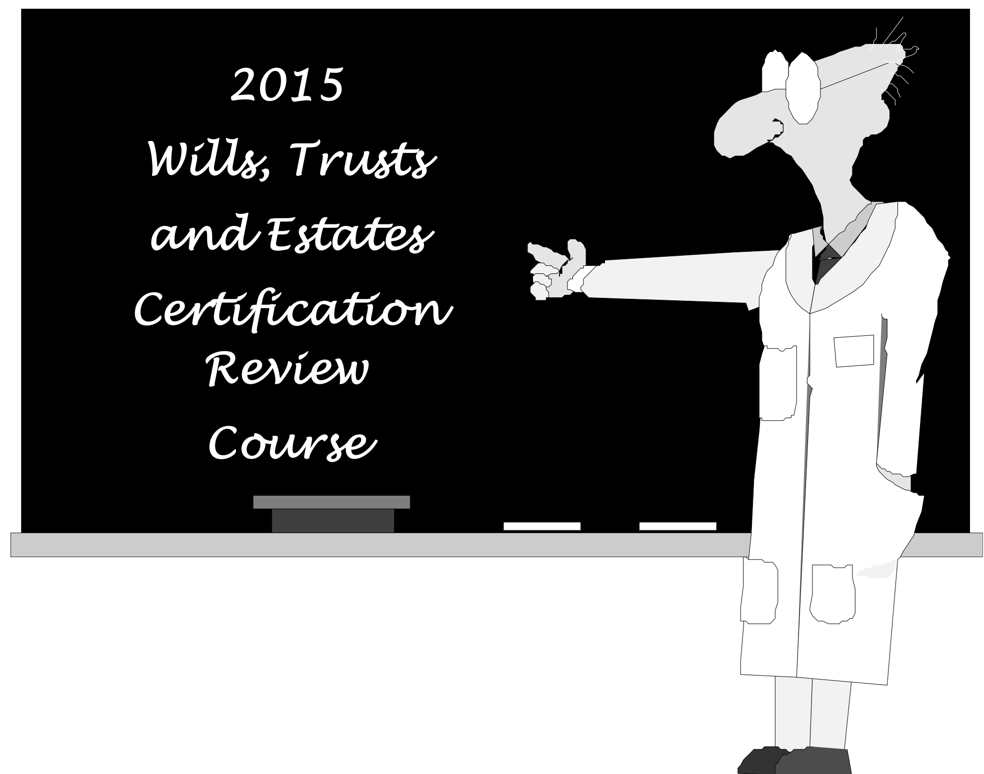
Estate Planning

TAX CONSIDERATIONS

By David F. Powell



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Spring 2015 Edition

Preface

This is the 30th (and for me, the last) anniversary of the Wills, Trusts and Estates Certification Review Course. The outline for this year continues the stylistic approach of past 30 versions. Important legislation and case decisions as well as drafting tips, cautions, and comments have been clearly marked. Material you need to know to prepare for the Certification exam appears in the outline text. A complete analysis of all examples appears at the end of each chapter. Additional information and detail together with all citations to the Code,[1] regulations, and other authority are placed in the footnotes. This approach makes the text easier to follow.

The Certification Review Course is an advanced course and I have tried to tailor my coverage with that in mind. I hope my judgment on what to emphasize meets with your expectations for this course. Whether it does, or it doesn't, I would sincerely appreciate your comments. Please direct them to:

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[1] Citations are to the Internal Revenue Code of 1986, as amended.

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I. THE FEDERAL GIFT TAX

A. TRANSACTIONS SUBJECT TO THE TAX

By express edict of the Code, the gift tax applies only to transfers of property. It, therefore, does not apply to the gratuitous rendering of services even though the forbearance of an opportunity for compensation may be seen as an estate-depleting event.

> ***Ex-1:*** D's will leaves the residue of his estate in a QTIP trust for the benefit of his spouse W for life, remainder to their child S. W is named as the personal representative of D's estate. If W accepts a fee for her services, she will have taxable income. To avoid this, W waives her right to a fee. Does she make a taxable gift when she does this? *Answers to the examples in this chapter begin on page 25.*

COMMENT
If W waives, the estate gets no IRC § 2053 deduction. But this will not necessarily increase D's estate taxes. The money that would otherwise pass to W as a fee passes instead to the marital trust for which D's estate may claim a marital deduction.

1. Forbearance of right to use property

In Dickman v. Commissioner,[2] the Supreme Court held that the forbearance of a right to use property is taxable as a gift. The Dickman case involved an interest free demand loan, a transaction the taxation of which has since been more comprehensively legislated in IRC § 7872. The underlying principle of Dickman, however, extends far beyond interest free loans.[3]

> ***Ex-2:*** T makes an interest free loan to her son S. How is this transaction treated for tax purposes?

2. General powers of appointment

For gift and other transfer tax purposes, powers of appointment are classified as either general or special. The exercise or release of a general power of appointment is a gift.[4] With few exceptions, the exercise of a special power is not.

a) Definition of general power

The essential indicia of a general power is that it may be exercised to the economic advantage of its holder.

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2 465 U.S. 330 (1980).

3 See Elizabeth W. Snyder, 93 T.C. 529 (1989), holding that a gift occurs when a shareholder fails to convert stock into other stock having a cumulative dividend right and thereafter receive dividends. See also PLR 9117035, (Dickman applied to a waiver of rights under buy-sell agreement) and TAM 9301001 (Controlling shareholder's acquiescence in low dividend on noncumulative preferred stock is a gift).

4 IRC § 2514(b).

Thus, a power is general if its holder may exercise it in favor of himself, his estate or the creditors of either.[5]

There are three exceptions:

1. A power which permits its holder to consume only so much of the property as is reasonably needed for his health, support, maintenance and education.[6]
2. A power the exercise of which requires the consent of a person who has an adverse economic interest.[7]
3. A power which may be exercised only with the consent of its creator.[8]

> ***Ex-3:*** As trustee of a discretionary trust, T has the power to appoint trust income and principal to and among her adult children. Does T make a gift when she exercises her power in favor of her son S?

b) Tax treatment of lapses

A power is said to "lapse" when it expires by reason of its own terms. A lapse is treated as a taxable release to the extent the value of the property over which the lapsed power could have been exercised exceeds the greater of $5,000 or 5 percent of the aggregate value of the property over which an exercise of the power could have been satisfied.[9]

> ***Ex-4:*** Under the terms of the trust created by his father, D is to receive the income for life. The remainder at D's death is distributable to D Jr. D also has the power exercisable in December of each year to demand distribution of $30,000 in trust principal. This December, when the value of the trust is $200,000, D permits the power to lapse without exercise. To what extent will the lapse result in a gift?

COMMENT
On the valuation of the gift in this example, see "*Valuation of retained interests*" beginning on page 30

3. Taxable special powers

In general, the exercise or release of a special power of appointment is not a gift.

Exceptions: The exercise of a special power is a gift when the power is exercised in such a manner that:

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5 IRC § 2514(c).

6 IRC § 2514(c)(1).

7 IRC § 2514(c)(3)(B).

8 IRC § 2514(c)(3)(A).

9 IRC § 2514(e). For the estate, GST, and income tax consequence of lapses, see "*Crummey powers*" on page 19.

- It has the effect of releasing a general power.
- It has the effect of transferring an appendant interest in the appointive property.
- It violates the so-called "Delaware tax trap."[10] (In Florida and most states, this latter event occurs when a special power is exercised to create a general inter vivos power in someone else.)

> ***Ex-5:*** As the sole income beneficiary of a trust created by his mother, T has both a special inter vivos and a general testamentary power of appointment over trust property. Would T make a gift if he exercises his special power to appoint trust property to his daughter?

> ***Ex-6:*** As the sole income beneficiary of a trust created by his mother, T has a special inter vivos power of appointment over trust property. Would T make a gift if he exercises his special power to appoint trust property to his daughter?

COMMENT
It would seem that the gift in this example occurs only if T had the right to trust income. No gift should occur if income distributions to T were discretionary. The Service, however, has expressed a contrary view. [11] Note also that this rule does not apply to an income beneficiary of a trust who, as trustee, makes a discretionary distribution of principal to another beneficiary if the trustee's discretionary authority is restricted by an ascertainable standard.[12]

4. Dispositions of an income interest in a QTIP trust

In general, transfers from one spouse to a QTIP trust for the benefit of the other qualify for the gift or estate tax marital deduction. Where the deduction is allowed, IRC § 2519 provides that any disposition of all or part of the donee spouse's income interest in the QTIP trust is treated as if the spouse made a gift equal to the value of all property in the trust reduced by the value of the spouse's income interest in the trust.

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10 See IRC § 2514(d). A similar rule applies to the estate tax. See IRC § 2041(a)(3). On the use of this rule in planning for the GST tax, see "*Estate or gift tax exposure*" on page 123

11 See PLR 8535020.

12 See Treas. Regs. § 25.2511-1(g)(2) .

Ex-7: W is the beneficiary of a QTIP trust created and deducted in the estate of her deceased husband. The remainder of the trust at W's death passes outright to W's child C.

1. What are the gift tax consequences, if any, to W if she assigns her income interest in the trust to her child C?

2. Would the answer differ if W and C agreed to terminate the trust, each taking property equal to the IRC § 7520 value of their interest?

3. Suppose in 1 that W assigned only half of her income interest to C?

4. Suppose, instead, that the QTIP trust is split into two equal trusts pursuant to an authority to do so either in the governing instrument or under the Florida Trust Code[13] and that after the split, W assigned all of her income interest in one of the resulting trusts to C?

B. TRANSACTIONS NOT SUBJECT TO THE TAX

1. Qualified disclaimers

In sharp contrast to a forbearance of a right to use property which we have seen is a gift, a refusal to accept a gift, devise or inheritance is not, provided the refusal meets the requirements of a qualified disclaimer as set out in IRC § 2518.

For more, see "*Disclaimers*" beginning on page 234.

