|  |
| --- |
|  |

**Estate and Gift Tax**

**Noël B. Cunningham**

***Problems & Answers***

**Nicholas R. Peterson, Esq.**

New York University School of Law

40 Washington Sq. South

New York, NY 10012

nick.peterson@nyu.edu

(404) 658-5439

Fall 2020

**Table of Contents**

[I. Unit I: Overview of the Transfer Taxes 1](#_Toc58156813)

[A. Part A: Policy Considerations in Taxing Wealth Transfers 1](#_Toc58156814)

[1. Readings 1](#_Toc58156815)

[2. Questions 1](#_Toc58156816)

[B. Part B: Interrelationship of the Transfer Taxes 2](#_Toc58156817)

[1. Readings 2](#_Toc58156818)

[2. Questions 2](#_Toc58156819)

[II. Unit II: Gift Tax Fundamentals 6](#_Toc58156820)

[A. Part A: Transfers Subject to the Tax 6](#_Toc58156821)

[1. Readings 6](#_Toc58156822)

[2. Questions 6](#_Toc58156823)

[B. Part B: The Concept of Completed Gift 9](#_Toc58156824)

[1. Readings 9](#_Toc58156825)

[2. Questions 9](#_Toc58156826)

[C. Part C: Introduction to Valuation 12](#_Toc58156827)

[1. Readings 12](#_Toc58156828)

[2. Questions 12](#_Toc58156829)

[D. Part D: Statutory Exclusions from Taxable Exclusions 14](#_Toc58156830)

[1. Readings 14](#_Toc58156831)

[2. Questions 14](#_Toc58156832)

[E. Part E: Introduction to Disclaimers 15](#_Toc58156833)

[1. Readings 15](#_Toc58156834)

[2. Questions 15](#_Toc58156835)

[III. Unit III: Property Owned at Death (§§ 2033, 2034 & 2040) 16](#_Toc58156836)

[A. Part A: The Starting Point in Determining the Gross Estate (§ 2033) 16](#_Toc58156837)

[1. Readings 16](#_Toc58156838)

[2. Questions 16](#_Toc58156839)

[B. Part B. Joint Interests in Property (§ 2040) 20](#_Toc58156840)

[1. Readings 20](#_Toc58156841)

[2. Questions 20](#_Toc58156842)

[IV. Unit IV: Transfers with Retained Interests (§§ 2036-2038) 22](#_Toc58156843)

[A. Part A: Retained Rights and Powers over Income and Principal (§ 2036) 22](#_Toc58156844)

[1. Readings 22](#_Toc58156845)

[2. Questions 22](#_Toc58156846)

[B. Part B. Retained Reversionary Interests 30](#_Toc58156847)

[1. Readings 30](#_Toc58156848)

[2. Questions 30](#_Toc58156849)

[C. Part C: Retention of Voting Rights in a Controlled Corporation 32](#_Toc58156850)

[1. Readings 32](#_Toc58156851)

[2. Questions 32](#_Toc58156852)

[D. Part D: “Adequate and Full Consideration” Transfers within Three Years of Death 33](#_Toc58156853)

[1. Readings 33](#_Toc58156854)

[2. Questions 34](#_Toc58156855)

[V. Unit V: Annuities & Life Insurance (§§ 2039 & 2042) 36](#_Toc58156856)

[A. Part A: Annuities Receivable by the Decedent (§ 2039) 36](#_Toc58156857)

[1. Readings 36](#_Toc58156858)

[2. Questions 36](#_Toc58156859)

[B. Part B: Life Insurance (§ 2042) 38](#_Toc58156860)

[1. Readings 38](#_Toc58156861)

[2. Questions 38](#_Toc58156862)

[VI. Unit VI: Powers of Appointment (§ 2041) 42](#_Toc58156863)

[A. Part A: Powers of Appointment and the Transfer Tax in General 42](#_Toc58156864)

[1. Readings 42](#_Toc58156865)

[2. Questions 42](#_Toc58156866)

[VII. Unit VII: Deductions (§§ 2053, 2055 & 2056) 50](#_Toc58156867)

[A. Part A: Expenses, Indebtedness & Taxes (§ 2053) 50](#_Toc58156868)

[1. Readings 50](#_Toc58156869)

[2. Questions 50](#_Toc58156870)

[B. Part B: Transfers to Charity (§ 2055) 51](#_Toc58156871)

[1. Readings 52](#_Toc58156872)

[2. Questions 52](#_Toc58156873)

[C. Part C: The Marital Deduction: (§ 2056) 54](#_Toc58156874)

[1. Readings 54](#_Toc58156875)

[2. Questions 54](#_Toc58156876)

[VIII. Unit VIII: Advanced Gift Tax Issues (§§ 2503, 2703 & 2518) 59](#_Toc58156877)

[A. Part A: Annual Exclusion Gifts in Trust 59](#_Toc58156878)

[1. Readings 59](#_Toc58156879)

[2. Questions 60](#_Toc58156880)

[B. Part B: Gift Tax Valuation 65](#_Toc58156881)

[1. Readings 65](#_Toc58156882)

[2. Questions 66](#_Toc58156883)

[C. Part C: Disclaimers 71](#_Toc58156884)

[1. Readings 71](#_Toc58156885)

[2. Questions 72](#_Toc58156886)

[IX. Unit IX: Valuation Issues 73](#_Toc58156887)

[A. Part A: General Valuation Issues 73](#_Toc58156888)

[1. Readings 73](#_Toc58156889)

[2. Questions 73](#_Toc58156890)

[B. Part B: The Alternate Valuation Date 74](#_Toc58156891)

[1. Readings 74](#_Toc58156892)

[2. Questions 74](#_Toc58156893)

[C. Part C: Valuation of Business Entities 75](#_Toc58156894)

[1. Readings 75](#_Toc58156895)

[2. Questions 75](#_Toc58156896)

[D. Part D: Intentionally Defective Grantor Trusts 77](#_Toc58156897)

[1. Readings 77](#_Toc58156898)

[2. Questions 77](#_Toc58156899)

[X. Unit X: The Tax on Generation-Skipping Transfers 78](#_Toc58156900)

[A. Part A: Introduction to Terminology: Who is a “Skip Person”? 78](#_Toc58156901)

[1. Readings 79](#_Toc58156902)

[2. Questions 79](#_Toc58156903)

[B. Part B: Taxable Events: What is a “GST”? 84](#_Toc58156904)

[1. Readings 84](#_Toc58156905)

[2. Questions 84](#_Toc58156906)

[C. Part C: The Taxable Amount 94](#_Toc58156907)

[1. Readings 94](#_Toc58156908)

[2. Questions 94](#_Toc58156909)

[D. Part D: The Applicable Rate 95](#_Toc58156910)

[1. Readings 95](#_Toc58156911)

[2. Questions 95](#_Toc58156912)

[E. Additional GST Problems 97](#_Toc58156913)

[XI. Sample Exam Question: 99](#_Toc58156914)

# Unit I: Overview of the Transfer Taxes

## Part A: Policy Considerations in Taxing Wealth Transfers

### Readings

* Class #1
* ~~Transfer Taxes: Revised Chapter One, Parts A & B~~
* ~~Add’l Materials:~~
  + ~~Joint Committee on Taxation, Description and Analysis of Alternative Wealth Transfer Tax Systems (Do not focus on the details of the various systems described. This is a good overview of the various approaches worldwide to wealth taxation)~~
  + ~~Huang & Frentz, Myths & Realities About the Estate Tax (Center on Budget & Policy Priorities)~~
  + ~~Lily Batchelder, Tax the Rich and Their Heirs (NYT)~~
  + ~~Michael Graetz, Estate Tax is Fair, and We Need the Revenue (WSJ)~~
  + ~~David Cay Johnston, Few Wealthy Farmers Owe Estate Taxes, Report Says (NYT)~~
  + ~~Nicholas Kristof, An Idiot’s Guide to Inequality (NYT)~~
  + ~~Robert Farley, Facts on Warren’s Wealth Tax Proposal (Fact Check)~~

### Questions

1. Consider whether the following statements are accurate:

a. The sole justification for the federal transfer taxes is the raising of revenue.

*Answer:* While the raising of revenue is a justification for the transfer taxes, it is not the sole justification. Other justifications include redistribution of wealth, multiple tax bases, charitable giving, and labor and savings.

b. Under current law, the estates of most decedents are required to file an estate tax return.

*Answer:* The transfer taxes affect a small number of people—typically the wealthiest 1 percent of decedents.

c. Estate taxation represents a double tax on income earned during life.

*Answer:* Because many large estates consist to a significant degree of unrealized capital gains, there is no double taxation on assets.

d. The estate tax has had a devastating effect on family-owned farms and businesses.

*Answer:* Only a handful of small, family farms and businesses owe any estate tax, and virtually none have to be liquidated to pay the tax.

e. The terms “estate tax” and “inheritance tax” are synonymous.

*Answer:* An “estate tax” imposes tax on the transferor, while an “inheritance tax” imposes tax on the recipient.

2. As a policy matter, Professor Lily Batchelder believes that it is very important to increase the tax on inherited wealth. What are her concerns?

*Answer:* Professor Lily Batchelder is concerned that a massive transfer of wealth is underway because baby boomers are dying. The transfer of wealth with further cement the economic inequality that plagues the United States. She sees increasing the taxation of inheritances as one vital component in addressing systematic inequalities.

3. There are many different ways to tax wealth. As the Joint Committee points out, one might impose a tax on the transfer of wealth under an estate tax, an inheritance tax, an income inclusion tax, or a tax on the deemed realization on gifts and bequests. In addition, Senator Elizabeth Warren has proposed an annual wealth tax on the very wealthy (i.e., on those owning more than $50 million in assets). Senator Warren’s proposal does not require a transfer. What are the advantages and/or disadvantages of each of these taxes? If we as a society determined that we want to tax wealth, would you favor retaining the estate tax or replacing it with one of these other alternatives? Why?

*Answer:* See Joint Committee on Taxation, Description and Analysis of Alternative Wealth Transfer Tax Systems.

## Part B: Interrelationship of the Transfer Taxes

### Readings

* Class #2
* ~~Transfer Taxes:~~ 
  + ~~Revised Chapter One, Parts C – E,~~
  + ~~Appendix: (“A Brief Survey of Wills & Trusts”)~~
* Code: §§ 2001(a)-(c); 2010; 2011(a), (b) & (f); 2035(b); 2501(a)(1); 2502; 2503(b)(1)(first sentence); 2505, 2601, 6018(a), 6019. Review §§ 1014 & 1015.
* Regs: Skim § 20.2010-2

### Questions

In answering the following questions, and all questions throughout this course, disregard all inflation adjustments to the basic exclusion amount under § 2010(c)(3), and assume the following basic exclusion amounts for the following years:

* 2011-2017: $5,000,000
* 2018-2025: $10,000,000

1. Dana made no taxable gifts prior to 2015. Her spouse Harry died in 2007. In 2015, she made gifts of stock to each of her two children. The stock transferred to each child had a fair market value of $1,500,000 on the date of the transfer. Dana had paid $500,000 for the stock. Because Dana utilized her annual exclusions in making holiday gifts to her children, the amount of her taxable gifts for the year was $3,000,000.

In January 2017, Dana contributed $2,500,000 to a trust established for the benefit of her two children. Again she utilized her annual exclusions on holiday gifts, so the amount of her taxable gifts for 2017 was $2,500,000.

Dana died in June 2021, with a taxable estate of $10,500,000. Included in that estate is $7,000,000 worth of stock, for which Dana had paid $2,000,000. Assume that Dana resided in a state that did not have an estate or inheritance tax.

a. What is Dana’s gift tax liability for 2015?

*Answer:*

* Step 6: Current Year Taxable Gifts
  + The current year taxable gifts equal $3,000,000 ($1,500,000 to Child 1 and $1,500,000 to Child 2).
* Step 7: Prior Year Taxable Gifts
  + The prior year taxable gifts equal $0.
* Step 8: Aggregate Amount of Taxable Gifts
  + The aggregate amount of taxable gifts is therefore $3,000,000.
* Step 9: Tentative Tax on Aggregate Amount of Taxable Gifts
  + The tentative tax on the aggregate amount of taxable gifts is $345,800 plus $800,000 ($3,000,000 - $1,000,000 \* 40%) equals $1,145,800.
* Step 10: Less Tentative Tax on Prior Taxable Gifts
  + The tentative tax on prior taxable gifts is $0.
* Step 11: Tentative Tax on Current Year Taxable Gifts
  + The tentative tax on current year current year taxable gifts is therefore $1,145,800.
* Step 12: Unified Credit
  + The amount of the unified credit is $345,800 plus $1,600,000 ($5,000,000 - $1,000,000 \* 40%) equals $1,945,800
  + The amount of the unified credit used in prior years is $0.
  + The amount of the unified credit used in 2015 is $1,145,800.
  + The amount of the remaining unified credit is $800,000 ($1,945,800 - $1,145,800).
* Step 13: Gift Tax Due
  + Because the amount of the credit available for the current year exceeds the current year’s taxable gifts, there is no gift tax due for 2015.

b. Does the gift in 2015 result in income tax liability for Dana? If her children sell the stock shortly after the gift for $1,500,000, what will be the income tax consequences to them?

*Answer:*

* The gift does not result in income tax liability for Dana. Under §102, gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.
* Under §1015, the children take a carry-over basis in the stock.
* When the children sell the stock, they will each recognize $1,000,000 ($1,500,000 FMV less $500,0000 basis).

c. What is Dana’s gift tax liability for 2017?

*Answer:*

* Step 6: Current Year Taxable Gifts
  + The current year taxable gifts equal $2,500,000.
* Step 7: Prior Year Taxable Gifts
  + The prior year taxable gifts equal $3,000,000.
* Step 8: Aggregate Amount of Taxable Gifts
  + The aggregate amount of taxable gifts is therefore $5,500,000.
* Step 9: Tentative Tax on Aggregate Amount of Taxable Gifts
  + The tentative tax on the aggregate amount of taxable gifts is $345,800 plus $1,800,000 ($5,500,000- $1,000,000 \* 40%) equals $2,145,800.
* Step 10: Less Tentative Tax on Prior Taxable Gifts
  + The tentative tax on prior taxable gifts is $1,145,800.
* Step 11: Tentative Tax on Current Year Taxable Gifts
  + The tentative tax on current year current year taxable gifts is therefore $1,000,000 ($2,145,800 less $1,145,800).
* Step 12: Unified Credit
  + The amount of the unified credit is $345,800 plus $1,600,000 ($5,000,000 - $1,000,000 \* 40%) equals $1,945,800
  + The amount of the unified credit used in prior years is $1,145,800.
  + The amount of the amount of the available unified credit is $800,000 ($1,945,800 - $1,145,800).
  + Because the amount of the tentative tax on current year taxable gifts exceeds the amount of the available unified credit, the amount of the unified credit used in 2017 is therefore $800,000.
  + The amount of the remaining unified credit is $0.
* Step 13: Gift Tax Due
  + The amount of the gift tax due is $200,000 ($1,000,000 less $800,000).

d. What is Dana’s federal estate tax liability?

*Answer:*

* Step 3: Taxable Estate
  + The amount of the taxable estate is $10,500,000.
* Step 4: Adjusted Taxable Gifts
  + The amount of adjusted taxable gifts is $5,500,000 ($2,500,000 plus $3,000,000).
* Step 5: Tax Base
  + The amount of the tax bases is $16,000,000.
* Step 6: Tentative Tax
  + The amount of tentative tax is $345,800 plus $6,000,000 ($16,000,000- $1,000,000 \* 40%) equals $6,345,800.
* Step 7: Less Gift Taxes Payable
  + Because the rate schedule on the gifts did not change from 2015 to 2021, the amount of the gift taxes payable is equal to the amount of gift taxes actually paid.
  + The amount of gift taxes payable is therefore $200,000.
  + The tentative tax is therefore reduced to $6,145,800 ($6,345,800 less $200,000).
* Step 8: Unified Credit
  + The amount of the unified credit is $345,800 plus $3,600,000 ($10,000,000 - $1,000,000 \* 40%) equals $3,945,800.
* Step 9: Credits
  + The amount of other credits is $0.
* Step 10: Estate Tax Due
  + The amount of the estate tax due is $2,200,000 ($6,145,800 less $3,945,800).

e. Does the bequest of the stock result in income tax liability to Dana or her estate? If her children subsequently sell the stock for $7,000,000, what will be the income tax consequences to them?

*Answer:*

* The bequest does not result in income tax liability for Dana. Under §102, gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.
* Under §1014, the children receive a stepped-up basis in the stock.
* When the children sell the stock, they will recognize $0 ($7,000,000 FMV less $7,000,000 basis).

2. Assume that Dana’s husband Harry died in 2015 rather than 2007, leaving his entire $1,000,000 estate to charity.

a. Must Harry’s estate file an estate tax return? Should it?

*Answer:*

* Under §2010(c)(5), the portability election is only available to the estate of the surviving spouse if the executor of the estate of the first spouse to die files an estate tax return that elects portability.
* Therefore, Harry’s estate should file an estate tax return that elects portability.

b. How would your answers to question #1 change if Harry’s estate did file a return?

*Answer:* The exclusion amount available to Dana’s estate would be $15,000,000 ($10,000,000 + $5,000,000 <- get amount of Harry’s exclusion at his death). This would reduce the estate tax due to $0.

3. Assume in addition to the above facts that Dana was the income beneficiary of a trust created by her father in 1990. Under the terms of the trust, on Dana’s death the trust assets are distributed to Dana’s children in equal shares. Because Dana’s interest terminated at her death, the assets of the trust (which total $8,000,000 when Dana dies in 2021) are not included in her taxable estate. Without getting into the details, will the assets pass to Dana’s children free of any transfer tax?

*Answer:* The transfer will be subject to the GST.

# Unit II: Gift Tax Fundamentals

## Part A: Transfers Subject to the Tax

### Readings

* ~~Transfer Taxes: Chapter Two, Part A~~
* Code: §§ 2501(a)(1); 2511(a); 2512; 7872(a), (b)(1), (c)(1)(A), (e)
* Regs: §§ 25.2511-1(a), (e), (g)(1); 25.2512-1, -8
* Add’l Materials:
  + Rev. Rul. 66‑167
  + Hogle v. Comm’r
  + Dickman v. Comm'r
  + Comm’r v. Wemyss

### Questions

1. Do any of the following transactions constitute a "transfer of property by gift" as that phrase is used in §2501(a)?

(a) Father pays the following expenses for his 19 year old daughter who is enrolled in college:

(i) Room and board of $6,000

*Answer:* This transfer is likely excluded as a support obligation. Whether payment of room and board is encompassed in the obligation of support is a question of state law and depends on all of the facts and circumstances.

(ii) Tuition of $50,000

*Answer:* This transfer is excluded as a transfer to an educational organization for tuition under §2503(e).

(iii) Spring break trip to Florida $3000

*Answer:* This transfer may be excluded as a support obligation. Whether payment of the spring break trip is encompassed in the obligation of support is a question of state law and depends on all of the facts and circumstances.

Would your answers be different if daughter was enrolled in graduate school and was 25?

*Answer:*

* The transfers room and board and the spring break trip may not be excluded as support obligations, because it is a question of state law and depends on all of the facts and circumstances.
* The transfer for tuition will continue to be excluded as a transfer to an educational organization for tuition under §2503(e). There are no age or degree type requirement for the exclusion.

(b) Mother is a real estate broker. Daughter is selling her house. Mother lists the property and finds a buyer, and waives the right to collect the $100,000 commission she would otherwise earn from the sale. Has Mother made a gift? What additional facts might you want to know in answering the question?

*Answer:*

* Generally, the gratuitous performance of services is not a transfer of property, and is not subject to gift tax.
* However, if the services ripen into a property right, which is then transferred, then it will be subject to gift tax.
* The waiver would be respected if it is made shortly after the mother begins rendering services (gift of services, not property) but disregard the waiver if made after the services are performed (gift of property, not services).

(c) On January 1 of year 1 Grandmother makes an interest free demand loan to grandson of $2,000,000. Assume the AFR is 4% compounded annually.

(i) On the date that she makes the loan, has she made a gift?

*Answer:*

* Yes, under §7872 the Grandmother has made a gift.
* Because this is a demand loan, for both income and gift tax purposes, the gift loan is treated under §7872(a).
* The forgone interest is $80,000 ($2,000,000 \* 4%).
* For income tax purposes, in year 1 Grandmother has interest income equal to $80,000, and the grandson has a corresponding interest expense equal to $80,000.
* For gift tax purposes, in year 1 Grandmother has made a taxable gift to the grandson of $80,000.

(ii) Are there any other gift tax consequences resulting from the loan?

*Answer:*

* The gift tax consequences repeat each year.

(iii) Five years after making the loan, grandmother forgives the loan. Has she made a gift?

*Answer:*

* Under §25.2511-1(a), the forgiveness of debt is a taxable gift.
* In year 5 Grandmother has made a taxable gift to the grandson of $2,000,000.

(d) In the alternative, assume Grandmother makes a 5 year term loan to her grandson of $2,000,000 at 0% interest. Assume the AFR is 4% compounded annually. (Hint: The present value of $2,000,000 payable in 5 years discounted at 4% compounded annually is $1,645,000).

*Answer:*

* For income tax purposes, this loan is treated under §7872(a) and the income tax consequences are the exact same as in part (c).
* Because this is a term loan, and for gift tax purposes the loan is treated under §7872(b).
* For gift tax purposes, the foregone interest is $355,000 ($2,000,000 less $1,645,000).
* In year 1, Grandmother has made a taxable gift to grandson of $355,000.

(e) A and B are competitors in the real estate business and own adjoining tracts of land. Each tract is worth approximately $1,000,000. A needs $850,000 for immediate use in his business. He offers his lot to B for that amount and B accepts. Might your answer be different if A and B were related?

*Answer:*

* The regulations provide that “a sale, exchange, or other transfer of property made in the ordinary course of business” is not a gift. §25-2512-8.
* A business transaction is one that is (i) bona fide (ii) at arms’ length, and (iii) free from donative intent.
* Transactions between family members are presumed to be motivated by donative intent. The transfers are subject to special scrutiny and the transferor will have the burden of establishing that the transfer is (i) bona fide (ii) at arms’ length, and (iii) free from donative intent.

(f) Fred and Ethel execute a pre-nuptial agreement in anticipation of their upcoming marriage. In the agreement Ethel waives her right to an elective share of Fred’s estate in the event of his death, and to spousal support in the event of divorce, and in exchange Fred transfers to her stock worth $2,000,000. Has Fred made a gift?

*Answer:*

* The release of marital rights is not consideration in money or money’s worth. §25-2512-8.
* Because Ethel has not provided adequate and full consideration in exchange for the transfer of $2,000,000, the Fred has made a taxable gift.

## Part B: The Concept of Completed Gift

### Readings

* ~~Transfer Taxes: Chapter Two, Part B~~
* Regs: §§ 25.2511-2

### Questions

2. Gail Grantor, a fifty year‑old individual, creates a trust funded with $10,000,000 in income‑producing securities, and names herself Trustee. The trust instrument provides that during Gail’s life the Trustee shall divide the trust income between A and B in such shares and amounts as the Trustee deems appropriate. If either A or B dies during Gail’s lifetime then the Trustee is to pay the entire income to the survivor, and if the survivor dies during Gail’s lifetime the income is paid to the survivor’s estate. On Gail’s death, the trust terminates and goes to C or C's estate. For purposes of this problem, assume that A, B and C are unrelated to Gail.

For purposes of problems (a) – (c), assume that Gail retains the right to revoke the trust, and at all relevant times is acting as Trustee of the trust.

(a) Does Gail make a completed gift upon the creation of the trust?

*Answer:* The transfer of property to a revocable trust is not a completed gift because the donor has not given up dominion and control over the property. §25.2511-2(b). Because Gail retains the right to revoke the trust, the gift is incomplete. §25.2511-2(c)

(b) Does any gift occur when Gail distributes the first year's income equally between A and B?

