
- No valid explanation for why decedent's attorney not used
- Close mouthed attitude/hostility

- **Criminal Penalties**
 - Alterations on records
 - Entangled transactions
 - Delays
 - Inadequate records/allegations that records are lost or destroyed

• Criminal Penalties

- Unexplained absence of expected public records
- Implausible lack of records for last few years of decedent's life
- Suddenly wealthy heirs
- Return not consistent with decedent's status
- Return not consistent with decedent's lifetime earnings

• Criminal Penalties

- Implausible explanation for distant bank accounts
- Large checks drawn to “cash” by decedent
- Corporate receipts not deposited in corporate bank account
- Examiner given the “run around”

Interest

- Compounded daily
- Extension of time or reasonable cause don't cause interest to stop running

Audit Conclusion

- Agreement
 - Form 80 signed by executor
 - Interest runs until tax paid
 - Closing letter
 - Not a formal closing agreement
 - However, under Reg. §301.7121-1(c), estate audit only reopened in the case of fraud, concealment, misrepresentation or clearly defined error

Audit Conclusion

- - No Agreement
 - Similar to income tax audit
 - 30 Day Letter
 - Accept and sign waiver
 - Request Appeals Conference
 - Wait for the 90 Day Letter
 - 90 Day Letter
 - File with Tax Court
 - Pay tax/file refund claim
 - Pay tax
 - Negotiate with collections

Charitable Gift Giving Techniques

- Module 5

IRC §2055

- Authority for deduction from gross estate for charitable gifts (§2522 for gifts)
- Deduction
 - Fair market value of the gift
 - Value of portion of gift for split interest gift

Eligible Recipients

- Government for public purposes
- Charitable organization (§501(c)(3))
- Fraternal society, order or association for religious, charitable, scientific, literary or educational purposes
- Veterans organization
- ESOP if qualifies as gratuitous transfer under §664(g)

Limitation

- Must be bequest of donor or decedent—not the heirs
- Be specific in documents creating the gift

Power of Appointment

- If pass to charity under power of appointment, will be deductible

Pledges

- Must be legally enforceable to be deductible

Disclaimed Gifts

- Allowed for gifts passing via disclaimer
- Remember that disclaimer has to meet specific criteria

Valid Gifts

- If bequest is void under state law, no deduction allowed
- Rather is considered to pass to “rightful” heirs who then make a charitable contribution

Partial Interests

- IRC §2055(e)(2) restricts deductible to four categories
 - Charitable Remainder Unitrust
 - Charitable Remainder Annuity Trust
 - Pooled Income Fund
 - Charitable Lead Trust

Charitable Remainder Trusts

- Defined at §664(d)
- Payment to income beneficiary for period of years (or life)
- At end of term, balance passes to charity

Charitable Remainder Unitrust

- Pay amount to income beneficiary based on value of trust
- Payment varies over time

Charitable Remainder Unitrust

- Term
 - Lifetime of beneficiary
 - Period of years (no more than 20)
- Remainder interest must compute to at least 10%
- Payment fixed percentage, at least 5% can limit to income of trust
- Valued annually, payment at least on annual basis

Charitable Remainder Unitrust

EXAMPLE 5-1

Tom creates a CRUT during his lifetime and transfers property worth \$1 million. He retains the right during his lifetime to receive 6% of the value of the trust. In year one, Tom must receive \$60,000. In year two, the value of the trust increases to \$1.2 million. Therefore, in year two, he must receive \$72,000. In year three, Tom contributes an additional \$1 million to the trust. The trust in year three is now valued at \$2.2 million. Therefore, in year three, Tom must receive \$132,000. Upon his death, the property is distributed to the charity.

Charitable Remainder Unitrust

- Income paid to beneficiary retains its nature in trust
- Distributed from specific layers in order
 - Ordinary income
 - Capital gains
 - Nontaxable income
 - Trust corpus
- Within layer, passed out with highest rate first

NIM-CRUT

- Net income makeup provision
- Can payout income in later years to “make up” for missed payments in prior years

NIM-CRUT Example

EXAMPLE 5-2

Assume a 5% NIM-CRUT for a 10 year period is created and \$44,229 is invested at an 8 1/2% zero coupon bond maturing in 10 years. At the end of the 10 year period, the trust will be valued at \$100,000 of which \$55,771 would be interest. If a valuation date is the last date of each year, \$35,595 of this interest would represent the payout deficiency over a 10 year period, which is limited by the 5% rate. Therefore, the trust principal would have increased by \$20,176, after reflecting payment of the makeup amount to the recipient.

NIM-CRUT Planning

- Trust drafting can allow for capital gain treatment (PLRs 9511007 and 9511029)
- Early growth with little or no income
- Current income tax deduction
- Primarily used if believe can control income

FLIP Unitrust

- Begins life as net income trust, after triggering event becomes fixed income trust
- Trigger must be event beyond control of trustee or other person
 - Marriage
 - Death
 - Birth
 - Sale of unmarketable securities

FLIP Unitrust

- Makeup not paid by end of year following triggering event will be lost

FLIP Unitrust

EXAMPLE 5-3

In 2000, Jennifer contributes land with a fair market value of \$1 million to a FLIP Unitrust. On January 3, 2009 the land is sold. Jennifer must receive all the back up information no later than December 31, 2010.