2. Incomplete transfers

The gift tax does not apply to incomplete transfers. A transfer is incomplete if the donor, without the consent of an adverse party,[14] can

- revoke the transfer, or
- appoint a new donee, or
- except for a power held as a fiduciary and limited by an ascertainable standard, alter the respective shares of existing donees.[15]

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[13] See Fla. Stat. § 736.0417 (2015)

[14] On the effect of a power requiring the consent of an adverse party, see Camp v. Comm., 195 F.2d 999 (1st Cir. 1952).

[15] See generally, Estate of Sanford v. Comm., 308 US 39 (1939). See also Treas. Regs. § 25.2511-2(c). A transfer is not incomplete simply because it is difficult (or even impossible) to value. Estate of Anthony F. DiMarco, 87 T.C. 643 (1986), acq. 1990-1 C.B. 1.

Ex-8: As part of his estate plan, T creates a revocable inter vivos trust and couples it with a pour over will.

1. Does T make a gift when he funds his trust during life?

2. How about when the trustee distributes trust property to a member of T's family?

3. How about at T's death when T's power to revoke terminates?

Ex-9: T creates an irrevocable trust for the benefit of his adult child C. Under the instrument, the trustee has the power to distribute income to C or to accumulate it and add it to principal. The trustee also has the power to advance principal to C. The trust is to last until C attains the age of 35 or dies, whichever first occurs. At the termination of the trust, all trust property is to be distributed to C, if living; otherwise to C's child GC. T names himself trustee of the trust.

1. Is T's transfer to the trust a completed gift?

2. Suppose T had a power to accumulate income but no power to advance principal?

3. Suppose in 2, that T's power to accumulate income required the consent of C?

4. Suppose T had both a power to advance principal and a power to accumulate income but the trust provided that all property was to be distributed to C's estate in the event that he died under the age of 35.

Ex-10: T creates an irrevocable discretionary trust for the "benefit" of her family, including herself. Is T's gift complete?

Ex-11: T gives S a durable power of attorney which makes no explicit reference to gifts. Subsequently, S exercises the power to make a gift to B. Is the gift complete?

Ex-12: On December 14th of 2012, T makes annual exclusion gifts to several of his children. The checks are deposited on December 31st but they are not presented to the drawee bank until January 5, 2013.

1. When must T report her gifts?

2. If T died on January 2 of 2013, would the gifts be excluded from his gross estate?

3. Joint tenancies with noncitizen spouse

No gift occurs when one person provides more than half of the consideration for the creation of a right of survivorship tenancy in land with that person's spouse if the noncontributing spouse is not a U.S. citizen. However, a gift will occur if the land is later sold unless the proceeds of sale are divided in proportion to the consideration furnished by each spouse at acquisition.[16]

4. Transfers for full consideration

No gift occurs to the extent that property is transferred in return for a full consideration in money or money's worth.

Consideration in this context is a tax concept. It includes a relinquishment of the right to be supported but excludes a relinquishment of a spouse's claim to an elective share.[17]

5. Transfers incident to divorce

Transfers from one spouse to another and reasonable transfers to a child for support are deemed to have been made for full consideration if:

- They are made pursuant to a written property settlement entered into in conjunction with a divorce, and
- Divorce actually occurs within a three-year period beginning one year before the date of the agreement.[18]

6. Qualified tuition and medical expense payments

Tuition payments to a college or private school are excluded from the gift tax.[19]

- The exclusion is available only for tuition payments. Amounts paid "for books, supplies, dormitory fees, board, or other similar expenses" do not qualify.[20]

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16 IRC § 2523(i)(3). The exclusion also applies to additions in value to the tenancy in the form of improvements, reductions in indebtedness, etc. See Treas. Regs. § 25.2523(i)-2(b)(1); 25.2523(i)-2(b)(2)(i) and 25.2523(i)-2(b)(2)(ii). See also Treas. Regs. § 25.2523(i)-2(b)(3) (these rules apply to both tenancies by the entireties and joint tenancies).

If the creation of a survivorship tenancy in real property was treated as a gift to the noncitizen spouse under former IRC § 2515(c) or IRC § 2511, then the amount so treated as a gift is deemed to be consideration furnished by the noncitizen spouse. Treas. Regs. § 25.2523(i)-2(b)(2)(ii).

As for survivorship tenancies in personal property, a gift will occur at the creation of a tenancy unless the noncitizen spouse furnishes half of the consideration for the property. See Treas. Regs. § 25.2523(i)-2(c)(1) providing that each spouse's interest in the property is deemed to be one-half. But see Treas. Regs. § 25.2523(i)-2(c)(2).

17 IRC § 2043(b).

18 IRC § 2516.

19 IRC § 2503(e).

- Nor do transfers in trust or to the student individually.[21] The transfer must be made directly to the educational institution.

An exclusion also applies to payments to a medical care provider in payment for the medical care expenses of another person. The exclusion does not apply to the extent that the medical costs are reimbursed by insurance.[22]

C. THE ANNUAL EXCLUSION

Under the so-called "annual exclusion," the first $14,000 of gifts per year per donee are excluded from the gift tax.[23]

COMMENT
The exclusion for gifts to a noncitizen spouse is $147,000. See "*Gifts to a noncitizen spouse*" on page 21.

1. Present interest requirement

The annual exclusion is available only for gifts of present interests. A gift is a present interest only if the donee has the unrestricted right to immediate possession and enjoyment of the property or its income.

Ex-13: GP transfers $15,000 in trust to pay income in equal shares to C1 and C2 for 10 years with remainder at that time to GC.

1. To what extent does GP's transfer qualify for the annual exclusion?

2. Would the answer be the same if the trustee had the authority to accumulate (or spray) income?

3. Suppose all income had to be distributed to C1 and C2 but in shares left to the discretion of the trustee?

Ex-14: P transfers $70,000 to a Qualified State Tuition Plan. How many annual exclusions is P entitled to on the gift?

Ex-15: P transfers $200,000 to a corporation owned in equal shares by P and her 4 children. How many annual exclusions is P entitled to on the gift?

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20 Treas. Regs. § 25.2503-6(b)(2).

21 Treas. Regs. § 25.2503-6(b)(2).

22 Treas. Regs. § 25.2503-6(b)(3).

23 IRC § 2503(a). Beginning in 1999, this amount is indexed for inflation in $1,000 increments.

2. Minor's present interest trusts

A transfer to a discretionary trust[24] qualifies for the annual exclusion if:

a) The trust is for a single beneficiary under the age of 21 (a tax minor);

b) The trustee has the authority to use trust income and principal for the "benefit" of the minor;

c) The minor is entitled to outright distribution of the trust property no later than age 21;[25] and

d) If the minor dies under age 21, the trust property is either distributable to the minor's estate[26] or as the minor appoints under a general power of appointment.[27]

COMMENT
If a power of appointment is used it is immaterial that the minor is too young to exercise it or that the taker in default is someone other than the minor's estate.

3. Crummey powers

A "Crummey power" is a power given to a trust beneficiary to withdraw a contribution to a trust for a limited period after it is made. Because the power enables its holder to obtain immediate possession and enjoyment of the gift, courts have consistently held that the existence of a Crummey power will qualify a gift for the annual exclusion.[28]

> ***Ex-16:*** GP transfers $238,000 to Crummey a trust for the benefit of his children. In the event one of the children fails to survive GP by 120 days, that child's children are entitled to share. When GP creates the trust he has 5 children and 12 grandchildren, all of whom are given a Crummey withdrawal power. How many exclusions may GP claim for this transfer?

COMMENTS

- The Service is not fond of Crummey powers. Accordingly, caution dictates that the withdrawal period be reasonable (30 days is fine) and that the trustee be required to notify the beneficiary of any contribution that would trigger the withdrawal right.
- In PLR 9532001, the Service ruled that no annual exclusion is available if a Crummey trust beneficiary waives the requirement that the trustee notify the beneficiary of future contributions that would trigger the demand right.
- In PLR 8121069, the Service approved a once-only notice informing the trust beneficiaries of an irrevocable life insurance trust of expected annual gifts for the payment of premiums.

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24 The transfer need not be in trust. It may be made to a custodian pursuant to Chapter 710 of the Florida Statutes.

25 The termination age is a maximum. Termination at an earlier age is not a problem. Moreover, the trust may continue beyond the age of 21 as long as the minor has the right to demand distribution at age 21.

26 Distribution to "heirs" or "next of kin" is NOT the same as distribution to the estate.

27 IRC § 2503(c).

28 Crummey v. Comm., 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321 (1973).

- In PLR 8107009, the Service implied that the annual exclusion is not available unless the beneficiaries demand rights are superior to all other distribution powers during the withdrawal period.

a) Gift tax consequences of lapse

The lapse of the Crummey power at the end of the withdrawal period will be a taxable release for gift tax purposes to the extent that the amount subject to the power exceeds the greater of $5,000 or 5 percent of the property out of which the power could have been satisfied.[29]

- This problem is avoided if the withdrawal powers are limited to the $5,000 or 5 percent safe-harbor.
- The drawback here is that the trust must have a value in excess of $280,000 in order for the safe-harbor to shelter a gift equal to the full $14,000 annual exclusion.
- An alternative approach — giving the power holder a special testamentary power so that the gift is incomplete — has collateral estate tax consequences. See "*Estate tax consequences of lapse*" below.

COMMENT
Where it is desirable to build the size of the trust to the $280,000 level quickly, the donor could use the applicable credit amount (unified credit) to "seed" the trust at the desired level.

b) Estate tax consequences of lapse

Lapses of Crummey powers in excess of the $5,000 or 5 percent safe-harbor will cause estate tax exposure to the power holder if he or she dies before termination of the trust.[30] If, however, the Crummey powers are restricted in amount to the safe-harbor for lapses, only the property that could be withdrawn by an exercise of the power at the time of the power holder's death will be included in his gross estate.

COMMENT
For an illustration of the estate tax consequences of a lapse of a power, see Ex-45 on page 56.

c) Income tax consequences of lapse

According to the IRS, the lapse of the Crummey power also renders the power holder taxable on a portion of the trust income under IRC § 678 of the Code.[31]

- The portion increases on a cumulative basis each time a Crummey power lapses.[32]
- And unlike the gift and estate taxes, IRC § 678 contains no $5,000 or 5 percent safe-harbor.