*Answer:* Transfers from revocable trusts to individuals other than the donor will be completed gifts. §25.2511-2(f). When Gail distributes the income to A and B, Gail has made a gift at the time of the distribution.

(c) What result if, at the end of the second year, Gail relinquishes her power to revoke the trust but continues to act as Trustee? Has Gail made a gift? If so, how would you value it?

*Answer:*

* A gift is incomplete any time that the donor can change the beneficial ownership (§25.2511-2(b)-(c)), unless it is a fiduciary power constrained by an “ascertainable standard” (§25.2511-2(d)). Because Gail is the trustee, because she can change the beneficial ownership between A and B, and because her power as trustee is not constrained by an ascertainable standard, the transfer to A and B of an income interest in the trust is an incomplete gift.
* Because Gail has not retained an interest in the remainder and cannot change the beneficial ownership of C, the transfer to C of a remainder interest in the trust is a complete gift.
* The value of the remainder interest is the present value of the principal at the end of Gail’s expected life. The value could be determined using actuarial tables found in §20.2031-7(d)(7).

For purposes of problems (d) through (h) assume that the trust is irrevocable, and that during all relevant times Gail acts as Trustee of the trust.

(d) When Gail creates the trust has she made a completed gift?

*Answer:*

* Gail as trustee has a retained interest in the income interest, but not the remainder interest.
* A gift is incomplete any time that the donor can change the beneficial ownership (§25.2511-2(b)-(c)), unless it is a fiduciary power constrained by an “ascertainable standard” (§25.2511-2(d)). Because Gail is the trustee, because she can change the beneficial ownership between A and B, and because her power as trustee is not constrained by an ascertainable standard, the transfer to A and B of an income interest in the trust is an incomplete gift.
* Because Gail has not retained an interest in the remainder and cannot change the beneficial ownership of C, the transfer to C of a remainder interest in the trust is a completed gift.

(e) Suppose that shortly before the end of the third year, A dies, so that Gail (as Trustee) no longer has discretion to allocate income; thereafter all the income effectively becomes payable to B or B's estate. Has a completed gift occurred?

*Answer:* Because Gail cannot change the beneficial ownership of B, the transfer to B of a beneficial ownership in the trust is a completed gift.

(f) Would your answer in (d) be different if the trust instrument directed the Trustee to distribute $10,000 per year of trust income to A, and the balance of the income to B?

*Answer:* Because Gail cannot change the identities or shares of A and B, the transfer to A and B of a beneficial ownership in the trust is a completed gift. Both the income interests and the remainder interests are completed gifts.

(g) Would your answer in (d) be different if the trust instrument directed the Trustee to pay to A as much income as the Trustee deems necessary to maintain A in his accustomed standard of living, and to pay the balance of the income to B?

*Answer:* The power to distribute trust property for the beneficiary’s comfort, happiness, or welfare is not an ascertainable standard. §25.2511-2(g)(2). Because Gail is the trustee, because she can change the beneficial ownership between A and B, and because her power as trustee is not constrained by an ascertainable standard, the transfer to A and B of a beneficial ownership in the trust is an incomplete gift. The remainder interest is complete.

(h) Would your answer in (d) be different if the trust instrument instead directed the Trustee to distribute all trust income to A (or his estate) for 10 years, then distribute the principal to A or A's estate, and in addition the Trustee had the discretion in any given year to accumulate the income rather than distribute it? What if instead the trust directs that after 10 years the principal passes to B or B’s estate?

*Answer:*

* §25.2511-2(d) provides that a gift is not incomplete “merely because the donor reserves the power to change the manner or time of enjoyment.
* In the first instance, because Gail’s retained interest is limited to deciding the manner or time of enjoyment, the gift of the income interest is complete. Because Gail does not retain an interest in the remainder, the transfer of the remainder interest in the trust is also a complete gift.
* In the second instance, because Gail has retained the right to change the beneficial ownership interest for both A and B. The transfer of the income interest is a completed gift. The transfer to B however still is a complete gift because Gail has not retained the right to diminish B’s remainder interest.
  + The rationale for this is very interesting.
  + See end of class 4.
  + Each year, Gail is treated as making two gifts. Income to A, and income to B.
  + The value of the gift of the remainder will be as of the date of the initial transfer.

3. George creates an irrevocable trust with income to A for A's life, remainder to B or B's estate. To what extent, if any, has George made a completed gift if:

(a) George retains a power to give income to C, but only with A's approval.

*Answer:*

* For the income interest, George has retained a power to change the beneficial ownership but only in conjunction with A. Because A has an interest that is substantially adverse to the exercise of the power, the gift of the income interest is complete.
* For the remainder interest, the gift is complete.

(b) George has no power over trust income, but retains a power to substitute C or his estate as remainderman if he secures A's approval.

*Answer:*

* For the remainder interest, George has retained a power to change the beneficial ownership but only in conjunction with A. Because A does not have an interest that is substantially adverse to the exercise of the power, the gift of the remainder interest is incomplete.
* For the income interest, the gift is complete.

(c) George retains the power to invade principal for B, but only with A's consent.

*Answer:*

* For the income interest, the invasion of the principal could reduce A’s beneficial interest (i.e., less income because of less principal). Because A has an interest that is substantially adverse to the exercise of the power, the gift of the income interest is complete.
* For the remainder interest, the right to invade the principal is the mere power to change the manner or time of enjoyment. Therefore, the gift of the remainder is complete.

(d) George retains a power to give income to C, but only with B's approval.

* For the income interest, George has retained a power to change the beneficial ownership but only in conjunction with B. Because B does not have an interest that is substantially adverse to the exercise of the power, the gift of the income interest is incomplete.
* For the remainder interest, the gift is complete.

## Part C: Introduction to Valuation

### Readings

* ~~Transfer Taxes: Chapter Two, Part C~~
* Code: §§ 2702(a), (b) & (e); 7520(a)
* Regs: §§ 20.2031-7(d)(7), 25.2511-1(e); 25.2511-1(h)(5); 25.2702-2(a)(4)
* Add’l Materials: Smith v. Shaughnessy

### Questions

4. Abner owns a piece of land.

(a) In the current year, Abner transfers title to the property to himself and his nephew Bob, as tenants in common. Has Abner made a gift? If so, how would you go about valuing it for gift tax purposes? Would your answer change if he and Bob took title as joint tenants with right of survivorship?

*Answer:*

* Tenancy in common is an arrangement where two or more people share ownership rights in property. When a tenant in common dies, the property passes to that tenant's estate.
* Joint tenancy with right of survivorship is arrangement where two or more people share ownership rights in property. When a joint tenant dies, the property passes to the other tenants.
* For the tenancy in common, Abner has made a gift to Bob of 50% of the value of the property.
* For the joint tenancy, if under local law Bob could sever the property, the amount of the gift is one-half of Blackacre’s value. §25.2511-1(h)(5). The ability to sever makes the gift complete.
* If the joint tenancy cannot be severs, then what happens? Maybe Abner has made a gift of a life estate and remainder in the property. The amount of each gift may be valued using actuarial tables found in §20.2031-7(d)(7).

(b) In the alternative, Abner transfers title to the property to Bob, reserving a legal life estate for himself. Has Abner made a gift? If so, how would you go about valuing it? Calculate the value of the gift on the assumption that the land has a fair market value of $3,000,000, that Abner is 65 years old, and the federal mid-term rate is 5%.

*Answer:*

* Abner has made a gift of the remainder interest in the property.
* Section 7520 directs that the appropriate rate is 120% of the federal midterm rate, or 6%.
* From Treas. Reg. 20.2031-7(d)(7), we get a remainder factor of .40420.
* The value of the remainder interest is $1,212,600 ($3,000,000 \* .40420).

(c) In the alternative, Abner transfers title to the property to a trustee, under a trust instrument that directs the trustee to pay the income from the property to Abner for life, remainder to Bob, or his estate. Has Abner made a gift? If so, how would you go about valuing it?

*Answer:*

* The answer is the same as part (b).

(d) What difference would it make in part (c) if Bob is Abner’s son?

*Answer:*

* Section 2702 applies to any transfer of an interest in a trust (i) to a member of the transferor’s family if (ii) the transferor or an applicable family member (iii) retains an interest in the trust.
* If these conditions are met, the value of any “interest” retained by the grantor is zero and the full value of the assets transferred will be subject to gift tax.
* Therefore, Abner made a gift of $3,000,000 to Bob.

5. Reconsider parts (a) and (d) of Problem 2 on the assumption that A, B and C are Gail’s descendants.

Gail Grantor, a fifty year old individual, creates a trust funded with $10,000,000 in income producing securities, and names herself Trustee. The trust instrument provides that during Gail’s life the Trustee shall divide the trust income between A and B in such shares and amounts as the Trustee deems appropriate. If either A or B dies during Gail’s lifetime then the Trustee is to pay the entire income to the survivor, and if the survivor dies during Gail’s lifetime the income is paid to the survivor’s estate. On Gail’s death, the trust terminates and goes to C or C's estate.

(a) Assume that Gail retains the right to revoke the trust, and at all relevant times is acting as Trustee of the trust. Does Gail make a completed gift upon the creation of the trust?

*Answer:*

* The transfer of property to a revocable trust is not a completed gift because the donor has not given up dominion and control over the property. §25.2511-2(b).
* §2702 does not apply to incomplete gifts. §2702(a)(3)(B).
* Because Gail retains the right to revoke the trust, the gift is incomplete.
* [Need to discuss with professor – he indicated that my understanding in incorrect]

(d) Assume that the trust is irrevocable, and that during all relevant times Gail acts as Trustee of the trust. When Gail creates the trust has she made a completed gift?

*Answer:*

* Gail as trustee has a retained interest in the income interest, but not the remainder interest.
* A gift is incomplete any time that the donor can change the beneficial ownership (§25.2511-2(b)-(c)), unless it is a fiduciary power constrained by an “ascertainable standard” (§25.2511-2(d)). Because Gail is the trustee, because she can change the beneficial ownership between A and B, and because her power as trustee is not constrained by an ascertainable standard, the transfer to A and B of a beneficial ownership in the trust is an incomplete gift.
* Because Gail has not retained an interest in the remainder and cannot change the beneficial ownership of C, the transfer to C of a remainder interest in the trust is a complete gift.
* The question however, is what is the value of that gift?
* §2702 applies to the transfer of the remainder interest in the trust because (i) it was transferred to C, a member of the transferor’s family, and (ii) A and B, applicable family members retained an interest in the trust.
* Under §2702, the value of the interests by Gail, A, and B will be valued at zero, and the value of the retained interest will be $10,000,000.
* Therefore, Gail is treated as having made a completed gift of $10,000,000 to C.
* [Need to discuss with professor – he indicated that my understanding in incorrect]

## Part D: Statutory Exclusions from Taxable Exclusions

### Readings

* ~~Transfer Taxes: Chapter Two, Part D~~
* Code: §§ 2503(a), (b) & (e); 2513; 6019, 6075(b)

### Questions

6. Donor Diane, a widow, has three children and five grandchildren. She has previously made no taxable gifts. In 2019 she transfers $35,000 in cash to each child and grandchild. The annual exclusion for 2019 is $15,000.

(a) What is the amount of her taxable gifts?

*Answer:* The amount of her taxable gifts is $160,000 (8 \* ($35,000 - $15,000).

(b) How and when must she report these gifts to the federal government?

*Answer:* Diane must report these gifts on her 2019 gift tax return.

(c) Will she owe any gift tax as a result of these transfers?

*Answer:* Diane will not have any gift tax payable because she has not previously used any of her unified credit.

(d) How might your answer change if Diane’s husband was still alive?

*Answer:* Under §2513, if one member of a married couple makes a gift, the other can elect to treat that gift as being made by one-half by each spouse. If Diane’s husband consented, the amount of their taxable gifts is $40,000 (8 \* ($35,000 - $30,000).

## Part E: Introduction to Disclaimers

### Readings

* ~~Transfer Taxes: Chapter Two, Part, E~~
* Code: §§ 2518(a)
* Regs: §§ 25.2518-1(b), 25.2518-3(b) & (c)

### Questions

7. Mother dies testate in the current year. Her will leaves $2,000,000 to her son, S, if he survives her, and if not the gift lapses into the residue. The residue of the estate is left to her daughter D.

(a) S disclaims the $2,000,000 bequest. Has he made a gift?

*Answer:* §2518(a) provides that if a disclaimer is “qualified,” then no transfer is deemed to have been made to or from the person making the disclaimer. Therefore, S has not made a gift.

(b) S disclaims $1,000,000 of the bequest. Has he made a gift?

*Answer:*

* An individual can disclaim an undivided portion of an interest in property. §2518(c)(1).
* The undivided portion must be either a specific portion, a pecuniary amount, a fraction, or a percentage of the property. §25.2518-3(c).
* Therefore, S has inherited $1,000,000 and disclaimed $1,000,000.
* He has not made a gift.

(c) Would your answer in (a) or (b) be different if Mother’s will provided that the residue of her estate passes into a testamentary trust, providing for income to S for life, remainder to S’s children?

*Answer:* §2518(b)(4) provides that as a result of a qualified disclaimer, the interest must pass to a person other than the person making the disclaimer. Therefore, S has made a gift.

(d) What if, in (a), S's disclaimer occurs one year after Mother's death but is nevertheless effective under local law?

*Answer:* §2518(b)(2) provides that the disclaimer must occur within 9 months of the day on which the transfer creating the interest in such person is made. If S transfers the property to D, then S has made a gift.

# Unit III: Property Owned at Death (§§ 2033, 2034 & 2040)

## Part A: The Starting Point in Determining the Gross Estate (§ 2033)

### Readings

* ~~Transfer Taxes: Chapter Three, pp. 47-52~~
* Code: §§ 691(a)(1), (c)(1); 1014(a)(1), (b)(6); 2031, 2033, 2034
* Regs: §§ 20.2033-1(a) & (b)
* Add’l Materials:
  + Helvering v. Safe Deposit & Trust Co.
  + Comm’r v. Estate of Bosch

### Questions

1. During the current year, Don dies. His will leaves his entire estate to Ted, as Trustee. Under the terms of the testamentary trust, Ted is instructed to distribute the income to Abe for Abe's life. On Abe’s death the remainder is distributed to Bea if she survives Abe, and if not, then to Charlie or Charlie's estate. In each of the following circumstances, determine if the designated person holds an “interest” in property which will be included in his or her estate under § 2033, if:

(a) Ted dies.

*Answer:* §2033 only reaches property that is “beneficially owned” by the decedent. Ted, as trustee holds only legal title, not beneficial title, in the trust property, so the assets will not be included in his estate. §20.2033-1(a).

(b) Abe dies.

*Answer:* §2033 does not reach property interests or rights held by the decedent during life terminate with his death. Because Abe’s income interest terminates with his death, the income interest will not be part of his gross estate.

(c) Bea dies, survived by Abe.

*Answer:* §2033 does not reach property interests or rights held by the decedent during life terminate with his death. Because Bea’s remainder interest terminates with her death, the remainder interest will not be part of her gross estate.

(d) Charlie dies, survived by Abe, but not Bea.

*Answer:* §2033 includes vested remainder interests. Even though the trust is still in existence at Charlie’s death, the remainder will go his estate, and hence to his heirs or will beneficiaries, when Ted later dies. The remainder will be included in Charlies’ gross estate at its actuarial value. <- Note, this would be true even if the remainder were only contingent.

(e) Charlie dies, survived by both Abe and Bea.

*Answer:* §2033 includes contingent remainder interests. Charlie’s remainder is contingent on Bea failing to survive Abe. When Charlies dies survived by both Abe and Bea, we still don’t know if the remainder will become possessory. Nevertheless, this contingent remainder interest will be included in Charlie’s gross estate. The value of the remainder will reflect the fact that it is subject to contingency.

2. What if in ***Question #1*** Abe, in addition to holding an income interest in the trust, also had the right to demand principal distributions during his life, and to designate who should receive the property on his death, with Bea or Charlie receiving the property only if Abe failed to so designate. Are Abe’s rights with respect to the property significantly different from what they would be had D simply left the property to Abe by will? Do they constitute an “interest” in property for purposes of § 2033?

*Answer:*

* Even though Abe has substantial rights with respect to the trust, including the right to enjoy it during life and direct where it passes when he dies, at the time of his death he doesn’t hold an “interest” in the property within the meaning §2033, and the trust assets will not be included in his estate under that section.
* However, other provisions govern powers of appointment (§2041(b)(1)).

3. Decedent David owned a valuable painting, which was kept in storage during his life. After his death, David’s son Sam claims that David gave him the painting ten years prior to his death, although the gift was never documented. The executor of David's estate applies to the probate court for an order determining ownership of the painting, and the court issues an order determining that Sam is the owner. Did David have an “interest” in the painting at his death for purposes of § 2033? In determining your answer, consider the following: What if Sam was the executor and sole beneficiary of the estate? What if Sam was not the executor, and shared the estate with five siblings with whom he did not get along?

*Answer:*

* In both situations, Sam and the family might ask seek out a probate ruling that would have the effect of decreasing the federal transfer tax liability.
* For this reason, the Supreme Court ruled in Bosch, that the ruling of a state court is not necessarily determinative.
* Absent a decision by the state’s highest court, the federal court must “apply what they find to be the state law after giving ‘proper regard’ to relevant rulings of other courts of the State.”
* Whether the painting will be included in David’s estate will depend on the facts and circumstances.

4. Decedent lent his friend Zoe $10,000 during his lifetime, the loan was evidenced by a promissory note. If the note remains unpaid at Decedent's death, is it an “interest” in property for purposes of § 2033? Would it make a difference if Decedent’s will directed that the loan should be forgiven?

*Answer:*

* Any payments that are due to the decedent under contracts, whether written or oral, are included in her gross estate as long as the right to those payments has accrued at the moment of death.
* The future stream of payments is not included in the gross estate, but the value of the contract or other property is included.
* It should not make a difference that Decedent’s will directed that the loan should be forgiven. The forgiveness of the debt is a bequest, but the property is still included in the the gross estate.

5. Decedent owns stock in X Corporation. Two weeks prior to Decedent’s death, the corporation declares a dividend to the holders of record on that date; Decedent’s share of the dividend is $10,000. The dividend is not paid until one week after Decedent’s death. Does Decedent have an “interest” in property for purposes of § 2033? If Decedent is a cash method taxpayer, what will be the income tax consequences of payment of the dividend to his estate? Is this double taxation? Do we care?

*Answer:*

* The estate tax consequences are straightforward. Because Decedent had a claim to the $10,000 on the date of her death, that amount must be included in her estate. §20.2033-1(b).
* The income tax consequences are determined under §691.
* This is an example of “income with respect of a decedent.”
* Because the Decedent did not receive the $10,000 before death, the entire $10,000 would be in her estate, and subject to 40% estate tax, resulting in tax of $4,000.
* Under §691, the Decedent recognizes the $10,000 of income, but receives a deduction for the estate taxes. The amount included by the estate will be $6,000 ($10,000 less $4,000), resulting in income tax due of $1,200 ($6,000 \* 20%).
* The total amount due is $5,200 ($4,000 plus $1,200).
* If the decedent had received the $10,000 before death the income tax due would have been $2,000 ($10,000 \* 20%) and the estate tax due would have been $3,200 ($10,000 - $2,000 \* 40%). The total amount due would have been $5,200.
* Therefore, the amount available to the beneficiaries is the same.

6. Hilda and Wally are a married couple and have accumulated assets of $15,000,000 during their marriage. Hilda is the sole earner in the family, Wally is a homemaker. Most of the assets are held in accounts under Hilda’s name alone.

(a) The couple lives in a common law state. Hilda dies, and leaves her entire estate to her children from a prior marriage. Under the elective share statute of their state, Wally is entitled to elect against Hilda’s will and receive one third of Hilda’s probate estate. What is included in Hilda’s gross estate under § 2033?

*Answer:*

* The value of a decedent’s gross estate is not decreased due to the rights of a surviving spouse. §2034.
* Therefore, all of the accumulated assets of $15,000,000 are included in Hilda’s gross estate under §2033.

(b) Hilda and Wally jointly hold title to their home, which they purchased for $1,000,000. At the time of Hilda’s death, the property’s value is $5,000,000. In each of the following situations, describe what portion of the property would be included in Hilda’s estate under § 2033.

(i) The couple lives in New York and hold title to the property as tenants in common, and Hilda leaves her interest in the property to Wally by will. ***Further question:***  What is Wally’s basis in the property for income tax purposes?

*Answer:*

* Hilda’s interest as a tenant in common ($2,500,00) is included in her gross estate.under §2033.
* Because Hilda owns an undivided partial interest in the property as a co-tenant, only her proportionate shares will pass under her will, and only that portion will be included in the gross estate.
* Wally should receive a stepped-up basis in the portion of the property; that is, Wally’s basis is the fair market value of the property on the date of death ($2,500,000).
* Wally’s combined basis in the property is $3,00,000 ($2,500,000 + $500,000). §1014(a) & (b)(1)

(ii) The couple lives in California and hold title to the property as community property, and Hilda leaves her interest in the property to Wally by will. ***Further Question:*** What is Wally’s basis in the property for income tax purposes?

*Answer:*

* Because each spouse in a community property state owns an undivided one-half interest in the community assets, half of the property is owned by Hilda at death and will be included in her gross estate under §2033 ($2,500,00).
* Wally should receive a stepped-up basis for both spouses’ halves of the property; that is, Wally’s basis is the fair market value of the property on the date of death. §1014(b)(6).
* Wally’s combined basis in the property is $5,00,000 ($2,500,000 + $2,500,000).

(iii) The couple lives in New York and holds title as joint tenants with right of survivorship.

*Answer:*

* Hilda’s interest as a joint tenant with right of survivorship is not included in her gross estate.under §2033.
* However, other provisions govern joint interests in property (§2040).
* Wally should receive a stepped-up basis in the portion of the property; that is, Wally’s basis is the fair market value of the property on the date of death ($2,500,000).
* Wally’s combined basis in the property is $3,00,000 ($2,500,000 + $500,000). §1014(a) & (b)(9)

## Part B. Joint Interests in Property (§ 2040)

### Readings

* Transfer Taxes: Chapter Three, pp. 53-56
* Code: § 2040
* Regs: §§ 20.2040-1

### Questions

1. Abby and her two daughters, Beatrice and Carol hold title to a parcel of real estate as joint tenants with right of survivorship. If Abby predeceases Beatrice and Carol, what portion of the property will be included in her estate (and under what authority) if title to the property was acquired in the following alternative manners:

(a) The three jointly purchased the property, each making an equal contribution to the purchase price from their earnings.

*Answer:*

* The entire value of the property is included, except for any portion of the value attributable to consideration supplied by the other owners. §20.2040-1(a)(2).
* Because the three each made equal contributions to the purchase price from their earnings, one-third of the value of the property should be included in Abby’s gross estate.

(b) The three jointly purchased the property. Abby used funds from her earnings, and Beatrice and Carol used funds that they had received five years earlier from their mother by gift.

*Answer:*

* Because Beatrice and Carol contributed to the purchase with funds that were gifted by Abby, their contributions are disregarded. §20.2040-1(a)(2).
* Therefore, the entire value of the property will be included in Abby’s gross estate.

(c) The three inherited the property from Abby’s husband Harold.

*Answer:*

* When all the joint tenants acquire their interests as gifts or bequests from someone else, the interest of the deceased joint tenant is his fractional interest in the property. §20.2040-1(a)(1).
* Because Abby, Beatrice, and Carol each inherited the property from Abby’s husband Harold, one-third of the value of the property should be included in Abby’s gross estate.

(d) Beatrice purchased the property, and transferred title into joint names with Abby and Carol.

*Answer:*

* The transfer of a donor's separate property into the names of the donor and one or more others as joint tenants is a gift to the extent that the new co-tenants did not provide consideration equal to the value of their property interest received, as determined under local law.
* Under the general consideration furnished rule, none of the property will be included in Abby’s gross estate.

