**Estate and Gift Tax Outline – Cunningham Fall 2020**

**I. Overview of the Estate Tax System**

* Unification of the Estate Tax:
  + Beginning in 1797 and until 1916, there were taxes enacted to tax transfers and estates during times of war, but non were permanent.
  + In 1932, Congress enacted the first permanent estate tax.
  + In 1981 Congress enacted the marital deduction and reduced the rate from 70% to 50%.
  + In 2001, Congress began phasing out the estate tax, and in 2010, the estate tax was repealed.
  + In 2011, the estate tax came back
* Justifications for the Estate Tax:
  + Raising revenue
    - Today, few people are subject to this tax and it raises only a small portion of the revenue.
  + Limiting extreme concentrations of wealth
    - Want to limit the dynastic accumulation of wealth
    - The tax is used to *redistribute* the accumulation of wealth.
    - Limits the concentration of power
  + Fairness:
    - Argument: double taxation.
      * In reality, most of the amount taxed is from unrealized appreciation/gains that have not been taxed yet.
    - The burden is on the recipient because the transferor pays the tax the recipient ends up with less.
* Alternative Ways to Tax Wealth & Wealth Transfers:
  + Estate Tax: tax based on the amount of wealth a decedent transfers at death.
  + Inheritance Tax: tax the beneficiary on the receipt of transferred wealth from a decedent.
  + Income Inclusion: includes gifts and amounts received from a decedent in income, rather than creating a new tax.
  + Deemed Realization: When the decedent dies holding assets, treat this as a realization event and treat the decedent as if he sold it right before death for FMV.
  + Combined Deemed Realization with Inheritance Tax: use 1014 [square this up

**II. Gift Tax Fundamentals**

* Statutes:
  + § 2501: tax imposed on transfers of property by gift.
  + § 2502: computation of tax
  + § 2503: Defines Taxable gifts; provides for exclusions from gifts.
* What is a transfer of property by gift?
  + § 25.2511-1(a): the gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.
  + However, a gift of services is not a transfer of property.
    - Ex. Mother is a real estate broker and lists house for daughter for no commission is not a gift.
      * But if the waiver was after the commission was owed, would be a gift.
  + Exclusion for Educational Expense:
    - § 2503(e) – must be paid directly to the educational institution; only applicable for tuition.
      * Room and board, spring break, etc. would not fall into this exclusion.
    - No age limit for paying educational expenses.
  + Exclusion for Medical Expenses:
    - § 2503(e): Like educational expense must be paid directly to the provider.
  + Charitable Deduction: § 2055
    - [Come back to this – later Unit]
  + Marital Deduction: § 2523
    - [come back to this – later Unit]
* Below Market/Interest Free Loans treated as Gifts
  + § 1274: provides the AFR. The AFR will determine whether the loan in question is a below market loan.
    - If AFR > Interest rate = below market loan.
  + If it is an interest free loan demand loan -- § 7872(a):
    - The interest that would be charged by using the AFR is treated as being gifted each year.
      * The interest is also treated as income to the grantor.
    - If the loan is forgiven, the principal is treated as a gift.
  + If it is an interest free term loan -- § 7872(b):
    - The interest that would have been charged based on the AFR is treated as a gift each year and as income to the grantor.
    - The value of the gift is the Amt. Loaned over the PV of all of the payments required to be made under the loan discounted by the AFR.
* Donative Intent:
  + Where property is transferred for less than full and adequate consideration in money or money’s worth, then the amount by which the property exceeded the value of the consideration shall be deemed a gift.
    - The inquiry: Was the asset replaced with consideration of equal value in money or money’s worth?
      * Love and affection; promise of marriage; etc. are not consideration in terms of money or money’s worth.
      * A relinquishment of dower or curtesy, or other marital rights is not considered consideration for money or money’s worth.
  + Ordinary Business Transactions:
    - § 25-2512-8: a sale, exchange, or other transfer or property made in the ordinary course of business (a transfer which is bona fide, at arm’s length, and free from any donative intent), will be considered as made for adequate and full consideration within the meaning of the statute.
      * In a situation where someone sells a piece of property for below FMV look to whether:
        + It is a liquid asset/no precise market; a need for the money; an arm’s length transaction; and a relationship between the parties.

If there is a relationship, it may point towards a lack of bargaining and show donative intent.

* + - * + Ex. A sells real estate to competitor B with FMV of $1M for $850K b/c needs cash for immediate use.

Without more, looks like ordinary business transaction. But add a relationship – e.g., A is B’s father – looks like possible donative intent.

* Completed Gift:
  + Grantor must give up dominion and control over the property.
    - § 25.2511-2(b): donor has so parted with dominion and control as to leave him in no power to change its disposition.
      * § 25.2511-29c): power to revoke, change beneficiaries, unless fiduciary power limited by fixed or ascertainable standard.
      * § 25.2511-1(g)(2): clearly measurable standard – e.g., HEMS
      * § 25.2511-2(d): may change the time or manner of enjoyment
      * § 25.2702-2(a)(4): power = a retained interest.
  + § 25.2511(c): the power to revoke and the power to change beneficiaries renders the gift incomplete.
    - Ex. A gift to a revocable trust with A & B as income beneficiaries and C as a remainder beneficiary. Neither the income nor the remainder interest is compete.
      * But if there is a distribution of income, the gift is compete for that distribution.
  + Each interest transferred must examined to determine whether the gift is complete.
  + If the trustee has substantial discretion, this can render the gift incomplete.
    - However, if the Trustee’s discretion is limited by an ascertainable standard (i.e., HEMS standard), it will be a completed gift. § 25.2511-1(g)(2).
    - An ascertainable standard will even render the gift complete if the grantor is serving as trustee.
  + A donor is considered as himself having a power if it is exercisable by in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom.
    - A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.
  + § 25.2511-2(d): a gift is not incomplete merely because the donor reserves the power to change the manner or time of enjoyment.
    - This could possibly have estate tax implications – i.e., brought back into the estate because of a string.
* Joint Ownership of Property:
  + If a grantor owns property and transfers title to himself and the donee as TICs or JTWRS, it would be a gift of half of the property.
* Valuation of Gifts:
  + If the gift is split between the remainder and income, the gift must be valued for gift tax purposes.
  + 1) Find the age of the holder of the life estate;
  + 2) Find the § 7520 rate: 120% of the AFR.
  + 3) Use that the § 7520 rate and the tables located in § 20.2031-7(d), find the remainder value based on the life estate holder’s age – gives you the discount rate
    - This gives you the remainder factor
    - 1 – the remainder factor = life estate factor
* Disclaimer:
  + General Principal: no one can force you to take a gift; you are allowed to refuse it.
  + § 2518 unifies the requirements for a valid disclaimer.
  + The effect: the disclaimant is treated as having predeceased the donor. Any property that passes through the disclaimer is not treated as a gift from the disclaimant.
  + Disclaimer Requirements:
    - Must be in writing;
    - Must be received by donor with 9 months;
    - During that 9-month period, cannot accept any benefits of the property whatsoever; and
    - The disclaimant cannot be a beneficiary of the property (exception for spouses).
  + Must disclaim an undivided portion of an interest.
    - You can disclaim a portion of the money, land, etc. but cannot disclaim a remainder, life estate, etc.