Charitable Remainder Annuity Trust

- Payout to beneficiary fixed
- Must be paid annually
- Must be at least 5%
- Remainder at least 10%

CRAT vs CRUT

- Disadvantages
 - No additional contributions allowed
 - Annuity must be paid even with decline in principal
 - Beneficiary faces decline in real value received annually due to inflation
- Advantages
 - Easier to manage (no revaluation)
 - Certainty of payout

Charitable Remainder Annuity Trust

EXAMPLE 5-4

Toni transfers \$1 million to a CRAT. She retains the right to receive 8% for the remainder of her life. Therefore, Toni must receive \$80,000 each year. No additional contributions may be made to the trust. If the trust increases or decreases in value, the \$80,000 remains constant during Tony's life. Upon her death, the balance of the trust is distributed to the charity.

Pooled Income Fund

- Defined in IRC §642(c)(5)
- Trust, typically maintained by a charity
- Payment of income for life to charity
- Disadvantages
 - One charitable beneficiary
 - Cannot invest in tax exempts
 - Not likely to want hard to liquidate property

Charitable Lead Trust

- Income to charity for term, then to beneficiaries
- For deduction, must be treated as a grantor trust
- Income must be fixed annuity amount or a unitrust amount

Charitable Lead Trust

EXAMPLE 5-5

Ricky, at his death, bequeaths \$1 million to a Charitable Lead Annuity Trust. The trust provides that the charity must receive 6% each year for a period of 20 years. Therefore, the charity must receive \$120,000 each year from the trust. At the end of the trust, the remainder is distributed to Ricky's then living grandchildren. The present value of the charitable annuity is deductible in computing Ricky's taxable estate.

Valuation of Split Interest Trusts

- IRC §7520 prescribes method for valuing
- 120% of the federal mid-term rate in effect for month of gift
- Lifetime gift—can use current month or either of two months before
- Death gift
 - DOD values used—must use rate for month of death
 - Alternate date—back to three months

Example

EXAMPLE 5-6

CRAT for a Term of Years:

Bethie created a charitable remainder annuity trust at death. Her will left \$1 million to the trust. Bethie died on January 1, 1995. The Section 7520 rate was 9.6%. Bethie's husband receives an annuity equal to 8% payable for 15 years. At the end of the 15 years, the trust terminates and is distributed to the charity. The charitable deduction for the estate is \$377,368. The remaining \$622,632 is subject to estate taxes. Since she left it to her husband, the estate may take a marital deduction for amount left to her husband.

Example

EXAMPLE 5-7 CRAT for Life:

Liz, age 65, contributes \$1 million to a CRAT. The Section 7520 rate is 9.6%. The trust provides that for the remainder of Liz's life, the trust will pay 6% of the initial fair market value of the property each year to Liz. Therefore, the trust must distribute \$60,000 each year to her. The value of the remainder interest distributed to charity equals \$561,652 and is the amount deductible as a charitable contribution for income tax purposes. The present value of the retained annuity by Liz is \$438,348. This is not subject to gift tax since she retains the right to receive the payments. Had she created the trust for daughter, a gift would have resulted in the amount of \$438,348.

Example

EXAMPLE 5-8

CRUT for a Term of Years:

Robert creates a trust at his death (April 30, 2006) which provides that \$1 million is contributed to a charitable remainder unitrust. The trust provides that for a period of twenty years, Robert's grandchild, Nick, shall receive an amount equal to 8% of the fair market value of the trust property. In year one, Nick must receive \$80,000. In year two, the trust principal decreases to \$900,000. Therefore, in year two, Nick will receive \$72,000. At the end of the twenty years, the balance of the trust will be distributed to charity. Robert's estate will be entitled to a deduction of \$199,991. The difference, \$800,009 ($\$1,000,000 - \$199,991$) will be subject to estate taxes. This was calculated based on the effective Section 7520 of 5.6%.

Example

EXAMPLE 5-9

Charitable Lead Annuity Trust:

Robert's will provides for a \$1 million bequest to a charitable lead annuity trust. The date of valuation was February 2, 2006. The charity must receive 6% of the initial fair market value each year for a period of twenty years. Therefore, the charity will receive \$60,000 each year. The Section 7520 rate is 5.2%. The charitable deduction in Robert's estate equals \$749,406. The remainder interest, \$250,594 (\$1,000,000 — \$749,406) is subject to estate taxes.

Gift Tax Deductions

- Deduction for charitable gifts similar to estate tax

IRD Items and Charity

- IRD Items Attractive for Charitable Giving
- IRA Payable
 - QTIP - fully taxable at spouse's death
 - CRT - not taxable at spouse's death

IRA to QTIP or CRT?