(e) Abby inherited the property from Harold, and transferred title into joint names with Beatrice and Carol.

*Answer:*

* The transfer of a donor's separate property into the names of the donor and one or more others as joint tenants is a gift to the extent that the new co-tenants did not provide consideration equal to the value of their property interest received, as determined under local law.
* The rule for joint tenancies acquired by inheritance will apply under §20.2040-1(a)(1).
* Because Abby acquired the property by inheritance, the entire value of the property will be included in Abby’s gross estate.

2. Darlene is a wealthy widow. She owns a home on the Gulf Coast of Florida, the property was left to her in her deceased husband’s will. Several years after her first husband’s death she marries Gary, her tennis instructor. Shortly after marriage, Darlene transfers title to the Gulf Coast home into Darlene and Gary’s names as joint tenants, with right of survivorship. Darlene dies several years later. Assume the property had a fair market value of $10,000,000 when Darlene’s first husband died, and a value of $15,000,000 when Darlene dies.

(a) What are the gift tax consequences when Darlene creates the joint tenancy?

*Answer:*

* The transfer of a donor's separate property into the names of the donor and one or more others as joint tenants is a gift to the extent that the new co-tenants did not provide consideration equal to the value of their property interest received, as determined under local law.
* The transfer will qualify for the marital deduction.
* Gary will take a basis of $5,000,000 in the property.

(b) What portion of the property will be included in Darlene’s estate?

*Answer:*

* For spousal joint tenancies, of the joint tenants own a qualified joint interest, then only one-half of the value of the joint tenancy interest is included in the gross estate of the first joint tenant to die. §2041(b)(1).
* One-half the value of the property ($7,500,000) will be included in her gross estate.
* The transfer will again qualify for the marital deduction.

(c) What is Gary’s basis in the property following Darlene’s death?

*Answer:*

* Gary’s combined basis is $12,500,000 ($5,000,000 + $7,500,000)

# Unit IV: Transfers with Retained Interests (§§ 2036-2038)

## Part A: Retained Rights and Powers over Income and Principal (§ 2036)

### Readings

* Transfer Taxes: Chapter Four, Parts A, B (except pp. 66-69 dealing with § 2036(b)) & C
* Code: §§ 2035(a), (d), 2036, 2038, 2043(a)
* Regs: § 20.2036-1(a), (b) & (c)(1), 20.2038-1(a)
* Add’l Readings:
  + U.S. v. Allen (problem 1(b))
  + Jennings v. Smith (problem 1(f))
  + Rev. Rul. 95-58 (problem 1(e))
  + U.S. v. Estate of Grace (problem 1(d))
  + Rev. Rul. 70-513 (problem 1(i))
  + Estate of Maxwell v. Comm’r (problem 2)

### Questions

1. Consider the following trusts. In each case, identify whether all or any portion of the trust will be included in the Grantor’s (or other designated decedent’s) estate under § 2033, 2036, or 2038.

(a) Bob creates a trust with income to his sister Sally for life, remainder among Sally’s children in such shares as Sally designates by will. Absent designation, the property passes to Sally’s children, or their estates, in equal shares.

(ii) If Bob predeceases Sally will any portion of the trust be included in his estate?

*Answer:*

* Not the possibility for statutory reversion if S predeceases Bob.
* Bob did not have a property interest immediately before death. Therefore, no portion of the trust will be included his gross estate under §2033.
* §2036 will not apply to the possibility of reversion because, this is retained right in the remainder.
* §2038 will not apply to the possibility of reversion because Bob did not have the power to alter, amend, terminate, or revoke at the moment of his death.
* Therefore, no portion of the trust will be included in his gross estate under §§2036 or 2038.
* Note, if he paid gift tax within three years of tax then §2035(b) may apply.

(iii) How would your answer to part (ii) change if Bob reserved the right to revoke the trust?

*Answer:*

* §2033 does not reach property interests or rights held by the decedent during life terminate with his death. Because Bob did not exercise the right to revoke the trust at death, he did not have a property interest immediately before death. Therefore, no portion of the trust will be included his gross estate under §2033.
* Bob’s rights and powers over income and principal would be sufficient to bring the property into the grantor’s trust under either §2036(a)(1), §2036(a)(2), or §2038.
* The full value of the trust will be included in Bob’s gross estate.

(b) Bob creates a trust with income to Bob for life, remainder to Bob’s children, or their estates, in equal shares. Sally is the Trustee.

*Answer:*

* §2033 does not apply because Bob’s income interest terminated with death, and the remainder interest in Bob’s children or their estate were transferred at the creation of the gift.
* §2036(a)(1) will apply because Bob has retained the right to income for life. The full value of the trust will be included.
* §2036(a)(2) will apply, because Bob has retained the right to designate income for life. The full value of the trust will be included.
* §2038 will not apply, because Bob did not retain the right to alter, amend, terminate, or revoke in the income interest at the moment of his death. This is because Bob’s income interest terminated with death. §2038 will not apply to the remainder interest, because Bob did not retain the right to alter, amend, terminate, or revoke the remainder interest.

(i) Would it make a difference if under the trust Bob was not entitled to the income for the month preceding his death?

*Answer:*

* §2036(a)(1) and (a)(2) would continue to apply because Bob retained the interest for a period which is not ascertainable without reference to his death.

(ii) What if the trust called for income to Bob for 15 years, instead of for life, and Bob dies after 10 years?

*Answer:*

* §2033: The income interest for 5 years following Bob’s death will be included in his gross estate.
* §2036(a)(1): Because D’s income interest does not in fact end before her death, §2036(a)(1) will reach the remaining 5 years of income payments to be made to D’s estate as well as the remainder. §20.2036-1(c)(1)(i).
* §2036(a)(2): Because D retained the right to designate income for a period which did not in fact end before death, §2036(a)(2) will reach the remaining 5 years of income payments to be made to D’s estate as well as the remainder.

(iii) What if Bob irrevocably assigned his income interest to Sally two years prior to his death?

*Answer:*

* Because Bob no longer holds the income interest, he will avoid §2036.
* The transfer of the income interest to Sally will be gift.
* The entire value of the estate will also be included in his estate under §2035.

(c) Bob creates a trust with income to Bob’s children for Bob’s life, remainder to Bob’s children, or their estates, in equal shares.

*Answer:*

* Bob did not have a property interest immediately before death. Therefore, no portion of the trust will be included his gross estate under §2033.
* If the children have not yet reached the age of majority, then Bob will be considered to have retained a life estate. §20.2036-1(b)(2).
* Therefore, the trust would be included in his gross estate under §§2036 or 2038.

(d) Bob transfers $2,000,000 into a trust, providing for income to Sally for life, remainder to Sally’s children, or their estates. Six months later Sally transfers $1,000,000 in trust with income to Bob for life, remainder to Bob’s children, or their estates.

*Answer:*

* These are reciprocal trusts.
* Bob will be treated as transferring $1,000,000 into trust, retaining an income interest for his life, and remainder to his children or their estates.
* Similarly, Sally will be treated as transferring $1,000,000 into trust, retaining an income interest for his her, and remainder to her children or their estates.
* §2033 does not apply because Bob’s income interest terminated with death, and the remainder interest in Bob’s children or their estate were transferred at the creation of the gift.
* §2036(a)(1) will apply because Bob has retained the right to income for life. The full value of the trust will be included.
* §2036(a)(2) will apply, because Bob has retained the right to designate income for life. The full value of the trust will be included.
* §2038 will not apply, because Bob did not retain the right to alter, amend, terminate, or revoke in the income interest at the moment of his death. This is because Bob’s income interest terminated with death. §2038 will not apply to the remainder interest, because Bob did not retain the right to alter, amend, terminate, or revoke the remainder interest.
* The result is the same for Sally.
* See Estate of Grace.

(e) Bob creates a trust with income to Sally’s children for Sally’s life in such shares as the Trustee shall determine, remainder to Sally’s children, or their estates, in equal shares. Bob predeceases Sally. Assume, in the alternative:

(i) Bob was acting as Trustee at the time of his death.

*Answer:*

* §2033 will not apply because Bob holds only legal title, not beneficial title, in trust property.
* §2036(a)(1) will not apply, because Bob did not retain a right to income.
* §2036(a)(2) applies when the decedent has retained the power as trustee to designate the amounts of income to be distributed between income beneficiaries. Because Bob held the power for life, the full value of the trust will be included in his gross estate.
* §2038 applies to the income interest because the decedent retained the power to alter the amounts of income to be distributed between income beneficiaries.
  + The value of the income interest is the FMV of Sally’s life estate.
* §2038 will not apply to the remainder interest because Bob did not retain the power to alter, amend, terminate, or revoke the remainder interest.

(ii) Sally was acting as Trustee of the trust at Bob’s death, and Bob had the power to remove the Trustee and appoint a successor, including Bob.

*Answer:*

* For §2036 and §2038 the powers of the trustee will be imputed to the decedent, where the decedent retains the power to replace the existing trustee with themselves.
* Because the power to appoint trustees is not limited to persons other than the grantor and related and subordinate persons, the tax consequences, are the same as part (i).

(iii) Sally was acting as Trustee of the trust at Bob’s death, and Bob had the power to remove the Trustee, and appoint a successor other than Bob.

*Answer:*

* For §2036 and §2038 the powers of the trustee will be imputed to the decedent, where the decedent retains the power to replace the existing trustee with one that is related or subordinate.
* See Rev. Rul. 95-58 §672(c).
* Because the power to appoint trustees is not limited to persons other than the grantor and related and subordinate persons, the tax consequences, are the same as part (i).

(f) Bob creates a trust with income to Sally for Bob’s life as needed for her health, remainder to Sally’s children, or their estates, in equal shares. Bob predeceases Sally, and was acting as Trustee at the time of his death.

*Answer:*

* §2033 will not apply because Bob holds only legal title, not beneficial title, in trust property.
* §2036(a)(1) will not apply, because Bob did not retain a right to income.
* §2036(a)(2) and §2038 will not apply because Bob’s power to designate income is limited by an ascertainable standard.
* Jennings v. Smith
* §20.2041-1(c)(2) – list of ascertainable standards.

(g) Bob creates a trust with income to Sally for Bob’s life, remainder to Bob’s children in such shares as Bob shall designate by will, absent designation then to his children, or their estates, in equal shares.

*Answer:*

* §2033 will not apply because Bob holds only legal title, not beneficial title, in trust property.
* §2036(a)(1) will not apply, because Bob did not retain a right to income.
* §2036(a)(2) will not apply, because Bob did not retain the right in the income interest and because he did not retain the power for life.
* §2038 will apply, because Bob had the power, exercisable in his will, to alter, amend, revoke, or terminate the interests of the remainder beneficiaries. Bob will only include the remainder in his gross estate because he does not have the power to alter or amend the income interest.

(i) What if 2 years prior to his death, Bob irrevocably released his power to designate the remainder?

*Answer:*

* §2038 would not longer apply, because Bob did not hold the power at the moment of his death.
* However, the transfer will be subject to §2035.

(h) Bob creates a trust with income to Bob’s mother Marie for life, then income to Bob for life, remainder to Sally, or her estate. Bob predeceases Marie.

*Answer:*

* The property interests are as follows:
  + Vested income interest in Marie.
  + Contingent income interest in Bob.
  + Vested remainder interest in Sally or her estate.
* §2033 does not apply because Bob’s contingent income interest because it terminated at death.
* Vested Remainder Interest in Sally or Her Estate:
  + §2036(a)(1): Bob retained a contingent income interest in the remainder interest for life. Therefore, §2036(a)(1) will apply. The actuarial value of the remainder will be included in Bob’s estate (i.e., the value will take into account the actuarial value of Marie’s remaining income interest). §20.2036-1(b)(ii).
  + §2038: Bob has not retained the right to alter, amend, revoke, or terminate the remainder interest. Therefore, §2038 will not apply.
* Contingent income interest in Bob.
  + §2036(a)(2):
    - Because Bob’s retained a power to designate income is contingent, it is not for life. Therefore, §2036(a)(2) will not apply.
  + §2038:
    - Bob did not hold the power to alter, amend, revoke, or terminate the income interest at the moment of his death. Therefore §2038 will not apply.
* Vested income interest in Marie.
  + §2036(a)(2):
    - Bob did not retain the power to designate the income interest in Marie. There was only one beneficiary. Therefore, §2036(a)(2) will not apply.
  + §2038:
    - Bob did not hold the power to alter, amend, revoke, or terminate the income interest at the moment of his death. Therefore §2038 will not apply.

(i) Bob creates a trust with income to Bob’s mother Marie for life, remainder to Sally, or her estate. The Trustee has the discretion to distribute principal to Marie as he deems appropriate. Bob predeceased Marie, and was acting as Trustee at the time of his death.

*Answer:*

* The property interests are as follows:
  + Income interest in Marie.
  + Remainder interest in Sally or her estate.
* §2033 does not apply because Bob does not have a beneficial interest in the estate at the time of his death.
* Income Interest in Marie
  + §2036(a)(2):
    - Bob may retain the power to designate the income interest because the distribution of principal will change the potential amount of income. Although the amount of income generated by the trust will be reduced if D distributes principal to M, as the fee owner of the principal amount M will continue to receive that income in his individual capacity. Thus D does not have any power over the income interest that would invoke §2036(a)(2).
  + §2038:
    - Bob may hold the power to alter, amend, revoke, or terminate the income interest at the moment of his death because the distribution of principal will change the potential amount of income. Although the amount of income generated by the trust will be reduced if D distributes principal to M, as the fee owner of the principal amount M will continue to receive that income in his individual capacity. Thus D does not have any power over the income interest that would invoke §2038.
* Remainder Interest in Sally
  + §2036(a)(1):
    - Bob did not retain an income interest in the remainder property. Therefore, §2036(a)(1) will not apply.
  + §2038:
    - Bob did retain the power to alter, amend, revoke, or terminate the remainder interest at the moment of his death. This consisted of distributing principal out of the remainder. The power was not limited by an ascertainable standard. Therefore, §2038 will apply. Therefore, the value of the remainder interest will be included in Sally’s gross estate. Rev. Rul. 70-513.

(i) Would it make a difference if the Trustee’s power to distribute principal to Marie was limited to amounts needed for her health?

*Answer:*

* §2038 does not apply where the decedent’s power to designate the remainder is limited by an ascertainable standard. Therefore, §2038 would not apply, and Bob would not be required to include the remainder interest in his gross estate.

(j) Bob creates a trust with income to Marie for ten years, remainder to Marie, or her estate. Bob predeceases Marie, and was acting as Trustee at the time of his death.

(i) The Trustee has the power to accumulate income.

*Answer:*

* The property interests are as follows:
  + Income interest in Marie.
  + Contingent income interest in Marie’s estate.
  + Remainder interest in Marie or her estate.
* Income Interest in Marie
  + §2036(a)(2):
    - Bob has the power to change the time and manner of Marie’s enjoyment of the income interest for his life. Therefore, §2036(a)(2) will apply.
    - The entire value of the trust will be brought into ob’s estate.
  + §2038:
    - Bob has the power to change the time and manner of Marie’s enjoyment of the income interest for his life. Therefore, §2038 will apply.
    - The value of the income interest will be brought into Bob’s estate.
* Contingent Income Interest in Marie’s Estate
  + §2036(a)(2):
    - Bob has the power to change the time and manner of Marie’s estates’ enjoyment of the income interest for his life. Therefore, §2036(a)(2) will apply.
    - The entire value of the trust will be brought into Bob’s estate.
  + §2038:
    - Bob has the power to change the time and manner of Marie’s estates’ enjoyment of the income interest for his life. Therefore, §2038 will apply.
    - The value of the income interest will be brought into Bob’s estate.
* Remainder Interest in Marie or her estate.
  + §2036(a)(1):
  + §2038:
    - Bob has the power to change the time and manner of Marie’s estates’ enjoyment of the remainder interest for his life. Therefore, §2038 will apply.
    - The value of the remainder interest will be brought into Bob’s estate.

(ii) Alternatively, the Trustee has the power to invade principal for the benefit of Marie.

*Answer:*

* The IRS has determined that the remainder will be included in Bob’s gross estate under §2038.
* See class 10.

2. Diane transfers to her son, Sam, her personal residence for no consideration. Will all or any portion of the residence be included in Diane’s estate under the following alternatives:

(a) Diane continues to live alone in the house until her death.

*Answer:*

* The property interests are as follows:
  + Remainder interest in the house to Sam.
  + Use, possession of the property for life to Diane.
* Remainder Interest in the House to Sam
  + §2036(a)(1):
    - Because Diane was in fact in possession of the house at, §2036(a)(1) will apply. The entire value of the house will be included in Diane’s gross estate.

(b) Diane and Sam live in the house together until Diane’s death.

*Answer:*

* §20.2036-1(a) provides that where the decedent retains an interest with respect to only a part of the income from the property transferred, the “corresponding proportion” of the property is included in the estate.
* Therefore, a proportion of the value of the house will be included in Diane’s gross estate.
* Will be respected for husband and wife. Rev. 78-409.

(c) Diane leases the house from Sam for its fair rental value, and continues to live in it alone until her death.

*Answer:*

* Because Diane pays Sam the fair market rent and all parties treat Diane like a tenant rather than an owner, §2036(a)(1) will not apply.

(d) Diane sells the house to Sam for cash equal to its fair market value, and continues to live in it alone until her death.

* §2036 does not apply to transfer made for full an adequate consideration. Therefore, §2036(a)(1) will not apply.

## Part B. Retained Reversionary Interests

### Readings

* Transfer Taxes: Chapter Four, Parts D & E
* Code: §§ 2035(a), 2037
* Regs: § 20.2037-1

### Questions

1. Gene creates a trust with income to Harriet (Gene’s sister) for Harriet’s life, remainder to Carrie (Gene’s niece), if she survives Harriet and if not, then to Gene or his estate. If Gene predeceases Harriet and Carrie, is all or any portion of the trust includible in his estate?

*Answer:*

* The property interests are as follows:
  + Vested income interest in Harriet
  + Contingent remainder interest in Carrie
  + Contingent remainder interest in Gene
* Vested income interest in Harriet
  + §2037 will not apply to Harriet’s income interest, because Harriet is enjoying the income interest during D’s life.
* Contingent remainder interest in Carrie
  + §2037 will not apply to Carrie’s remainder interest, because Carrie can enjoy the property if Gene is alive.
* The reversionary interest will be included in Gene’s estate under §2033.

2. Gene creates a trust with income to Harriet or her estate for Gene’s life, remainder to Carrie if she survives Gene, and if not then to her estate. If Gene predeceases Harriet and Carrie, is any portion of the trust includible in her estate?

*Answer:*

* The property interests are as follows:
  + Vested income interest in Harriet or her estate
  + Contingent income interest in Harriet’s estate
  + Contingent remainder interest in Carrie
  + Contingent remainder interest in Carrie’s estate
* Vested income interest in Harriet or her estate
  + §2037 will not apply to Harriet’s income interest, because Harriet is enjoying the income interest during D’s life.
* Contingent income interest in Harriet’s estate
  + §2037 will not apply to Harriet’s estate’s income interest, because the estate can enjoy the property while Gene is alive
* Contingent remainder interest in Carrie
  + §2037 will not apply because Gene did not retain a reversionary interest in the property.
* Contingent remainder interest in Carrie’s estate
  + §2037 will not apply because Gene did not retain a reversionary interest in the property.

a. Would your answer be different if the words “and if not then to her estate” were removed?

*Answer:*

* The property interests are as follows:
  + Vested income interest in Harriet or her estate
  + Contingent income interest in Harriet’s estate
  + Contingent remainder interest in Carrie
  + Contingent remainder interest in Gene by operation of law
* Vested income interest in Harriet
  + §2037 will not apply to Harriet’s income interest, because Harriet is enjoying the income interest during D’s life.
* Contingent income interest in Harriet’s estate
  + §2037 will not apply to Harriet’s estate’s income interest, because the estate can enjoy the property while Gene is alive
* Contingent remainder interest in Carrie
  + §2037 will apply to Carrie’s remainder interest, because:
    - Gene transferred the property into the trust during his life for no consideration.
    - Carrie cannot enjoy the remainder if Gene is alive.
    - Gene retained a reversionary interest in the property if Carrie dies before Gene. Under most state law, the remainder would revert to Gene or his estate if Carrie were to die before Gene.
    - If the value of the reversionary interest is more than 5% of the total value of the property, then §2037 will apply. The value of the reversionary interest would be valued as of the moment before Gene dies, taking into account the relative ages of Gene and Carrie.
* Under §2037, all interests in the trust that can only be enjoyed after Gene dies are included in the estate.

3. Gene creates a trust with income to Harriet for Harriet’s life, reversion to Gene if he survives Harriet and if not then remainder to Carrie or her estate. If Gene predeceases Harriet and Carrie, is any portion of the trust includible in his estate?

*Answer:*

* The property interests are as follows:
  + Vested income interest in Harriet
  + Contingent remainder interest in Carrie
  + Contingent remainder interest in Gene
* Vested income interest in Harriet
  + §2037 will not apply to Harriet’s income interest, because Harriet is enjoying the income interest during D’s life.
* Contingent remainder interest in Carrie
  + §2037 will apply to Carrie’s remainder interest, because:
    - Gene transferred the property into the trust during his life for no consideration.
    - Carrie cannot enjoy the remainder if Gene is alive.
    - Gene retained a reversionary interest in the property if he survives Harriet.
    - If the value of the reversionary interest is more than 5% of the total value of the property, then §2037 will apply. The value of the reversionary interest would be valued as of the moment before Gene dies, taking into account the relative ages of Gene and Harriet.
* Under §2037, all interests in the trust that can only be enjoyed after Gene dies are included in the estate.

a. Would your answer be different if Gene irrevocably transferred his reversionary interest to Carrie one year prior to his death?

*Answer:*

* Absent the transfer, his reversionary interest would be subject to §2037.
* Because Gene transferred the interest within three years of his death, §2035 will apply.
* The full date of death value of the trust will be included in his estate under §2035(a).
* If he paid any gift tax with respect to the gift of the income interest, then it would also be included under §2035(b).

## Part C: Retention of Voting Rights in a Controlled Corporation

### Readings

* Transfer Taxes: Chapter Four, Part B, pp. 66-69
* Code: § 2036(b)
* Prop. Regs: § 20.2036-2
* Add’l Reading: Byrum v. U. S.

### Questions

Basic Facts: A owns 10% of X Corp. stock, which has one class of stock (voting common) outstanding. A’s wife W owns an additional 10% interest in X Corp. A transfers one-half of his interest in X Corp. (representing a 5% interest overall) to a trust for the benefit of his children. A serves as the initial trustee of the trust. The 5% interest has a value of $300,000 at the time the trust was funded. The trust requires that the net income be distributed to A’s children until A dies, with the remainder passing to the children outright. When A dies, the 5% interest owned by the trust is worth $500,000. At A’s death, A still owns 5% of the X Corp. stock outright, and W still owns her 10% interest.

1. What amount, if any, is included in A’s gross estate under IRC § 2036(a)(1)?

*Answer:*

* Because A is considered to own the 5 shares he owns outright, the 10 that are owned by his wife, and the 5 that are owned by the trust, the corporation is controlled within the meaning of the statute (both under §318 and in terms of 20% voting).
* The relevant stock is the stock that A transferred to the trust of which she is the trustee, because she will continue to have the power to vote that stock, so the necessary “retention” has occurred.
  + §2036(a)(1) will apply and the stock that D transferred to the trust will be included in his gross estate at its fair market value as of the date of death (i.e., $500,000).

2. Same as (1) except A named an independent commercial trust company as trustee instead of himself?

*Answer:*

* Because A is considered to own the 5 shares he owns outright, the 10 that are owned by his wife, and the 5 that are owned by the trust, the corporation is controlled within the meaning of the statute (under §318).
* However, because A is not the trustee of the trust, he will not continue to have the power to vote that stock. Therefore, the necessary retention has not occurred, and §2036(a)(1) will not apply.