**II. the Estate Tax Calculation:**

Gross Estate

(Marital Deduction)

(Charitable Deduction)

(Allowed Expenses)

**Taxable Estate**

Adjusted taxable gifts made during life

**Total Transfers subject to Tax**

Total Transfers Subject to Tax X § 2001(c) rate = **Tentative Transfer Tax**

Tentative Transfer Tax

(Gift taxes paid during life)

**Tentative Tax on Estate**

(Unified Credit Available)

**Total Estate Tax Due**

**III. What is Included in the Gross Estate:**

* Estate Tax Overview:
  + General Statute Break Down:
    - § 2001: Compute estate tax based on the taxable estate.
    - § 2051: Taxable estate = gross estate – deductions
    - § 2031: gross estate
    - §§ 2053-2058: deductions
  + Gross Estate:
    - § 2033: property in which the decedent held an interest at death are included in the gross estate.
    - §§ 2036 – 2038: retained interests that are brought back into the estate.
    - § 2040: Joint Tenancy Property
    - §§ 2039 & 2042: Insurance and retirement plans.
    - § 2041: General powers of appointment held by the decedent.
    - The estate. Tax approach is that an item is part of the estate *only* if specifically included by statute.
  + Deductions
    - § 2053: Costs of administration and debts
    - § 2055: Charitable Bequests
    - § 2056: Transfers to spouse
* § 2033: What interests are included:
  + § 2033 includes the value of all property to the extent of the interest therein of the decedent at the time of his death. Regs say all property beneficially owned by the decedent at death.
  + Interests are determined by state law.
    - § 2033 does not reach property interests or rights held by the decedent during life that terminate with his death.
    - SCOTUS has read § 2033 very narrowly.
  + State law, not federal law, determines the existence of property rights.
    - *Bosh* held that absent a decision by the state’s high court, the federal court must apply what they find to be the state law after giving proper regard to relevant ruling of other courts of the state.
    - If state
  + Jointly Held Property:
    - TICs: If a decedent owns an undivided partial interest in the property as a co-tenant, then only the decedent’s proportionate share of the property will pass under his will or to his heirs, and only that portion will be included in the gross estate under § 2033.
    - If spouses live in a common law state and have jointly owned assets accumulated during the marriage, the full value of the assets are included in the estate and later deducted through the marital deduction. §§ 2034, 2056.
    - § 2040 has two regimes:
      * 1) Spousal:
        + Spouses:

Each spouse is treated as supply ½ of the consideration.

The portion attributable to the decedent spouse will be included.

* + - * 2) Non-Spousal:
        + Inclusion depends on how the property was acquired.

General rule: include full value of the property except the part that was originally owned or contributed by the other owner (and wasn’t received by decedent).

Provided rule: only pull out that portion attributable to consideration furnished by the other owner.

Provided further: if acquired by gift, devise, or inheritance, include the proportionate part of the value.

* + - * + Reg. § 20.2040-1(a) clears this up:

If acquired by the decedent and other joint owners by gift, devise, bequest, or inheritance, include proportionate share;

In all other cases, include the entire value less the part attributable to consideration furnished by the other owners. Only take into account consideration paid by the other owners.

If the consideration the other owners used can be traced to a gift from the decedent, their consideration would be disregarded.

* + - * + If the decedent owns a piece of property and transfers it to B as JTWRS, there is a gift at the time of the transfer. But the entire value would be included in the gross estate because there was no consideration paid by B. The estate tax owed would be adjusted by the gift taxes already paid though.

This is only true with JTWRS, not TICs.

* + Causes of Action:
    - If the interest – i.e., the cause of action – arose after the decedent’s death, it is not include.
      * The decedent must not have possessed a claim during his lifetime for damages.
  + Amounts Owed to the Decedent:
    - Income owed before death but paid after death:
      * Because the decedent would have a claim to the amount owed prior to death, it would be included under § 2033.
      * Income tax consequences:
        + § 691 controls the income tax consequences.

This is Income with Respect to Decedent (IRD) – income earned by the decedent during life but not reported.

IRD is not entitled to a stepped-up basis under § 1014.

It is included in the income of the person entitled to receive it.

The estate would be entitled to an income tax deduction in the amount of the tax that would have been paid had it been included in the estate.

The remaining amount is taxed at the income level of the estate/whoever is entitled to receive the amount.

Net amount to the B: Gross Amt. – estate tax – income tax.

* + - * + The right to receive a dividend constitutes and interest in property.

Whether it is IRD depends on whether the decedent had paid taxes on the income from the dividend.

* + - Notes or other claims held by the decedent are included in the gross estate.
      * If the decedent’s will cancels the debt, the amount is still included in the gross estate.
      * However, if the note provides for the debt to be cancelled upon death, it will not be included in the gross estate.
        + This must be part of the bargained for consideration between the decedent and the borrower.
      * Accrued interest on the note
        + This would be trated as IRD, and § 691 would control here.

**IV. Transfers with Retained Interests - §§ 2035-2038:**

* Retained Rights and Powers over Income and Principal:
  + § 2036: Transfer by decedent during life; Not made for full and adequate consideration; And retained one or more strings: (1) retained rights to income; (2) retained powers over income
    - The entire FMV on the date of death will be included in the decedent’s estate.
    - Retention of beneficial interest in the income, even if not trustee, will cause inclusion under § 2036(a)(1).
    - If you retain a string for any period not ascertainable without reference to the decedent’s death or any period that does not end before the decedent’s death, it will be included under § 2036.
      * Ex: if decedent retained income interest but not entitled to it in the month preceding his death – inclusion.
      * Ex: income to decedent for X years and decedent dies turning that timeframe – inclusion.
    - However, if the decedent survives the income interest period, it would not be included under § 2036 – i.e., there is a cliff and once the period has expired, no inclusion, but if the decedent dies during the period, full inclusion.
    - Support Obligations:
      * D retains possession or enjoyment or right to income if it is to be applied toward the discharge of a legal obligation of the D or otherwise for his pecuniary benefit. § 20.2036-1(b)(2).
        + To prevent this, draft the trust so that it is clear that the income shall not be used to discharge support obligations – only to make distributions in excess of D’s legal obligation to support the minor child.
    - Reciprocal Trust Doctrine:
      * Where a A sets up a trust with income to B for life and remainder to C. At the same time, B sets up a trust with income to A for life and remainder to C.
      * The IRS says that B will be treated as creator of the A trust and A will be treated as the B trust and both are deemed to have retained a life estate – so inclusion under § 2036(a)(1).
      * A trust is interrelated to another trust if the arrangement leaves the settlors in approximately the same economic position as they would have been had they created the created trusts naming themselves as income beneficiaries (*Estate of Grace*).
        + Substantially identical terms and created at approximately the same time.
        + *Levy*: Reciprocal Trust Doctrine didn’t apply because the trusts were created at different times and had different terms.

Significant time period difference – like 20 years.

* + - Retention of a Secondary Life Estate:
      * There would still be inclusion, but it would be the FMV of the trust less the first life estate.
  + § 2036(a)(2) – Power to direct income:
    - The value of the GE shall include the value of all property to the extent of any interest therein of which the D has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money’s worth) by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death, or for any period which does not in fact end before his death, the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
    - Elements:
      * Must have a transfer;
      * Retention of a string:
        + Did the decedent retain the *right* alone or *in conjunction with anyone else* to designate the persons who shall possess or enjoy the property or its income;