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29 IRC § 2514(e).

30 IRC § 2041(b)(2). Since each lapse (to the extent it is treated as a release) is taxed as if the power holder made a transfer of a percentage of the trust assets to the trust, the tax exposure of the power holder increases with each lapse/release. See Treas. Regs. §§ 20.2041-3(d)(3) - (5).

31 See e.g., PLR 9535047.

32 See PLR 200022035. Accord, PLR 9034004; PLR 8521060; PLR 9232013.

- Again, this is a concern only if the trust produces significant income.

PLANNING IDEA
This explains the widespread use of Crummey powers in irrevocable life insurance trusts. As a trust asset, insurance policies produce no income and in some cases, premium payments can be funded within the strictures of the $5,000 or 5 percent safe-harbor.

4. Hanging powers

A hanging power is an alternative means of using a Crummey withdrawal power to secure the full annual exclusion for transfers to a discretionary trust without adverse transfer tax consequences when the withdrawal powers lapse.[33]

With a hanging power, a trust beneficiary's power to withdraw contributions from the trust lapses each year but only to the extent that it can do so without exceeding the $5,000/5-percent safe-harbor.

- To the extent the power exceeds the safe-harbor, it "hangs" around until it may safely lapse in a later year.
- Thus at any given time there is a withdrawal account the balance of which is subject to withdrawal by the beneficiary or beneficiaries of the trust.
- The balance in this account will increase in the early years and decline (ultimately to zero) in the later years.

A brief example will illustrate the concepts. Assume D creates a trust with hanging Crummey withdrawal powers in 4 donees. Each year D transfers $56,000 to the trust. Disrgarding changes in value from income and capital appreciation or depreciation, it will take nine years to reduce the outstanding balance in the hanging Crummey power account to zero. The chart below illustrates this with the columns labeled "Open", "Lapsing" and "Close" reflecting the balance of the withdrawal accounts at the beginning of the year, the amount lapsing each year and the balance at the end of the year, respectively.[34] The figures shown are the aggregate for all four donees.[35]

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33 But see TAM 8901004 holding that the hanging power recommended by Richard Covey ("if upon termination of any power of withdrawal the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes, then such power of withdrawal will not lapse, but will continue to exist with respect to the amount that would have been a taxable gift and will terminate as soon as such termination will not result in a taxable gift.") violates public policy.

See also Rev. Rul. 86-41, 1986-1 C.B. 300 (1986) (Provisions calling for refund if gifts are determined to exceed available annual exclusions or which call for consideration from the donee in the same event will be ignored by the IRS).

34 The "TRUST" column reflects total aggregate contributions to the trust. The "OPEN" column shows the balance in the withdrawal account as of the end of the preceding year increased by the amount of gift for the current year. The "LAPSING" column is the maximum amount of lapse that can occur within the safe-harbor rules. Since there are 4 donees, for any given year it is equal to the greater of $20,000 or 20 percent of the value in the trust (e.g. the amount in the "TRUST" column). The "CLOSE" column reflects the outstanding balance of the withdrawal account at the end of the year. This is the amount in the "OPEN" column less the amount in the "LAPSING" column for the year in question.

35 As the chart in the text shows, in YRs 5 and 6, when the balance in the withdrawal account is at its zenith, each donee could withdraw slightly less than $40,000. This amount and the number of years it takes to attain a zero balance can be reduced by increasing the number of Crummey power holders. Alternatively, (or in addition), a donee's access to his or her share of the withdrawal account could be made subject to the approval of an independent trustee. Note, however, that this approval could only be required after the expiration of the withdrawal period.

1	$56,000	$56,000	$56,000	($20,000)	$36,000
2	$56,000	$112,000	$92,000	($22,400)	$69,600
3	$56,000	$168,000	$125,600	($33,600)	$92,000
4	$56,000	$224,000	$148,000	($44,800)	$103,200
5	$56,000	$280,000	$159,200	**($56,000)**	$103,200
6	$56,000	$336,000	$159,200	($67,200)	$92,000
7	$56,000	$392,000	$148,000	($78,400)	$69,600
8	$56,000	$448,000	$125,600	($89,600)	$36,000
9	$56,000	$504,000	$92,000	($92,000)	**$0**

D. THE MARITAL DEDUCTION

In calculating the gift tax, a donor who is either a citizen or a resident of the United States may take a deduction for qualifying gifts to a spouse.[36]

To qualify:

- The donor and donee must be married at the time of the gift,
- The gift must not be a nondeductible terminable interest, and
- The donee spouse must be a U.S. citizen.

1. Nondeductible terminable interests

To qualify for the marital deduction, a gift to a spouse must comply with the nondeductible terminable interest (NDTI) rule.[37] In practice, this usually means that gifts to a spouse will either be made outright or to a QTIP trust.[38] For more on QTIP trusts and other matters relating to the NDTI rule, see "*Qualification requirements*" on page 86

2. Gifts to a noncitizen spouse

No marital deduction is permitted for gifts to a non-U.S. citizen spouse.[39] However, the annual exclusion for such gifts is $147,000 instead of the normal $14,000.[40]

COMMENT
In addition to the usual requirements for an annual exclusion, the increased exclusion is available only for gifts that would have been eligible for the gift tax marital deduction had one been available.

36 IRC § 2523. The requirement that the donee spouse be a U.S citizen does not apply to disallow a deduction with respect to transfers resulting in the acquisition of rights by the noncitizen spouse in joint and survivor annuity arrangements described in IRC § 2523(f)(6). See Treas. Regs. § 25.2523(i)-1(b). See also Treas. Regs. § 25.2523(i)-1(d), Example 2.

37 IRC § 2523(b).

38 IRC § 2523(f). For purposes of the gift tax, the QTIP election may be made on a timely filed gift tax return, including extensions. IRC § 2523(f)(4)(A). Under newly issued form 709, applicable to gifts made after October 8, 1990, the QTIP election will be deemed made for any property listed on Schedule A and deducted in the Schedule A reconciliation.

39 See IRC § 2523(i)(1). But see Treas. Regs. § 25.2523(i)-1(b) (IRC § 2523(i)(1) does not disallow a deduction for transfers resulting from the acquisition of joint and survivor annuities described in IRC § 2523(f)(6). See also Treas. Regs. § 25.2523(i)-1(d), Example 2.

40 The spouse must be a nonresident at the time of the gift. The donor spouse can be a citizen, or a resident or nonresident alien. Treas. Regs. § 25.2523(i)-1(c)(2).

Ex-17: T transfers $147,000 in trust to pay the income quarterly to her noncitizen spouse S for life with remainder to such persons (including her estate) as S appoints by will.

1. To what extent may T claim an annual exclusion for this transfer?

2. Would your answer differ if S's power were limited to appointing among T's descendants?

3. Suppose in this latter case, S also had a Crummey withdrawal power over the entire $147,000 transfer?

E. THE CHARITABLE DEDUCTION

In general, a gift to a qualifying charity is deductible without limit for purposes of the gift tax.[41] However, a gift of a future interest to charity following a present interest in a noncharitable beneficiary is deductible only if it is a legal remainder following a life estate in the decedent's personal residence or farm,[42] a remainder interest in a pooled income fund, a charitable remainder unitrust, or a charitable remainder annuity trust.[43]

F. THE GIFT TAX RATE SCHEDULE

The rate schedule used to calculate the gift tax is found in section 2001(c). This is the same rate schedule used to calculate the estate tax. For years 2013 and after, the highest marginal rate is 40 percent.

G. THE UNIFIED CREDIT

A unified credit equal to the "applicable credit amount" is available against the gift tax.[44] The credit, which is not discretionary, is available to offset estate tax liability to the extent it is not used against taxable gifts during life.

The applicable credit amount is equal to the tax under the unified rate schedule on "the applicable exclusion amount." For 2015, the applicable exclusion amount is $5,430,000. Correspondingly, the applicable credit amount (unified credit) is $2,117,800. This amount is subject to two possible adjustments:

- First it may be increased by any unused estate exemption of a donor spouse's electing last deceased spouse.[45]
- Secondly, the applicable credit amount (above) is reduced for gift tax purposes by any credit used on prior gifts.[46]

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41 IRC § 2522.

42 IRC § 2522(c)(2). See also IRC § 170(f)(3)(B)(i), IRC § 2055(e).

43 But see IRC § 2055(e)(3) which permits reformation of a defectively created charitable remainder trust where either the instrument evidences an intention to comply with the code's requirements or the reformation proceedings are begun before an audit by the IRS.

44 IRC § 2505.

45 See IRC § 2505(a)(1) which, as amended by TRA 2010 § 303(b)(1), defined the gift tax applicable exclusions amount by reference to IRC § 2020(c). This latter section includes an electing predeceased spouse's unsued exemption amount.

H. SPLIT GIFTS

Upon election, a gift by a qualifying spouse may be treated as if made equally by both spouses.[47] This results in a doubling of exclusions, unified credit and generation-skipping transfer tax exemption.

- To qualify for gift splitting, the donor must be married at the time of the gift,[48] both spouses must be U.S. citizens or residents,[49] and neither can remarry before the end of the calendar year in which the gift is made.[50]
- To split a gift, the non-donor spouse must consent on a timely filed gift tax return or, if no return is filed, before either spouse is served with a notice of deficiency.[51]
- The split gift provision is also available for gifts made by D or his spouse before D's death for which a return is not due until after D's death.

I. BASIS OF PROPERTY ACQUIRED BY GIFT

A donee takes a bifurcated basis in property acquired by gift. For transactions giving rise to taxable gain, the donee's basis is equal to the basis of the donor increased by the gift tax, if any, allocable to appreciation in the property as of the time of gift.[52] For loss transactions, the basis is the lesser of the donor's basis or the FMV of property at the time of the gift.[53]

J. LIABILITY FOR TAX

Primary liability for the gift tax is on the donor. The donee is secondarily liable to the extent of the value of the gift.[54] Where the donor has died, the donor's personal representative is personally liable for the filing of all gift tax returns.