If payable to the surviving spouse, then full taxation upon the surviving spouse's death will result. If payable to a Q-TIP with a charitable remaindermen or CRT, no estate taxation will result upon the second spouse's death. The differences of designating a Q-TIP or CRT are as follows:

- A. In a Q-TIP, discretionary payments of principal are allowed.
- B. CRTs do not allow discretionary payments of principal.
- C. Payment to a CRT avoids the minimum distribution rules.

QTIP vs CRT Generally

- QTIP with charitable beneficiary gets similar treatment to CRT with more flexibility for spouse
- However, trickier to use IRA in QTIP
- Must remember to elect QTIP treatment

Generation Skipping Transfer Tax

- ## Module 6

GST Tax

- First enacted in Tax Reform Act of 1976
 - Prior to GST would leave to trust
 - Skip several generations for estate tax purposes

Example—Pre GST

For example, in 1940, Grandfather creates an irrevocable trust for the life of his child, Cassey, Cassey's child, Clancy, and Clancy's child, Clarence. Upon Clarence's death, the property continues in trust for the benefit of Clarence's children for 21 years. Cassey is age 60, Clancy is 40 and Clarence is 15. Based upon Clarence's life expectancy, the trust should continue for approximately 90 years. The only tax will be on the initial transfer into the trust. Upon the death of Cassey, Clancy and Clarence, no tax will result.

GST Rules

- 1976 Act Rules Removed After 1986
- New rules enacted in 1986 Tax Act
- Rules don't apply
 - Pre September 26, 1985 trusts with
 - No additions to trust and
 - No modifications of provisions

Basics

- Purpose to tax generation skips
- Maximum estate and gift rate in place at time of transfer (current rate 45%)
- Transfer multiplied by inclusion ratio
- Preferable to have “pure” trusts with 1 and 0 ratios
- Current GST exemption equivalent to estate tax exemption

Example

EXAMPLE 6-1

In 2006, Raymond creates a Trust of \$1,000,000. He allocates \$1,000,000 of his \$2,000,000 exemption to the Trust. Since Raymond allocated \$1,000,000 of his exemption to the Trust, the Trust has an inclusion ratio of 0 and no tax will be due on any transfer from the trust to its beneficiaries. Had Raymond allocated only \$200,000 of his GST exemption to the transfer, the inclusion ratio is .8 ($\$1,000,000 - \$200,000 = \$800,000 / \$1,000,000$). Therefore, any subsequent transfers from the Trust to a "skip person" will cause 80% of the transfer to be subject to the GST tax. If the trust distributes \$100,000 to Raymond's grandchild, Jett, the tax will equal .8 (inclusion ratio) x \$100,000 x 46% (maximum marginal tax rate).

GST Transfers

- Direct skips
- Taxable distributions
- Taxable terminations

Direct Skip

- Direct transfer to a person
 - Two or more generations below or
 - If unrelated, more than 37 ½ years younger
- Taxed on amount transferred to the person

Example

EXAMPLE 6-2 LIFETIME DIRECT SKIP

In 2006, Tina gave \$1 million to her grandson, Joe. She did not use her GST exemption. Previously, Tina had made more than \$5 million worth of taxable gifts. The total transfer tax is calculated as follows:

Gift Tax (46% x \$1 million)	\$ 460,000
GST Tax (46% x \$1 million)	460,000
Gift Tax on GST Tax (46% x \$460,000)	<u>211,600</u>
Total Transfer taxes	<u>\$ 1,131,600</u>

The total transfer taxes amount to 113.16% of the amount of the gift. However, if Tina wanted to gift a total of \$1 million, including taxes, she could only gift to Joe, \$469,132. The balance would be allocated to gift taxes (46% x \$469,132) + generation-skipping transfer taxes (46% x \$469,132) + gift tax on the generation-skipping transfer taxes (46% x 215,800). (\$215,800 = 46% x 469,132)

Example

EXAMPLE 6-3

Irving makes an outright gift to his grandchild, Kelly, of \$500,000. This transfer is a direct skip. Alternatively, if Irving makes the gift in trust for the benefit of Kelly and Kelly's children, the gift is a direct skip. Any distribution to Kelly's children is not taxed twice.

Trust as a Skip Person

- All trust beneficiaries who can receive a distribution are skip persons or
- No one has a present right to receive distributions and all future distributions may be made only to skip person

Example

EXAMPLE 6-4

Lana transfers \$1 million to a trust. The trust provides for discretionary payments of income and principal to her grandchild, Turner, during the lifetime of Turner. Upon the death of Turner, the trust terminates and is distributed to the Turner's children. This trust qualifies as a skip person.

Trusts

- Beneficiaries are skip and non-skip persons, trust not a direct skip

Example

EXAMPLE 6-5

Lionel creates a trust for the benefit of his child, Selma, and Selma's issue. Since Selma is not a skip person, the trust is not a direct skip.