There must be a legally enforceable right

* + - * D retained the string for one of the 3 time periods:
        + For life,
        + For a period not ascertainable without reference to death, or
        + For a period that does not in fact end before death
      * Bona Fide sale exception does not apply.
    - Serving as trustee: by serving as trustee and having the discretion to choose how the income is divided, this would cause inclusion under § 2036(a)(2).
      * § 20.2036-1(b)(3): the right to designate the persons who shall possess or enjoy the transferred property, or the income therefrom includes a reserved power to designate the persons to receive income from transferred property (e.g., the right as trustee of a trust).
      * This would also apply if the trustee was serving with one or more co-trustees.
    - Power to Remove Trustee:
      * If the decedent retained the power to appoint a successor including himself, the corpus of the trust will be included.
        + § 20.2036-1(b)(3) & § 20.2038-1(a)(3).
      * However, if the decedent is limited in his choices so that he cannot substitute himself, a related person, or a subordinate, it would not be included in his estate – RR 95-58: “as long as substitute trustee is not described in § 672(c), the power will not be imputed to the transferor.”
        + Disconnect, because you can initially appoint a family member, but if you have the power to appoint a related/subordinate person later, it would cause inclusion.
      * If the decedent’s powers are limited by an ascertainable standard, § 2036(a)(2) will not apply.
    - Power to remove trustee:
    - This often overlaps with § 2038, and you would use whichever section would bring more into the estate, likely § 2036.
  + § 2035: If you retain a string and give away that string within three years of death, there will be full inclusion.
    - This section looks at whether there was a string retained under §§ 2036, 2037, 2038, or 2042 on the original transfer, and then whether at some point the decedent transferred that string.
  + § 2037 – Retained Reversionary Interests
    - 4 Requirements:
      * 1) must make a transfer of the property during life for less than adequate consideration;
      * 2) the interest can only be possessed or enjoyed by surviving the decedent;
        + This goes towards stopping testamentary substitutes.
      * 3) the decedent must have retained a reversionary interest, whether or not explicit in the document – includes operation of law;
      * 4) the value of the reversionary interest, as of the time of decedent’s death must be worth more than 5% of the property.
    - If 2037 is catches this gift, it pulls in the FMV of all other interests in the trust that can only be enjoyed after the decedent has died.
    - Focus on each interest transferred, and ask whether the 4 requirements are met with each of the interests.
      * If they are, the value of that particular interest is brough back into the estate.
      * Look out for the language “remainder to X, if living, and if not then to Y, or . . . “
  + Retention of Voting Rights in a Controlled Corporation:
    - § 2036(b) applies here.
      * This is really a trap for the unwary.
      * (b)(1): “For purposes of subsection [**(a)(1)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTNEMTg_amNzZWFyY2g9SVJDJTI1MjAyMDM2Il1d--17ea985818376bc84a6dd65da690dd5745e1f61e/document/1?citation=26%20USC%202036(a)(1)&amp;summary=yes#jcite), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.”
      * (b)(2): “**Controlled Corporation** — For purposes of paragraph [**(1)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTNEMTg_amNzZWFyY2g9SVJDJTI1MjAyMDM2Il1d--17ea985818376bc84a6dd65da690dd5745e1f61e/document/1?citation=26%20USC%202036(b)(1)&amp;summary=yes#jcite), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section [**318**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTNEMTg_amNzZWFyY2g9SVJDJTI1MjAyMDM2Il1d--17ea985818376bc84a6dd65da690dd5745e1f61e/document/1?citation=26%20USC%20318&amp;summary=yes#jcite)), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.”
    - When is § 2036 triggered:
      * 1) D must have retained the right to vote, directly or indirectly;
      * 2) the corporation must be controlled, as defined in § 2036(b)(2).
    - What is a controlled corporation:
      * The right to vote 20% of the shares; or
      * Ownership of 20% of the total shares.
    - § 318 Attribution Rules:
      * § 318 does not apply to determine the right to vote.
      * § 318 only applies in determination of the ownership of the shares.
      * § 318:
        + a person is deemed to own stock owned by family members – spouse, children, parents.
        + Stock owned by a trust is deemed to be owned by its beneficiaries.
    - How to avoid § 2036(b):
      * Name the spouse as trustee.
      * The corporation could recapitalize and issue nonvoting shares.
    - Application to partnerships:
      * The statute only mentions corporations; so this doesn’t affect partnerships.
  + Adequate and Full Consideration:
    - If the transfer in question was made for adequate and full consideration, none of §§ 2035, 2036, 2037, or § 2038 will apply.
    - The sale of a life estate will not be respected as having been for AFC, and will result in inclusion under  §2035. *Allen* case.
      * The court held that the sale must be the full value of the property that *would have been included* in the estate udner § 2036.
    - The sale of a remainder interest: *D’Ambrosio* will not result in inclusion under § 2035. The sale a remainder, unlike a life estate, does not lend itself to tax avoidance.
      * If the parties have knowledge that the transferor is on her way out, the sale is not likely to be respected.
    - This distinction is lessened if the parties are related under § 2072.

**V. Annuities, Retirements Plans & Insurance:**

* Annuities and Retirement Plans – §2039:
  + § 2039(a): The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.
  + § 2039(b): **Amount Includible** — Subsection [**(a)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTNBMTg_amNzZWFyY2g9SVJDJTI1MjAyMDM5Il1d--96f1c6a5fc75d2aabdc27e719dc36a8bb131f5b3/document/1?citation=26%20USC%202039(a)&amp;summary=yes#jcite) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus or profit sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment.
  + 4 Requirements:
    - 1) There must be an annuity or other payment payable to a beneficiary by virtue of surviving the decedent;
    - 2) the amount is payable pursuant to any form of contract or agreement;
    - 3) prior to death the decedent was receiving payments, or had the right to receive payments (either alone or in conjunction with another) under the contract or agreement; and
    - 4) the payments to decedent were payable for the decedent’s life, or for any period not ascertainable without reference to his death, or for any period that does not in fact end before his death.
  + If § 2039 applies, then the value of the amount payable to the beneficiary will be included in the decedent’s estate, to the extent that the decedent contributed to the purchase of the agreement.
    - Contributions by a decedent’s employer are treated as though made by the decedent.
  + Income tax consequences:
    - The decedent would pay income taxes on any amounts received from the annuity/retirement plan prior to his death.
    - § 691: IRD
      * The balance that is paid out to the estate/beneficiary, would be subject to income tax.
  + Basis:
    - § 1014(b)(9)(A): the beneficiary does not receive a stepped-up basis in the annuity.
    - § 104(e): 691 is not entitled to a stepped-up basis.
* Life Insurance:
  + Types of Life Insurance:
    - Term: most basic
      * Betting you die within a certain number of years.
        + If so, it pays out.
      * What happens if A gifts the policy during the term of the policy:
        + § 25.2512-6(a), Ex. 3: You determine the value of the gift by how much of the premium has been benefited by A:

Ex: 5K premium; gift on June 30; 2.5K of the premium has been benefited, so 2.5K gift.

Ex: Gift on Sep. 30; ¾ of the premium has been benefited, so gift of $3,750.

* + - Whole/Ordinary Life:
      * For the entire life; pay premiums.
      * Premiums are larger in the beginning and may decrease towards the end of the term (later in life).
      * There is a savings element – you can cancel your policy and get the savings element.
        + Premium is split between earnings and savings.
      * How to value gift:
        + § 25.2512-6(a), ex. 4: The sum of the interpolated internal reserve (savings element) + a pro rata portion of the current premium.
  + When is life insurance included in the estate:
    - § 2042 will include the life insurance policy in the estate if:
      * 1) it is payable to the decedent’s estate;
      * 2) it is payable to another beneficiary if decedent died owning “incidents of ownership”
        + The right to change the beneficiary, surrender or cancel the policy, assign the policy, to pledge the policy as security, or to borrow against it.
        + § 20.2042-1(c)(2).
      * 3) it is payable to another beneficiary if decedent relinquished an incident of ownership within 3 years of her death -- § 2035.
    - Holding Life Insurance Policies in trust:
      * If the decedent was the trustee of the trust that owns the life insurance policy, this would be enough to have incidents of ownership – inclusion in decedent’s estate under § 2042.
      * Premiums Paid:
        + The premiums paid on the policy would be a gift of a future interest.
        + To make the premiums qualify for the annual exclusion, give the beneficiaries *Crummey* Powers over the premiums.
      * Make sure that the trust purchases the policy; don’t purchase the policy and then transfer to the trust. Would cause a relinquishment of incidents of ownership and inclusion under § 2035.
      * Make sure that someone other than the insured life serves as trustee.
    - RR 84-179: D had a policy on his own life; transferred to trust for benefit of wife and kids; 20 years later wife dies; he becomes the trustee of that trust created by his wife and the policy is one of the assets of the trust. Service held that it was not included in D’s estate because:
      * He really got rid of all incidents of ownership.
    - Ownership of a life insurance policy on someone else’s life:
      * If the owner predeceases the person whose life is being measured, the policy would be included in the owner’s estate under § 2033.
    - When Controlled Corporation purchases life insurance on controlling shareholder:
      * To the extent that the proceeds are payable to the corporation or for the corporation’s benefit, the incidents of ownership will not be attributable to the shareholder.
      * If the proceeds are paid to a 3rd party and not the corporation’s benefit (e.g., shareholder’s children), it will result in inclusion of the proceeds under § 2042.