> ***Ex-18:*** T makes a gift of property to his son on the condition that the son pay the gift tax. What are the income tax consequences of doing this?

K. LIMITATIONS ON ASSESSMENT

If a donor files a gift tax return, the normal statute of limitations for the assessment of any tax on gifts adequately disclosed[55] on the return is three years.[56] However, the limitations period is

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46 In a change from prior law, for gifts made after 2010, the reduction is not necessarily the amount actually used, but is instead the amount that would have been used had the prior gifts been taxed and the current rate schedule. See TRA § 302(d)(2), amending IRC § 2505(a).

47 IRC § 2513.

48 Treas. Regs. § 25.2513-1(a).

49 Id.

50 Treas. Regs. § 25.2513-2(c)

51 Because the election to split a gift must be made on a gift tax return, a return must be filed even when the amount of the gift is covered by the annual exclusion. Simplified form 709A may be used for this purpose.

52 The formula for calculating the addition for gift taxes paid appears below. In the application of the formula the amount of the gift is reduced by the annual exclusion and any portion of the gift for which a charitable or marital deduction is allowable; it is immaterial whether the tax was paid by the donor or the donee; and where a gift is split, the increase applies for the tax paid on both portions of the gift. Prop. Regs. § 1.1015(d)(2).

$$\left(\frac{\text{AMOUNT OF GIFT} - \text{BASIS}}{\text{BASIS}}\right) \times \text{GT PAID.}$$

53 IRC § 1015.

54 IRC §§ 2502(d); 6324(a)(2).

6 years if the donor omits gifts the value of which exceed by more than 25 percent the value of the gifts shown on the return for the year[57] and there is no statute of limitations for fraudulent returns or for years in which no return was made or for which there was no adequate disclosure on the return.[58]

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55 See Treas. Regs. § 301.6501(c)-1 for guidance on what constituted adequate disclosure. For procedure that may be used to make adequate disclosure on an amended gift tax return, see Rev. Proc. 2000-34, 2000-34 I.R.B 186.

56 IRC § 6501(a). In the case of an early return, the three year period is measured from the due date of the return, not that actual date of filing. IRC § 6501(b)(1). A donee has transferee liability for unpaid gift taxes up to the value of the property received by the donee. IRC § 6324(b) The fact that the statute of limitations for assessments against the donor has expired does not prevent the Service for assessing transferee liability against the donee. Kirkman O'Neal II, 102 T.C. 666 (1994).

57 IRC § 6501(e)(2).

58 IRC § 6501(c).

ANSWERS—THE FEDERAL GIFT TAX

Ex-1. **Answer –** Assuming W waives her right to a fee, in writing, within six months of her husband's death, and before she accepts payment for her services, the answer is no. If these requirements are met, W will be treated as if she performed the services of personal representative for free. Not only will she have no taxable income, she will have made not taxable gift either. See Rev. Rul. 66-167, 1966-1 C.B. 20.

Ex-2. **Answer –** Under IRC § 7872, this transaction is treated as two deemed events. In the first, T is deemed to have received interest from S. This gives rise to interest income to T. In the second, T is deemed to have transferred the interest back to S as a taxable gift.

Ex-3. **Answer –** The answer depends on a fact that is not given in the question — Who created the trust? If T created the trust, the power to distribute is a retained power that rendered the initial transfer to the trust incomplete. See "*Incomplete transfers*" on p. 14. In that case, a subsequent exercise of the power would be taxable as a gift. However, if someone other than T created the trust, T's power is a special power of appointment and its exercise would not be a gift.

Moral: The estate and gift taxes draw a sharp distinction between retained powers and powers of appointment.

Ex-4. **Answer –** The lapse of D's power will be treated as a transfer by D only to the extent that the lapse is treated as a release under IRC § 2514(e). Under our facts, the release will amount to $20,000. This is the excess of the $30,000 lapse over the greater of $5,000 or 5 percent of $200,000. For the valuation of D's gift see "*Valuation of retained interests*" beginning on p. 33.

Comment: No gift would occur when D's power lapses if D had a special testamentary power to appoint the trust property among his lineal descendants. The power would render any gift incomplete. However, eliminating the gift in this manner comes at the expense of ever increasing estate tax exposure at D's death. See Treas. Regs. § 20.2041-3(d)(4). All gift and most estate tax exposure can be eliminated by limiting D's power to the safe-harbor provided by IRC § 2514(e).

Ex-5. **Answer –** Yes. If T exercises his special power, he makes a gift because the effect of the exercise is to release his general power. See Treas. Regs. § 25.2514-1(d).

Ex-6. **Answer –** Yes. T's exercise is a gift because the effect of the exercise is to transfer his income interest to the appointee. See Treas. Regs. § 25.2514-1(b)(2) and Treas. Regs. § 25.2514-3(e), Example 3. See also Estate of Ruth B. Register, 83 T.C. 1 (1984). But see Self v. U.S., 142 F. Supp. 939 (Ct. Cl. 1956).

Ex-7. **First question –** The facts involve two gifts. The assignment is a gift of the income interest itself under normal gift principles. In addition, under IRC § 2519, the assignment is a gift of the entire value of the trust less the value of W's income interest.

Comment: The Service appears to agree that the value of the gift under IRC § 2519 is to be determined on a net gift basis. See the Comment in the answer to ***Ex-18***.

Second question – Yes and no. The termination (i.e. "commutation") of W's interest in the trust triggers gift tax exposure under IRC § 2519. See PLR 200013015. Since W winds up with the value of her income interest, however, this is the only gift. That is, there is not additional gift under normal gift principles.

Third question – The gift exposure under IRC § 2519 is the same whether W assigns all or any part of her income interest. Obviously, the gift that occurs under normal gift principles will vary with the amount of the income interest assigned.

Fourth question – Apparently the result here is different. In several private rulings, the Service has ruled that where the trust is appropriately severed prior to the assignment of the income interest in one of the shares, IRC § 2519 is applied separately and independently with respect to each of the shares. See PLR 200137022; PLR 200116006; PLR 200044034; PLR 199926019.

Ex-8. **First question –** No, revocable transfers are incomplete gifts.

Second question – Yes. The distribution frees the distributed property from T's revocation power and completes the gift as to that property. See Treas. Regs. § 25.2511-2(f)

Third question – No. A gift that becomes complete at the death of the donor is not subject to the gift tax. Treas. Regs. § 25.2511-2(f). Accord, Estate of Anthony F. DiMarco, 87 T.C. 643 (1986), acq. 1990-1 C.B. 1.

Ex-9. **First question –** No. The power to accumulate income is a power to alter who the ultimate taker of the income might be. The same is true of the power to advance principal to C, since it is not certain that C would ultimately be entitled to the principal at termination of the trust. See Estate of Goelet v. Comm., 51 T.C. 352 (1968).

Second question – The gift is partially complete and partially incomplete. The power to accumulate income renders the gift of the income interest incomplete since the consequences of accumulation are to shift income from C to GC. The gift of the remainder interest, however, is complete. Although the ultimate taker of the interest is not yet know, the taker is not within the continuing influence of T.

Third question – Here the entire gift is complete. The gift of the remainder is complete for the same reasons as described in the second question; the taker is not within the continuing influence of T. The gift of the income interest is also complete because T's power to accumulate income requires the consent of C who is economically adverse to giving his consent. See e.g., Camp v. Comm., 195 F.2d 999 (1st Cir. 1952).

Fourth question – Here the entire gift is complete. Whether the income is distributed or accumulated, whether the principal is advance or retained until the termination of the trust, all income and principal is ultimately distributable exclusively to C or C's estate. For gift tax purposes, C and C's estate are considered to be the same person. Accordingly, T's retained powers merely allow him to alter the timing of the enjoyment of the trust income and principal. A power to alter the timing of enjoyment as opposed to who enjoys the property, does not render a gift incomplete. See Treas. Regs. § 25.2511-2(d)

Comment: It is informative to consider the estate tax consequences to T at his death in this example. Whether or not the gift to the trust is complete for gift tax purposes, the trust remains includible in T's gross estate. This is true, even if the remainder goes to C or C's estate. A power to affect only the time or manner of enjoyment triggers inclusion of under either of IRC §§ 2036(a)(2) or 2038. See Lober v. U.S., 346 U.S. 335 (1953); Estate of Alexander v. Comm., 81 T.C. 757 (1983). Accord, Treas. Regs. § 20.2038-1(a). And this remains true even if T's retained power requires the consent of someone economically adverse to giving it. Treas. Regs. §§ 20.2036-1(b)(3); 20.2038-1(a).

Ex-10. **Answer –** It depends. If T's creditor can force a distribution to T, the gift is incomplete. Otherwise it is complete. Compare Comm. v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); Outwin v. Comm., 76 T.C. 153 (1981); Estate of Floyd G. Paxton v. Comm., 86 T.C. 785 (1986); Rev. Rul. 76-103, 1976-1 C.B. 374 with PLR 932006 (Foreign trust where jurisdiction did not allow creditors to force distribution).

Ex-11. **Answer –** Probably not. In the absence of a statute which expressly permits the holder of a durable power to make a gift, the transfer by S is voidable by T and therefore incomplete. See e.g., Swanson Estate v. U.S., 46 Fed. Cl. 388 (2000); Estate of Casey v. Comm., 948 F.2d 895 (4th Cir. 1991). See also TAM 9403004; TAM 9231003. But see Estate of Suzanne C. Pruitt, 80 TCM 348 (2000); TAM 199944005.

The Florida statute does not expressly authorize gifts. See Fla. Stat. § 709.2201(1)(c) (2015).

Ex-12. **First question –** In 2010. According to the Tax Court, a gift by check is a completed gift in the year the check is drawn (on our facts, 2010) if the donor's intent can be clearly established; the delivery is unconditional; and the check is presented for payment in the same year in which it is written. Although technically the gift is revocable until it is honored by the drawee bank, when it is so honored in due course and in the ordinary course of business, the gift related back to the year the check was drawn and delivered. Estate of Metzger v. Comm., 94-2 USTC ¶60,179 (4th Cir 1994), aff'g, 100 T.C. 204 (1993). The Service now agrees. Rev. Rul. 96-56, 1996-2 C.B. 161.