Direct Skip

- Transfer to
 - Skip person individual
 - Transfer to trust with only skip person beneficiaries
 - Transfer from trust to skip person

Taxable Termination

- IRC §2612(a)(1) Termination by death, lapse of time, release of power or otherwise unless
 - Non-skip person has an interest in the property
 - At no time after termination may a distribution be made to a skip person

Example

EXAMPLE 6-6

Ted creates a trust for the benefit of his child, Bobby, and Bobby's spouse, Betty. Upon the death of Bobby, no taxable termination occurs. Only upon the death of Bobby and Betty will a taxable termination occur since both are non-skip persons.

Taxable Distributions

- IRC §2612(a)
 - Distribution by trust to skip person
 - Other than by
 - Taxable termination
 - Direct skip

Example

EXAMPLE 6-7

Eliot creates a trust for the benefit of his child, Cindy, and Cindy's issue. Any distribution to Cindy is not a taxable distribution. However, any distributions to Cindy's issue are a taxable distribution. All distributions are taxed only once no matter how many generations are skipped.

Exceptions

- Pre-2001 Act
 - Crummey trust transfer was not a current gift for GST purposes
 - Thus gift tax return had to be filed to allocate GST exemption
- Now does qualify
- Pre-2001 trusts may have ratio between 0 and 1

Exceptions

- Predeceased Child Exception
 - IRC §2612(c)(2)
 - Grandchild moves up one generation
 - Needs to be predeceased at time transfer is made, not when distribution is made
 - Does not apply to disclaimers

Example

EXAMPLE 6-8

Megan makes a transfer to Lucy, her granddaughter. Megan's child, had predeceased Lucy at the time of the transfer. The transfer to Lucy is not a direct skip since Lucy is treated as Megan's child.

Example

EXAMPLE 6-9

Megan's Will provides that the entire estate is distributed to Megan's issue, per stirpes. Megan has only one child, Linda, and one grandchild, Lucy. Linda disclaims her interest in Megan's estate. Although Linda will be deemed to have predeceased Megan, the predeceased child exception does not apply for GST purposes since Linda is not dead.

Trust Example from Regulations

Treasury Regulation 26.2612-1(f), provides in Example 6 a transfer to a trust:

Predeceased ancestor exception — Terry establishes an irrevocable trust providing that trust income is to be paid to Terry's grandchild, George, for five years. At the end of the five-year period, the trust is to terminate and the principal is to be distributed to George. Terry's child, Chad, a parent of George, is deceased at the time Terry establishes the trust. Therefore, George is treated as a child of Terry rather than as a grandchild. As a result, George is not a skip person and the initial transfer to the trust is not a direct skip. Similarly, distributions to George during the term of the trust and at the termination of the trust will not be GSTs.

Education & Medical Expenses

- §2611(b) GST does not include
 - Transfers not treated as gift by §2503(e)
 - Education expenses
 - Medical expenses

Example

EXAMPLE 6-10

Terry establishes an irrevocable trust under which the income is to be paid to Terry's child, Charlie, for life. During Charlie's life, the trustees are also authorized to invade the principal for the benefit of Terry's grandchildren and great grandchildren. The trustees directly pay the tuition to the educational institution which Terry's great-grandchild, Greg, is attending. Since this distribution will qualify under IRC Section 2503(e) if made by an individual, it is not a taxable distribution and not subject to the GST tax. However, had the trustee paid the tuition directly to Greg, the distribution would be considered taxable for GST purposes.

GST Exemption

- Exemption provided under IRC §2631(a)
- Equal to estate exemption
- Automatic allocation

Automatic Allocation

- First applied to direct skips occurring at death
- Remaining exemption allocated prorata to trusts which, at death of transferor there may occur a
 - Taxable distribution
 - Taxable termination

Automatic Allocation

- Elect out if don't want automatic allocation
- Must be filed on or before due date of return, including extensions
- May wish to consider if plan to do direct skips

Inclusion Ratio

- One minus “applicable fraction”
- Applicable fraction = amount of GST exemption allocated
- Value transferred reduced by Federal and State death taxes plus charitable deduction

Tax

- Applicable rate – maximum tax rate (currently 45%) times inclusion ratio
- GST Tax = property subject to GST transfer X applicable rate

Example

EXAMPLE 6-11

COMPUTATION OF THE INCLUSION RATIO. Kate transfers \$100,000 to a newly created irrevocable trust providing that income is to be accumulated for 10 years. At the end of 10 years, the accumulated income is to be distributed to Kate's child, Spencer, and the trust principal is to be paid to Kate's granddaughter Dena. Kate elects to exclude \$60,000 of her GST exemption on a timely filed gift tax return. The applicable fraction with respect to the trust is $\frac{2}{5}$ [\$40,000 (the amount of GST exemption allocated to the trust) over \$100,000 (the value of the property transferred to the trust)]. The inclusion ratio is $\frac{3}{5}$ ($1 - \frac{2}{5}$). If the maximum Federal estate tax rate is 45 percent at the time of a GST, the rate of tax applicable to the transfer will be 27.0 percent [45 percent (the maximum estate tax rate) x $\frac{3}{5}$ (the inclusion ratio)].