**VI. Powers of Appointment [Important]:**

* Power of Appointment Terminology:
  + Donor: creator of the power
  + Donee: holder of the power
  + Appointee: person in whose favor the power is exercised
  + Appointive Property: property subject to the power
  + Testamentary Powers: exercisable by will
  + Presently Exercisable (inter vivos): currently exercisable
* § 2041(a)(2): to the extent of any property with respect to which D has at death a ***General Power*** of appointment, or with respect to which D has exercised or released a ***General Power*** such that §§ 2035–2038 would apply, will be included in the gross estate.
  + This means that if it is a special power of appointment, it is not included in the gross estate.
* What is a General Power of Appointment:
  + The power is exercisable in favor of the *Fatal Four*:
    - The decedent,
    - The decedent’s estate,
    - The decedent’s creditors, or
    - The creditors of the decedent’s estate.
  + Exceptions:
    - When the power is subject to an ascertainable standard;
    - Jointly held powers
  + Ascertainable Standard:
  + Jointly Held Powers:
    - § 2041(b)(1)C)(i): If the power can only be exercised in conjunction with the Grantor, it is not a GPA.
      * If the grantor dies and the donee’s power would otherwise be a GPA, it would result in inclusion if the donee died holding the power.
    - § 2041(b)(1)(C)(ii): if the power can only be exercised in conjunction with someone who holds an adverse interest, it is not a GPA.
      * If the co-holder of the power blocks the exercise, will the co-holder benefit (economic benefit) from that?
        + If yes, adverse interest.

If the co-holder is the remainder beneficiary

* + - * + If no, not an adverse interest.

Could block it or let it go through and would end up with nothing either way.

* + - * If the co-holder dies, it would become a GPA and would be included.
    - If jointly held power, but still GPA, how much is included in estate:
      * § 2041(b)(1)(C)(iii): the power is deemed to be a GPA only in respect to the fractional share subject to the power – the value of property / # of persons (including decedent) in favor of whom such power is exercisable.
        + 2 people hold the power; ½ would be included in the estate.
    - Both individual and fiduciary powers can give rise to a GPA.
* General Power Held at Death:
  + If GPA held at time of death, it is included in the decedent’s estate.
* Exercise, Release, or Lapse of the Power:
  + Exercise & Release:
    - Gift Tax Consequences:
      * If the decedent exercised or released the GPA during his lifetime, then the Code treats it as a transfer of property - § 2514(b).
  + Lapse:
    - If the decedent let a power lapse, it is treated as a release - § 2514(e).
      * The decedent is deemed to have transferred the lapsed amount to the trust, with the same terms.
    - 5 & 5 Rule:
      * § 2514(e): a GPA is treated as lapsing only to the extent that it exceeds the greater of $5,000 or 5% of the value of the assets of which the exercise would be satisfied from.
    - The Total Amount the decedent is able to appoint is reduced by the 5 & 5 amount; the balance is treated as transferred to the trust.
    - Amount Included in estate:
      * (Amt. of deemed transfer to trust) / (Value of trust at time of transfer) = percentage of trust included in estate.
        + If there were multiple years, add up the percentages, and that is the percentage of the trust included in the decedent’s estate.
      * The GPA held at the death is determined separately.
* Estate Planning Tip:
  + To provide for the closest to complete ownership of property:
    - 1) give a life estate in the trust;
    - 2) Trustee:
      * Make sure to avoid giving a GPA if the paramour is the trustee;
        + Or limit to an ascertainable standard
      * If paramour is not the trustee, give trustee ability to invade principal in trustee’s own discretion for benefit of paramour.
    - 3) Give paramour power to withdraw principal in a limited time period and subject to the 5 & 5 Rule;
    - 4) Give a specific power of appointment – power to designate but carve out the fatal 4.

**VII. Deductions – §§ 2053, 2055 & 2056:**

* Expenses, Indebtedness, & Taxes – § 2053:
  + § 2053 allows a deduction for funeral expenses, the costs of administering the estate ,and the debts of the decedent (mortgages and “claims against the estate”), so that the taxable estate reflects the actual wealth transferred.
    - Funeral Expenses – § 2053(a)(1): § 20.2053-2: provides for a reasonable expenditure for a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family.
    - Administration Expenses – § 2053(a)(2) & (b): allows a deduction for expenses incurred by the estate during the probate process – legal fees, accounting fees, brokerage fees, property management fees, personal representative’s fees – and also for similar fees incurred for the administration of a trust.
      * The expenses must be for the benefit of the estate, not the beneficiaries.
      * § 20.2053-3(a)(1): if the administration of the estate is extended for a prolonged period of time, the expenses related to preserving the estate’s assets may not be deductible under § 2053.
    - Claims Against the Estate – § 2053(a)(3): the extent estate assets are being used to satisfy debts owed by the decedent at death, they should and do reduce the gross estate under § 2053(a).
      * A claim against the estate is a personal obligation of the decedent existing at the time of death.
        + This includes amounts owed by the decedent on personal loans, credit cards, and rent or mortgage payments due as of the date of the death. Also tort and contract obligations.
        + § 2053(b): allows for a deduction for expenses that would otherwise be deductible under (a), but there is no claim – e.g., trustee’s commissions.

§ 20.2053-8(a).

* + - * Limitation – § 2053(c)
        + § 20.2053-1(b)(2) Bona Fide Requirement:
        + Must be bona fide in nature – i.e., bequests cloaked as claims are not deductible.

Ex: promissory note to housekeeper shortly before death. Looks like a disguised bequest, not a bona fide claim.