Second question – Probably not. In Rosano Estate v. U.S., 245 F.3d 212 (2d Cir. 2001) the court held that the gifts were revocable at the time of death and that even though the checks were honored by the drawee bank in the ordinary course of business, the relation back doctrine does not apply to noncharitable transfers for purposes of the estate tax. See also Estate of Newman v. Comm., 84 AFTR 2d 99-6451 (D.C. Cir. 1999); McCarthy v. U.S., 806 F.2d 129 (7th Cir. 1986); Estate of Gagliardi v. Comm., 89 T.C. 1207 (1987)..

Comment: The relation back doctrine also applies for purposes of the estate tax when the transfer is made to a charity. See e.g., Estate of Belcher v. Comm., 83 T.C. 227 (1984). It has also been applied to noncharitable transfers for purposes of the income tax. See Estate of Spiegel v. Comm., 12 T.C. 525 (1949).

Ex-13. **First question –** The actuarial value of interests of C1 and C2 qualify for the exclusion; the gift of the future interest to GC does not. See Treas. Regs. § 25.2503-3(b).

Second question – No. The gift tax annual exclusion is not available if the trustee has the power to withhold (accumulate) income or to distribute it to others. Treas. Regs. § 25.2503-3(c), Ex. 1.

Third question – No exclusion here either. Treas. Regs. § 25.2503-3(c), Ex. 3.

Ex-14. **Answer –** At least 1 and maybe 5. Transfers to Qualified State Tuition Plans are treated as transfers of a present interest eligible for the gift tax and GST tax annual exclusion under IRC § 529(c)(5). And this is true, even though P has the right to reclaim the funds at will (subject to a 10 percent penalty) and the right to decide who will ultimately receive the funds. Hence, the transfer will qualify for at least 1 annual exclusion for both the gift tax and the GST tax. See IRC § 529(c)(2)(A); Prop. Regs. § 1.529-5(b)(1). Moreover, P may elect the "spread out" the transfer over a 5 year period, in effect treating the one-time transfer as if it was a series of five $14,000gifts over a five year period commencing with the year of the gift. This will qualify the gift for 5 annual exclusions. IRC § 529(c)(2)(B). See also Prop. Regs. § 1.529-5(b)(2)(v). Accord PLR 200602002.

Comment: In general, amounts contributed to a Qualified State Tuition Plan are subject to the estate tax at the death of the account beneficiary, but not at the death of the account creator. IRC §§ 529(c)(4)(A) and (B). An exception applies if P makes the election to spread the $55,000 gift over a five year period and then P dies before the allocation period expires. In that event, any unallocated portion will be includible in P's gross estate. Earnings on the unallocated portion, however, are not includible in P's gross estate. IRC § 529(c)(4)(C).

Ex-15. **Answer –** The answer is none. The donee's of a gift made to a corporation are the shareholders, not the corporation. Treas. Regs. § 25.2511-1(h)(1). Accordingly, there is no annual exclusion because no single shareholder has the present right to enjoy the gift. See Stinson Estate v. Comm., 214 F.3d 846 (7th Cir. 2000); Accord Channin v. U.S., 393 F.2d 972 (Ct. Cl. 1968); Rev. Rul. 71-443, 1971-2 C.B. 338.

Ex-16. **Answer –** In the view of the Service, the answer is 5. The gifts to the children, but not the grandchildren, qualify for the annual exclusion. The Tax Court, however, has held that the annual exclusion is available for the gifts to the grandchildren as well. See Estate of Maria Cristofani, 97 T.C. 74 (1991) , acq. in result only, AOD 1996-010. Accord, Estate of Lieselotte Kohlsaat, 73 TCM 2732 (1997); Estate of Carolyn W. Holland, 73 TCM 3236 (1997).

Caution: In their acquiescence to the result in Cristofani, the Service stated they will no longer deny the exclusion to current income beneficiaries and those with vested remainder interests. But they will continue to deny annual exclusions for gifts to trusts if the beneficiaries hold only demand powers or only those powers plus contingent remainder interests. Their reason is that a failure of such beneficiaries to exercise their power can only be explained by a prior understanding not to, since to not exercise is to give up all or most potential for getting the property. See also TAM 9628004; TAM 9141008. Note, however, that this reasoning was explicitly rejected by the Tax Court in the Kohlsatt and Holland opinions.

References: On Cristofani and the position of the Service, see Fiore & Ramsbacher, IRS Takes a Tougher Position on Crummey Trusts in New TAM, 23 Estate Planning 413 (Nov. 1996); Cavanaugh and Preston, When will Crummey Transfers to Contingent Beneficiaries be Excludible Present Interests, 76 J. Taxation 68 (Feb. 1992).

Ex-17. **First question –** This trust is in the form of a general power of appointment trust described in IRC § 2056(b)(5). Accordingly, the exclusion is available for the value of the life interest given to S. Treas. Regs. § 25.2523(i)-1(d), Example 3.

Second question – No. The answer is the same. Without the general power, the trust still takes the form of a QTIP trust under IRC § 2056(b)(7). Accordingly, the income interest in S qualifies for the annual exclusion. It is not necessary to actually make a QTIP election on a gift tax return. Treas. Regs. § 25.2523(i)-1(d), Example 4.

Third question – This produces a better result because the entire $147,000 transfer to the trust will qualify for the annual exclusion. As long as S also has a power to appoint the trust property at death, any gift on the lapse of the power will be incomplete.

Ex-18. **Answer –** This "net gift" is treated as a part gift, part sale under which T must recognize gain to the extent that the tax paid by daughter exceeds T's basis in the property. Diedrich v. Comm., 457 U.S. 191 (1982).

Comment: Under IRC § 2519, a surviving spouse makes a gift of the value of property held in a QTIP trust if the spouse assigns the right to income during life. Under IRC § 2207A(b), the spouse has a right of recovery against the QTIP trust for the gift taxes on the gift. It would seem, therefore, that the IRC § 2519 gift should be calculated on a net gift basis. The final regulations, however, deleted a provision to that affect that had appeared in the proposed regulations. The Service has invited comment on the issue. In the interim, however, the Service continues to apply net gift treatment to IRC § 2519 gift transactions. See PLR 200044034; 199926019.

See also: For the interplay of the net gift principle to a gift of an interest in a QTIP trust under IRC § 2519, see PLR 9736001 (gift is entire value of property in the QTIP trust reduced by gift tax paid by donee).

Comment: Compare treatment of a part gift, part sale to charity. See Treas. Regs. § 1.1011-2.

II. SPECIAL VALUATION RULES

The four sections that comprise Chapter 14 of the Code (sections 2701 through 2704) provide special rules for the valuation of certain transfers where the donee of the transfer is a member of the transferor's family.[59]

A. GENERAL PRINCIPLES OF VALUATION

The gift tax is based on the value of the property interest or interests transferred by the donor as of the date of the gift.[60]

As is the case with all of the transfer taxes, value means fair market value, defined in the regulations to be "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[61]

COMMENT
The willing buyer and willing seller contemplated by this definition are hypothetical persons; they cannot be equated with the actual donor and donee.[62]

Ex-19: D owns 70 of the 100 outstanding shares of X Corporation stock. The other 30 shares are owned equally by D's two sisters. *Answers to the examples in this chapter begin on page 49.*

1. What special valuation considerations would be involved if D gave all of his stock to his daughter M?

2. Suppose D gave M only 15 shares of stock?

3. How about 40 shares?

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59 In general, the valuation principles of Chapter 14 apply only to transfers after October 8, 1990.

Proposed regulations for Chapter 14 were issued in 1991. Final regulations, differing in numerous respects from the proposed regulations, were issued in 1992. The final regulations are effective as of January 28, 1992. With respect to transfers prior to that date, the regulations provide that taxpayers may rely on any reasonable interpretation of the statute, including the interpretation taken in the proposed regulations. Treas. Regs. §§ 25.2701-8; 25.2702-7; 25.2703-2 and 25.2704-3.

60 Under IRC § 2515, the value of a gift that constitutes a direct skip for purposes of the GST tax is increased by the amount of any GST taxes imposed on the transfer.

61 Treas. Regs. § 25.2512-1.

62 E.g, Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981); Nancy N. Mooneyham, 61 TCM 2445 (1991); Estate of Woodbury G. Andrews, 79 T.C. 938 (1982); Estate of Elizabeth M. Lee, 69 T.C. 860 (1978). The service has reluctantly agreed. See Rev. Rul. 93-12, 1993-1 C.B. 202, revoking Rev. Rul. 81-253, 1981 C.B. 187.

Ex-20: D and her brother have a plan to jointly develop certain real property owned by D. Accordingly, D conveys an undivided one-half interest in the real estate to her brother. In valuing the gift, what discounts might D be entitled to?

Ex-21: D transfers investment real property to a family limited partnership. Sometime later, D transfers a limited partnership interest to Jr.

1. In valuing the gift, what discounts might D be entitled to?

2. Would the answer change if D had formed the limited partnership by transferring marketability securities to it immediately before his gift of the partnership interest to Jr.?

B. VALUATION OF RETAINED INTERESTS

In the case of a gift of a partial interest, the value of the gift is determined by subtracting the value of the retained interest from the total value of the property involved in the transfer. Prior to the enactment of IRC § 2702, the value of a retained interest was determined using valuation tables promulgated pursuant to IRC § 7520.[63] Use of the tables led to a number of split interest transactions which were designed to leverage the actuarial assumptions of the regulations.

- IRC § 2702 curtails attempts to do this by denying donors the use of the tables for valuing transfers to a member of the transferor's family where the transferor or certain related persons retain an interest in the property transferred.