Example

EXAMPLE 6-12

GIFT ENTIRELY NONTAXABLE. On December 1, 2006, Kate transfers \$12,000 to an irrevocable trust for the benefit of her grandchild, Dena, in a manner that qualifies the entire transfer for the annual exclusion under section 2503(b) of the Code. Under the terms of the trust, the income is to be paid to Dena for 10 years or until Dena's prior death. Upon the expiration of Dena's income interest, the trust principal is payable to Dena or Dena's estate. The transfer to the trust is a direct skip. Kate made no prior gifts to or for the benefit of Dena during 2006. The entire \$12,000 transfer is a nontaxable transfer. For purposes of computing the tax on the direct skip, the denominator of the applicable fraction is zero, and thus the inclusion ratio is zero.

Example

EXAMPLE 6-13

GIFT NONTAXABLE IN PART. In 2001, Kate transferred \$12,000 to an irrevocable trust for the benefit of her grandchild, Dena. Under the terms of the trust, the income is to be paid to Dena for 15 years or until Dena's prior death. Upon the expiration of Dena's income interest, the trust principal is payable to Dena or her estate. Ten thousand dollars of the transfer qualified for the annual exclusion under section 2503(b) of the Code. The amount of the nontaxable transfer is \$10,000. Solely for the purposes of computing the tax on the direct skip, Kate's transfer is divided into two portions. One portion is equal to the amount of the nontaxable transfer (\$10,000) and has a zero inclusion ratio; the other portion is \$2,000 (\$12,000 — \$10,000). With respect to the \$2,000 portion, the denominator of the applicable fraction is \$2,000. Assuming that Kate had sufficient GST exemption available, the numerator of the applicable fraction is \$2,000 (unless Kate elected to have the automatic allocation provisions not apply). Thus, assuming the automatic allocation is made, the applicable fraction is one ($\$2,000/\$2,000 = 1$) and the inclusion ratio is zero ($1 - 1 = 0$).

Estate Tax Inclusion

- Exemption may not be made to an inter vivos transfer which would be includable in gross estate of the transferor (other than by §2035) if transferor died immediately after transfer
- Estate Tax Inclusion (ETIP)

Leveraging Effect of GST Exemption

- Want to apply exemption to property expected to appreciate
- Note that for non-direct skips in trusts, it is value at distribution that controls

Post Mortem Planning

- ## Module 7

Disclaimers

- §2046 Estate Tax Disclaimer Statute references
- §2518 Gift Tax Statute

Disclaimer

- Asset passes as if person had predeceased
- Means cannot control who will get the asset
- However, can be used in drafting to give options at death

Disclaimer

- State irrevocable and unqualified
- Disclaimer
 - Should be in writing
 - Identify interest being disclaimed
 - Signed and acknowledged by disclaimant
 - Must comply with state law rules

Disclaimer

- Reg. §25.2518-2(c)(1) must be delivered within 9 months
- Different rules for lifetime and transfers at death

Lifetime Transfers

- Occurs when is a completed gift for federal gift tax purposes regardless of when gift tax imposed
- Life estate—time starts running at date of transfer even though included in estate
- Special case for joint tenant

At Death Transfers

- Recipient of disclaimed property can disclaim —but the timer still goes back to original transfer
- If transfer in revocable trust, date doesn't start until trust becomes irrevocable

Jointly Held Property

- Can disclaim at date of death the amount surviving joint tenant did not contribute
- Tracing rules under §2040(a) determine portion that may be disclaimed

Example

EXAMPLE 7-1

On July 1, 2007, B transfers \$10,000 to a bank account which is held jointly by B and C. Assume the transfer is not a completed gift for Federal gift tax purposes. The funds in the bank account may be withdrawn in full by either B or C at any time. C never receives funds from the bank account. B dies on August 15, 2008, and C disclaims the amount in the bank account on October 15, 2008. Assuming the remaining requirements of section 2518(b) are satisfied, C made a qualified disclaimer under section 2518(a) because it was made no later than 9 months after the taxable transfer that created an interest in C.

Jointly Held Property

- Joint tenancy with spouses—50% allowed to disclaim
- Tenancy by the entirety
 - State law has to allow for partition
 - Without that right, cannot disclaim

Double Disclaimer

- Be careful for boomerang effect due to mechanical nature of disclaimer
- May need to disclaim result of disclaimer—won't presume “predeceased” status after passes by once
- So IRA may pass to estate, where we'd need to disclaim it again

Acceptance

- Disclaimant cannot accept the property—once you take it, it's yours
- Exception for minors
- Exception for initial minimum required distribution

Example

EXAMPLE 7-3

If Neil had not taken his required minimum distribution prior to his death, Liz could have received that amount and still disclaimed the IRA.