* + - Encumbered Property:
      * Nonrecourse Mortgages: The net value of the property is included in the estate – FMV less the mortgage.
      * Recourse Mortgage: the full FMV of the property is included in the estate and a deduction is allowed for the amount of the mortgage.
* Transfers to Charity – §§ 2055 & 2522:
  + § 2055 allows a deduction for all bequests, legacies, devises, or transfers to a qualified organization. This deduction is unlimited.
    - Policy Reason: if a principal reason of the estate tax is to break up dynastic estates, the deduction is reasonable. But family foundations raise particular concerns in this area.
    - If it is an outright gift, the entire gift is deductible.
    - If it is a split interest gift:
      * Charitable Lead trust: the PV of the
  + § 2522: allows for a gift to qualified organization, like § 2055, but for gift tax.
  + § 2055(a) describes qualified organizations.
  + § 2055(b) provides that if a holder of a power of appointment appoints property to a qualified organization, that is treated as a charitable bequest.
  + Split Interests – § 2055(e)(2):
    - Charitable Lead Trusts must:
      * Have a guaranteed annuity; or
      * A fixed percentage distributed each year; and
      * No percentage restrictions.
    - Charitable Remainder Annuity Trust (CRAT) – § 664(d)(1):
      * Must give an annuity of a sum certain over the life of the person holding the life estate or for a term of years.
        + Value of the annual payment cannot exceed 50% of the initial corpus and must be at least 5% of the initial corpus.
      * No other non-charitable distributions can be made from the trust – annuity to individual only.
        + This means no principal distribution to the annuity holder – even an ascertainable standard.
      * At termination of the annuity, the corpus must be distributed to the charity or set aside for the charity’s exclusive benefit.
      * The value of the remainder must equal at least 10% of the initial value of the corpus.
    - Charitable Remainder Unitrust (CRUT) – § 664(d)(2):
      * Same as a CRAT, except that the annuity is fixed percentage of the trust’s assets rather than a sum certain.
    - Pooled Income Fund – § 642(c)(5):
      * Charity sets up the income fund and donors transfer assets and retain an income interest with remainder to the charity.
      * Allowed a deduction for the value of the remainder.
      * The charity runs the fund and controls the investments.
      * These are quite popular with universities.
      * A deduction will be allowed for a gift to a pooled income fund.
      * Congress is comfortable because the charity is the trustee and controls the investments – less concern that the remainder interest will be undercut.
    - Exception for Personal Residence or Farm:
      * § 2055(e)(2): provides an exception for split interests in personal residences or farms.
      * For a personal residence because it is not possible to manipulate the income interest in the property, the estate is permitted a deduction for the charity’s remainder interest.
* The Marital Deduction – §§ 2523, 2056:
  + The Marital Deduction was enacted to cure the disparity between community property states and common law property states.
  + § 2056(a): allows a deduction for the value of all property that passes to the decedent’s spouse, but only to the extent that the property is included in the spouse’s gross estate (or consumed).
    - Spouse includes same-sex spouse now.
  + Passing Requirement:
    - § 2056(a) only allows for a deduction for property that passes to a surviving spouse.
      * § 2056(c): defines“ passing:
        + would include property that passes under the laws of intestacy to the surviving spouse;
        + Bequest or devise to surviving spouse;
        + Dower or curtsey of surviving spouse;
        + Lifetime gifts from decedent to surviving spouse;
        + Joint property owned by decedent and surviving spouse;
        + Life insurance proceeds from a policy on the life of the decedent.
        + Property that the decedent appointed through a power of appointment to the surviving spouse during life or through a testamentary power.
      * If a would-be donee disclaims a gift that then passes to the surviving spouse, it is treated as passing to the surviving spouse.
        + Must be a qualified disclaimer.
  + Limitation on Terminable Interests:
    - If a gift to the spouse is of the decedent’s entire interest in the property and the interest expires at some date certain – e.g., patent – it is not a terminable interest. Analogous to being consumed.
    - A terminable interest would be granting a life estate to the spouse, remainder to the children.
      * The rule applies when the decedent splits the property into 2 or more interests, giving one to the spouse and the other to a non-spouse.
      * If the interest going to the surviving spouse will terminate upon some event, and at that point, the property will go to the non-spouse, then that is a terminable interest.
      * These limitations are designed to ensure that the tax on the amounts quality for the deduction is delayed, not forgiven.
      * If the bequest instructs an executor/trustee to purchase an annuity for the surviving spouse, it is considered a terminable interest (trap for the unwary).
    - Survivorship requirements:
      * § 2056(b)(3): allows a survivorship requirement of up to 6 months.
        + Any longer and the transfer will not be eligible for the marital deduction.
    - Watch out for a transfer in trust with income to spouse for life, remainder to spouse’s estate.
      * The spouse and the spouse’s estate are considered the same person. This alone would qualify for the marital deduction because it would be included in the spouse’s estate.
      * However, if there is a discretionary distribution to the spouse, it would essentially be a gift to the spouse’s estate and an attempt to circumvent the estate tax. This would not qualify for the marital deduction.
  + Exceptions to the Terminable Interest Rule:
    - General Power of Appointment Trusts (GPA Trusts) – § 2056(b)(5):
      * Common prior to the unlimited marital deduction; not common today.
        + A deduction is allowed for a transfer in trust so long as the surviving spouse is entitled to *all* of the income from the property for life (payable at least annually) and has a GPA over the property.

No other person can have a power to appoint property to anyone other than the surviving spouse.

A power to invade principal for the benefit of the surviving spouse is ok.

* + - QTIP Trust – § 2056(b)(7):
      * The marital deduction is allowed for property that is transferred in trust, so long as the requirements for a QTIP trust are satisfied.
      * Requirements:
        + Surviving spouse must have a qualify income interest in the property for life;

Qualifying income interest:

Must be paid all of the income at least annually;

No person has the power to appoint the property to anyone other than the spouse during the spouse’s lifetime.

* + - * + The executory of the deceased spouse must make the election for § 2056(b)(7) to apply.
      * What happens if the surviving spouse gifts all of or a portion of the life estate?
        + There is a gift:

The portion of the life estate given up and

deemed gift of the entire remainder of the trust.

* + - * + None of the trust would be included in her estate.
  + Portability: the unused portion of the surviving spouse’s unified credit can be used by the surviving spouse in the lesser of the 2 amounts:
    - The current basic exclusion or
    - The unused portion of the decedent’s exemption.
  + Disclaimer Trusts:
    - If a couple have a large estate, it may be beneficial for the surviving spouse to disclaim an amount equal to the maximum exclusion so that the maximum amount can be used – especially when there is a strong likelihood the exclusion will be decreased in the somewhat near future.
      * This would prevent the possibility of utilizing portability with a smaller exclusion.
    - The remaining portion of the estate can pass tax free to the surviving spouse, so long as it qualifies for the marital deduction.
  + Spousal Lifetime Access Trusts (SLAT):
    - You intentionally make a transfer that does not qualify for the marital deduction.
      * You would have a completed taxable gift.
        + You could fully utilize the basic exclusion amount (10M adjusted for inflation).
      * Purpose:
        + The annual exclusion is likely to drop in at some point in the relatively near future.
        + § 20.2010-1(c) states that if the exclusion amount at death is lower than the exclusion amount on the date of the gift, then the exclusion amount applicable on the date of gift is the applicable exclusion amount – grandfathers these gifts in.
    - So, after the gift, there is no estate tax paid on the gift and this $10M+ passes tax free, with the potential to grow.
    - There is an exemption from the GST which is identical to the estate tax exclusion, and this plan could be used to take advantage of that and make the gift to grandchildren or future generations.