3. Same as (1) except X Corp. had two classes of common stock outstanding (one voting and one nonvoting), and the 5% interest transferred to the trust consisted of nonvoting shares?

*Answer:*

* Because A is considered to own the 5 shares he owns outright, the 10 that are owned by his wife, and the 5 that are owned by the trust, the corporation is controlled within the meaning of the statute (under §318).
* However, because the shares transferred to the trust are non-voting, A will not continue to have the power to vote that stock. Therefore, the necessary retention has not occurred, and §2036(a)(1) will not apply.

## Part D: “Adequate and Full Consideration” Transfers within Three Years of Death

### Readings

* Transfer Taxes: Chapter Four, Part F
* Code: §§ 2035 & 2042
* Add’l Readings:
  + Estate of Allen
  + Estate of D’Ambrosio
  + TAM 8806004

### Questions

1. Grantor, age 55, transfers $1,000,000 to a trust that provides for income to the Grantor for life, remainder to Grantor’s nephew, or his estate. Ten years later, when the Grantor is 65 years old and the value of the trust principal is $3,000,000, Grantor makes the following alternative transfers. Assume that at the time of the transfer the actuarial value of the Grantor’s income interest is $700,000, and the value of the nephew’s remainder is $2,300,000.

a. He makes a gift of the income interest to his niece.

b. He sells the income interest to his niece for $700,000.

What will be the estate tax consequences to Grantor under each alternative if (i) Grantor dies two years after making the transfer, and (ii) Grantor dies 4 years after making the transfer. In all events assume that the trust has a value of $4,000,000 when Grantor dies.

*Answer:*

* The property interests are:
  + Vested income interest in Grantor
  + Vested remainder interest in Nephew
* If Grantor were to hold the income interest at death, he would be required to include the full value of the trust in his estate at death under §2036(a)(1)
* a. Gift of the Income Interest to Niece
  + i. Grantor dies two years after making the transfer
    - Because the transfer was made within three years of death, §2035 will apply.
    - The full date of death value of the trust ($4M( will be included in his estate under §2035(a).
    - If he paid any gift tax with respect to the gift of the income interest, then it would also be included under §2035(b).
  + ii. Grantor dies 4 years after making the transfer
    - §2036(a)(1) will not apply, because the grantor did not retain an interest in the remainder for life.
    - §2035 will not apply because the Grantor did not make a transfer within three years of death.
* b. Sale of Income Interest to Niece
  + i. Grantor dies two years after making the transfer
    - §2036(a)(1) will not apply, because the grantor did not retain an interest in the remainder for life.
    - §2035 will apply because there was not adequate and full consideration. The fair market value will mean the value of the property that would have been included in the estate under §2035.
    - Therefore, $3,300,000 ($4,000,000 less $700,000 will be included in Grantor’s estate.
  + ii. Grantor dies 4 years after making the transfer
    - §2036(a)(1) will not apply, because the grantor did not retain an interest in the remainder for life.
    - §2035 will not apply because the Grantor did not make a transfer within three years of death.

2. Grantor creates a $1,000,000 trust, with income payable to Grantor’s niece for life, reversion to Grantor or her estate. When the Grantor is 80 years old and his niece is 50 years old Grantor makes one of the following alternative transfers:

a. He makes a gift of the reversionary interest to his nephew.

b. He sells the reversionary interest to his nephew for its actuarial value.

What will be the estate tax consequences to Grantor under each alternative if (i) Grantor dies two years after making the transfer, and (ii) Grantor dies 4 years after making the transfer.

*Answer:*

* The property interests are:
  + Vested income interest in Niece.
  + Contingent remainder interest in Grantor
  + Contingent remainder interest in Grantor’s estate.
* Absent a transfer, §2037 will apply because:
  + Grantor transferred the asset into the trust during her life for no consideration.
  + Grantor’s estate cannot enjoy the remainder if Grantor is alive.
  + Grantor retained a reversionary interest in the property, if he outlived niece.
  + If the value of the reversionary interest is more than 5% of the total value of the property, then §2037 will apply. The value of the reversionary interest would be valued as of the moment before Grantor dies, taking into account the relative ages of Grantor and Niece.
  + The full value of the property, minus niece’s life interest, will be included in Grantor’s estate.
* Gift of the Reversionary Interest to Nephew
  + i. Grantor dies two years after making the transfer
    - §2037 will not apply, because the grantor did not retain an interest in the remainder for life.
    - Because the transfer was made within three years of death, §2035 will apply.
    - The value of the gross estate shall include the value of any property (or interest therein) which would have been so included under §2037.
    - If he paid any gift tax with respect to the gift of the income interest, then it would also be included under §2035(b).
  + ii. Grantor dies 4 years after making the transfer
    - §2037 will not apply, because the grantor did not retain a reversionary interest.
    - §2035 will not apply because the Grantor did not make a transfer within three years of death.
* b. Sale of the Reversionary Interest to Nephew
  + i. Grantor dies two years after making the transfer
    - §2037 will not apply, because the grantor did not retain a reversionary interest.
    - §2035 will not apply because there was adequate and full consideration. In this case, the value of the property that would have been included in the estate under §2037 is equal to its actuarial value.
    - Allen versus Ambrosio question (what is adequate and full consideration?) – Life estates diminish in value over time, but not remainders. That is why there is different treatment.
  + ii. Grantor dies 4 years after making the transfer
    - §2037 will not apply, because the grantor did not retain a reversionary interest.
    - §2035 will not apply because the Grantor did not make a transfer within three years of death.

3. Grantor, having made no prior gifts, transfers stock worth $6,000,000 to her daughter, and pays gift tax on the transfer of $350,000. Grantor dies two years later, when the stock is worth $8,000,000. What, if anything, will be included in her estate?

*Answer:*

* Because the gift was made within three years of her death, §2035 applies.
* §2035(b) will bring back into D’s gross estate the $350,000 in gift taxes that were paid on the gift.
* The estate is grossed up to include that amount.

# Unit V: Annuities & Life Insurance (§§ 2039 & 2042)

## Part A: Annuities Receivable by the Decedent (§ 2039)

### Readings

* Transfer Taxes: Chapter Five, Part A
* Code: § 2039. See also §§ 72(a) – (c) & 1014(b)(9)(A)
* Regs: § 20.2039-1(b)(1)

### Questions

1. X Corporation maintains a qualified retirement plan for its employees. Under the plan, both the employer and the employee make contributions to the plan on a pre-tax basis, i.e., amounts contributed to the plan are not included in the employee’s taxable income. Instead, the benefits will be included in the employee’s taxable income when paid to the employee. When each employee retires, he or she has the option to receive the amount in his or her account in one lump sum, or to have the amount paid out as an annuity, i.e., the employee receives regular payments over a period of time. If the employee dies prior to receiving the entire amount in his or her account, then the balance is payable to the employee’s surviving spouse, if any, and if none then to other beneficiaries designated by the employee.

(a) Dave is an X Corp employee, who retires at age 65. He elects to receive a lump sum payout of the $600,000 in his retirement account. He pays income tax on the amount, and invests it in the stock market. He dies two years later. What portion, if any, of his retirement benefits will be included in his estate? Under what authority?

*Answer:*

* The entire value of the amount invested in the stock market will be included in Dave’s estate under §2033.
* §2033 applies because (i) Dave had a property interest immediately before death and (ii) that property interest passed from Dave to others as a result of his death.

(b) Debby is also an X Corp employee, a widow, who retires at age 65. She elects to receive her retirement benefits as an annuity. She receives $100,000 per year for three years, and then she dies. At that point her undistributed account balance is $800,000, and under the terms of the plan the company pays that amount out to her adult children.

(i) What portion, if any, of her retirement benefits will be included in her estate? Under what authority?

*Answer:*

* The $800,000 undistributed balance payable to Debby’s adult children will be included in her gross estate under §2039.
* §2039 will apply because:
  + There is an annuity payable to the children by virtue of surviving Debby.
  + The amount is payable pursuant to a retirement plan.
  + Prior to death the Debbie was receiving payments under the retirement plan; and
  + The payments to decedent were payable for a period that did not in fact end before Debby’ death.

(ii) In order to answer this question, do you need to know what portion of the account was contributed by Debby, and what portion came from her employer?

*Answer:*

* Under §2039(b), the amounts contributed by the employer are attributed to Debby. The rules regarding proportionate allocation will not apply. Therefore, we do not need to know what portion of the account was contribute by Debby.

(iii) What income tax consequences will result when the account proceeds are paid to Debby’s children?

*Answer:*

* §691 will apply.
* The kids do not get a step up in basis. §1014(b)(9)(A) & (e)
* The $800K was never subject to income tax. Therefore, there is no basis step up.
* Basis in what? Isn’t this cash?

## Part B: Life Insurance (§ 2042)

### Readings

* Transfer Taxes: Chapter Five, Part B
* Code: §§ 2035(a), 2042 & 2503(b). See also § 101(a)(2)
* Regs: §§ 20.2031-8(a)(1); 20.2042-1; 25.2503-3(c)(ex 2), 25.2512-6(a)
* Readings: Rev. Rul. 84-179

### Questions

1. Darlene owns a $5,000,000 annual renewable term insurance policy on the life of her husband Hubert. The policy premiums are $50,000 per year. Under the terms of the policy, the owner of the policy has the sole right to name (and change) the beneficiary of the death benefit, and to cancel the policy.

(a) Darlene names her son Sam beneficiary of the policy. Has she made a taxable gift?

*Answer:*

* Darlene has not made a taxable gift, because the gift is not complete.
* The gift is incomplete because Darlene has the sole right to name (and change) the beneficiary of the death benefit and to cancel the policy,

(b) Darlene predeceases Hubert. Is the policy included in her gross estate? If so, what amount would be included?

*Answer:*

* The policy is included in Darlene’s gross estate under §2033.
* The value of that policy on the date of Darlene’s death will be included in her gross estate under §2033.

(c) Under the terms of Darlene’s will, ownership of the policy passes to Hubert. Hubert continues to pay the premiums and dies several years after Darlene. The $5,000,000 death benefit is paid to Sam. Is anything includible in Hubert’s estate?

*Answer:*

* The policy is included in Hubert’s gross estate under §2041(2).
* Hubert owned a life insurance policy on his own life, and he held at death one or more “incidents of ownership” with respect to the policy.
* The proceeds of the life insurance policy (i.e., $5,000,000) will be included in his gross estate.

(i) Would your answer be different if Darlene’s will left the policy to Sam instead of Hubert?

*Answer:*

* If Sam were the owner of the policy, the policy would not be included in Hubert’s gross estate.
* §2042(1) will not apply because Hubert’s estate is not the designated beneficiary of the policy.
* §2042(2) will not apply because Hubert did not hold at death one or more “incidents of ownership” with respect to the policy.
* §2033 will not apply because Hubert is not the owner of the policy.

(d) Alternatively, assume Darlene’s will leaves the policy to Hubert, who shortly thereafter transfers ownership of the policy to Sam. Hubert dies one year later.

(i) Has Hubert made a gift? Of what amount?

*Answer:*

* Hubert has made a completed gift of the policy in an amount equal to its replacement value at that time. §25.2512-6.

(ii) Is anything includible in Hubert’s gross estate? Under what authority?

*Answer:*

* The entire $5,000,000 that Sam receives will be pulled back into Hubert’s gross estate under §2035(a). Since Hubert relinquished all incidents of ownership over the policy within 3 years of his death when he transferred the policy, and because the policy would have been included in his estate under §2042 had he not made the transfer, §2035 clearly applies.
* If Hubert paid any gift tax with respect to the gift of the policy, then it would also be included under §2035(b).

2. Fred and Wilma are a married couple in their 40’s, who have two school age children. Fred is the principal wage earner, and although Fred’s interest in his computer company has substantial value, they don’t have much cash. Fred’s will leaves his estate to Wilma if she survives him, and if not the estate is held in trust until the children reach age 25. Wilma’s will mirrors Fred’s.

The couple’s financial advisor has suggested that they purchase a substantial insurance policy on Fred’s life in order to provide the family with liquid assets in the event of Fred’s death. The advisor has offered the following suggestions for structuring the purchase of the policy. Evaluate the benefits and risks of each of them:

(a) Fred will purchase the policy as owner, naming Wilma as beneficiary, and the children as contingent beneficiaries.

*Answer:*

* Assuming Fred holds “incidents of ownership” as the owner of the policy, the insurance proceeds of the policy will be included in his gross estate under §2042(2).
* However, the transfer will be eligible for the marital deduction. Therefore, nothing will be included in his estate.
* Wilma’s estate will include the policy under §2033.
* The children will receive net $3,000,000.
* See slides for example if Wilma dies first.

(b) Wilma will purchase the policy as owner, naming Fred’s estate as beneficiary. The proceeds can then be used to pay the expenses of Fred’s estate, including estate taxes, if needed, and any remaining cash can pass under Fred’s will.

*Answer:*

* The insurance proceeds of the policy, including the proceeds used to pay expenses, will be included in Fred’s gross estate under §2042(1).
* However, the transfer will be eligible for the marital deduction. Therefore, nothing will be included in his estate.
* Wilma’s estate will include the policy under §2033.
* The children will receive net $3,000,000.
* Under §20.2042-1(b)(1), any amount that is receivable (i) by the executor; (ii) by any other beneficiary subject to a legally binding obligation to pay debts, expenses, or taxes, or (iii) directly by a creditor is included in the decedent’s gross estate pursuant to §2042(1).
* See slides for example if Wilma dies first.

(c) Wilma will purchase the policy as owner, and will be named beneficiary, with the children as contingent beneficiaries.

*Answer:*

* For Fred:
  + §2042(1) will not apply because Fred’s estate is not the designated beneficiary of the policy.
  + §2042(2) will not apply because Fred did not hold at death one or more “incidents of ownership” with respect to the policy.
  + §2033 will not apply because Fred is not the owner of the policy.
* If Wilma predeceases Fred, then the policy is included in Darlene’s gross estate under §2033. The value of that policy on the date of Darlene’s death will be included in her gross estate under §2033.

(d) Fred will create a trust, funded with sufficient assets to pay at least the first year’s premium on the policy. The trust will purchase the policy as owner, and will be the named beneficiary. Under the terms of the trust, after Fred’s death the proceeds are held in trust, with income to Wilma for life, and then for the benefit of the children until they reach age 25.

(i) Should Fred be trustee?

*Answer:*

* Fred should not be the trustee.
* §2042(2) may apply if the decedent is the trustee and has the power to change the beneficial enjoyment of the policy proceeds even if he cannot do so for his own benefit. §20.2042-1(c)(4).
* If §2042(2) applies, the full amount of the insurance proceeds will be includible in his estate under §2042(2).

(ii) Should Wilma be trustee?

*Answer:*

* Wilma should be the trustee.
* If Wilma is the trustee, the proceeds of the policy will not be included in Fred’s estate.
* If Wilma predeceases Fred, the policy will not be included in her estate under §2033 because she did not beneficially own the property.

(iii) Assume the premiums on the policy are $20,000 per year, and that Fred will contribute to the trust the funds necessary to pay the premiums each year. Will that constitute a gift? If so, will it qualify for the annual exclusion?

*Answer:*

* This is a gift if the trust is irrevocable.
* This is a gift of a future interest. Therefore, the annual exclusion will apply.
* However use power of appointment to create present interest and qualify for annual exclusion.
* See 25.2503-3(c) Ex. 2.

3. Grantor has heard about the benefits of irrevocable life insurance trusts. He creates such a trust, naming a bank as Trustee, and providing for income to his wife for life, remainder to their children (or estates). He then purchases a $5,000,000 policy on his life, and transfers the policy to the trust.

a. What are the estate tax consequences to the Grantor if he dies within three years of the transfer?

*Answer:*

* The entire $5,000,000 that the beneficiary receives will be pulled back into Grantor’s gross estate under §2035(a). Since Grantor relinquished all incidents of ownership over the policy within 3 years of his death when he transferred the policy, and because the policy would have been included in his estate under §2042 had he not made the transfer, §2035 applies.
* If Grantor paid any gift tax with respect to the gift of the policy, then it would also be included under §2035(b).

b. Can the Grantor avoid these consequences by selling the policy to the trust for its fair market value? Are there any income tax issues raised by the sale?

*Answer:*

* §2035 should not apply because the policy was transferred for adequate and full consideration.
* §101 – do not have to recognize income.
* §101(a)(2) – However gives you a big problem.

c. What does this tell you about how the purchase of life insurance should be structured?

*Answer:*

* When possible, the trust should apply for and purchase the policy to avoid gift, estate, and income tax consequences.
* Grantor should have created the trust with a transfer of cash, and had the trust be the initial owner of the policy.

4. D owns 60% of X Corp. Several years ago, X Corp. took out a $5 million life insurance policy on D’s life. This year D dies. Is all or a portion of the life insurance proceeds in D’s estate? Do you need to know additional facts? See § 20.2042-1(c)(6).

*Answer:*

* We need to know whether some or all of the insurance proceeds are receivable by a beneficiary other than the corporation.
* If not, then the incidents of ownership in the corporation are not attributable to the decedent.
* If so, then the incidents of ownership in the corporation are attributable to the decedent.
* §20.2042-1(b)(6).

# Unit VI: Powers of Appointment (§ 2041)

## Part A: Powers of Appointment and the Transfer Tax in General

### Readings

* Transfer Taxes: Chapter Six
* Code: §§ 2041, 2514(b), (c) & (e)
* Regs: §§ 20.2041-1 (omit (c)(3), (d) & (e)); -3(a)-(d)

### Questions

Note: in answering the following problems disregard any potential application of the tax on generation-skipping transfers.

1. Gilda’s will creates a trust for the benefit of her son Sammy. The trust provides that Sammy is entitled to all of the income from the trust for life. Alternative principal distribution provisions are listed below. In each of the following alternatives, determine if Sammy holds a general power of appointment over the trust. In each case, consider if your answer depends on whether Sammy is Trustee at the time of his death.

(a) Remainder to Sammy’s issue, by representation.

*Answer:*

* By representation means by the default state rules without a will.
* Sammy does not have a power of appointment, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

(b) On Sammy’s death the trustee shall distribute the principal to such one or more of Sammy’s issue as he shall appoint by will. In default of appointment the principal will pass to Sammy’s issue, by representation.

*Answer:*

* Sammy holds a power appointment by will.
* However, Sammy does not have a general power of appointment because he does not have the power to appoint to himself, his creditors, his estate, or the creditors of his estate.

(c) On Sammy’s death the trustee shall distribute the principal to such one or more persons or entities as Sammy shall appoint by will. In default of appointment the principal will pass to Sammy’s issue, by representation.

*Answer:*

* Sammy holds a power appointment by will.
* However, Sammy has a general power of appointment because he has the power to appoint to himself, his creditors, his estate, or the creditors of his estate.

(d) During Sammy’s life the trustee may distribute principal to Sammy’s sister Betty, in the Trustee’s discretion. On Sammy’s death the remainder passes to Sammy’s issue, by representation.

*Answer:*

* The trustee holds a power of appointment.
* If Sammy were the trustee, the powers of the trustee would be imputed to him. However, he would not hold a general power of appointment because he does not have the power to appoint to himself, his creditors, his estate, or the creditors of his estate.
* Sammy does not have a power of appointment at death, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

(e) During Sammy’s life the trustee may distribute principal to Sammy, in such amounts as the trustee deems appropriate solely in the trustee’s discretion. On Sammy’s death the remainder passes to Sammy’s issue, by representation.

*Answer:*

* The trustee holds a power of appointment.
* If Sammy were the trustee, the powers of the trustee would be imputed to him. He would hold a general power of appointment because he has the power to appoint to himself, his creditors, his estate, or the creditors of his estate.
* Sammy does not have a power of appointment at death, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

(f) During Sammy’s life the trustee shall distribute principal to such persons and in such amounts as Sammy shall request from time to time. On Sammy’s death the remainder passes to Sammy’s issue, by representation.

*Answer:*

* Sammy holds a general power of appointment, regardless of whether he is the trustee, because he has the power to appoint to himself, his creditors, his estate, or the creditors of his estate.
* Sammy does not have a power of appointment at death, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

(i) During a particular year Sammy directs the Trustee to distribute $50,000 to Betty. Has Sammy made a gift?

*Answer:*

* When Sammy exercises the power during life, by directing that the trustee pay out $50,000 of principal to Betty, he has made a taxable gift to Betty under §2514.

(g) During Sammy’s life the trustee may distribute principal to Sammy in amounts needed for his health, education, maintenance and support in his accustomed standard of living. On Sammy’s death the remainder passes to Sammy’ issue, by representation.

*Answer:*

* The trustee holds a power of appointment.
* If Sammy were the trustee, the powers of the trustee would be imputed to him. However, he would not hold a general power of appointment because the power to appoint to himself is limited by an ascertainable standard.
* Sammy does not have a power of appointment at death, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

(h) During Sammy’s life the trustee may distribute principal to Sammy in amounts needed for his happiness and comfort. On Sammy’s death the remainder passes to Sammy’s issue, by representation.

*Answer:*

* The trustee holds a power of appointment.
* If Sammy were the trustee, the powers of the trustee would be imputed to him. He would hold a general power of appointment because he has the power to appoint to himself, and this power is not limited by an ascertainable standard.
* Sammy does not have a power of appointment at death, because he does not have the right to designate the beneficiaries of the remainder. The remainder goes to his issue.

2. Under the terms of a $1,000,000 trust created by his mother’s will, Dave was entitled to the entire net income, and as much of the principal as he requests from time to time, remainder to Dave’s niece Ann, or her estate. Assume, in the alternative:

a. Dave never exercised the power and died holding it.

*Answer:*

* The property interests are as follows:
  + Dave has an income interest for life.
  + Dave has a general power of appointment over the remainder.
  + Ann has contingent remainder interest.
  + Ann’s estate has a contingent remainder interest.
* If Dave chose to do so, he could terminate the trust and distribute the entire principal to himself, so the general power gives him ownership of the property.
* When Dave dies, the entire value of the trust will be included in his gross estate under §2041.

b. Dave exercised the power two years prior to his death, and withdrew $200,000 of the principal of the trust, which he invested.

*Answer:*

* When Dave dies, the entire value of the trust will be included in his gross estate under §2041.
* In addition, the $200,000 of principal of the trust which he invested, will be included in his gross estate under §2033.

c. Dave exercised the power two years prior to his death by directing the Trustee to distribute $200,000 to his child.

*Answer:*

* When Dave exercised his power, he made a taxable gift of $200,000 to his children under §2514.
* When Dave dies, the entire value of the trust will be included in his gross estate under §2041.

d. Dave exercised the power five years prior to his death by directing the Trustee to distribute $200,000 of the trust principal to a new trust, of which Dave is Trustee, which provided for income to his children for Dave’s life, in such shares as the Trustee determines, remainder to Dave’s children or their estates.

*Answer:*

* Year1: the creation of the trust was done through an exercise of a general power.
  + Treated as a gift to the trust.
  + Is this a completed?
    - The remainder is completed.
    - The income is not completed.
* If he had dies, the full value of the property would have been included under §2036(a)(2).
* On the date of Dave’s death, if he is trustee:
  + He has a non-general power of appointment.
  + However, it will be brought back in under 2041(a)(2). §2041(a)(2) and §2036(a)(2) both apply, but §2041(a)(2) supercedes.

3. Several years ago, George created an intervivos trust for the benefit of his daughter Debbie and her family. The trust instrument directs the Trustee that during Debbie’s life it is to distribute the net income and/or principal of the trust to Debbie and her three children in such proportions and amounts that the Trustee deems appropriate. On the death of Debbie, the Trustee is to distribute the principal to Debbie’s children, or their estates, in equal shares. Debbie is named Trustee. On Debbie’s death, will any portion of the trust be included in her estate under § 2041?