Partial Disclaimers

- Are allowed to make a partial disclaimer
- Cannot direct passage of property
- Generally cannot come back to yourself, but can go to credit shelter trust
(Reg. §25.2518-2(e)(2))

Advantages of Disclaimer

- Make use of full exemptions
- Utilize unlimited marital deduction
- May be non-tax issues (like claims of creditors) impacted by state law
- Federal liens do attach, however (Dye, Jr.)
- Revocation of QTIP alternative

Extension of Time to Pay Tax

- §6161 IRS authority to extend payment of tax for up to 10 years
- Reasonable cause

Alternate Valuation

- §2032 offers choice of valuing estate at
 - Date of death
 - Six months thereafter
- Conditions
 - Value of estate decreased and
 - Estate tax decreased

Alternative Valuation

- Election within one year of due date of return, including extensions
- Distribution of assets will fix value at date of distribution

QTIP Property

- Partial QTIP—Reg. §20.2056–5(c)(2)
 - Invasions should come from QTIP portion
 - Will be in estate anyway
- Election out of QTIP—§2056(b)(7) election
- Consider potential for disclaiming general power of appointment (creditor issue—seek counsel)

Qualified Domestic Trust

- Generally marital exclusion limited to US citizen spouses
- QDOT however will qualify
 - Requirements under §2056A
 - Surviving spouse can create if not created in will
 - Can reform trust under will as QDOT
 - Must become citizen before estate tax return filed to avoid QDOT requirement

Administration Provisions

- Estate administration expenses—election to deduct on estate tax return or fiduciary return
- Taxable year
 - Not limited to calendar year
 - Can elect to treat decedent's trust as part of estate (Form 8855)
- 65 Day Election (§665)

Decedent's Final Return

- Final income tax return—can file joint return if surviving spouse does not remarry by year end
- Election on E and EE bonds
- Option for medical expenses

Miscellaneous

- Gift splitting on pre-death gifts
- Renunciation of commissions
 - Consider advisability in taxable estate
 - Self-employment tax issue
- Taxes and nonprobate estate

Retirement Plans

- Spouse options
 - Rollover and treat as spouse's own
 - Treat as inherited
- Nonspouse options
 - If plan allows, can roll into IRA in name of decedent
 - IRS backtracked on initial positions plans would be required to offer this option

Right of Election

- Consider spouse's right of election
- Could increase marital deduction

Partnership/Shareholder Agreements

- Review agreements in place for buy/sell
- Inquire of partnership about whether a §754 election is in place or will be made

Income Tax Return

Module 8

General

- Separate taxable entity, begins at death
- Accounting period chosen with first 1041
- Revocable trust that becomes irrevocable at decedent's death
 - Form 8855 to combine with estate (or simply treat as estate)
 - Will need two identification numbers

Filing Requirements

- General rule: gross income of \$600 or more
- However, if any beneficiary is a nonresident alien, must file regardless of income

Income of Estate

- All items of income included
- Character of asset in hands of estate determines its treatment
 - Capital assets received from decedent have a long term holding period by statute regardless of time actually held
 - Basis linked to value of date of death for property acquired from decedent (or AVD)

Installment Agreement

- Income continues to be recognized by estate in same manner
- No “change” to long term gain
- No elimination of gain due to basis step up
- Income in respect of a decedent

Income of Estate

- Special use valuation—sale to qualified heir
- Separate share rule
 - Share does not affect other heirs
 - Shares not affected by other heirs shares
 - Generally requires including both corpus and income
- Retirement plan distributions under UIPA—
income 10% and corpus 90%

Deductions

- Generally allowed same deductions as an individual
- Exemption of \$600
- Charities
 - AGI limits don't apply
 - Must be specifically provided for in decedent's will

Deductions

- Losses
 - Sale of property
 - Net operating loss
 - Carryover losses on decedent's final return don't make it to estate

Deductions

- Administrative Expenses
 - Must choose to take on 706 or 1041
 - Must take on 706 unless properly elect
 - Hubert regulations
 - Management expenses
 - Transmission expenses
 - Reduce marital or charitable deduction regardless of where deducted

Expenses

- Investment Expenses
 - Rudkin case settled the matter
 - Must show incremental cost for advice beyond what would normally be paid by an individual
 - Show that it would be unusual for an individual to pay the expense
 - Need to “unbundle” fees

Expenses

- Accrued expenses
 - Not blocked by prohibition on double deduction for deductions in respect of a decedent
- Tax Exempt Income—not allowed expenses related to the same
- Depreciation—allocated between estate and beneficiaries

Depreciation Example

EXAMPLE 8-1

In 2007, the decedent's estate realized \$3,000 of business income during the administration of the estate. \$1,000 of the income was distributed to the decedent's son, Tom, and \$2,000 to son Will. The allowable depreciation on the business property is \$300. Tom can take a deduction of \$100, and Will, \$200

Nondeductible

- Funeral expenses
- Medical or dental expenses

Distribution Deduction

- Income that must be distributed currently
- Other amounts properly paid, credited or required to be distributed
- Deduction limited to distributable net income of estate

State Income Tax

- Most states look at domicile of decedent at date of death
- Many use very different rules for trusts (though most respect election to treat trust as estate)
- Like individuals, also tax income sourced to the state even for nonresident estates