- In particular, IRC § 2702(a) provides that for the purposes of determining whether a transfer in trust for the benefit of a member of the transferor's family is a gift, the value of any nonqualifying interest retained by the transferor or any applicable family member is treated as being zero.[64]

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63 The IRS issues actuarial tables for valuing life estates, remainders, and other term interests. In any given case, valuation is determined using the table based on a rate equal to 120 percent of the federal midterm rate under IRC § 1274(d)(1), rounded to the nearest 2/10th of a percent. IRC § 7520. Effective for transfers (or decedent's dying) on or after May 1, 2009, split interests which are dependent on the life expectancy of one or more persons are to be valued using the mortality assumptions in Table 2000 CM rather than Table 1990 CM. These new tables reflect the increased life expectancy mortality data produced by the 2000 U.S. census. Unless otherwise noted, however, the examples used in this outline predate the effective date of the new tables and are therefore based on the older Table 1990 CM. As a transition rule, if the date of a gift or of a decedent's death is on or after May 1, 2009 but before July 1, 2009, the transferor may elect to use either the new Table 2010 CM or the older Table 1990 CM. The July 1, 2009 limitation does not apply to decedents who were under a mental disability that existed on May 1, 2009 and which disability continued uninterrupted until the decedent's death or which disability did not end more than 90 days prior to the decedent's death. See T.C. 9448, 74 Fed. Reg. 21437 (May 7, 2009), corrected 74 Fed. Reg. 27079; REG 107845-08, 74 Fed. Reg. 21519 (May 7, 2009), corrected 74 Fed. Reg. 27080, corrected again Ann 2009-52, 2009-25 I.R.B. 1106 (June 22, 2009).

64 Although the typical application of IRC § 2702 involves a transfer of a remainder interest, the section also applies to a transfer of an income interest to a family member. In such a situation, when the donor dies, his estate will include either the property itself or the actuarial value of the remainder, depending on whether the income interest had ended. In either situation, the donor will be taxed twice on the same property, once under the gift tax and again under the estate tax.

The regulations eliminate this double taxation through a downward adjustment of the donor's adjusted taxable gifts at death. A similar adjustment to taxable gifts is available under the gift tax if the donor makes a gift of a retained interest that received a zero value under IRC § 2702. Treas. Regs. § 25.2702-6. The adjustment is equal to the lesser of the value of the retained interest (determined without regard to IRC § 2702) at the time of the initial transfer and the value of the interest at the time of the subsequent taxable event. The adjustment may be assigned between spouses if the transferor and the transferor's spouse elected to split either the initial or the subsequent transfer. Treas. Regs. § 25.2702-6(a)(3). The adjustment is

Ex-22: Sixty-year-old T transfers property worth $500,000 to a trust retaining the income until the earlier of T's death or 10 years at which time the trust property is to pass to T's estate if he is not living; otherwise to T's children.

1. Assuming a 10 percent interest rate,[65] what is the value of T’s gift under prior law (i.e. under IRC § 7520)?

2. How does the answer change under IRC § 2702?

COMMENT
The Service has issued regulations describing the situations where the tables issued pursuant to IRC § 7520 will be ignored.[66] In general, the standard tables may not be used if the individual whose life is being used to measure the value of an interest is known[67] to have an incurable illness or deteriorating physical condition such that there is a least a 50 percent probability that the individual will die within one year.[68] In the application of this test, if the person whose life is being measured survives for at least 18 months, the individual is presumed not to have been terminally ill on the date of the transfer. This presumption may be overcome only by clear and convincing evidence to the contrary.[69] Additionally, the regulations also state that: • The tables cannot be used to value an income interest unless the assets upon which the income interest is based produce a reasonable amount of income or the beneficiary can compel the trustee to make them productive; and • The tables cannot be used to value an annuity or income interest if the governing instrument or state law permits the income or beneficial enjoyment to be withheld, diverted or accumulated for the benefit of someone else, without the consent of the income or annuity beneficiary.[70]

1. Important terms

a) Transferor's family

This is defined broadly to include the transferor's spouse, ancestors, lineal descendants, siblings of T or T’s spouse or the spouse of any of them. It does not include nephews and nieces.[71]

discussed in Schneider, GRIT, GRAT, GRUT, What Will Your Client Want?, Twenty-Sixth Annual Phillip E. Heckerling Institute on Estate Planning, 11-20 , 11-39 - 11-42 (1992). See also the examples in Treas. Regs. § 25.2702-6(c).

65 IRC § 7520 rates are equal to 120 percent of the midterm applicable federal rate. All examples in this work use an IRC § 7520 rate of 10 percent.

66 Substantially identical regulations were issued under the income, estate and gift taxes. See generally Treas. Regs. §§ 1.7520-3(b), 20.7520-3(b), and 25.7520-3(b). For convenience, only the estate tax regulations are cited in subsequent references.

67 By any person.

68 The requirement that there be an incurable illness or deteriorating physical condition is not satisfied simply because the person’s whose life is being measure suffers from the general infirmities of old age.

69 Treas. Regs. § 20.7520-3(b)(3)(i).

70 Treas. Regs. § 20.7520-3(b)(2).

71 IRC §§ 2702(e), 2704(c)(2).

b) Applicable family member

This is defined more narrowly to include only the transferor's spouse, the ancestors of either the transferor or the transferor's spouse, and the spouses of any of them.[72]

c) Transfer in trust

According to the regulations, the term "transfer in trust" includes transfers to new or existing trusts as well as assignments of interests in existing trusts.

The term does not include transfers occurring

- as a result of qualified disclaimers,
- through the exercise of a special power of appointment, or
- through the nontaxable release of a general power.[73]

d) Term interest

The term "transfer in trust" also includes outright transfers where the transferor or an applicable family member retains a term interest in the property transferred.[74] A "term interest" includes a life interest or interest for a term of years.[75]

e) Retained

The regulations define "retained" to mean that the same transferor (or applicable family member) possessed the interest both before and after the transfer.[76]

> ***Ex-23:*** Sixty-year-old W transfers property to husband H for life, remainder to their child C.
>
> 1. Does IRC § 2702 apply to this transfer?
>
> 2. Does it matter whether W makes a QTIP election for this transfer?
>
> 3. After the initial transfer, C assigns his remainder interest to GC. Does IRC § 2702 apply to the assignment?

2. Sale of remainder interest

IRC § 2702 also prevents leveraging of the actuarial tables through a sale of a remainder interest at its IRC § 7520 value.

Under IRC § 2702, the sale of the remainder interest for its section 7520 value will result in a taxable gift because the consideration received will not equal the deemed value of the interest transferred.

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72 IRC § 2701(e)(2).

73 Treas. Regs. § 25.2702-2(a)(2).

74 IRC § 2702(c)(1).

75 IRC § 2702(c)(3). The regulations state that term “interest” does not include leasehold interests to the extent they are supported by full and adequate consideration. Treas. Regs. § 25.2702-4(b). Nor does the term include fee interests held in tenancy in common, tenancy by the entirety, or in joint tenancy with right of survivorship. Treas. Regs. § 25.2702-4(a).

76 Treas. Regs. § 25.2702-2(a)(3).

Ex-24: Sixty-year-old D transfers an apartment building worth $100,000 in trust to pay income back to D for life, remainder to Son. In return for this transfer, Son pays D the actuarial value of the remainder interest which the appropriate table shows to be $30,000. To what extent, if any, does this transaction result in a taxable gift?

COMMENT
Under prior law, for a sale of a remainder to save taxes the transferred property had to be excludable from the gross estate as a transfer for full consideration. The courts are split on whether this is the case.[77]

3. Joint purchases

A joint purchase by members of the same family where one of them acquires a term interest in the property is treated as if the owner of the term interest acquired the entire property and then transferred a remainder to the other joint purchaser in exchange for the consideration the remainderman provided.[78]

The end result is a gift equal to the difference between the value of the property and the consideration furnished by the remainderman.

Ex-25: Sixty-year-old D and Son pool their resources to purchase an apartment building for $100,000, taking title in the names of "D for life, remainder to Son." D and Son contribute $70,000 and $30,000 respectively, each amount being equal to the IRC § 7520 value of the interest received. What, if any, are the gift tax consequences of this transaction?[79]

4. Excluded transfers

The Code provides exclusions from the valuation rule of IRC § 2702 for personal residence trusts and for certain "qualified" interests. These are examined in depth later. In addition, the Code and regulations create a number of more specialized exceptions.

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77 Compare Gradow v. U.S., 897 F.2d 516 (Fed. Cir. 1990); Pittman v. U.S., 878 F. Supp. 833 (E.D. N.C. 1994). (a sale of a remainder is not supported by full consideration unless the consideration received equals the amount of estate tax exposure the transferor faced immediately before the transfer) with Estate of Magnin v. Comm., 184 F.3d 1074 (9th Cir. 1999); Wheeler v. Comm., 116 F.3d 749 (5th Cir. 1997); Estate of D'Ambrosio v. Comm., 101 F.3d 309 (3d Cir. 1996), *rev'g* 105 T.C. 252 (1995); (adequacy of consideration is measured against the value of the interest transferred, not the fee interest.

78 IRC § 2702(c)(2).

79 According to the regulations, the joint purchase rule would apply even if D Jr. paid no consideration as might be the case where the seller was another family member. However, the amount of the gift that D can be deemed to have made to Son is limited by the amount of consideration D provided for his term interest. Thus in this example, if D had paid only $50,000 for his income interest, his deemed gift to Son. would only be $50,000. This result would not be affected by the amount of consideration Son provided. Treas. Regs. §§ 25.2702-4(c) and 25.2702-4(d), Example 4.

a) Incomplete transfers

IRC § 2702 does not apply to incomplete transfers.[80] This exclusion applies only when a transfer is totally incomplete.