*Answer:*

* The property interests are as follows:
  + Debbie has an income interest for life.
  + Debbie’s three children have an income interest for life.
  + Debbie has an interest in principal for life.
  + Debbie’s three children have an interest in principal for life.
  + Debbie’s three children have a remainder interest.
  + The trustee has the power to designate income an principal, without limitation of an ascertainable standard.
  + Debbie is the trustee at death.
* Debbie, as the trustee, has a general power of appointment over the income and principal of the trust.
* The entire value of the trust will be included in her gross estate under §2041.

a. Would your answer change if George was co-Trustee of the trust, and was acting in that capacity when Debbie died?

*Answer:*

* Because Debbie can exercise the power of appointment with the donor, the power is not a general power of appointment.
* Therefore, no potion of the trust will be included Debbie’s gross estate under §2041.

b. What if George predeceased Debbie, and Debbie was sole Trustee at the time of her death?

*Answer:*

* Debbie, as the trustee, has a general power of appointment over the income and principal of the trust.
* The entire value of the trust will be included in her gross estate under §2041

c. What if Debbie’s brother Bobby was appointed Co-Trustee?

*Answer:*

* Although, Bobby must agree to distributions as co-trustee, jointly held general powers come within §2041, unless they can be exercised only in connection with either the (i) the creator of the power or (ii) a person who has a substantial interest adverse to its exercise.
* Bobby did not create the trust nor does he have any beneficial interest in the trust, let alone a substantial adverse one. §2041(b)(2)(c)(ii).
* Debbie therefore holds a general power of appointment, and the entire value of the trust will be included in her estate.

d. What if Debbie’s eldest child Sarah was Co-Trustee?

*Answer:*

* Jointly held general powers come within §2041, unless they can be exercised only in connection with either the (i) the creator of the power or (ii) a person who has a substantial interest adverse to its exercise.
* Because Sarah has a substantial adverse interest to Debbie, the power is not a general power of appointment.
* Therefore, no potion of the trust will be included Debbie’s gross estate under §2041.

e. What if Sarah was Co-Trustee, but the trust instead provided that the remainder passes to Bobby or his estate at Debbie’s death.

*Answer:*

* While Sarah might object to principal distributions to Debbie and not to her or her two siblings, §20.2041-3(c)(2)(3) makes it clear that Sarah’s status as a permissible appointee is not a substantial adverse interest.
* Therefore, Debbie dies holding a general power of appointment over the trust.
* The statute assumes that if Debbie wanted a principal distribution, then Sarah would only permit equal distributions to them. As a result, one half of the trust would be included in Debbie’s estate.

4. Horace’s will created a trust, with a bank as Trustee, for the benefit of his son Sean. The trust provides for income to Sean for life, remainder to Sean’s children, or their estates. In addition, Sean is entitled to withdraw $20,000 of the principal of the trust each year, by submitting a written request to the Trustee. This right is non-cumulative, so that if in any year Sean does not request a principal distribution his right to that year’s distribution terminates. Sean died five years after creation of the trust, and never made a request for a principal distribution. For purposes of this problem, assume that the principal of the trust during all relevant times is $400,000.

a. What portion of the trust, if any, will be included in Sean’s estate?

**[Prof. said Question 4(a) will be on the final exam – Class #14, 1 hour mark]**

*Answer:*

* First, Sean will include in his gross estate the amount ($20,000) he had the right to withdraw.
* Second, Sean will include in his gross estate the amount of the trust principal attributable to the lapse.
  + Sean has allowed his right to withdraw $20,000 to lapse.
  + This will be treated as a release to the extent that it exceeds the greater of $5,000 or 5% of the value of the trust (i.e., $20,000).
  + Therefore, Sean made a transfer of $0 as a result of the transfer ($20,000 from $20,000).
  + Because none of the lapse is treated as released, none of the trust principal is attributable to the lapse.

b. Would your answer to part (a) be different if the right to withdraw could only be exercised during the month of December, and Sean died in November?

*Answer:*

* Because, Sean did not hold at the time of his death the power to withdraw $20,000 in the year of his death, nothing will be included in his gross estate.

c. Would your answer to part (a) be different if the withdrawal right was $50,000 per year?

*Answer:*

* First, Sean will include in his gross estate the amount ($50,000) he had the right to withdraw.
* Second, Sean will include in his gross estate the amount of the trust principal attributable to the lapse.
  + Sean has allowed his right to withdraw $50,000 to lapse.
  + This will be treated as a release to the extent that it exceeds the greater of $5,000 or 5% of the value of the trust (i.e., $20,000).
  + Therefore, Sean made a transfer of $30,000 as a result of the transfer ($50,000 less $20,000).
  + The percentage of the trust property attributable to this release of powers is 7.5% ($30,000 / $400,000).
  + Therefore, Sean will include 7.5% of the remaining value of the trust in his estate.
    - See §20.2041-3(d)(4) & (5).
    - See slides for actual numbers.
    - $50,000 + $105,000 ($400,000-$50,000 \* 30%)
* But see §2702.
* Interesting hypo if Sean actually transferred $30,000 to the trust.

5. A partner in your law firm asks you to draft a trust for the benefit of a wealthy client. The client wants to make a substantial gift to his paramour, but because the paramour is quite wealthy in her own right the client wants to protect the assets from estate tax on her death. The partner asks you to draft a trust that provides the paramour with as close to complete ownership of the trust assets as is consistent with non-includibility in her estate. What type of distribution provisions would you include?

*Answer:*

* See CB, page 105, “Drafting to Allow Principal Distributions While Avoiding the Lapse Problem”

6. Lapse Review Problem: Assume G transfers $7,500,000 to an irrevocable intervivos trust on January 1 of year one, giving her daughter A the income for life, remainder to A’s children, or their estates. In addition to the income, A is given a noncumulative power to withdraw $500,000 of principal each year, exercisable during the month of December.

Assume that A does not exercise the power in years one or two, and dies on December 15 of year 3, and that the value of the trust in December of each year is as follows:

Year 1: $8,000,000

Year 2: $9,000,000

When A dies in year three, the value of the trust is $10,000,000.

What are the estate and gift tax consequences in years one through three (to A and G)?

*Answer:*

* Year 1:
  + A has allowed her right to withdraw $500,000 to lapse.
  + This will be treated as a release to the extent that it exceeds the greater of $5,000 or 5% of the value of the trust (i.e., $400,000).
  + Therefore, A made a transfer of $100,000 as a result of the lapse (subtract $400,000 from the $500,000 subject to the lapsed power).
  + A has made a gift of the remainder interest in the $100,000 subject to the power, which will be valued actuarially.
* Year 2:
  + A has allowed her right to withdraw $500,000 to lapse.
  + This will be treated as a release to the extent that it exceeds the greater of $5,000 or 5% of the value of the trust (i.e., $450,000).
  + Therefore, A made a transfer of $50,000 as a result of the lapse (subtract $450,000 from the $500,000 subject to the lapsed power).
  + A has made a gift of the remainder interest in the $50,000 subject to the power, which will be valued actuarially.
* Year 3:
  + First, A will include in her gross estate the amount ($500,000) she had the right to withdraw.
  + Second, A will include the amount of trust property attributable to the lapse (deemed release of the power of appointment).
    - A has allowed her right to withdraw $500,000 to lapse.
    - This will be treated as a release to the extent that it exceeds the greater of $5,000 or 5% of the value of the trust (i.e., $500,000).
    - Therefore, Sean made a transfer of $0 as a result of the transfer ($500,000 from $500,000).
    - Because none of the lapse is treated as released, none of the trust principal is attributable to the lapse.
* When A dies §2036 will apply.
  + In year 1, A is considered a settlor of 1.25% of trust ($100K/$800K)
  + In year 2, is considered a settlor of an additional .56% of trust ($50K/$9,000K).
  + In year 3, he is the settlor of 1.81% (1.25%+.56%)/
* Under §2041(a)(2): $672K [$500K + (1.81% \* $950K]

# Unit VII: Deductions (§§ 2053, 2055 & 2056)

## Part A: Expenses, Indebtedness & Taxes (§ 2053)

### Readings

* Transfer Taxes: Chapter Seven, Part A
* Code: §§ 2051, 2053(a), (b)
* Regs: §§ 20.2053-1(a), (b)(1) & (2), -7, -8

### Questions

1. Decedent died in 2019 with the following assets and liabilities:

a. The only asset of his probate estate was his margin investment account holding $2,000,000 in marketable securities. D owed the brokerage firm the sum of $200,000 on the account.

b. D was the grantor and lifetime beneficiary of a revocable living trust that contained most of his other assets, with a total value of $4,000,000.

c. Several years prior to his death D transferred his home into joint tenancy with his daughter, subject to a $500,000 recourse mortgage. At the date of death, the property was worth $1,500,000, and the mortgage still had a principal balance of $500,000.

d. D maintained a charge account with Tiffany’s. On the date of his death he owed Tiffany’s $50,000.

e. Shortly before he died D delivered a promissory note to his housekeeper for $50,000.

Consider the effect of the following transactions in determining the amount of D’s taxable estate:

a. The brokerage firm filed a claim against D’s probate estate for payment of the $200,000 on the margin account. The executor paid the claim.

*Answer:*

* The $200,000 will be deductible under §2053(a)(3) as a claim against the estate.
* Because there is security against the loan, it may also be deductible under §2053(a)(4).

b. Tiffany’s filed a claim against D’s probate estate for payment of the $50,000 due on the charge account. The executor paid the claim.

*Answer:*

* The $50,000 will be deductible under §2053(a)(3) as a claim against the estate.

c. The housekeeper filed a claim against D’s probate estate for payment of the $50,000 promissory note. The executor paid the claim.

*Answer:*

* The $50,000 may be deductible under §2053(a)(3) as a claim against the estate. However, an issue may arise whether the claim is bona fide in nature.
* If the $50,000 was for services rendered, then the $50,000 will be deductible. However, it will be income to the housekeeper, potentially implicating employment taxes.
* If the $50,000 was donative in nature, then it will be treated as a bequest and not deductible.

d. The probate court administering D’s estate approved an executor’s commission for D’s executor of $30,000. The executor paid the amount.

*Answer:*

* The $30,000 will be deductible under §2053(a)(2) as an administrative expense.

e. The Trustee of the revocable living trust paid himself $100,000 as a fee for managing and distributing the assets of the trust after D’s death.

*Answer:*

* The $100,000 may be deductible under §2053(b).
* However, an issue may arise may arise whether the expenses are for the benefit of the estate, of whether they are for the benefit of the beneficiaries.
* If the expenditures are not essential to the property settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, then portions of the $100,000 may not be taken as a deduction.

f. Because of D’s death the joint tenancy property vested in his daughter’s name. The bank holding the mortgage agreed to allow the daughter to become the obligor on the mortgage, and she took over the payments. Would the result be different if the mortgage was nonrecourse?

*Answer:*

* Property subject a recourse mortgage is included in the gross estate at its full value, and the mortgage deduction is deducted under §2053(a)(4).
* The entire value of the property (i.e., $1,500,000) will be included in the gross estate under §2040, and a mortgage deduction (i.e., $500,000) will be allowed under §2053(a)(4).
* Property subject to a non-recourse mortgage is included in the gross estate at its value net of the mortgage, meaning no deduction is taken. §20.2053-7.
* Therefore, if the mortgage was non-recourse, the net value of the property (i.e., $1,000,000) would be included in the gross estate, and no deduction would be taken.

## Part B: Transfers to Charity (§ 2055)

### Readings

* Transfer Taxes: Chapter Seven, Part B
* Code: §§ 2055(a), (b), (d), (e)(1) & (2); 2522(a), (c)
* Regs: §§ 20.2053-1, -7, -8

### Questions

1. D died with a gross estate of $15,000,000. Would any of the following alternative will provisions result in a deduction for his estate?

a. $5,000,000 to the Metropolitan Museum of Art, residue of his estate to his mother.

*Answer:*

* This is an outright transfer to a qualifying charitable organization.
* The $5,000,000 will be deductible from D’s estate under §2055.

b. The entire estate in trust with the following terms:

i. Income to his mother for life

ii. Principal to his mother as needed for her health.

iii. Remainder to the Metropolitan Museum.

*Answer:*

* The trust does not qualify as a CRAT because the trust will not pay a sum certain.
* The trust does not qualify as a CRUT because the trust will not pay a fixed percentage of the net fair market value of the trust assets.
* The trust is not a pooled income fund.
* Therefore, the D’s estate will not receive a charitable deduction.

c. The entire estate in trust with the following terms:

i. Income to Metropolitan Museum for 10 years

ii. Remainder to D’s children, or their estates.

*Answer:*

* The amount distributed to the charity is not in the form of an annuity or a unitrust payment.
* Therefore, the D’s estate will not receive a charitable deduction.

d. The entire estate in trust with the following terms:

i. $700,000 per year is paid to his mother for life.

ii. Remainder to the Metropolitan Museum.

*Answer:*

* The trust qualifies as a CRAT:
  + The trust is paying a sum certain to mother (i.e., $700,000);
  + The annuity is paid for the life of mother;
  + The annuity amount is 14% of the initial FMV of the property place in trust (i.e., $700,000 / $5,000,000);
  + The remainder is to be paid to a charitable organization;
  + The remainder is presumably at least 10% of the initial fair market value of the property contributed to the trust (determined using §7520).
* D’s estate will be allowed deduction for the present value of the remainder using the §7520 rates.

e. Left his estate in trust with the following terms:

i. $100,000 per year is paid to his mother for life.

ii. Remainder to the Metropolitan Museum.

*Answer:*

* The trust does not qualify as a CRAT because mother is receiving less than 5% of the initial value of the trust per year. Mother is receiving 2% per year ((i.e., $100,000 / $5,000,000).

f. The entire estate in trust with the following terms

i. Each year for her life D’s mother receives an amount equal to 6% of the value of the trust on the last day of the calendar year.

ii. Remainder to the Metropolitan Museum.

*Answer:*

* The trust qualifies as a CRUT:
  + The trust is paying a fixed percentage of the net fair market value of the trust assets to mother (i.e., 6%);
  + The annuity is paid for the life of mother;
  + The annuity amount is at least 5% and not more than 50% of the fair market value of the trust property;
  + The remainder is to be paid to a charitable organization;
  + The remainder is presumably at least 10% of the initial fair market value of the property contributed to the trust (determined using §7520).
* D’s estate will be allowed deduction for the present value of the remainder using the §7520 rates.

g. The entire estate in trust with the following terms

i. Each year for 10 years the Trustee pays $700,000 to the Metropolitan Museum.

ii. Remainder to D’s children, or their estates.

*Answer:*

* This is called a charitable lead trust.
* The income interest to charity will be deductible under §2055(e)(2)(B) because:
  + The property is transferred through trust;
  + The amount distributed to charity must be in the form of a unitrust payment (a fixed portion of the trust's market value); and
  + The amount must be distributed on an annual basis.
* D’s estate will receive a deduction for the present value of the ten year stream of payments, using the §7520 rate.

## Part C: The Marital Deduction: (§ 2056)

### Readings

* Transfer Taxes: Chapter Seven, Part C
* Code: §§ 2044, 2056, 2523, 2518
* Regs: §§ 20.2056(b)-1, -3(a), (b); 20.2056(c)-1, -2, 20.2056(d)-2

### Questions

1. D died in 2019, and as a result of his death the following occurred. In each case, what is the amount of the marital deduction available to D’s estate:

a. D died owning stocks and bonds valued at $1,000,000. His will left those assets to his wife.

*Answer:*

* The stocks and bonds valued are $1,000,000 are probate property.
* The stocks and bonds valued are $1,000,000 transferred to the wife qualify for the marital deduction under §2056(c)(l).

b. D died owning stocks and bonds valued at $1,000,000. His will left those assets to his same sex husband.

*Answer:*

* The stocks and bonds valued are $1,000,000 are probate property.
* The stocks and bonds valued are $1,000,000 transferred to the wife qualify for the marital deduction under §2056(c)(l).
* The supreme court case U.S. v. Windsor made it clear that the term “surviving spouse” includes legally married same sex couples.

c. D died without a will and under the intestacy law of his state the stocks and bonds were distributed to his wife as heir.

*Answer:*

* The stocks and bonds valued are $1,000,000 are probate property.
* The stocks and bonds valued are $1,000,000 transferred to the wife qualify for the marital deduction under §2056(c)(2).

d. D and his wife owned their residence (valued at $2,000,000) as joint tenants with right of survivorship. At D’s death title to the property vested in his wife.

*Answer:*

* D's interest that transfers to the wife by operation of law at the moment of death qualifies for the marital deduction under §2056(c)(5).

e. Under a trust created by his father’s will, D held a testamentary general power of appointment over $2,000,000. In his will D appointed those assets to his wife.

*Answer:*

* D exercised a power to appoint property to his wife.
* That property qualifies for the marital deduction under §2056(c)(6).

f. Under a trust created by his mother’s will, D held a non-general (special) testamentary power of appointment. In his will D appointed those assets to his wife.

*Answer:*

* That property does not qualify for the marital deduction under §2056(c)(6), because it is not included in the surviving spouses, gross estate.

g. D owned a $1,000,000 life insurance policy on his own life. At his death the company paid the death benefit to his wife, who was the designated beneficiary.

*Answer:*

* The proceeds of insurance on the life of D receivable by the wife for the marital deduction under §2056(c)(7).

h. D had a $2,000,000 retirement plan, which paid the death benefit in that amount to his wife, the designated beneficiary.

*Answer:*

* The amount will be included in the surviving spouse’s gross estate.
* That property qualifies for the marital deduction under 20.2056(c)-1(a)(6).

i. D leaves $1 Million to her child, residue to her husband. Child disclaims the entire $1 Million.

*Answer:*

* If the surviving spouse is then entitled to the· property, the property is deemed to have passed from the decedent to the survivor.
* That property qualifies for the marital deduction under §20.2056(d)-2(b).

2. Decedent’s will make the following dispositions. Which will qualify for the marital deduction?

a. My residence to my spouse, outright and free of trust.

*Answer:*

* The residence is probate property.
* The residence transferred outright to the wife qualifies for the marital deduction under §2056(c)(1).

b. My residence to my spouse for life, remainder to my children (i.e., a legal life estate).

*Answer:*

* The wife’s legal life estate in the residence is a terminable interest because her interest in the property will terminate at her death.
* The life estate will not qualify for the marital deduction under §2056(b)(1).

c. $1,000,000 to my trustee, to pay income to my spouse for life, remainder to my spouse’s estate.

*Answer:*

* Because D devised the property in trust for the benefit of the surviving spouse and at the spouse's death the property passes to her estate, the trust is treated as an “estate trust.”
* This type of trust qualifies for the marital deduction under §2056(b)(l)(A).

d. $1,000,000 to my trustee, to pay income to my spouse for life, remainder as my spouse appoints by will, in default of appointment to my children, or their estates.

*Answer:*

* This trust qualifies as a General Power of Appointment Trust because the surviving spouse is entitled to:
  + All the income from the property for life;
  + The income is paid at least annually; and
  + She received a general power of appointment over the property.
* This type of trust qualifies for the marital deduction under §2056(b)(5).

e. $1,000,000 to my trustee, to pay income to my spouse for life, remainder to my children, or their estates.

*Answer:*

* This is a QTIP trust under §2056(b)(7).
* The trust property qualifies for the marital deduction under §2056(b)(7).
* The trust property will be in the surviving spouse's gross estate pursuant to §2044.
* §2207A allows her to collect taxes that may be due as a result of this election.

f. $1,000,000 to my spouse, outright and free of trust, if she survives me by 90 days.

*Answer:*

* The survivorship clause will not prevent the marital deduction because the following conditions are met (§2053(b)(3)):
  + The spouse in fact survived the decedent by the requisite period of time; and
  + The required period of survivorship did not exceed six months.
* Here the 90 days definitely falls within the 90 days.

g. $1,000,000 to my spouse, outright and free of trust, if she survives until distribution of my estate.

*Answer:*

* The survivorship clause will not prevent the marital deduction because the following conditions are met (§2053(b)(3)):
  + The spouse in fact survived the decedent by the requisite period of time; and
  + The required period of survivorship did not exceed six months.
* Here, this provision will cause the property to definitely not qualify for the marital deduction. §20.2056(b)-3, ex. 4

h. Consider whether either of the following two interests in property are terminable interest within the meaning of § 2056(b)(1):

1. D leaves her spouse a patent with 12 years remaining in its useful life.

*Answer:*

* This is not a terminable interest.
* This interest will fail on the lapse of time, but no one other than the surviving spouse receives and interest in the property.
* This type of trust qualifies for the marital deduction.

2. D’s will instructs the executor of her estate to buy her spouse an annuity of $1,000,000 a year for life. The cost of the annuity is $10 million dollars.

*Answer:*

* Under §2056(b)(1)(C) this is a terminable interest.
* This makes not sense. Simply a trap for the unwary.

3. D’s will created a trust that provided for income to his spouse for life (payable at least annually), and the remainder to his children, or their estates. D's executor made a QTIP election under § 2057(b)(7). When her life estate was worth $10 Million and the remainder was worth $15 Million, D’s spouse transferred by gift 1/2 of her income interest. What are the transfer tax consequences, if any, of that transfer?

*Answer:*

* See CB, page 123, example #3, variation #3(d).
* Gift of life estate. §2511.
* Gift accelerates the taxation of the entire remainder. §2519.
* No estate tax consequences because of acceleration. §2044(b)(2).

3.5. Consider the following “Disclaimer Trust:” H & W, both age 60, have 4 children and jointly hold $50 million in assets.  By will, H leaves his estate to his spouse if she survives him, and if not then to his children or their estates in equal shares.  Any assets disclaimed by his spouse will be placed in Trust with the following terms: Income to W for life, Remainder to his children or their estates in equal shares.  H dies with a gross estate of $25 million.

Should W consider disclaiming all or a portion of her bequest?

*Answer:*

* The issue her is that the exemption amount may be going down in the future.
* Therefore, it may be beneficial to use exemption now.
* The spouse should disclaim $10,000,000.
* If she does not disclaim, then she is entitled to portability under §2010(c).
* However, the amount of the portability exemption is at the surviving spouse’s death, which may be lower.

4. W is married to H, they have no children. W wants to provide for H for his life, and wants the ASPCA to receive her estate after H’s death. What will be the amount of W’s taxable estate if she leaves her $15 million in assets as follows:

a. $1,500,000 per year to H for life, remainder to ASPCA.

*Answer:*

* The trust does not qualify a QTIP.
  + No, because the surviving spouse has to be entitled to the entire income interest.
* The trust qualifies as a CRAT:
  + The trust is paying a sum certain to wife (i.e., $1,500,000);
  + The annuity is paid for the life of mother;
  + The annuity amount is 10% of the initial FMV of the property place in trust (i.e., $1,500,000 / $15,000,000);
  + The remainder is to be paid to a charitable organization;
  + The remainder is presumably at least 10% of the initial fair market value of the property contributed to the trust (determined using §7520).
* The income interest will qualify for the marital deduction under §2056(b)(8).

b. Income to H for life, remainder to ASPCA.

*Answer:*

* The trust does not qualify as a charitable remainder trust because the amount distributed to charity must be in the form of an annuity or a unitrust payment.
* The income interest will therefore not qualify for the marital deduction.
* The trust may qualify as a QTIP trust. The gross estate will therefore be included in Harold’s gross estate under §2044(c), which will be eligible for the charitable deduction under §2055(a).

c. Income to H for life, remainder as Harold appoints by will.

*Answer:*

* The trust does qualify for the marital deduction under §2056(b)(5).
* The trust does not qualify as a charitable remainder trust because the remainder not is to be paid to a charitable organization. Therefore, W does not qualify for the charitable deduction.
* If Harold appoints to ASPCA, then it may qualify for the charitable deduction in his estate.

5. Consider the following “Spousal Lifetime Access Trust,” or SLAT: W creates an inter vivos trust by transferring $10 Million to its Trustee. The terms of the trust give to her spouse income for life with the remainder to her children. The Trustee has the power to distribute &/or accumulate income annually.