Funding Credit and Marital Trusts

- Pecuniary Funding
 - Gift of a specific amount
 - Can be dollar amount or formula (maximum amount that can pass tax free)
- Fractional Funding
 - Gift of percentage of estate
- If document is silent, look to local probate law

Pecuniary Funding

- True worth
 - Freeze dollar amount at date of death
 - Uses asset value at funding date
- Fairly representative
- Minimum worth—fund marital trust valued at lesser of
 - Date of death value or
 - Date of funding value

True Worth

- Marital Deduction Funding
- Credit Shelter Funding

Marital Deduction Funding

- Marital deduction funded first based on date of death values for amount of funding
- Advantages
 - Flexibility
 - Decrease felt by credit shelter trust
 - Easy to administer

Marital Deduction Funding

- Disadvantages
 - Potential gain or loss on funding
 - Marital trust does not share in appreciation (and survivor may not like that)
 - Funding immediately triggers IRD

Credit Shelter Funding

- Credit shelter trust funded first, amount to be funded determined at date of death values
- Advantages
 - Flexibility
 - Credit shelter trust does not decrease if estate decreases in value
 - Easy to administer

Credit Shelter Funding

- Disadvantages

- Potential gain or loss on funding
- Marital trust receives all appreciation (and that one will be taxed at death of spouse)
- Immediate trigger of IRD

Fairly Representative

- Marital Deduction Funding
- Credit Shelter Funding
- Select “fairly representative” assets based on appreciation/depreciation of all assets

Marital Deduction Funding

- Revenue Proc 64-19 governs—asset's FMV must be at least the pecuniary amount
- Advantages
 - No gain or loss triggered
 - Marital deduction shares in appreciation

Marital Deduction Funding

- Disadvantages
 - Assets must be revalued
 - IRD may be triggered
 - Limited flexibility

Credit Shelter Funding

- Same Rev Proc controls—same limit
- Advantages
 - No gain or loss triggered
 - Credit trust can share appreciation
 - Some flexibility

Credit Shelter Funding

- Disadvantages
 - Assets must be revalued
 - May trigger IRD
 - Credit trust could be underfunded

Minimum Worth

- Marital trust funded first, credit shelter receives residual
- Advantages
 - No gain on funding
 - Only assets that have decreased in value need to be revalued
 - Marital share doesn't risk depreciation
 - Flexible funding

Minimum Worth

- Disadvantages
 - Marital bequest almost always overfunded
 - Losses may not be recognized
 - May end up with no credit shelter trust
 - May accelerate IRD on IRA
 - GST tax exemption funding problems

Example

Required funding amount is \$200,000

Stock A

Income Tax Basis	\$100,000
Date of Distribution Value	\$150,000

Stock B

Income Tax Basis	\$200,000
Date of Distribution Value	\$100,000

Total Income Basis	\$300,000
Total Date of Distribution Value	\$250,000

Total Trust Would be Funded With:

Stock A	\$100,000
Stock B	<u>\$100,000</u>
Total	<u>\$200,000</u>

Fractional Funding

- Pro-Rata Method
- Pick and Choose Method

Pro-Rata Method

- Assets valued at date of death value to determine percentage allocated to each trust
- Advantages
 - No gain or loss
 - No revaluation
 - No acceleration of IRD

Pro-Rata Method

- Disadvantages
 - Marital bequest not fixed—shares in appreciation and depreciation
 - No flexibility in funding
 - Difficult to administer
 - Certain assets may not be susceptible to fractional division

Pick and Choose Method

- Assets valued at date of death—fraction applied to assets of grantor's estate at time of distribution to marital trust
- Advantages
 - No gain or loss on funding
 - Maximum flexibility
 - No acceleration of IRD

Pick and Choose Method

- Disadvantages
 - Revaluation of assets whenever there is a distribution to either trust
 - Marital deduction not frozen
 - Difficult to administer
 - Expenses must be allocated pro-rata between the trusts

Basic Charitable Gifting Techniques

Module 9

Eligible Recipients

- ◆ Government
- ◆ Charity §501(c)(3)
- ◆ Fraternal society or association
- ◆ Veterans organization
- ◆ ESOP

Limitation

- Intent of donor or recipient
- “What Mom would have wanted”

Pledges

- Must be legally enforceable
- Disclaimed gift generally allowed
- Limits on split interest transfers

Split-Interest Transfers

- Charitable Remainder Trusts (9-3)
- Pooled Income Fund (9-6)
- Charitable Lead Trust (9-6)

Charitable Remainder Trusts

- CRUT
- NIM-CRUT
- FLIP Unitrust
- CRAT

Charitable Remainder Unitrust

EXAMPLE 9-1

Tom creates a CRUT during his lifetime and transfers property worth \$1 million. He retains the right during his lifetime to receive 6% of the value of the trust. In year one, Tom must receive \$60,000. In year two, the value of the trust increases to \$1.2 million. Therefore, in year two, he must receive \$72,000. In year three, Tom contributes an additional \$1 million to the trust. The trust in year three is now valued at \$2.2 million. Therefore, in year three, Tom must receive \$132,000. Upon his death, the property is distributed to the charity.