**VIII. Advanced Gift Tax Issues:**

a. Annual Exclusion Gifts in Trust:

* The annual exclusion is only available for gifts of present interests.
* When there is a gift to a trust, look at the interests:
  + The Income interest: If it is a present interest, you must value this interest to determine the amount eligible for the annual exclusion.
    - Take the § 7520 rate and go to § 2031-7(d)(7) to find the remainder factor.
      * 1 – Remainder factor = income interest factor.
    - Multiply this by the gift and that is the value of the income interest.
    - If the trustee has discretion to accumulate income, this would render the gift not a present interest – Reg. § 25.2503-3(c), ex. 1
    - If the trustee has discretion to divide income between beneficiaries, it is not a present interest because there is no requirement to distribute income to them – Reg. § 25.2503-3(c), ex. 3
    - The right to demand principal creates a present interest – essentially a GPA. What portion of the gift will constitute the present interest?
      * The portion she can demand – so up to the full amount of the gift.
      * A testamentary GPA will not create a present interest though.
  + The remainder interest is not a present interest; not eligible for annual exclusion.
* Gifts in trust to Minors:
  + § 2503(c): a gift to minor that complies with this section will be eligible for the annual exclusion:
    - Requirements:
      * Property & income may be expended to donee – must be available to the donee;
        + Must have both principal and income available to the donee.
      * The balance must pass to donee when he reaches 21, or to the donee’s estate should he die before he reaches 21.
    - The trustee can have some discretion, but the money must be available for the donee when he needs it. Trustee’s discretion cannot be subject to substantial restrictions.
      * “as the trustee deems appropriate” is fine.
      * “for education” is likely too restrictive.
        + *Herr*: would allow you to view it as 2 separate gifts – an income interest and a remainder; give the donor the annual exclusion for the income interest, but not the remainder.
    - Watch out for terms that accumulate income and don’t make it available for the donee’s benefit between the gift and reaching 21.
    - The trustee is in control of the property.
  + Uniform Gifts to Minors Act:
    - As long as in compliance with AGMA act, it will be a present interest.
  + Make sure that the donor is not the trustee – it would be pulled back into the trustee’s estate because of the amount of control.
  + Continuation of Trust past 21:
    - The trust can allow a brief time for the beneficiary to terminate the trust, and if the beneficiary does not elect to terminate, the trust can continue – RR 74-43.
      * Subsequent contributions wouldn’t qualify under § 2503(c), but if there are *Crummey* Powers, there might be a present interest to still qualify under § 2503.
        + The presence of the *Crummey* Powers could cause inclusion in the beneficiary’s estate if it is not protected by the 5 & 5 Rule.
* § 2503(e):
  + If tuition or medical bills are paid directly to the provider, it is not treated as a gift.
    - If the donor reimburses the beneficiary or his parents, it would not be excluded as a gift.
* *Crummey* Powers:
  + The *Crummey* powers create a present interest in a trust for a beneficiary which allows the gift in trust to qualify for the annual exclusion.
    - The name is derived from the case *Crummey v. Comm.*.
  + Who are *Crummey* Powers applicable to:
    - *Cristofani*: contingent beneficiaries can have Crummey powers and qualify for the annual exclusion.
    - Kohlsaat: contingent remaindermen’s Cummey powers were valid.
    - You should be careful how far you push this – the Board of Directors example from class – the director won’t risk his/her seat for 15K; no real likelihood of exercise.
  + The trustee must give notice to the beneficiary when there is a contribution subject to withdrawal is made and allow a reasonable time for exercise.
    - Similar windows to GPAs.

b. Gift Tax Valuation: Split Gifts:

* § 2702: was aimed at Grantor Retained Income Trusts (GRIT).
  + Requirements for § 2702 to apply:
    - 1) there must be a transfer in trust to a family member (as defined in § 2702(e); and
    - 2) the Grantor or applicable family member (as defined in § 2701(e)(2)) simultaneously retains an interest in the trust.
      * 25.2702-2(a)(4): An interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. So, a power of the income interest would be a retained interest.
      * Reg. § 25.2702-2(a)(3): define retained to mean held by the person *both before and after* the transfer to the trust.
    - \*\*\* There must be a complete gift for § 2702 to apply – i.e., the Grantor has given up dominion & control.
  + Family Member – § 2702(e):
    - Directs us to § 2704(c)(2):
      * The grantor’s spouse;
      * any ancestor or lineal descendant of such grantor or such grantor’s spouse;
        + nieces/nephews not included here.
      * any brother or sister of the grantor; and
      * any spouse of any ancestor or lineal descendant of the grantor or any spouse of the grantor’s brother/sister.
  + Applicable Family Member – § 2701(e)(2):
    - The transferor’s spouse;
    - An ancestor of the transferor or the transferor’s spouse;
    - The spouse of any such ancestor.
  + If § 2702 applies, the value of the Grantor’s retained interest is 0; the grantor is treated as making a gift of the full value of the property, even though § 7502 & § 20.2031-7(d) table would value the two (or more) interests separately.
  + Consideration paid:
    - The value of the gift will be the full value of the property less the amount of consideration paid.
  + Joint Purchases of Property:
    - § 2702(c)(2): joint purchases where the property is split temporally:
      * Grantor would be deemed to have acquired the property in its entirety;
      * Then to have sold the interest for the consideration contributed by the beneficiary;
      * Grantor is treated as having gifted the full value of the property less the consideration paid by the beneficiary.
  + Retention of Qualified Interests:
    - § 2702(a)(2)(B): The value of any retained interest which is a qualified interest shall be determined under section [**7520**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvMjYyOTE1MzQ4ODgiXV0--1cdd4fa7174195f9d88db0ab8806b563a699df5d/document/1?citation=26%20USC%207520&amp;summary=yes#jcite).
    - Qualified Interest – § 2702(b):
      * any interest which consists of the right to receive fixed amounts payable not less frequently than annually,
      * any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and
      * any noncontingent remainder interest if all of the other interests in the trust consist of interests described in the paragraphs above.
    - Zeroed Out GRAT:
      * Grantor transfers an amount to the trust; receives an annuity (typically 2 years) based upon the AFR (§ 7520 Rate X 1.2).
        + The payments are designed to payback the entire value of the gift contributed.
      * The interest would be a qualified interest under § 2702.
      * If there was appreciation of the trust’s assets, then the appreciated value would pass to the beneficiaries tax free.
        + Expecting the appreciation to outpace the AFR rate, which is usually possible in a short time, like 2 years.
        + This is the *Walton* case.
    - Exception for Personal Residence – not tested over this.
      * PRTs & QPRTs.
  + § 25.2702-6(a & b) reduce taxable gifts by the lesser of:
    - Overvaluation caused by § 2702; or
    - Current gift

c. Disclaimers – § 2518:

* If an individual makes a qualified disclaimer of a transfer of property interest, then for the purposes of the transfer taxes, the interest is treated as if it were never transferred to that person.
* Requirements for a Qualified Disclaimer – 2518(b):
  + 1) the disclaimer must be made in writing (formalities);
  + 2) it must be received no more than 9 months after the later of (timing):
    - (i) the date of the transfer; or
    - (ii) the disclaimant’s 21st birthday.
  + 3) the disclaimant must not have accepted the interest or any of its benefits (unequivocal); and
  + 4) the disclaimed interest must pass without any direction of the disclaimant to a person other than the disclaimant or the spouse of the decedent (passage).
* Timing of Disclaimers – § 25.2518-2(c)(3):
  + *Intervivos Gifts*: the 9-month period begins on the date the transfer is a completed gift for gift tax purposes.
  + *Testamentary Transfers*: the 9-month period begins on the date of death.
  + *Powers of Appointment*:
    - GPA: if passed to transferee by reason of the exercise or release of a GPA, the 9-month period stats on the date the power is exercised or released.
    - Special Power of Appointment: any person who may benefit from the Special Power of Appointment must disclaim within 9 months of the power being created.
  + *Remainder Interest*: must disclaim within 9 months of the transfer that originally created the remainder interest.
  + *Residuary Beneficiaries*: 9-month window begins on the date of the decedent’s death.
  + *Joint Tenancy Property*:
    - Entire Interest: must disclaim the interest within 9-months of the original transfer of property creating the JT.
    - ½ Interest: must disclaim within 9 months of the date of death of the co-tenant.
  + Minority: the 9-month window does not begin to run until the beneficiary reaches the age of 21.
    - There are no other legal disabilities that toll the clock.
    - Not even lack of notice.
    - § 25.2518-2(d)(3): Any actions taken with regard to an interest in property by a beneficiary or a custodian prior to the beneficiary's twenty-first birthday will not be an acceptance by the beneficiary of the interest.
      * If the B used part of the property while in his minority, can still make a valid disclaimer when he turns 21.
* Types of interests that can be disclaimed:
  + An undivided portion - § 2518(c)(1);
    - You cannot divide the property temporally.
    - You cannot retain an income interest and disclaim the remainder (or vice versa).
  + A power is treated as an interest – § 2518(c)(2);
    - You are not able to disclaim who you are able to appoint property to – e.g., disclaiming a GPA to make it a SPA.
  + Each interest is treated separately – 25.2518-3(a);
    - Acceptance of one interest does not preclude the disclaimer of another – 25.2518-2(d).
* Special Situation for Surviving Spouses:
  + Even though. The surviving spouse will be a beneficiary if she disclaims, it will not invalidate her disclaimer.
  + A surviving spouse would want to disclaim the unified credit amount and take the rest as the marital deduction. This is so that the unified credit will be used while it is higher rather than use portability and risk the unified credit decreasing.
    - The spouse would have access, so is not giving up much. If she doesn’t need it, why subject it to the estate tax.