- Where a transfer is only partially incomplete, IRC § 2702 applies for purposes of valuing the complete portion of the transfer.
- Moreover, the regulations indicate that the power that renders the gift partially incomplete is itself a retained interest in the transferor that must be assigned a zero value.[81]

> ***Ex-26:*** T makes an irrevocable transfer in trust retaining the power to spray trust income among his descendants for 10 years with remainder to his children. How is this transfer treated under IRC § 2702?

b) Section 2516 transfers

IRC § 2702 does not apply to a transfer in trust to a spouse if the transfer is deemed to be for full consideration under IRC § 2516, provided any remaining interests in the trust are retained by the transferor.[82]

c) Split interest charitable trusts

In general, IRC § 2702 does not apply for purposes of valuing the noncharitable interest in a pooled income fund or a qualifying charitable remainder or lead trust.[83]

> ***Ex-27:*** Donor transfers property to a NIMCRUT to pay the lesser of the trust income or a fixed percentage to the donor for a term of 15 years or life, whichever is shorter, and then to the donor's daughter for life. Does the zero valuation rule of section 2702(a) apply to these facts?

d) Certain tangible property

The special valuation rule of IRC § 2702 does not apply to a transfer of a term interest in real or tangible personal property for which no deduction for depreciation or depletion would be allowable if the property were held in a trade or business and as to which the failure of the term holder to exercise any rights would not affect the value of the property passing at the end of the term interest.[84]

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80 IRC § 2702(a)(3)(A)(i).

81 Treas. Regs. §§ 25.2702-1(c)(1), 25.2702-2(a)(4).

82 Treas. Regs. § 25.2702-1(c)(7).

83 Treas. Regs. § 25.2702-1(c)(3) - (5).

84 IRC § 2702(c)(4); Treas. Regs. § 25.2702-2(c)(2). Examples might include artwork or undeveloped land. Improvements that might otherwise cause disqualification are ignored if their fair market value in the aggregate does not exceed 5 percent of the entire property. Treas. Regs. § 25.2507-2(c)(2)(II).

For this type of property, the value of the term interest is the amount for which the transferor establishes the interest could be sold to an unrelated person.[85]

C. PERSONAL RESIDENCE TRUSTS

According to IRC § 2702(a)(3)(A)(ii), the zero valuation rule of IRC § 2702 does not apply to a transfer "of an interest in trust all the property in which consists of a residence to be used (or held for the use) as a personal residence by persons holding term interests in such trust."

The regulations clarify the meaning of "personal residence" and detail the requirements for creating a "qualified personal residence trust."

1. Meaning of "personal residence"

The regulations list two substantive requirements for a residence to qualify as a personal residence.

a) First, it must be either a principal residence within the meaning of IRC § 1034 (relating to rollover of capital gains), or one other residence within the meaning of IRC § 280A(d)(1) (relating to deductions for business uses of homes and rental of vacation houses), or a fractional interest in either.[86]

b) Secondly, during the period it is occupied by the term holder, its primary use must be as a residence of the term holder,[87] or, in the case of a residence held for the use of the term holder, it may not be occupied by any other person (other than a spouse or dependent) and it must be available at all times for use by the term holder as a personal residence.[88]

Subject to these requirements, the regulations state that:

- personal residence includes appurtenant structures used for residential purposes and reasonably related adjacent land;
- the term excludes household furnishings and other personal property; and
- personal residence status is not affected by the existence of a mortgage.[89]

2. Types of personal residence trusts

Two types of trusts qualify for the personal residence exception:

- a personal residence trust (PRT) and
- a qualified personal residence trust (QPRT).

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85 IRC § 2702(c)(4). Conversion of the property into non-qualifying property and nonqualifying additions and improvements are treated as transfers of the unexpired portion of the term interest. An exception exists for a conversion to a qualified annuity. See Treas. Regs. §§ 25.2702-2(c)(4) and 25.2702-2(c)(5).

86 Implicit in this, and explicit in the regulations, is the limitation that a person may not be the holder of a term interest in more than two personal residence trusts. Treas. Regs. §§ 25.2702-5(b)(2); 25.2702-5(c)(2). Trusts holding fractional interests in the same residence are treated as one trust. Treas. Regs. § 25.2702-5(a).

87 Treas. Regs. §§ 25.2702-5(b)(2); 25.2702-5(c)(2). There is an exception for activities meeting the requirements of IRC § 280A(c)(1). The definition of personal residence is applied in the examples found in Treas. Regs. § 25.2702-5(d).

88 Treas. Regs. § 25.2702-5(b)(1). See also Treas. Regs. § 25.2702-5(d), Example 5. In PLR 9328040 the IRS ruled that occasional rent free use of a guest house adjacent to a main house on land which T intended to place in a QPRT would not disqualify the trust under Treas. Regs. § 25.2702-5(c)(2)(iii). A similar result was reached in PLR 9249014 which involved a cooperative apartment in which T and a friend lived, the latter with no lease and at the sufferance of T.

89 Treas. Regs. §§ 25.2702-5(b)(2)(ii); 25.2702-5(c)(2)(ii). The existence of a mortgage will reduce the value of the residence for gift tax purposes. For ways to avoid this reduction, see Covey, Practical Drafting 2454 - 2456 (April 1991).

The former is a trust the sole assets of which are a personal residence and certain qualified proceeds resulting from damage to or destruction or involuntary conversion of the residence.[90] The latter is a trust the governing instrument of which complies with the numerous detailed requirements of the regulations.[91]

Of the two, a QPRT will generally be preferable to a PRT because:

a) A QPRT may hold cash for up to three months for the purpose of purchasing the personal residence or upon sale when the proceeds are to be reinvested in a new personal residence.[92]

b) Cash may also be held for up to six months to cover the costs of trust expenses, mortgage payments, and improvements.[93]

c) Additionally, if the residence held in a QPRT ceases to qualify as a personal residence, a QPRT may continue in converted form as a qualified annuity trust.[94] Alternatively, the trust instrument may provide for termination in favor of the term holder. Or it may give the trustee discretion to chose between a qualified annuity or termination in favor of the term holder.

CAUTION

Care must be exercised in the selection of the approach used on this point.

- Since it is always within the unilateral power of the term holder to cease using the residence as a personal residence, where the term holder is also the transferor, a mandated termination in favor of the term holder is inadvisable because it would render the transfer to the trust incomplete. In such cases, it would be preferable to give the trustee discretion to choose between conversion to a qualified annuity trust or termination in favor of the transferor.
- Where the term holder is someone other than the transferor, the trustee should not be given discretion to choose between the conversion and termination options if the transferor is to serve as trustee. In such cases, the power to select between the two options would be a retained power to alter the timing of beneficial enjoyment that could cause inclusion of the trust in the grantor's gross estate under IRC § 2038.

3. Planning considerations

Given the gift tax cost the zero valuation rule of IRC § 2702 places on most split interest family transfers, the QPRT stands out as one of the best ways to transfer property to a family member at a relatively small transfer tax cost.

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90 Treas. Regs. § 25.2702-5(b). A PRT must expressly prohibit the trust from holding any asset other than a single personal residence. Additionally, the instrument must require that all qualified proceeds be reinvested in a personal residence within two years of their receipt. Treas. Regs. §§ 25.2702-5(b)(1) and 25.2702-5(b)(3).

91 Treas. Regs. § 25.2702-5(c) details the many provisions which must be included in the governing instrument of a QPRT. Among these are a provision which prohibits distributions to any beneficiary other than the term holder, a provision which prohibits the trust from holding any property other than a single personal residence and eligible cash, a provision that requires any ineligible cash to be distributed at least quarterly to the term holder; a provision that requires that all eligible cash be distributed to the term holder at the termination of the term interest, a provision that prohibits commutation of the term holder's interest and a provision requiring termination in favor of the term holder or conversion to a qualified annuity trust in the event the residence ceases to be a personal residence of the term holder.

92 Treas. Regs. §§ 25.2702-5(c)(5)(ii)(A)(iii) and 25.2702-5(c)(5)(ii)(A)(iv).

93 Treas. Regs. §§ 25.2702-5(c)(5)(ii)(A)(i) and 25.2702-5(c)(5)(ii)(A)(ii). All improvements must meet the requirements of a personal residence. Treas. Regs. § 25.2702-5(c)(5)(ii)(B).

94 Treas. Regs. § 25.2702-5(c)(8)(i)(B). The first annuity payment may be deferred for 30 days provided interest is payable at a rate no less than that provided in IRC § 7520. For other aspects of the conversion option, see Treas. Regs. § 25.2702-5(c)(8). For an example of how the annuity is calculated, see Treas. Regs. § 25.2702-5(d), Example 6.

COMMENT
Planning factors include the trust term, tax costs, the disposition of the residence at termination, and who is to serve as trustee.

a) Choosing a trust term

For a QPRT to gain any transfer tax advantage, it must be structured so that the residence is not taxed in the estate of the grantor/term holder. This means that the trust must be for a set period. A QPRT for the life of the grantor will achieve nothing because the QPRT property will be included in the grantor's gross estate.

b) QPRT tax considerations

In the absence of adequate consideration,[95] the creation of a QPRT constitutes a taxable gift of a remainder interest in the residence.

- The remainder is valued using the IRC § 7520 tables so its value will be a function of the applicable interest rate and the term of the trust. The longer the term, the smaller the gift.
- But this must be balanced with the risk that the grantor will die during the term. If that happens, the property will be included in the grantor's gross estate and the benefits of the QPRT will be lost.

DRAFTING TIP
In drafting a QPRT, consideration should be given to having the grantor retain a contingent reversion in the event that the grantor dies before the trust terminates. Not only would this make the property available for the payment of estate taxes, it would also serve to reduce the amount of the gift at the creation of the QPRT.[96]

Ex-28: Sixty-year-old T transfers his personal residence worth $500,000 to a QPRT to last until the earlier of T's death or 10 years. At termination of the trust, the trust property is to pass to T's estate if he is not living, otherwise to T's children. Ten years later, when the personal residence is worth $700,000, the QPRT terminates in favor of T's children.

1. What are the transfer tax consequences of these events?

2. If T is married, would you recommend that T and his spouse elect gift-splitting on the transfer to the trust?

c) Disposition of residence at termination

When creating a QPRT, it is important to consider where the grantor is to live at the end of the term period. Without careful planning, the grantor may have to move out of his home.

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95 A sale of the remainder interest in a QPRT will avoid the gift tax without compromising QPRT status. See PLR 9315010.