NIM-CRUT

EXAMPLE 9-2

Assume a 5% NIM-CRUT for a 10 year period is created and \$44,229 is invested at an 8 1/2% zero coupon bond maturing in 10 years. At the end of the 10 year period, the trust will be valued at \$100,000 of which \$55,771 would be interest. If a valuation date is the last date of each year, \$35,595 of this interest would represent the payout deficiency over a 10 year period, which is limited by the 5% rate. Therefore, the trust principal would have increased by \$20,176, after reflecting payment of the makeup amount to the recipient.

When compared to a 5% ten year CRUT (not a NIM-CRUT), the recipient will receive an additional \$4,531 from the NIM-CRUT.

FLIP Unitrust

EXAMPLE 9-3

In 2000, Jennifer contributes land with a fair market value of \$1 million to a FLIP Unitrust. On January 3, 2009 the land is sold. Jennifer must receive all the back up income no later than December 31, 2010.

Charitable Remainder Annuity Trust

EXAMPLE 9-4

Toni transfers \$1 million to a CRAT. She retains the right to receive 8% for the remainder of her life. Therefore, Toni must receive \$80,000 each year. No additional contributions may be made to the trust. If the trust increases or decreases in value, the \$80,000 remains constant during Tony's life. Upon her death, the balance of the trust is distributed to the charity.

Charitable Lead Trust

- Income to charity, remainder to beneficiary
- Grantor trust required for charitable deduction
- Either annuity or unitrust

Charitable Lead Trust

EXAMPLE 9-5

Ricky, at his death, bequeaths \$1 million to a Charitable Lead Annuity Trust. The trust provides that the charity must receive 6% each year for a period of 20 years. Therefore, the charity must receive \$120,000 each year from the trust. At the end of the trust, the remainder is distributed to Ricky's then living grandchildren. The present value of the charitable annuity is deductible in computing Ricky's taxable estate.

Payouts to Beneficiary

- Ordinary income (current & prior)
- Gains (current & prior)
- Tax exempt income (current & prior)
- Corpus

Valuation Examples

- CRAT – Term
- CRAT – Life
- CRUT – Term
- CLAT

CLAT (Term)

EXAMPLE 9-6

CRAT for a Term of Years:

Bethie created a charitable remainder annuity trust at death. Her will left \$1 million to the trust. Bethie died on January 1, 1995. The Section 7520 rate was 9.6%. Bethie's husband receives an annuity equal to 8% payable for 15 years. At the end of the 15 years, the trust terminates and is distributed to the charity. The charitable deduction for the estate is \$377,368. The remaining \$622,632 is subject to estate taxes. Since she left it to her husband, the estate may take a marital deduction for amount left to her husband.

CRAT (Life)

EXAMPLE 9-7

CRAT for Life:

Liz, age 65, contributes \$1 million to a CRAT. The Section 7520 rate is 9.6%. The trust provides that for the remainder of Liz's life, the trust will pay 6% of the initial fair market value of the property each year to Liz. Therefore, the trust must distribute \$60,000 each year to her. The value of the remainder interest distributed to charity equals \$561,652 and is the amount deductible as a charitable contribution for income tax purposes. The present value of the retained annuity by Liz is \$438,348. This is not subject to gift tax since she retains the right to receive the payments. Had she created the trust for daughter, a gift would have resulted in the amount of \$438,348.

CRUT (Term)

EXAMPLE 9-8

CRUT for a Term of Years:

Robert creates a trust at his death (April 30, 2006) which provides that \$1 million is contributed to a charitable remainder unitrust. The trust provides that for a period of twenty years, Robert's grandchild, Nick, shall receive an amount equal to 8% of the fair market value of the trust property. In year one, Nick must receive \$80,000. In year two, the trust principal decreases to \$900,000. Therefore, in year two, Nick will receive \$72,000. At the end of the twenty years, the balance of the trust will be distributed to charity. Robert's estate will be entitled to a deduction of \$199,991. The difference, \$800,009 (\$1,000,000 — \$199,991) will be subject to estate taxes. This was calculated based on the effective Section 7520 of 5.6%.

CLAT

EXAMPLE 9-9

Charitable Lead Annuity Trust:

Robert's will provides for a \$1 million bequest to a charitable lead annuity trust. The date of valuation was February 2, 2006. The charity must receive 6% of the initial fair market value each year for a period of twenty years. Therefore, the charity will receive \$60,000 each year. The Section 7520 rate is 5.2%. The charitable deduction in Robert's estate equals \$749,406. The remainder interest, \$250,594 (\$1,000,000 — \$749,406) is subject to estate taxes.

Gift Tax

- “Taxable” gifts
- Annual exclusion
- Remainder deduction

IRD to Charity

- Issues to make IRA payable to charity via
 - QTIP – discretionary distributions possible
 - CRT – avoids minimum distributions
- Problem of non-person beneficiary

Current Developments

Module 10