**IX. Valuation Issues:**

a. General Valuation Issues:

* Reg. § 20.2031-1(b): the value of every item in the decedent’s gross estate is the FMV at the time of the decedent’s death, unless the decedent elects for the alternate valuation method under § 2032.
  + FMV = the price at which a willing buyer and a willing seller would exchange the property both having knowledge of the reasonable facts – Reg. § 20.2031-1(b).
    - Personal sentiments are not taken into account.
    - The personal profile of the decedent and heir – i.e., their situation in life – is not taken into account.
    - We want to measure the value of the property in isolation.
  + Life Insurance:
    - Reg. § 20.2031-8(a)(1 & 2): Valuation of life insurance policies and annuities.
      * As a general proposition, you don’t take into account the health of the person when valuing life insurance.
      * You would value it based on the cash value / interpolated terminal reserve.
* Methods of Valuation:
  + Historical cost:
    - If the property was acquired close in time to the valuation in an arm’s length transaction, the price paid will be the starting point for determining its value.
      * Useful if the asset was purchased relatively recently.
      * Ex. Decedent purchased a car a month before death.
  + Comparable Sales:
    - Look for the actual sales of similar property within a short period of time before and/or after the valuation date.
      * Look at what similar property sold for.
      * Good for jewelry; publicly traded securities – Reg. § 20.2031-2(e)(1); real estate.
  + Capitalization of Income:
    - The underlying assumption is that the FMV of any business or investment asset is the present value of its expected income stream.
      * To estimate future earnings, the starting point is past earnings records. A lot of judgment calls must be made.
      * Discounting the expected cashflows into the present value.
        + Must choose a discount rate
      * If you have a stable income/cash flow, you can get an accurate value for the property.
      * Used commonly for commercial real estate; non-publicly traded business interests.

b. Alternative Valuation Date – § 2032:

* Unless the estate elects the alternate valuation date, the valuation must be made as of the date of the decedent’s death.
* If the estate elects the alternate valuation date, the valuation date is 6 months after the death of the decedent.
* § 2032 Requirements:
  + 1) the election must reduce the size of the gross estate; and
  + 2) the election must reduce the amount of taxes due.
  + The valuation date will be 6 months after the death or on the date the estate disposes of the property within that 6-month period.
* Situation where you can reduce the size of the estate but not the taxes owed:
  + If you are under the Unified Credit amount, you would have a decrease in value but your estate taxes due would not change – still 0.

c. Valuation of Business Entities:

* Discounts available to Business Valuation:
  + Blockage Discount – 20.2031-2(e):
    - In a situation where a person dies with a huge amount of property, a dump on the market would decrease the value.
      * It can apply to publicly traded stock.
      * When the founding person of a company dies.
      * *Maytag* case.
    - Theory:
      * Because you are flooding the supply and the demand will likely stay the same.
      * Has been utilized with not only business, but other assets:
      * Art of a particular artist,
      * Owner of a gallery dies and the gallery specializes in a particular type of art, the same theory would work. Putting the same type of art out in the market would discount the price. – *Janis*
  + Lack of Marketability:
    - Allow a discount for what would otherwise be the value just because of the fact that it will be difficult to unload.
    - Distinct from minority interest
    - No market for such interest, therefore, cannot be readily liquidated.
    - Can be applied to a controlling interest in a small closely-held business.
  + Control Premium:
    - The value of the control would be more valuable than just the number of shares that would put you over the threshold of 50%.
  + Minority Discount:
    - When you have a situation where someone else, or a closely related group, owns the majority of the shares, you are at a disadvantage and don’t have much control.
    - You can discount the shares by 40%, and that would not be considered too aggressive.
      * Mirror image of the control premium.
      * Theory:
        + You cannot directly manage the business;
        + No ability to control distributions;
        + No ability to influence management and therefore the performance of the business;
        + No assurance of employment.
  + Relation to the transfer taxes:
    - RR 93-12: The issue was how do you value each block of stock transferred. The Service held that you look at what each person is getting, not what is being given in the whole. Able to get a minority discount and marketability discount together – blessed by the Service.
      * Facts: Mom owns 100% of business; decides to split it up and give a block of 20% to each kid.
        + She created 5 minority interest and drastically decreased the value of the shares transferred.
      * This destruction of value has been blessed by the service.
      * Value each gift independent of:
        + 1) the amount owned by the transferor; and
        + 2) independent of the profile of the transferees.
    - What if it is passed through an estate:
      * The asset is valued the decedent’s whole interest.
        + So it could potentially have a control premium.
      * There is a different result if it is passed through a will rather than inter vivos.
        + *Death bed transfers:*

*Estate of* Wright would seem to bless the transfer of a minority interest in an inter vivos gift and then passed a minority interest through will.

2 days after the transfer, transferor died. Entitled to a minority discount.

*Elsie Church*: transferor was deathly ill; transferred her interest in the ranch into a FLP, as well of other assets; took a minority interest; died a few days later. Estate was valued at less than 50% of what it had been had she held assets outright.

* + - Creation of minority discounts by contributing assets to family-controlled entities (LFP or LLC) and what ends up being valued is a minority interest.
  + Relation to QTIP trusts:
    - If two spouses both own shares of stock and one dies leaving his shares in a QTIP trust, when the surviving spouse dies, the two blocks of shares are valued separately – which provides the opportunity for there to be a minority discount.
      * *Estate of Mellinger*.
  + Relation to GPAs:
    - However, if the facts above were changed and the shares were left in a trust where the surviving spouse held a GPA, the shares would be valued as a single block.
  + Zeroed Out GRAT:
    - You can utilize a zeroed out GRAT with a transfer of FLP interests to the GRAT.
    - This would allow the appreciation to pass tax free to the beneficiaries.
    - You can transfer a minority interest to the GRAT.
      * This would allow them to be eligible for the marketability and minority discounts – roughly 40%.
      * By zeroing out the GRAT, there is no taxable gift.
        + Use the AFR to determine the annuity amount.
      * If the trustee is able to beat the market (which is likely because of the low AFR rates), the appreciated amount will pass tax free.
  + SLATs:
    - 1 spouse sets up a trust for the other spouse that intentionally does not qualify as a QTIP trust. This allows the spouse to utilize his unified credit at the current high amount.
      * Creating a trust that your spouse is able to benefit from, if needed.
        + Usually, you don’t want her to need it, but it is written so that can get access to principal or income.
      * Trustee can invade principal & may dist. or accumulate income.
    - If the grantor retains the right to acquire the corpus of the trust by substituting property of equal value, this would render it a grantor trust.
      * § 675(4)(C): Grantor would pay income tax on the trust’s income.
        + The payments of the taxes are not treated as a gift.
        + Essentially allows the trust to grow tax free.
    - Also, this gift will grow – possibly at a substantial rate – so the transfer to the children and grandchildren could be substantially more than the original contribution (of the unified credit).
    - Should the other spouse set up a similar trust for the first spouse?
      * Possibly appropriate; but watch out for the reciprocal trust doctrine.
      * Or just set up for the kids.
  + IDGTs & Installment Sales:
    - Trust:
      * Grantor creates a FLP.
      * Grantor then funds a trust with securities of a certain amount.
        + This would be a completed gift of that amount.
      * Grantor reserves the right to reacquire the assets – to ensure it is a grantor trust.
    - Installment Sale:
      * Grantor will sell a percent of the FLP to the trust at its discounted value.
      * The trust will give in return a note bearing interest at the AFR rate; payable in a term.
      * Because of the nature of the installment sale, the interest income is reported as received and the gain is reported as each payment is received – § 453.
    - Year of sale:
      * FLP will pay the trust share of income to the trust;
      * Trust is required to pay interest on the note to the grantor.
      * The income tax consequences:
        + Interest income received: no income because it is a grantor trust paying to grantor.