What might be the advantages of such a trust? See § 20.2010-1(c).

*Answer:*

* This is a terminable interest.
* No election under §2523, therefore fully taxable. I.e., not a QTIP trust.
* §20.2010-1(c) is an “anti-clawback” provision. It prevents the IRS from using the exemption at your death, if it is less than the exemption when you made gifts during your life.
* A SLAT therefore preserves the exemption amount.
* Better than portability election §2010(c)(3)(C), because portability election is the amount at the surviving spouses death.

# Unit VIII: Advanced Gift Tax Issues (§§ 2503, 2703 & 2518)

## Part A: Annual Exclusion Gifts in Trust

### Readings

* Transfer Taxes: Chapter Eight, Part A
* Code: §§ 2503; 2513
* Regs: §§ 25.2503-1, -3, -4, -6
* Readings:
  + Rev. Rul. 73-287
  + Rev. Rul. 74-43
  + Comm’r v. Herr
  + Cristofani v. Comm’r
  + Kohlsaat v. Comm’r

### Questions

Note: In answering the following questions disregard the potential impact of the GST.

1. In 2019 Donor Don, a widower, transfers $15,000 into a trust with Bank as Trustee that provides for income to Don’s daughter Ann for life, remainder to Ann’s son Bob, or his estate. If Ann is age 45, and the § 7520 rate is 3%, what is the amount of Don’s taxable gifts?

*Answer:*

* Don has transferred two property interests:
  + An income interest to Ann.
  + Remainder interest to Bob or his estate.
* Both transfers are completed gifts.
* The value of the completed gifts are as follows:
  + Section 7520 directs that the appropriate rate is 120% of the federal midterm rate, or 3% (given).
  + From Treas. Reg. 20.2031-7(d)(7), we get a remainder factor of .38817.
  + The value of the remainder interest is $5,823 ($15,000 \* .38817).
  + The value of the income interest is $9,177 (15,000 – 5,823).
* For the income interest to qualify as a present interest, there must be: (i) mandatory payments of income; (ii) income producing property; and (iii) no restrictions on distributions.
* The remainder interest is a future interest and does not qualify for the annual exclusion.
* If the income interest qualifies as a present interest, then Don’s taxable gifts equal $5,823.
* If the income interest does not qualify as a present interest, then Don’s taxable gifts equal $15,000.

a. Would your answer change if the trust allowed the Trustee the discretion to accumulate income?

*Answer:*

* If the trustee has the discretion to accumulate income, then the income interest is not a present interest.
* For the income interest to qualify as a present interest, there must be mandatory payments of income.
* See §25.2503-3(c) Ex. 1.
* Therefore, Don’s taxable gifts equal $15,000.

b. Would your answer change if the Trustee was directed to divide the income during Ann’s life between Ann and Bob in such proportions as the Trustee deemed appropriate?

*Answer:*

* Because the bank is acting as trustee, Don has not retained an interest in the income interests and cannot change the beneficial ownership of Ann and Bob. The transfer of the income interests are completed gifts.
* Because Don has not retained an interest in the remainder and cannot change the beneficial ownership of Bob, the transfer to C of a remainder interest in the trust is a complete gift.
* The income interests do not qualify as present interests, because the trustee is not mandated to make payments to either Ann or Bob. The payments are discretion. Therefore, neither Ann nor Bob’s income interest qualifies for the annual exclusion.
* The remainder interest is a future interest and does not qualify for the annual exclusion.
* See §25.2503-3(c) Ex. 3.

c. Would your answer change if the Trustee was directed to distribute the principal of the trust to Ann at her request?

*Answer:*

* Ann has been given a general power of appointment to withdraw trust property for her own benefit.
* This type of trust qualifies as a Crummey Trust.
* Ann’s income interest qualifies for the annual exclusion.
* Don’s taxable gifts equal $15,000 and the annual exclusion is $15,000.

d. Would your answer change if Ann had a testamentary general power of appointment over the trust?

*Answer:*

* Only has a present interest in income interest.
* The testamentary power of appointment is not eligible for annual exclusion.

2. Granny would like to make gifts to her grandchild George that will qualify for the annual exclusion. George is currently in grade school. Consider the consequences if Granny adopts the following alternative gift giving plans:

a. She transfers $15,000 each year to George’s parent as custodian under the Uniform Transfers to Minors Act.

*Answer:*

* Transfers to custodians are completed gifts of present interest that qualify for the annual exclusion.
* If the parents use the property for the support of George, the parents will be taxed on the income from that property.
* If the parents die before George reaches the age of majority, the property will be included in the parents’ gross estate under §2041. §2041 applies because the custodian’s powers are the equivalent of a general power of appointment.

b. She transfers $15,000 each year to George’s parent as Trustee of a trust that provides for accumulation of the income until George reaches age 21. When George reaches age 21 the trust terminates and all of the principal and accumulated income is distributed to George. If George dies prior to attaining age 21 the property passes to his estate.

*Answer:*

* The trust fails to qualify for the annual exclusion because it is unclear whether the trustee may distribute principal and income for George’s benefit.

c. She transfers $15,000 each year to George’s parent as Trustee of a trust that provides for distribution of income and principal to George as the Trustee deems appropriate until George reaches age 21. Any undistributed income is accumulated and added to principal. When George reaches age 21 the trust terminates and all of the principal and accumulated income pass to George. If George dies prior to attaining age 21 the property passes to his estate.

*Answer:*

* The trust qualifies as a Minor’s Trust under §2503(c).
* §2503(c) provides that no part of a gift to a minor will be considered a future interest if the following conditions are met:
  + The property and income therefrom may be expended by, or for the benefit of, the donee before his attaining the age of 21.
  + The property and its income must be distributed to or for the benefit of the donee before age 21 or accumulated and made available to the donee at age 21.
  + If the done dies before 21, the property and accumulated income must be payable to the donee’s estate or as the donee appoints under a general power of appointment.
* The value of the income interest qualifies as a present interest under §2503(c).
* The value of the remainder interest constitutes a taxable gift of a future interest.

(i) Would your answer be different if the trust continued until George reaches age 30 unless, within one month following his 21st birthday, he elects to terminate the trust?

*Answer:*

* To qualify under §2503(c), the trust must provide that the property and accumulated income will pass to the donee at age 21.
* However, this rule can be circumvented with a demand provision.
* As long as the child has the power to obtain the property at age 21 (e.g., through a demand provision), the trust can be drafted to continue past 21 and qualify under §2503(c).
* This power can be limited to a reasonable amount of time, such as 30 days, so long as the beneficiary has actual notice of the existence of the power.
* Case law has permitted such trusts to extend until the beneficiary is 25 or 30.
* Rev. Rul. 74-43.

d. She transfers $15,000 each year to George’s parent as Trustee of a trust that provides for distribution of income and principal to George as the Trustee deems necessary for George’s education until he reaches age 21. Any undistributed income is accumulated and added to principal. When George reaches age 21 the trust terminates and all of the principal and accumulated income is distributed to George. If George dies prior to attaining age 21 the property passes to his estate.

*Answer:*

* Transfers to a §2503(c) trust will not qualify as present interests, if there are substantial restrictions on the trustee’s ability to use the property for the child’s benefit.
* Distributions for George’s education are likely too restrictive, and will defeat the annual exclusion.
* §25.2503-4(b)(1).

e. She transfers $15,000 each year to George’s parent as Trustee of a trust that provides for distribution of income and principal in such amounts as the Trustee deems necessary for George’s health and education. When George reaches age 35 the trust terminates and all of the principal and accumulated income is distributed to George. If George dies prior to attaining age 35 the principal passes to Granny’s issue, by representation. The trust contains a provision that directs the Trustee to send written notice to George within 10 days following a contribution to the Trust by Granny. For 30 days thereafter George has the right to demand distribution of that contribution, up to the lesser of the amount contributed or the then applicable annual exclusion under § 2503(b).

*Answer:*

* This trust qualifies as a Crummey Trust.
* Because George has the right to demand distribution of the contribution, up to the lesser of the amount contributed or the then applicable annual exclusion under § 2503(b), he has a general power of appointment to withdraw trust property for his own benefit.
* The value of the income interest qualifies as a present interest, and will qualify for the annual exclusion.
* The value of the remainder interest constitutes a taxable gift of a future interest.
* This will create an inclusion for George as a retained power of appointment under §2036/2041.

f. George attends private school, at an annual cost of $45,000. Granny pays the tuition. What is the amount of her taxable gifts if she (i) pays the tuition directly to the school, or (ii) reimburses George’s parents for the cost.

*Answer:*

* Tuition Paid Directly to the School
  + Section 2503(e) excludes qualified transfers from the statutory definition of a gift.
  + Qualified transfers are (i) transfers to educational organizations for tuition, and (ii) transfers to medical care providers and to insurance companies for medical insurance.
  + For transfers to educational organizations for tuition, the exclusion is unavailable for amounts paid for books, supplies, dormitory fees, board, or other similar expenses that do not constitute direct tuition costs. §25.2503-6(a).
  + The trickiest part of Section 2503(e) is that the payment must be made directly to the provider; reimbursement of expenses made by the donee will not qualify for the exclusion.
  + If Granny pays the tuition directly to the school, there has not been a completed gift.
* Tuition Paid to the Parents
  + This is an outright gift to George’s parents.

3. Donor Diane creates a trust that provides for income to her 3 children for their lives, and on the death of the last child the trust is divided among Diane’s issue, by representation. Assume also the trust contains a “Crummey” provision, granting a withdrawal power to each of her three children and five grandchildren. In 2019, what is the maximum amount of wealth she can transfer to the trust without making a taxable gift if (i) she is unmarried, and (ii) she is married.

*Answer:*

* Diane has transferred the following property interests:
  + Income interests to her three children.
  + Remainder interest grandchildren.
  + General power of appointment in 3 children and grandchildren.
* The powers of appointment makes this a Crummey Trust.
* The maximum amount of wealth she can transfer to the trust which will qualify for the annual exclusion is $120,000 (8 \* $15,000), if she is unmarried.
* If she is married, then she can make split gifts. The maximum amount of wealth she can transfer to the trust which will qualify for the annual exclusion is $240,000 (2 \* 8 \* $15,000), if she is unmarried.

4. Irene owns a $1,000,000 whole-life life insurance policy on her own life, which has been in effect for a number of years. Its current value (determined under Reg. § 25.2512-6) is $300,000. The annual premium on the policy is $20,000. On December 1, 2019, she assigned all right, title and interest in the policy to a trust with her brother as Trustee which provides as follows:

a. During Irene’s life the Trustee will pay annual premiums on the policy. In the event the Trust lacks sufficient cash to pay the premium the Trustee is authorized to borrow against the policy as necessary.

b. Following Irene’s death the Trustee will collect the insurance proceeds, and will pay to Irene’s daughter Abby for her lifetime the entire net income, together with so much of the principal as the Trustee deems appropriate for Abby’s support. On Abby’s death the trust passes to Abby’s daughter Betty, or her estate.

c. If the Trustee receives a contribution to the trust from Irene, he is directed to notify Abby and Betty that they have the right to withdraw their pro-rata share of the contribution. For 30 days thereafter the beneficiary may exercise their right of withdrawal.

In 2019 Irene contributed $30,000 to the trust. The Trustee sent the requisite notice to Abby and Betty, and they did not exercise their withdrawal right. The Trustee then used the funds to pay the policy premium.

a. What are Irene’s total taxable gifts in 2019?

*Answer:*

* Irene has transferred the following property in 2019:
  + Life insurance policy with a value of $300,000;
  + Cash of $30,000.
* Because Irene is not the trustee, she has so parted with dominion and control as to leave in her no power to change the disposition.
* Therefore, she has made completed gifts of $330,000.
* However, Betty and Irene have Crummey powers over the $30,000 contribution.
* Therefore, the Irene should receive an annual exclusion for $30,000, bringing the taxable gifts down to $30,000.
* §20.2041-3(c) Ex. #2.
* Lapse problem for Abby?
  + Can avoid the lapse problem if 5% or 5%.
  + The denominator

b. What are Irene’s total taxable gifts in 2020?

*Answer:*

* Assuming Irene makes another gift of $30,000 for the premiums, the taxable gifts will be zero.
* This is because the taxable gifts will again qualify for the annual exclusion.

c. Will the assets of the trust be included in Irene’s estate if she dies in (i) 2021, or (ii) 2023?

*Answer:*

* If Irene dies in 2021, the $1,000,000 will be included in her gross estate under §2035(a).
* §2035(a) applies because Irene has relinquished all incidents of ownership over the policy within 3 years of her death, and the policy would have been included in her gross estate under §2042 had she not made the transfer.
* If Irene dies in 2023, no portion of the proceeds will be included in her gross estate.

d. When Abby dies will any portion of the trust be included in her estate?

*Answer:*

* No portion of the trust will be included in Abby’s gross estate:
  + §2033 will not apply because interest terminates at death.
  + §2036(a)(1) will not apply because Abby was not the initial transferor.

## Part B: Gift Tax Valuation

### Readings

* Transfer Taxes: Chapter Eight, Part B
* Code: §§ 2702, 7520
* Regs: §§ 25.2702-1; 25.2702-2(a), (b) & (d) Exs. 1-5; 25.2702-4(a), (c) & (d); 25.2702-5(a), (b)(1) & (2), (c)(1)

### Questions

1. Grantor Gayle transfers $1,000,000 into trust for the benefit of her niece Ann. The trust provides for income to Gayle for 15 years, remainder to Ann. Applying a discount rate of 10% the present value of Ann’s remainder interest is approximately $240,000.

a. What are the gift tax consequences of the transfer?

*Answer:*

* Gayle has transferred to her niece a remainder interest in the trust.
* This trust is a GRIT.
* §2702 does not apply to transfers to nieces.
* The value of the gift is therefore $240,000.

b. If Gayle dies 10 years after creating the trust, what will be the estate tax consequences?

*Answer:*

* §2036(a)(1) includes in the decedent’s gross estate the value of all property which the decedent has transferred during his life if the decedent retained the right to income whether or not the decedent is actually receiving the income at his death.
* The full value of the trust will be included in Gayle’s estate under §2036(a)(1).

c. If Gayle dies 18 years after creating the trust, what will be the estate tax consequences?

*Answer:*

* If the taxpayer retains the right to income for a term of years and outlives the term, nothing is in her gross estate.

d. Suppose Gayle also retains a reversionary interest in the trust, so that if she dies within the 15-year period the trust will revert to her estate. If the actuarial value of that reversionary interest is $140,000, how would that change your answers in (a) – (c)?

*Answer:*

* Gayle has created the following property interests:
  + Terms of years in income interest for herself;
  + Contingent remainder interest for herself;
  + Contingent remainder interest for Ann.
* The value of the gift of the contingent remainder interest in Ann is $100,000 ($240,000 - $140,000).
* If Gayle dies 10 years after creating the trust, the full value of the trust may be included in Gayle’s estate under §2037.
  + Gayle transferred the asset into the trust during her life for no consideration.
  + Neither Ann nor her estate cannot enjoy the remainder if Gayle is alive.
  + Gayle retained a reversionary interest in the property.
  + If the value of the reversionary interest is more than 5% of the total value of the property, then §2037 will apply. The value of the reversionary interest would be valued as of the moment before Gayle dies, taking into account the relative ages of Gayle and Ann.
* If Gayle outlives the term, she no longer holds a reversionary interest in the property. Therefore, nothing is included in her gross estate.

e. How would your answers in questions (a) and (d) change if the remainder beneficiary was Gayle’s son Sam?

a. What are the gift tax consequences of the transfer?

*Answer:*

* Gayle has transferred to Sam a remainder interest in the trust.
* Under §2702, the value of the interests retained by Gayle will be valued at zero, and the value of the retained interest will be $1,000,000.
* Gayle has therefore made a completed gift of $1,000,000 to Sam.

d. Suppose Gayle also retains a reversionary interest in the trust, so that if she dies within the 15-year period the trust will revert to her estate. If the actuarial value of that reversionary interest is $140,000, how would that change your answers in (a) – (c)?

*Answer:*

* If Gayle dies 10 years after creating the trust, the full value of the trust will be included in Gayle’s estate under §2036(a)(1).
* If Gayle retains the right to income for a term of years and outlives the term, nothing is in her gross estate.
* If Gayle retains a reversionary interest, and dies 10 years after creating the trust, the full value of the trust may be included in Gayle’s estate under §2037.

2. Grantor Greg transfers $1,000,000 in trust for the benefit of his two children. The trust provides for income to Greg for 10 years, remainder to his children in such shares as Greg shall direct in writing.

a. What are the gift tax consequences of the transfer?

*Answer:*

* The gifts of the remainder interests to the two children are incomplete because Greg can change the beneficial ownership (§25.2511-2(b)-(c))
* Therefore, §2702 does not apply.

b. What consequences if five years later Greg irrevocably directs that the remainder should be divided equally between the children, or their estates?

*Answer:*

* The gifts of the remainder interests to the two children were incomplete when created.
* When Greg irrevocably directs that the remainder should be divided equally between the children, or their estates, he has so parted with dominion and control over the property that the gifts are complete.
* Under §2702, the value of the income interest retained by Greg will be valued at zero, and the value of the remainder interest will be $1,000,000.
* Therefore, Greg has made completed gifts of $500,000 to each of his two children.

c. Would it make a difference if at the point he makes the designation the children pay him the actuarial value of the remainder at that time?

*Answer:*

* Under §2702(a)(1) adequate and full consideration is $1,000,000.
  + “(and the value of such transfer)”
* Because Greg did not receive adequate and full consideration for the remainder interests, the transfers of the remainder interests are gifts.
* Under 2702, the value will be $1,000,000 less the actuarial value.

d. What if instead the trust provided for income to Greg’s children for 15 years, in such shares as the Grantor shall determine, remainder to the children, or their estates.

*Answer:*

* The gifts of the income interests to the two children are incomplete because Greg can change the beneficial ownership (§25.2511-2(b)-(c)).
* However, the gifts of the remainders interests are complete.
* The question is what are the values of the gifts?
* Section 2702 applies to the transfers of the remainder interests in the trust because (i) it was transferred to the children, a member of the Greg’s family, and (ii) the children, applicable family members retained an interest in the trust.
* Under §2702, the value of the income interests will be valued at zero, and the value of the remainder interests will be $1,000,000.
* Therefore, Greg has made completed gifts of $500,000 to each of his two children.
* Professor says §25.2702-2(a)(4) applies.
* I think the answer is correct, but the rationale is wrong.

e. What if instead the trust provided for income to Greg’s brother for 10 years, remainder to Greg’s children in equal shares, or their estates.

*Answer:*

* Greg has made three completed gifts:
  + Gift of income interest to his brother;
  + Gift of half of remainder interest in child 1.
  + Gift of half of remainder interest in child 2.
* Gift of income interest to brother
  + Under §2702, a brother is a member of the family, but a descendant is not an applicable family member.
  + Therefore, §2702 will not apply.
  + Therefore, Greg has made a completed gift of the actuarial value of the income interest.
* Gift of remainder interests in children:
  + Under §2702, children are members of the family, but a brother is not an applicable family member.
  + Therefore, §2702 will not apply.
  + Therefore, Greg has made completed gifts of the actuarial value of the income interests.

f. What if instead the trust provided for $100,000 per year to Greg for ten years, remainder to Greg’s children in equal shares, or their estates.

*Answer:*

* Greg has made completed gifts of the remainder to his children.
* §2702 will not apply because the right to received fixed amounts payable is a qualified interest under §2702(B)(1).
* Therefore, Greg has made completed gifts of the actuarial value of the remainders to each of his children.

g. What if instead the trust provided for annual payments equal to 8% of the value of the trust, determined annually, for 10 years, remainder to Greg’s children in equal shares, or their estates.

*Answer:*

* Greg has made completed gifts of the remainder to his children.
* §2702 will not apply because the right to receive a fixed percentage of the trust property is a qualified interest under §2702(B)(2).
* Therefore, Greg has made completed gifts of the actuarial value of the remainders to each of his children.

3. Recall Grantor Gayle from Problem 1. Assume that the property she places in trust is her vacation home, worth $1,000,000. She retains the right to occupy the property for 15 years, and if she dies within that 15 year period the property will revert to her estate. After fifteen years the property passes to her son Sam.

a. What are the gift tax consequences upon creation of the trust?

*Answer:*

* Gayle has created the following property interests:
  + Terms of years in income interest for herself;
  + Contingent remainder interest for herself;
  + Contingent remainder interest for Sam.
* §2702 will not apply because the trust qualifies as a “personal residence trust” under §25.2702-5(b).
* The value of the gift of the contingent remainder interest in Sam is $100,000 ($240,000 - $140,000).
* §25.2702-5(b)(2)(B) is definition of personal residence.
* Excepted under §2702(a)(3)(A)(ii).
* Personal residence trusts (§25.2702-5(b)(2))
* Personal residence trusts (§25.2702-5(c))
* **Professor noted this will not be on the exam.**

b. What are the estate tax consequences if Gayle dies after 20 years, when the house is worth $5,000,000?

*Answer:*

* If Gayle outlives the term, she no longer holds a reversionary interest in the property. Therefore, nothing is included in her gross estate.

4. On September 1, 2016 Gaylord transfers $10,000,000 in assets to an irrevocable intervivos trust. Under the terms of the trust, the trustee is directed to pay to Gaylord the sum of $5,090,000 on September 1, 2017, and on September 1, 2018, at which point the trust will terminate and any remaining assets will pass to Gaylord’s children, or their estates. If Gaylord dies during the trust term the annuity will be paid to his estate. On September 1, 2013 the § 7520 rate is 1.2%. Applying that rate, the value of the children’s remainder interest is zero.

What are the estate and gift tax consequences of the trust? In answering, consider what difference it would make if the assets (i) appreciated at the § 7520 rate, or (ii) appreciated at the rate of 5% compounded annually.

*Answer:*

* Gaylord has made completed gifts of the remainder to his children or their estates.
* §2702 will not apply because the right to receive a fixed percentage of the trust property is a qualified interest under §2702(B)(2).
* If Gaylord dies during the trust term, the full value of the trust may be included in Gaylord’s estate under §2037.
  + Gaylord transferred the asset into the trust during her life for no consideration.
  + Neither his children, their estate, nor his estates can enjoy the remainder if Gayord is alive.
  + Gaylord retained a reversionary interest in the property.
  + If the value of the reversionary interest is more than 5% of the total value of the property, then §2037 will apply. The value of the reversionary interest would be valued as of the moment before Gaylord dies.
* If Gaylord outlives the term, he no longer holds a reversionary interest in the property. Therefore, nothing is included in his gross estate.
* Assuming Gaylord outlives the property and the appreciated rate is used, the remainder interest will be significantly higher than the estimated gift tax value using the §7520 rate. Therefore Gaylord will have successfully transferred assets without paying transfer taxes on their fair market value at the time the termination of the trust.

5. In 2018, Dad died, and his will created a testamentary trust with assets of $10 Million. The terms of the trust are as follows: Income to the wife of Dad’s Son (Dad’s daughter-in-law) for life, remainder to Dad’s Son, or his estate.

In 2020, Son made a gift of his remainder interest to his two children, or their estates. At the time of the gift, the trust was worth $12 Million and the actuarial value of the remainder interest was $400K. What are the gift tax consequences to S resulting from the gift of the remainder interest?

*Answer:*

* The son becomes the transferor in 2020.
* The spouse wil be an applicable family member (i.e., spouse of son)
* Therefore, §2702 will apply.

6. In 2016, Mom transfers property worth $1 Million into a trust that provides as follows: Income to Mom for life, remainder to Daughter, or her estate. At the time of the gift, the actuarial value of the remainder was $300K. Four years later, when the trust principal is worth $2 Million and the actuarial value of Mom’s income interest is worth $500K, one of the following alternative events occurs:

(i) Mom makes a gift of her income interest to Daughter, or

(ii) Mom dies

For each alternative, what are the transfer tax consequences to Mom or her estate in 2020? See Reg. sec. 25.2702-6(a) & (b).