No consequences to grantor or trust.

* + - * + Trust FLP income:

Grantor pays tax on this.

* + - These same results continue for the remaining term of the note.
    - Then the trust will repay the note to the Grantor.
* Policy Justifications for Reform:
  + Could go to an inheritance tax
  + Stay with Estate & Gift Tax:
    - Busines valuation discounts – especially when business created by grantor—must be addressed.
    - They seem to be commonplace – and to that extent there is a problem with the erosion of the tax base.
    - George Cooper called it voluntary in 1960 – it has become much more so today.
  + Cite to Alamo article written by Lara Cunningham.

**X. Generation Skipping Transfers:**

a. General Overview:

* Statutory Framework:
  + § 2601: imposes a tax on GSTs.
  + § 2602: tax is equal to:
    - Taxable amount X applicable rate = GST Tax.
  + § 2631(c): every individual gets an exemption from the GST.
    - The amount is the basic exclusion for that year.
    - There is a big difference between GST exclusion and the Unified Credit.
    - The GST exclusion is not portable; does not go to surviving spouse in any direct way.
  + § 2641(a): the maximum rate for estate tax – 40%
* What is the taxable amount of the transfer:

|  |  |  |  |
| --- | --- | --- | --- |
| **Type of GST** | **Taxable Amount** | **Liability** | **Tax Base** |
| Direct Skip: | Amount Rec’d - § 2623 | Transferor - § 2603 | Tax exclusive – tax comes out of taxable amt. |
| Taxable Termination: | Corpus - § 2622 | Trustee | Inclusive |
| Taxable Distribution: | Amount Rec’d - § 2621 | Distributee | Inclusive |

b. What is a Skip Person:

* Skip Persons are defined in § 2613:
  + (a)(1): natural person; that is a generation 2 or more below the transferor.
    - Look out for grandchildren
  + (a)(2): trust if:
    - (A) all interests in the trust are held by a skip person or persons;
      * Most common
    - (B) no one holds an interest in the trust, and no distribution can be made to a non-skip person.
    - § 2652(c) defines an interest in trust to be a current income beneficiary or a permissible current principal beneficiary – excludes future interest in the trust.
    - If there is a non-skip person who has a future interest, the trust will not be a skip person.
* Diagram

  Description automatically generated
  + The family tree is also extend to the spouse’s family – the exact same, just spouse’s family members.
    - So a child of the spouse is not a skip person, even if there was not a legal adoption.
  + If there was a legal adoption, the adopted child is considered 1 generation below the grantor.
  + § 2651(c)(2): spouses of all lineal descendants are assigned to the same generation as the lineal descendant.
* The Orphan’s Rule:
  + § 2651(e)(1): the orphan’s rule – If the transferee is a lineal descendant (first 2 columns) and the transferee’s parent is dead (parent must be a lineal descendant of the transferor), then the transferee is treated as being in his parent’s generation.
    - Must be in the first 2 columns for the orphan’s rule to apply.
      * The orphan’s rule would not apply to a son-in-law.
      * The orphan’s rule would not apply to first cousins, twice removed.
* Non-Lineal Descendants of the Grantor – § 2651(d):
  + General Rule: the non-lineal descendant is assigned a generation based on the age difference.
    - If within 12 ½ years of age, considered the same generation;
    - If between 12 ½ and 37 ½ years of age, it is considered 1 generation below;
    - If the difference is t is over 37 ½ years of age, then a new generation is deemed to occur every 25 years thereafter.
* Trusts as Skip Persons:
  + § 2613(a)(2): trust if:
    - (A) all interests in the trust are held by a skip person or persons;
      * Most common
    - (B) no one holds an interest in the trust, and no distribution can be made to a non-skip person.
    - § 2652(c) defines an interest in trust to be a *current* *income beneficiary* or a *permissible current principal beneficiary* – excludes future interest in the trust.
    - If there is a non-skip person who has a future interest, the trust will not be a skip person.
  + Application of Orphan’s rule with trusts:
    - The pertinent descendant must be dead before the transfer to the trust for the orphan’s rule to apply.
      * Ex: d. Income to GC for life, remainder to GC’s estate. C predeceased T.
        + C died before T died. T in its will created the trust.
        + So, GC holds a 2652 interest in the trust. Because of the orphan’s rule, GC is treated as being C’s generation, one below T, so therefore, GC is not a skip person. Therefore, the trust is not a skip person.
* Effect of QTIP Elections:
  + If there is no QTIP election:
    - If the pertinent descendant (child) survives the grantor buy predeceases the spouse, the orphan’s rule will not come into effect because the grantor is treated as the transferor.
  + If there is a QTIP election:
    - Because of the QTIP election, the property is included in the spouse’s estate under § 2044.
    - As a result, the spouse is treated as the transferor because the assets are flowing through her estate.
    - Now, the orphan’s rule could come into effect because the pertinent descendant was dead at the time of the transfer.
  + § 2653(a)(3): Reverse QTIP election:
    - The trust could elect to not have the spouse treated as the transferor for GST purposes.
      * The assets would still be taxed for estate tax purposes in her estate.
    - This would render the orphan’s rule ineffective.
    - Benefit of this: if the grantor died without utilizing his GST exemption.

c. What is a GST Event:

* § 2653(a): General Rule — For purposes of this chapter, if—
  + 2653(a)(1)  — there is a generation-skipping transfer of any property, and 2653(a)(2)  — immediately after such transfer such property is held in trust, for purposes of applying this chapter (other than section [2651](https://www.bloomberglaw.com/ms/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSE85SDg_amNzZWFyY2g9SVJDJTI1MjAyNjUzJTI1MjhhJTI1MjkiXV0--4cc2d01653bde3508fc8047b3d004432fdb300f5/document/1?citation=26%20USC%202651&amp;summary=yes#jcite)) to subsequent transfers from the portion of such trust attributable to such property, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer.
* Types of GST events – § 2612:
  + Direct Skip: a GP to a GC or GCC. The gift skips a generation. Can be made in trust or outright.
  + Taxable Termination: (possibly the most important) GP transfer property to trust; income to parent for life, remainder to child.
    - When the trust is created, there is no GST; might be subject to estate or gift tax though.
    - When parent dies, this is the taxable termination – Triggers GST.
  + Taxable Distribution: GP sets up trust income amount P, C and GC for life, remainder to C; because P is a B, not a GST event on creation of trust.
    - Before the taxable termination, the T dist. prop. To a skip person, in this case the dist. from the trust to the skip person (C or GC), will be treated as a GST event.