*Answer:*

* In 2016, §2702 will apply.
* In 2020, the question the full value of the gift of the life estate should be taxed mom?
  + The regulations provide relief. §25.2702-6(b)
  + Reduce Taxable gift = $500K
  + Overvaluation caused by §2702 = $700K
  + Current Gift = $500K
  + No tax is imposed in 2020.
* If mom dies before gifting, then §2036(a)(1) applies.
  + Is mom given credit for 2016 taxes paid.
  + Yes, her estate will be given a credit for gift taxes payable under §2001

## Part C: Disclaimers

### Readings

* Transfer Taxes: Chapter Eight, Part C
* Code: § 2518
* Regs: §§ 25.2518-1(b), -2(a), (b), (c)(1), (2), (3), (5), (d), (e), -3(a), (b)

### Questions

1. On January 1, 2010, George creates an irrevocable intervivos trust that provides for income payable quarterly to his niece Nell for life, remainder as Nell appoints by will. In default of appointment the remainder passes to Nell’s children who survive her, in equal shares. In each of the following variations assume all the requirements of § 2518(b) are met except those described.

a. The Trustee makes the first two quarterly income payments to Nell. On August 1, 2010 she delivers to the Trustee a written disclaimer of both the income interest and the power of appointment.

*Answer:*

* The disclaimer of the general power of appointment is qualified. There is no issue with disclaiming the general power of appointment while retaining the income interest.
* The disclaimer of the income interest may be qualified if she has not benefited from the property by accepting the two quarterly income payments.
* It is still possible to disclaim if Nell never cashed the checks and returns the payments within the within 9 months from the date that the transfer is completed (i.e., January 1, 2010). §25.2518-2(c)(5) Ex. 6.

b. On August 1, 2010, Nell delivers to the Trustee a written disclaimer of the power of appointment as to one-half of the property.

*Answer:*

* Nell received the power of appointment as an intervivos gift.
* There is no problem disclaiming power of appointment over half the property. Missed the cite on the slide.
* Therefore, Nell must disclaim the testamentary power of appointment within 9 months from the date that the transfer is completed (i.e., January 1, 2010).
* Because Nell disclaimed the transfer within 9 months, the disclaimer is qualified.

c. On August 1, 2010 Nell delivers to the Trustee a written disclaimer of her right to appoint the property to herself or her estate, thereby converting the power to a special power.

*Answer:*

* This is not a qualified disclaimer. The power to appoint property to oneself, is not an undivided interest. §25.2518-3(a)(iii) & (b).

d. On January 1, 2015, Nell dies, survived by three children. Her will exercises the power of appointment in favor of her 35-year-old son Sam. On March 1, 2015 Sam:

i. Disclaims the property entirely, or

*Answer:*

* Sam received the property by reason of the exercise of a general power of appointment.
* He must disclaim within 9 months from the date the power is exercised (i.e., January 1, 2015).
* See §25.2518-2(c)
* Because Sam disclaimed the transfer within 9 months, the disclaimer is qualified.

ii. Disclaims the remainder interest in the property, but retains the income.

*Answer:*

* This is not a qualified disclaimer, because Sam has retained an interest in the property.

iii. How would your answer in part (i) differ if the permissible appointees of the power were limited to Nell’s issue?

*Answer:*

* Nell’s issue will receive the property by the exercise of a special power of appointment.
* Any person who might benefit from the power, including the holder of the power, and any permissible appointee and taker in default, must disclaim within 9 months after the special power is created (i.e., January 1, 2010).

iv. Assume that Sam was 18 when Nell died. The assets of the estate were distributed to him, and he used some of the funds to pay for his college education. Sam turned 21 on March 15, 2018, and he executed a written disclaimer of his interest in the property on that date.

*Answer:*

* The disclaimer is not disqualified because of timing. The clock is tolled until Sam is 21. §25.2518-2(d)(3).
* The disclaimer is not disqualified because Sam benefited from the property before the age of 21. §25.2518-2(d)(3).

# Unit IX: Valuation Issues

## Part A: General Valuation Issues

### Readings

* Transfer Taxes: Chapter Ten, Parts A & C
* Code: §§ 2031 & 7520(a)
* Regs: §§ 20.2031-1(b), -7(d)(7), -8(a)(1) & (2); 25.2512-5

### Questions

1. David owned a diamond ring that has been in the family for 5 generations. David bequeaths the ring to Claire. The ring has such great sentimental value that David would not have sold it for any amount, and Claire would not sell it for less than $1 million. What amount is included in Daisy’s gross estate, and under what section?

*Answer:*

* The diamond ring is included in David’s estate under §2033.
* The value of the diamond ring is its fair market value. §20.2031-1(b)
* Claire’s personal sentiments are not taking into account.
* The fair market value would likely be determined by an appraiser using the market approach

2. Daisy owns a $1 million life insurance policy on her husband, Hank. When Daisy dies, the cash value of the life insurance policy is $400,000. A couple of months before Daisy’s death, Hank was diagnosed with colon cancer. Accordingly, the cost of replacing the existing policy on Daisy’s date of death would have been $950,000. What amount is included in Daisy’s gross estate, and under what section?

*Answer:*

* The life insurance policy on the life of Hank is included in Daisy’s estate under §2033.
* The value of life insurance policy is normally established by sales of comparable policies by that company. §20.2031-8.
* Professor Cunningham said you use the actuarial value of the life insurance policy.
* He was less receptive to my arguments below:
  + Even though the cash surrender value is $400,000, the value of comparable policy on Daisy’s date of death was $950,000.
  + Therefore, $950,000 will be included in Daisy’s gross estate

## Part B: The Alternate Valuation Date

### Readings

* Transfer Taxes: Chapter Ten, Part B
* Code: §§ 1014(a); 2031; 2032(a), (c) & (d); 2512, 7520
* Regs: §§ 1.1014-3(a); 20.2032-1(a) – (c) & (f); 25.2512-1

### Questions

1. D died owning the following assets:

|  |  |  |
| --- | --- | --- |
| **Property** | **Date of Death Value** | **Value 6 Months After Date of Death** |
| Residence | 800,000 | 900,000 |
| Vehicle | 50,000 | 50,000 |
| X Corp. stock | 4,000,000 | 3,600,000 |
| Y Corp. stock | 6,000,000 | 6,500,000 |
| Z Corp. stock | 4,000,000 | 4,500,000 |

Three months after D died, his executor sold the residence and vehicle for $850,000 and $50,000, respectively. Also, fearing that the Z Corp. stock had peaked, the executor sold it for $4,350,000 four months following D’s death.

Is the alternate valuation date election under IRC § 2032 available for D’s estate?

*Answer:*

* The date of death value of the estate is $14,850,000.
* If the alternate valuation date is elected then property that is sold, exchanged, distributed, or otherwise disposed of before the alternate valuation date is valued as of the date of disposition. §2032(a)(1). This rule applies to the residence, vehicle, and Z Stock.
* Therefore, the value 6 months after the date of death is $15,350,000
  + Residence = $850,000
  + Vehicle = $50,000
  + X Stock = $3,600,000
  + Y Stock = $6,500,000
  + Z Stock = $4,350,000
* Under §2032, the executor can elect the alternate valuation date only if (i) the election decreases the value of the gross estate and (ii) reduces the transfer taxes due.
* Because the election does not decrease the value of the gross estate, the executor cannot elect the alternate valuation date.

## Part C: Valuation of Business Entities

### Readings

* Transfer Taxes: Chapter Ten, Part D (through p. 177)
* Regs: §§ 20.2031; 25.2512-3. Review § 2702
* Add’l Materials:
  + Estate of Bright
  + Rev. Rul. 93-12
  + Laura E. Cunningham, Remember the Alamo: The IRS Needs Ammunition to Fight Against FLPs

### Questions

1. G owns 60% of the stock of X Corp., and his children, A and B, each owns 20%. G gives a 40% stock interest to A and a 20% stock interest to B, resulting in A and B owning 60% and 40% of X Corp. respectively. In valuing his gifts to his children, can G make use of a minority interest discount?

*Answer:*

* The gifts will not be aggregated, so each gift is analyzed separately. See Rev. Rul. 93-12.
  + The gifts are valued independently of the other gifts.
  + The gifts are also valued independently of the shares in the hands of the recipients.
* The gift of the 20% stock interest to B is likely eligible for the minority interest discount. The gift of the 20% is a minority interest, and the stock in the hands of B is a minority interest.
* The gift of the 40% interest to A is more difficult to determine. While the gift of the 40% interest is a minority interest, when combined with his other 20% interest it becomes a majority interest. Therefore, the IRS may disallow the minority interest discount.

2. Same as (1), except the transfers to A and B occur at G’s death. In valuing the amount of the X Corp. stock included in his estate, can G’s estate claim a minority interest discount?

*Answer:*

* For estate tax purposes, the two bequests are aggregated in the estate of G.
* Because the 60% interest represents a majority interest, a minority interest discount will be disallowed.
* G should make a deathbed transfer. But will it be respected?
  + Yes, it will. See Estate of Frank.

3. D owns $100 million worth of marketable securities. She is 70 years old, a widow, and in good health. She has 3 children, all happily married and 6 grandchildren. While surfing the internet, she has run across a web site entitled “paynotaxes.com” On that site there were references to “FLPs” and “GRATs,” which the web site said were very useful in avoiding estate taxes. This piqued her interest and has come to you for advice. She would like to know if it is true that these acronyms, whatever they stand for, could be to minimize her estate taxes, and if so, how. How would you respond? (If helpful in thinking about your response to D, assume that the federal midterm rate is 5%).

*Answer:*

* See CB, page 174, “Tax Planning and Discounts”
* See CB, page 176, “GRATs and Discounts”

4. Nancy and Fred are married and each owns 40% of the stock of Y Corp. Nancy predeceases Fred, and leaves her Y stock to a trust which provides for income to Fred for life, remainder to Nancy’s children. Nancy’s executor makes the QTIP election, entitling the estate to a marital deduction under IRC § 2056(b)(7).

a. At Fred’s death, what portion of the Y Corp. stock will be included in his gross estate, and under what section(s)?

*Answer:*

* The full value of the trust will be included in Fred’s estate under §2044.

b. Will Fred be able to claim a minority interest discount with respect to any of the portion of the Y Corp. stock that is included in his gross estate?

*Answer:*

* In Estate of Mellinger v. Commissioner, the Tax Court determined that QTIP assets should not be aggregated with other property in the surviving spouse's estate for valuation purposes.
* Fred will be able to claim a minority interest discount in both blocks of the Y Corp. shares, held personally and through the QTIP trust.
* See BNA Portfolio 831, VII, B. “Minority Interest Discount.”

5. Same situation as (4), except that instead of using a QTIP trust, Nancy leaves her stock in Y Corp. to a trust which provides for income to Fred for life, remainder to whomever Fred appoints pursuant to a general power of appointment.

a. At Fred’s death, what portion of the Y Corp. stock will be included in his gross estate, and under what section(s)?

*Answer:*

* Both §§§2044(c) and §2041(a) cause the value of QTIP property and property subject to a general power, respectively, to be included in a decedent's estate.

b. Will Fred be able to claim a minority interest discount with respect to any of the portion of the Y Corp. stock that is included in his gross estate?

*Answer:*

* In Estate of Fontana v. Commissioner, the Tax Court held that, in valuing the decedent's estate, stock held outright at the time of death must be aggregated with that over which the decedent held a general power of appointment.
* Fred will not be able to claim a minority interest discount in either block of the Y Corp. shares.

## Part D: Intentionally Defective Grantor Trusts

### Readings

* Transfer Taxes: Chapter Ten, Part D (pp. 178-80)
* Code: §§ 671, 674(a), 674(4)(C). Skim §§ 453(a), (b)(1) & (c); 672-677.
* Add’l Materials:
  + Cunningham & Cunningham, Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules

### Questions

**For purposes of your analysis of the following Problem, assume that all parties are always in the 40% income tax bracket and that all transfer tax issues are governed as if they arose in 2019.**

***Basic Facts:*** Several years ago, G set up a FLP by contributing to it marketable securities. The value of the contributed securities today is $100,000,000. In December of 2018, G set up a trust for her children and grandchildren to which she contributed $1,000,000 cash. She had never made any previous taxable gifts. G appointed an independent trustee to whom she gave the discretion to distribute (or not) trust income among the beneficiaries. She also reserved the right to reacquire the trust corpus by substituting property of equal value. On January 1, 2019, she sold a 15% interest in the FLP to the Trust for $10,000,000, the interest’s appraised fair market value. Under the terms of the sale, the Trust executed a secured promissory note for the entire purchase price in which it agreed to pay the full amount in a balloon payment in 9 years. The note bears interest at the current federal mid-term rate of 2.0%.

In 2019, the FLP earns taxable income of 6%, or $6,000,000, of which $900,000 is allocated and distributed to the Trust. The Trust invests the $1,000,000 contributed by G in marketable securities and earns $60,000. At year end, the Trust pays G $200,000 in interest on the note. The Trust reinvests the $900,000 it receives from the FLP in additional marketable securities and makes no distributions to its beneficiaries.

***Question:*** What are the income &/or transfer tax consequences to the parties as a result of these transactions in 2019?

*Answer:*

* See class #23.
* [Good Exam Prep]
* This is a grantor trust.
* The income from the trust will be taxable to G.
* What are the income tax consequences of the $200K interest payment?
  + Nothing happens. This is a transaction between the same entity.
* The trust has $960K of income for 2020, who is taxed on the income?
  + The grantor pays tax on the income.
* How much is the trust worth at the end of 2020?
  + At least the $1M and the $60K
  + Plus the 15.7M less the $10M liability
* Total = $1.06M + $15M - $10M = $6.96M
* This will continue for another 8 years.

***Additional Facts:*** From 2019 through 2027, each year, the FLP and the Trust earn 6% in taxable income on all their investments, the FLP distributes to the Trust its share of that income, the Trust pays G $200,000 of interest on the note, and on January 1, 2028, the Trust pays the principal balance on the note of $10,000,000.

***Further Question:*** Assuming the Trustee did not make any distributions from the Trust, what would be the value of the Trust on January 1, 2028? (Hint: $16,000,000 invested at 6% for 9 years will grow to $27,000,000.)

*Answer:*

* On January 1, 2029, after payment of the note to G, the value of the trust will be approximately $17M.

# Unit X: The Tax on Generation-Skipping Transfers

## Part A: Introduction to Terminology: Who is a “Skip Person”?

### Readings

* Transfer Taxes: Chapter Nine, Parts A & B
* Code: §§ 2611, 2612, 2613, 2651 & 2652
* Regs: §§ 26.2612-1(d), (e), 26.2651-1

### Questions

1. In each of the following situations, determine if the designated person is a skip person with respect to T. Unless otherwise specifically noted, assume the parent of every designated person is alive.

a. T’s child.

*Answer:*

* T’s child is generation -1. Not a skip person.

b. T’s nephew.

*Answer:*

* T’s nephew is generation -1. Not a skip person.

c. T’s first cousin.

*Answer:*

* T’s first cousin is generation 0. Not a skip person.

d. T’s grandchild.

*Answer:*

* T’s grandchild is generation -2. She is a skip person.

e. T’s grandchild, whose mother, T’s child, is deceased.

*Answer:*

* §2651(e) provides that if a recipient’s parent dies before the transfer that is subject to the gift tax or the estate tax, the recipient is moved up to the parent’s generation.
* T’s grandchild is therefore generation -1, and not a skip person.

f. T’s grandchild, whose father, T’s son-in-law, is deceased. The mother of the grandchild is alive.

*Answer:*

* The deceased parent exception does not apply. We are only concerned with the death of the parent who was related to the transferor or spouse by blood.
* T’s grandchild is generation -2. She is a skip person.

g. T’s great-grandchild, whose parent, T’s grandchild, is deceased.

*Answer:*

* The deceased parent exception applies.
* However, T’s great-grandchild is only moved up one generation.
* Therefore, T’s great-grandchild is generation -2. She is a skip person.

h. T’s grand-niece, whose parent, T’s nephew, is deceased. What additional information do you need to know in order to answer?

*Answer:*

* Application of the deceased parent exception will depend on whether T had living lineal descendants at the time of the gift.
* If T had none, then grand-niece would be move up one generation.
  + She would be generation -1.
  + She would not be a skip person.
* If T did have living descendants at the time of the gift, then grandniece’s generation assignment would not change.
  + She would be generation -2.
  + She would be a skip person.

i. T’s first cousin, twice removed, whose parent, T’s first cousin once removed, is dead.

*Answer:*

* Deceased parent exception will not apply because not a descendant of the parent.
* She is generation -2.
* She is not a skip person.

j. T’s spouse.

*Answer:*

* Spouses are assigned to the same generation as the transferor or other individual. §2651(c).
* T’s spouse is generation zero, and not a skip person.

k. T’s step-child, i.e., the child of T’s spouse

*Answer:*

* §2651(b)(2) provides an individual who is a lineal descendant of a grandparent of a spouse (or former spouse) of the transferor (other than such spouse) shall be assigned to that generation which results from comparing the number of generations between such grandparent and such individual with the number of generations between such grandparent and such spouse.
* T’s step child is generation -1. Not a skip person.

l. T’s step-grandchild, i.e., the grandchild of T’s spouse.

*Answer:*

* T’s step-grandchild is generation -2. She is a skip person. §2651(b)(2).

m. The spouse of T’s grandchild.

*Answer:*

* An individual who has been married at any time to an individual described in subsection (b) shall be assigned to the generation of the individual so described. §2651(c)(2).
* The spouse of T’s grandchild is generation -2. She is a skip person.

n. T’s long time companion. T is 70, her companion is 55.

*Answer:*

* If the individual is not more than 12.5 years younger than the transferor, she is assigned to the transferor’s generation. If the individual is more than 12.5 years, but less than 37.5 years younger, she will be assigned to the generation below the transferor. §2651(d).
* T’s long time companion is 15 years younger.
* T’s long time companion is generation -1. Not a skip person.

o. T’s long time companion. T is 70, the companion is 30.

*Answer:*

* T’s long time companion is 40 years younger.
* T’s long time companion is generation -2. She is a skip person.

p. The child of T’s companion. T is 70, the companion is 45, and the child is 15. Would it make a difference if T adopted the child?

*Answer:*

* The child of T’s companion is 55 years younger.
* The child of T’s companion is generation -3. She is a skip person.
* A relationship by legal adoption shall be treated as a relationship by blood.
* The child of T’s companion would therefore be generation -1. Not a skip person.

2. T’s will leaves his entire estate in trust. T has one child, C, and C has one child, GC. T also has a spouse, S. Unless specifically stated otherwise, assume that T is survived by C, S and GC. Will the trust be a skip person if it provides:

a. Income to Spouse for life, remainder to C, if living, and if not then to GC, or his estate.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - Spouse
  + The trust is not a skip person because spouse holds a §2652 interest in the trust and is not skip person.

b. Income to Child for life, remainder to GC, or his estate.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - Child
  + The trust is not a skip person because child holds a §2652 interest in the trust and is not skip person.

c. Income to GC for life, remainder to his estate. The Trustee has the authority to invade principal for the benefit of C.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - C
    - GC
  + The trust is not a skip person because child holds a §2652 interest in the trust and is not skip person.

d. Income to GC for life, remainder to GC’s estate. C predeceased T.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - None
    - GC is not a skip person because of the orphan rule.
  + The following people have §2652 interests:
    - GC
  + The trust is a not skip person because GC holds a §2652 interest in the trust and is not a skip person.

e. Income to S for life, remainder to C, if living, and if not then to GC or his estate. C survives T, but predeceases S. Assume, in the alternative, (i) T’s estate makes no QTIP election with respect to the trust, or (ii) T’s estate does make a QTIP election with respect to the trust.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - S
  + The trust is not a skip person because spouse holds a §2652 interest in the trust and is not skip person.
* At the death of S:
  + If T’s estate makes no QTIP election:
    - T remains the transferor
    - The following people are skip persons:
      * GC
      * The orphan’s rule does not apply. §2651(e)(1)(B).
    - The following people have §2652 interests:
      * GC
    - The trust is a skip person because all §2652 interests in the trust are held by skip persons.
  + If T’s estate makes a QTIP election:
    - Spouse becomes the transferor:
      * The trust property will be included in her gross estate under §2044.
      * Spouse is the transferor for GST purposes. §2652(a)(1).
    - The following people are skip persons:
      * None
      * GC is not a skip person because of the orphan rule.
    - The following people have §2652 interests:
      * GC
    - The trust is not skip person because a §2652 interest in the trust is held by a non-skip person.

f. Income to be accumulated until GC reaches age 35, at which the income is payable to GC and C in amounts determined in the Trustee’s discretion. When GC reaches age 50 the trust is distributed to him, or his estate.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - None
  + The trust is not a skip person because no one holds a §2652 interest in the trust, and C, a non-skip person, can receive a transfer when GC reaches the age of 35.

g. Income to be accumulated until GC reaches age 35, at which point the trust terminates and is distributed to GC, or his estate.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - None
  + The trust is a skip person because no one holds a §2652 interest in the trust, and at no time can a transfer be made to a non-skip person.

## Part B: Taxable Events: What is a “GST”?

### Readings

* Transfer Taxes: Chapter Nine, Part B
* Code: §§ 2611, 2612, 2642(f), 2652, 2653(a)
* Regs: §§ 26.2612-1, 26.2652-1(a)(1),(2), 26.2653-1

### Questions

In each of the following situations identify if a generation-skipping transfer (GST) has occurred, and if so, which type of GST it is. Unless otherwise specifically noted, assume the parent of any beneficiary is alive at the time of the transfer, and ignore the effect, if any of the annual exclusion.

1. T dies and her will leaves $100,000 to her daughter, D.

*Answer:*

* A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
* T is the transferor.
* T has made a transfer subject to the estate tax.
* D is not a skip person.
* Therefore, the transfer is not a direct skip.

2. T’ dies and her will leaves $100,000 to her grandson GC.

*Answer:*

* A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
* T is the transferor.
* T has made a transfer subject to the estate tax.
* GC is a skip person.
* Therefore, the transfer is a direct skip.

3. T dies and her will leaves $100,000 to her grandson GC, whose mother, D (T’s child), predeceased T.

*Answer:*

* T is the transferor.
* T has made a transfer subject to the estate tax.
* GC is not a skip person because of the orphan rule.
* Therefore, the transfer is not a direct skip.

4. T makes an intervivos gift of $100,000 to her great-grandson GGC.

*Answer:*

* T is the transferor.
* T has made a transfer subject to the gift tax.
* GCC is a skip person.
* Therefore, the transfer is a direct skip.
* Although this transfer skips multiple generations, there is only one GST due in addition to the gift tax. §26.2612-1(f) ex. 2.

5. T leaves his estate in trust with income to Daughter D for life, then to grandson GC for life, remainder to great-grandson GGC, or his estate.

a. Is there a GST when T dies?

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC
      * GCC
    - The following people have §2652 interests:
      * D
    - The trust is not skip person because a §2652 interest in the trust is held by a non-skip person.
    - Therefore, this is not a direct skip.
* Taxable Termination
  + This is not a taxable termination because no interest in the trust has been terminated.
* Taxable Distribution.
  + This is not a taxable distribution because there has been no distribution.

b. Is there a GST when D dies?

*Answer:*

* Taxable Termination
  + D’s interest in the trust has terminated because of death.
  + The trust is not included in D’s estate.
  + GC and GCC have interests in the trust property, and are both skip persons
  + No distributions may be made to non-skip persons.
  + Therefore, this is a taxable termination

c. Is there a GST when the Trustee distributes income to GC following D’s death?

*Answer:*

* Rule of Multiple Skips
  + Following the taxable termination, T is moved down to the generation just above GC. §2653(a).
  + Therefore, the following people are skip persons:
    - GCC
* Taxable Distribution
  + Because GC is not a skip person, the distribution of income to GC is not taxable distribution.

d. Is there a GST when GC dies?

*Answer:*

* Taxable Termination
  + GC’s interest in the trust has terminated because of death.
  + The trust is not included in D’s estate.
  + GCC has an interest in the trust property, and is a skip person
  + No distributions may be made to non-skip persons.
  + Therefore, this is a taxable termination

6. T transfers $10,000,000 to a trust that with the following alternative dispositive provisions. In each case, what are the GST consequences?

a. Income to GC for 10 years, remainder to GC, or his estate.

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC
    - The following people have §2652 interests:
      * GC
    - The trust is a skip person because all §2652 interests in the trust are held by GC, a skip person.
    - T has made a transfer subject to the gift tax.
    - The trust is a skip person.
    - Therefore, the transfer is a direct skip.
  + T will pay both gift tax and GST.
* Rule of Multiple Skips
  + Following the direct skip, T is moved down to the generation just above GC. §2653(a).
* Taxable Distribution
  + Because GC is not a skip person, the distribution of the remainder to GC or her estate is not taxable distribution.

b. Income to GC for 10 years, remainder to GGC or his estate.

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC
      * GGC
    - The following people have §2652 interests:
      * GC
    - The trust is a skip person because all §2652 interests in the trust are held by GC, a skip person.
    - T has made a transfer subject to the gift tax.
    - The trust is a skip person.
    - Therefore, the transfer is a direct skip.
  + T will pay both gift tax and GST.
* Rule of Multiple Skips
  + Following the direct skip, T is moved down to the generation just above GC. §2653(a).
  + Therefore, GCC is still a skip person.
* Taxable Termination
  + Because GCC is a skip person, the termination of the trust at GC’s death is a taxable termination.

c. Income to GC until age 21, as needed for his support and maintenance, remainder to GC, or his estate.

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC
      * GGC
    - The following people have §2652 interests:
      * GC
      * D may also have an interest in the trust because because the present interest is being used to discharge the parent’s obligation of support. §2652(c)(3).
        + D only has an interest if the trustee must use the income for support.
        + D does not have an interest if the trustee may distribute the income at her discretion.
    - Because the trustee’s obligation is discretionary, GC is the only person with an interest in the trust. Therefore, the trust is a skip person.
    - Therefore, the transfer is a direct skip.
  + T will pay both gift tax and GST.

d. $1,000 of income per year to C for life, the balance to GC for life, remainder to GC’s estate.

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC
    - The following people have §2652 interests:
      * C
    - Normally, the trust is not skip person because a §2652 interest in the trust is held by a non-skip person.
    - However, the de minimis distribution to C is disregarded. §2652(c)(2).
    - Therefore, the trust is a skip person, because there is no person holding an interest in the trust and no distributions can be made from the trust to a non-skip person.
    - Therefore, the transfer is a direct skip.

7. T pays a $30,000 hospital bill incurred by her grandchild.

*Answer:*

* A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
* Under §2642(c)(1) & (c)(3), the inclusion ratio is 0.
* T is the transferor.
* T has not made a transfer subject to the gift tax, because §2503(e) provides that “qualified transfers” include tuition and medical care payments made directly to the school provider.
* Therefore, the transfer is not a direct skip.
* This is true even if T’s estate or a trust piad the bill. §2611(b)(1).

8. T creates a trust with income payable to her two grandchildren for T’s life in such shares as the Trustee deems appropriate. On T’s death the trust is distributed to the grandchildren in such shares as T directs by will, and absent direction the property is divided equally between the grandchildren, or their estates. T is trustee of the trust and continues in that capacity until her death.

a. Is there a GST on creation of the trust?

*Answer:*

* Direct Skip
  + The creation of the Trust
    - T is the transferor.
    - The following people are skip persons:
      * GC1
      * GC2
    - The following people have §2652 interests:
      * GC1
      * GC2
    - The trust is a skip person because all §2652 interests in the trust are held by GCs, who are skip persons.
    - A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
      * A gift is incomplete any time that the donor can change the beneficial ownership (§25.2511-2(b)-(c)), unless it is a fiduciary power constrained by an “ascertainable standard” (§25.2511-2(d)).
      * Because T is the trustee, because she can change the beneficial ownership between her two grandchildren, and because her power as trustee is not constrained by an ascertainable standard, the transfer to the grandchildren of an income interest in the trust is an incomplete gift.
      * Because T has retained a special power of appointment in the remainder interest, the transfer to the grandchildren of a remainder interest in the trust is an incomplete gift.
    - Because this is an incomplete gift, this is not a direct skip.

b. Assume that the Trustee distributes the first year’s income equally between the two grandchildren. Has a GST occurred?

*Answer:*

* Direct Skip
  + A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
  + Because T is treated as making a completed gift on the distribution to skip persons, this is a direct skip.
* Taxable Distribution:
  + Because the transfer is subject to the GST as a direct skip, the taxable distributions rules do not apply.

c. When T dies, does a GST occur?

*Answer:*

* Direct Skip
  + A direct skip occurs any time a transferor (i) makes a transfer subject to either the gift or estate tax (ii) to a skip person.
  + The trust is included in T’s estate under §2036(a)(2).
  + Because the transfer is subject to the estate tax and the transfer is to skip persons, this is a direct skip.

d. How would your answers change if T was not Trustee of the trust?

*Answer:*

* The transfer of the income interest is a completed gift.
* The transfer of the remainder interest is not a completed gift.
* However, because this is a transfer to family members, the amount of the gift is the full value of the corpus. See §2702.
* In addition, if D dies immediately after the transfer, it will be included in his estate under §2038.
  + The creation of the trust is a direct skip because there is a completed gift and all interests in the trust are held by skip persons. §2613(a)(2).
  + But what is the value of the gift for GST purposes?
    - §2702 does not appear to apply to GST.
    - Need to allocate GST exemption using the exclusion ratio.
    - Special rule under §2642(f).

9. T’s will creates a trust that provides for income to T’s daughter D for life, then to D’s living children in equal shares until D’s youngest child reaches age 40, at which point the trust terminates and is divided among D’s then living children. D dies when her youngest child is age 35.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - D’s children
  + The following people have §2652 interests:
    - D
  + The trust is not a skip person because D, a non-skip person, holds a §2652 interest in the trust.
  + This is not a direct skip because there has not been a transfer to a skip person.
  + This is not a taxable termination because no termination of a trust interest has occurred.
  + This is not a taxable distribution because no taxable distribution has occurred.
* At the death of D:
  + T is the transferor.
  + The following people are skip persons:
    - D’s children
  + This is a taxable termination because D has died and none of the exception applies.

a. Suppose the trust also provided that the Trustee could invade principal for the benefit of D’s children during D’s life, and the trustee makes a principal distribution to one of the children.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - D’s children
  + The following people have §2652 interests:
    - D
  + The trust is not a skip person because D, a non-skip person, holds a §2652 interest in the trust.
* Distribution of principal
  + The distribution of principal to a grandchild during the lives of the children is subject to GST because the grandchild is a skip person.
  + This is a taxable distribution.

b. What if the distribution in (a) was made by the Trustee to the child’s college in satisfaction of his tuition bill?

*Answer:*

* Distribution of principal
  + Any transfer which is not treated as a taxable gift by reason of §2503(e) does not qualify as a generation skipping transfer. §2611(b)(1).
  + Because the payment by the trustee of the child’s tuition bill meets the requirements of §2503(e), this is not a generation skipping transfer.

c. What difference would it make if the trust also gave D a testamentary general power of appointment over the assets in the trust?

*Answer:*

* If D has a testamentary general power of appointment, she becomes the transferor. §2652(a)(1)(B).
  + The reason is that Property subject to a general power of appointment is included in the powerholder’s gross estate. §2041(a)(2).
* At the creation of the trust:
  + D is the transferor.
  + The following people are skip persons:
    - None
  + The following people have §2652 interests:
    - D
  + The trust is not a skip person because D, a non-skip person, holds a §2652 interest in the trust.
  + This is not a direct skip because there has not been a transfer to a skip person.
  + This is not a taxable termination because not termination of a trust interest has occurred.
  + This is not a taxable distribution because no taxable distribution has occurred.
* At the death of D:
  + D is the transferor.
  + The following people are skip persons:
    - None
  + This is not a direct skip because there has not been a transfer to a skip person.
  + This is not a taxable termination because the transfer is subject to the estate tax.
  + This is not a taxable distribution because no distribution of income or principal to a skip person has occurred.

10. T’s will leaves his estate in trust for the benefit of his spouse for life, remainder to his issue, by representation. T’s spouse dies 20 years later, and the trust is distributed equally between T’s son S, and T’s grandchild GC, who is the child of T’s daughter D, who survived T but predeceased S.

a. Assume first that the executor of T’s estate did NOT make and election under §2056(b)(7) with respect to the trust.

*Answer:*

* The executor of T’s estate did not make a QTIP election.
* The entire value of the trust will be included in T’s gross estate.
* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - Spouse
  + The trust is not a skip person because spouse, a non-skip person, holds a §2652 interest in the trust.
  + This is not a direct skip because there has not been a transfer to a skip person.
  + This is not a taxable termination because not termination of a trust interest has occurred.
  + This is not a taxable distribution because no taxable distribution has occurred.
* At the death of spouse:
  + T is the transferor.
  + The following people are skip persons:
    - GC
    - GC is a skip person because the orphan rule applies when the transfer was first subject to the estate tax. §2651(e)(1)(B).
    - Because D was still alive when the transfer was first subject to the estate tax, the orphan rule does not apply.
  + This is a taxable termination because spouse interest has terminated, and:
    - The property transferred to GC is not subject to estate tax;
    - A non-skip person does not have an interest in the property transferred to GC;
    - After the termination a distribution is made to GC, skip person.
  + Note, for the exam, look at each interest separately: S and GC.

b. Assume instead that the executor of T’s estate DID make an election under § 2056(b)(7) with respect to the trust, and made no other elections.

*Answer:*

* At the creation of the trust:
  + T is the transferor.
  + The following people are skip persons:
    - GC
  + The following people have §2652 interests:
    - Spouse
  + The trust is not a skip person because spouse, a non-skip person, holds a §2652 interest in the trust.
  + This is not a direct skip because there has not been a transfer to a skip person.
  + This is not a taxable termination because not termination of a trust interest has occurred.
  + This is not a taxable distribution because no taxable distribution has occurred.
* At the death of spouse:
  + Spouse is the transferor.
  + The following people are skip persons:
    - GC
    - GC is a not a skip person because the orphan rule applies when the transfer was first subject to the estate tax. §2651(e)(1)(B).
    - Because D was not alive when the transfer was first subject to the estate tax, the orphan rule not applies.
  + There has been not transfer to a trust, and the trust is terminating. Therefore, the question of whether the trust is a skip person is not relevant.
  + This is not a direct skip because spouse has not transferred assets to a skip person.
  + This is not a taxable termination because the assets are subject to estate tax at the time of termination.
  + This is not a taxable distribution because there has not been a distribution to a skip person.
  + Note, for the exam, look at each interest separately: S and GC.

c. Assume instead that the executor of T’s estate made an election under § 2056(b)(7) AND 2652(a)(3) with respect to the trust.

*Answer:*

* §2652(a)(3) allows the initial transferor to treat the trust as if the QTIP election has not been made. This is called the reverse QTIP election.
* The result is the same as part (a).
* A reverse QTIP election is made to use T’s GST exemption, because it is not portable.

## Part C: The Taxable Amount

### Readings

* Transfer Taxes: Chapter Nine, Part D
* Code: §§ 2515, 2603, 2621, 2622, 2623, 2641

### Questions

1. What is the amount of the transfer tax due in the following transactions, assuming a flat estate tax rate of 40% and an inclusion ratio of 1? Assume also that T has previously exhausted his unified credit, and any available annual exclusions.

a. T makes an intervivos transfer of $2,000,000 to his grandchild, and pays the resulting gift and GST tax.

*Answer:*

* The is a direct skip.
* The GST taxable amount is $2,000,000
* The transferor is responsible for the tax.
* The GST tax is $800,000 (40% \* $2,000,000).
* Under §2515, T would owe gift tax on $2,800,000 ($2,000,000 + $800,000).
* The gift tax due is $1,120,000 (40% \* $2,800,000).
* The total tax paid is $1,920,000.
* The effective tax rate is 96% ($1,920,000 (total tax paid) / $2,000,000 (amount received by transferee))

b. T transfers $2,000,000 in trust for the benefit of Child for life, remainder to Grandchild. Child dies when the assets of the trust are still valued at $2,000,000. The trustee pays the GST tax out of trust funds.

*Answer:*

* This is a taxable termination.
* The GST taxable amount is $2,000,000
* The trustee is responsible for the tax.
* The initial gift tax due is $800,000 (40% \* $2,000,000).
* The GST tax is is $800,000 (40% \* $2,000,000).
* The total tax paid is $1,600,000.
* The effective tax rate is 133% ($1,600,000 (total tax paid) / $1,200,000 (amount received by transferee))

c. T transfers $5,000,000 in trust for the benefit of Child for life, remainder to GC, and the trustee is authorized to make distributions of principal to Grandchild in the trustee’s discretion. The trustee distributes $2,000,000 to Grandchild. In addition, the trustee pays the GST tax due by reason of the distribution.

*Answer:*

* This is a taxable distribution.
* The initial gift tax due is $2,00,000 (40% \* $5,000,000).
* The GST is is $800,000 (40% \* $2,000,000).
* Because the trustee paid the tax, there is an additional distribution. §2621(b).
  + The amount of the total distribution is $800,000 / (1-40%) = $1,333K.

## Part D: The Applicable Rate

### Readings

* Transfer Taxes: Chapter Nine, Part E
* Code: §§ 2631, 2632(a), 2641, 2642(a)(1), (2), 2642(c)

### Questions

In each of the problems below, assume an inclusion ratio of one, unless otherwise specifically stated. Also assume that the parent of any beneficiary is alive at all relevant times.

1. In 2018 T transfers $15,000 per year to each of her fifteen grandchildren. What is her total gift and GST tax liability?

*Answer:*

* The transfers are not subject to either gift tax or GST.
* §2503(b) excludes $15,000 of gifts per donee.
* Transfers eligible for the exclusion under §2503(b) also escape the GST tax. §2642(c)(1).

2. In 2018 T transfers $225,000 into trust for the benefit of her fifteen grandchildren. The trust calls for accumulation of income until the youngest grandchild attains age 21, at which time the trust is to terminate and is equally divided among the grandchildren who are then living. In addition, the trust contains a “Crummey” power giving each grandchild a 30 day right to withdraw their ratable share of any contribution to the trust.

*Answer:*

* A gift in trust that is non-taxable (i.e., one that qualifies for the annual exclusion) has an inclusion ratio of zero only if: §2642(c)(2).
  + During the life of the beneficiary no portion of the income or principal can be distributed to anyone other than that beneficiary; and
  + If the trust does not terminate during the beneficiary’s lifetime, the trust assets will be in that beneficiary’s gross estate.
* The transfers to the trust for the benefit of the grandchildren, which qualify for the annual exclusion (e.g., because the grandchildren have Crummey powers) will be subject to the GST because the trust is for the benefit of multiple grandchildren. §2642(c)(2).

3. D dies in 2019, and leaves her entire $10,000,000 estate to her grandchild GC. D has made no previous taxable transfers. What is the amount of her federal transfer tax liability?

*Answer:*

* The $10,000,000 will be included in her gross estate, but will not be subject to the estate tax because of the unified credit.
* The $10,000,000 will also be subject to GST as a direct skip, but will not result in any tax paid because of the exemption.

a. How would your answer change if D’s estate was $20,000,000, and D’s husband died in 2018, leaving his entire estate to charity? His executor filed a timely estate tax return.

*Answer:*

* The $20,000,000 will be included in her gross estate, but will not be subject to the estate tax because of the unified credit and the portability election.
* The $20,000,000 will also be subject to GST as a direct skip, because the GST exemption is not portable.
* GC will receive:
  + X = $20,000,000 - .20X
  + X = $16,666,666
* Tax = $20,000,000 - $16,666,666 = $3,333,333

4. Decedent dies in 2019, having made no previous taxable transfers. Her husband died in 2001. D had two children, Abby and Ben, both of whom are very wealthy. Abby has two children and several grandchildren, Ben has one child Charlie, who is 45, has never been married, and does not expect to have children. D leaves her $35,000,000 estate as follows:

a. $11,000,000 in trust for the benefit of Abby’s children for life, then for the benefit of Abby’s grandchildren for life, remainder to Abby’s great-grandchildren, or their estates.

b. $11,000,000 outright to her grandson Charlie.

c. All the rest, residue and remainder, after payment of all federal transfer taxes, to the ASPCA.

How would you recommend that D’s executor allocate her GST exemption?

*Answer:*

* We have a direct skip to:
  + Charlie, an individual
  + A Trust.
* The transfer to the Charlie will only be subject to GST once.
* However, the transfer to the trust will be subject to GST twice.
* Therefore, an argument could be made that 2/3 of the exemption amount should be allocated to the trust and 1/3 to Charlie.

## Additional GST Problems

**Problem 1**

**Assume throughout that the basic exclusion amount is $10 Million.**

D, a widow, has assets of approximately $18,000,000. She has one child, C, who has three children (GCs). D wants to leave her estate to benefit C, with the expectation that it will ultimately pass to C’s children (and her more remote descendants). Consider the following alternative estate plans for D:

1. D’s will leaves all of her assets outright to C.

2. D leaves all of her assets in trust (bank trustee) for the benefit of C and the GCs. The trustee has the discretion to divide the income and principal among the beneficiaries as needed for their support and maintenance. After the death of C the trust terminates and is distributed to C’s issue, by representation.

3. D’s will divides her estate into two trusts, one in the amount of her unused GST exemption amount (Trust A), and the balance to the other (Trust B). Both trusts have the same provisions regarding distributions as described above.

Assume D dies in 2020, and her estate, after reduction for estate taxes, is approximately $15,000,000.

**Questions**:

1. If D’s estate plan is that described in #1 above, what will be the transfer tax consequences if C dies ten years after D, and leaves her then $18 million estate to her children?

*Answer:*

* Insert

2. If D’s estate plan is that described in #2 above,

a. Will there be GST tax due on D’s death?

*Answer:*

* Insert

b. What will be the GST consequences if the trustee makes a distribution of principal to one GC in order to assist in the purchase of a home?

*Answer:*

* Insert

c. What will be the GST consequences if the trustee pays one of the GC’s college tuition?

*Answer:*

* Insert

d. What will be the GST consequences if the trustee distributes $1,000,000 of principal to C?

*Answer:*

* Insert

e. What will be the GST consequences on C’s death?

*Answer:*

* Insert

3. Given your answers in questions 1 & 2, why might the plan described in #3 reduce taxes compared to the alternatives?

*Answer:*

* Insert

**Problem 2**

D dies in 2020. His estate consists of $16,000,000 in assets. D has previously made taxable gifts to his Child of $4,000,000. His wife W has $10,000,000 of assets in her name. He has one child C, who has several children (GCs)

Consider the consequences if D’s will divided his estate into two trusts: one, a “credit shelter” trust, which contains assets equal to D’s unused basic exclusion amount under § 2010, and the other a marital deduction (“QTIP”) trust for the balance. Each trust provides for income to W for life, then to C for life, then to the grandchildren for life until the youngest attains age 45, at which point the trust terminates and is distributed to D’s issue, by right of representation. The trustee has the discretion to invade the principal of the trust for W during her life, and following W’s death the trustee may distribute principal to the child, to any grandchild, and to any great-grandchild as needed for health, education, maintenance and support in the trustee’s discretion.

**Questions**:

1. How will the assets of the estate be divided between the trusts?

*Answer:*

* Insert

2. If the executor makes a QTIP election with respect to the marital trust, what will be the federal estate tax liability on D’s death?

*Answer:*

* Insert

3. Is there a generation skipping transfer at the time of D’s death?

*Answer:*

* Insert

4. How would you expect the executor will allocate the GST exemption between the trusts?

*Answer:*

* Insert

5. When W dies, what will be the inclusion ratio with respect to the marital trust?

*Answer:*

* Insert

6. Can you suggest an alternative estate plan that might make better use of D’s GST exemption?

*Answer:*

* Insert

# Sample Exam Question:

***Part II***

***(60 Minutes)***

On **January 1, 2021** Mogul transfers $20,000,000 to create an intervivos trust with the following terms:

1. **So long as Mogul is living, the Trustee shall distribute the income of the trust among the Mogul’s living children in equal shares.**
2. **In addition to distributing the net income, the Trustee may distribute to or for the benefit of any one or more of Mogul’s living children and grandchildren so much of the principal of the trust as the Trustee deems appropriate in its sole and absolute discretion.**
3. **On Mogul’s death, the trust shall terminate, and the Trustee shall distribute the trust principal among the Mogul’s children and grandchildren in such shares and amounts as Mogul designates in his will.  If he fails to so designate the trust shall be divided among his children in equal shares. If any child of the Mogul is then deceased, that child’s share will be distributed to his or her issue, if any, and if none then to the deceased child’s estate.**

**Mogul is named as the initial Trustee of the trust.**

Assume the following additional, cumulative facts, and answer the following questions.  Assume also in each case that the annual exclusion is otherwise exhausted by the donor each relevant year.

1. What are the transfer tax consequences, if any, resulting from creation of the trust in **2021**?

*Answer:*

* ***There are no transfer tax consequences.  He has not made a completed gift of the income or the principal because of his powers as Trustee. Although he doesn’t have discretion as Trustee regarding the income per se, his discretionary power to make principal distributions renders the gift the income and the remainder incomplete § 25.2511(b).  Note that he has also retained the ability, other than as Trustee,  to designate who among his children and grandchildren will be entitled to the principal upon his death.  This also renders the gift of the remainder incomplete.***

1. What transfer tax consequences, if any, result when Mogul, as Trustee, distributes the income equally to the children in **2021**?

*Answer:*

* ***The distributions would be treated as completed gifts by Mogul in his individual capacity.  He has given up complete D & C over the amount distributed.***

1. What transfer tax consequences, if any, result if Mogul, as Trustee, distributes $100,000 to his Grandchild Fran in **2024**?  Fran needs a car.

*Answer:*

* ***This is a completed gift from Mogul in his individual capacity to Fran, a skip person.  It is also a direct skip and is therefore subject to the GST.  Finally, the amount of the GST due on this transfer will also be subject to the gift tax under § 2515.***

1. Assume Mogul’s son Dan dies in **2025**, and Mogul is distraught and unable to focus on business affairs.  Dan left one surviving child, Georgie.  Mogul resigns as Trustee on **January 1, 2026**, irrevocably appointing a bank as successor Trustee.  At that point in time the trust has a value of $25,000,000.  What transfer tax consequences, if any, occur in **2026** as a result?

*Answer:*

* ***When Mogul resigns as Trustee, it completes the gift of the income interest, but not the remainder, because he still has the right in his individual capacity to designate the remainder at this death.  NTL, under § 2702(a), the amount of the gift will be $25 million (Mogul’s power over the remainder is treated as a retained interest, per Reg 25.2702-2(a)(4) so the remainder is valued at zero).***

1. Assume further that the Mogul then dies on **January 1, 2027**, at which point in time the trust assets have a value of $30,000,000.  His will dictates that the trust is to be distributed ¼ to his daughter Cathy, ¼ to his son Barry, ¼  to his grandson Georgie.  The remaining ¼ is divided between Cathy’s two children, Ellie and Fran, What transfer tax consequences, if any, occur upon the Mogul’s death with respect to the trust?

*Answer:*

* ***Mogul’s estate will include the entire value of the Trust, $30 million, because the income interest terminates at his death.  § 2038.  His estate will have to include whatever gift taxes he paid within 3 years of his death.  § 2035(b).  The distributions to Ellie and Fran, skip persons, are direct skips and subject to the GST.  The distribution to Georgie is not subject to the GST because of the “orphan’s rule.”  §2651(e).***