96 For authority that the grantor may retain a contingent reversion without disqualifying the QPRT, see Treas. Regs. § 25.2702-5(b)(1).

For QPRTs created after May 16, 1996, the governing instrument must "prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse,[97] or an entity controlled[98] by the grantor or the grantor's spouse" at any time after the creation of the trust.[99]

If the grantor dies before the expiration of the QPRT term, this prohibition does not apply to a distribution for no consideration to any person (including the grantor's estate)

- pursuant to the express terms of the governing instrument or
- pursuant to the exercise of a power retained by the grantor under the terms of the trust.

In addition, the prohibition is inapplicable to an outright distribution of the residence pursuant to the express terms of the trust to the grantor's spouse after the expiration of the original trust term.[100]

Ex-29: Sixty-year-old T transfers his personal residence worth $500,000 to a QPRT to last until the earlier of T's death or 10 years. At termination of the trust, the trust property is to pass to T's estate if he is not living, otherwise it is to be held in continuing trust for T's children. The trust gives T the power to reacquire trust property by substituting property of equal or greater value.

1. Does T's trust qualify as a QPRT?

2. Could the instrument have provided instead that T had the right to lease the residence for fair rental value after the expiration of the 10-year term?

3. Would it matter if the trust remained a grantor trust after the expiration of the term and during the period in which the grantor leased the residence from the trust?

D. QUALIFIED INTERESTS

Qualified interests retained by a transferor or an applicable family member are valued using the actuarial tables of IRC § 7520 rather than the zero value rule of IRC § 2702.[101]

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[97] For purposes of this prohibition, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered to be a sale or transfer to the grantor or the grantor's spouse. An exception applies for distributions for no consideration pursuant to the terms of the trust upon or after the expiration of the original trust term to another grantor trust that likewise contains the required language relating to prohibited sales.

[98] In the case of a corporation, control exists if the transferor owns at least 50 percent (by vote or value(of the corporation's stock. For a partnership the test is 50 percent of the capital or profits of the partnership, although any general partner of a limited partnership is deemed to have control. In either case, n testing for control, a transferor is deemed to own any interest owned by a sibling and lineal descendant of the transferor as well as any interest held indirectly through a corporation, partnership, trust or other entity.

[99] See Treas. Regs. §§ 25.2702-5(b)(1) and 25.2702-5(c)(9). The regulations provide a mechanism through which noncomplying trust may be modified by judicial or nonjudicial reformation to bring them into compliance with these requirements. See Treas. Regs. § 25.2702-5(a)(2).

[100] See Treas. Regs. §§ 25.2702-5(b)(1) and 25.2702-5(c)(9).

There are three types of qualified interests:

- a qualified remainder interest,
- a qualified annuity trust, and
- a qualified unitrust.

1. Qualified remainder interest

A qualified remainder interest is a non-contingent[102] remainder interest[103] retained by a transferor in a trust where all other interests are qualified annuity or unitrust interests.[104]

2. Qualified annuity and unitrusts

A qualified annuity trust is a transfer in trust in which the transferor or an applicable family member retains the right to an annuity. The annuity interest must be stated as a dollar amount or a fixed percent of the net fair market value of the trust as finally determined for federal tax purposes.[105]

A qualified unitrust is a transfer in trust in which the transferor or an applicable family member retains the right to a qualified unitrust interest. The unitrust interest must be stated as a fixed percentage of the net fair market value of the trust determined annually.[106]

COMMENT
The annuity or unitrust amount may be paid on either the calendar year or the trust's anniversary date. In either case, proration of the payment is required for any short taxable year either at the beginning or the end of the payment term.[107]

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101 IRC § 2702(a)(2)(B).

102 The remainder must be payable to the beneficiary or the beneficiary's estate "in all events." It may not be conditioned on anything including the failure of the grantor to survive the term of the annuity or unitrust interest. Treas. Regs. §§ 25.2702-3(f)(1)(iii) and 25.2702-3(f)(3), Example 4.

103 A remainder (which includes a reversion) is a right to receive all or a fractional share of the trust property upon termination of the annuity or unitrust interest. A right to receive a stated or pecuniary amount is not a remainder interest. Treas. Regs. § 25.2702-3(f)(2).

104 All interests in the trust, other than the non-contingent remainder interest or interests, must be qualified annuity or unitrust interests. This requirement is met "only if the trust does not permit payment of income in excess of the annuity or unitrust amount to the holder of the qualified annuity or unitrust interest." Treas. Regs. § 25.2702-3(f)(1)(iv).

105 After the first year, the annuity is not a qualifying payment to the extent it exceeds 120 percent of the amount or fraction for the preceding year. Treas. Regs. § 25.2702-3(b)(1)(ii). The governing instrument must contain language required by Treas. Regs. § 1.664-2(a)(1)(iv) relating to annualization of the annuity amount for short taxable years of the trust. Treas. Regs. § 25.2702-3(b)(3). Additionally, if the annuity is phrased as a fixed percentage of the initial value of the trust, the governing instrument must include provisions meeting the requirements of Treas. Regs. § 1.664-2(a)(1)(iii) relating to required adjustments in the event of incorrect valuations. Treas. Regs. § 25.2702-3(b)(2).

106 In any year after the first, the payment is not a qualified payment to the extent the unitrust fraction exceeds 120 percent of the fraction for the preceding year. Treas. Regs. § 25.2702-3(c)(1)(ii). The governing instrument must contain language required by Treas. Regs. § 1.664-2(a)(1)(iv) relating to annualization of the annuity amount for short taxable years of the trust. Treas. Regs. § 25.2702-3(c)(3). Additionally, the governing instrument must include provisions meeting the requirements of Treas. Regs. § 1.664-2(a)(1)(iii) relating to required adjustments in the event of incorrect valuations. Treas. Regs. § 25.2702-3(c)(2).

107 Treas. Regs. § 25.2702-3(b)(3); 25.2702-3(c)(3).

Ex-30: D transfers property to an irrevocable trust, retaining the right to withdraw $5,000 from the trust each year for 10 years, after which time, all trust property including accumulate income is to pass to D's child C. Does this trust qualify as a grantor retained unitrust?

a) Trust duration

The annuity (or uniamount) must be payable to (or for the benefit of) the term holder at least annually for a term period measured by:

1. the life of the transferor or applicable family member,
2. a specified term of years, or
3. the shorter (but not the longer) of either.

Successive term interests for the benefit of the same individual are treated as a single term interest.[108]

Moreover, the retention of a right to revoke a qualified annuity interest of the transferor's spouse is treated as the retention of a qualified interest by the transferor.[109]

Ex-31: W transfers property in trust retaining a qualified annuity for 10 years. At the expiration of the 10 year period, a qualified annuity is payable to H (W's spouse) for 10 years. At the expiration of H's interest, the trust terminates in favor of W's child. W retains the right to revoke H's interest.

1. How is W's gift valued?

2. Would the answer change if H's interest was to take effect only if W died during the initial 10 year term?

b) Other distributions

A qualified annuity or unitrust may provide for distributions of income in excess of that needed to pay the annuity or uniamount.[110] Additionally, the transferor may retain a contingent reversionary interest in the trust property. Typically this would be contingent on the transferor dying prior to the expiration of the term period.

In either case, however, the additional rights are valued at zero in computing the gift at the creation of the trust.[111] Beyond this, there can be no other distributions during the term period.[112]

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108 Treas. Regs. § 25.2702-3(d)(3). The actual payment of the annuity or uniamount may be made after the close of the trust's taxable year provided it is made before the due date of the trust's tax return (without regard to extensions). Treas. Regs. §§ 25.2702-3(b)(1)(i), 25.2702-3(c)(1)(i). It is unclear, however, whether and to what extent a trust provision authorizing this will affect the valuation of the grantor's interest.

109 Treas. Regs. § 25.2702-2(5).

110 Treas. Regs. §§ 25.2702-3(b)(1)(iii), 25.2702-3(c)(1)(iii).

111 See Treas. Regs. § 25.2702-3(e), Examples 1 and 5.

112 Thus the trust instrument must prohibit distributions to anyone other than the transferor or applicable family member. Treas. Regs. § 25.2702-3(d)(2). It must also prohibit distributions in commutation of the unitrust interest. Treas. Regs. § 25.2702-3(d)(4).

c) Subsequent contributions

Once created, no additional contributions of property may be made to a qualified annuity trust. Indeed, the governing instrument must expressly prohibit them.[113] This restriction is not applicable to a qualified unitrust.

E. PLANNING WITH GRATS

With careful planning, it is possible to use a qualified grantor retained annuity or unitrust (GRAT and GRUT, respectively) to save transfer taxes. Savings are possible, however, only if property remains in the trust at the expiration of the term period. On this point, a GRAT would generally offer the better performance since payments to the grantor will not increase as the value of the trust increases.

Beyond this, a number of factors influence the success of a GRAT. These include the tax costs of creating and operating it and the risk that the grantor will die before the end of the term period.

COMMENT
An installment sale to an intentionally defective irrevocable trust (IDIT) may be preferable to a GRAT. For the details, Michael D. Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT.[114]

1. Gift tax consequences at creation

A gift occurs at the creation of a GRAT (or a GRUT for that matter) only to the extent the value of the property transferred exceeds the IRC § 7520 value of the retained interest.

- Since the size of the retained annuity interest and the term of the trust are within the control of the grantor, with careful planning, it is possible to "zero out" all gift tax exposure at the creation of a GRAT by pegging the amount of the annuity and its term to whatever combination is necessary to equal the value of the property transferred.

- Under a former regulation, the value of a GRAT nominally for a fixed term was based on a term measured by the shorter of the stated term or the transferor's death. In Walton v. Comm.,[115] however, the Tax Court held that the regulation was invalid. According to the Tax Court, if the GRAT provides for a continuation of the payments to the estate of the transferor should the transferor predecease the specified term, the GRAT is to be valued on the basis of the term itself, without any reduction for a mortality factor reflecting the possibility that the term holder might die before the term expires. In effect, the Court held that for this purpose, the transferor and the transferor's estate are the same person. New regulations have been issued that comport with the Walton decision.[116]

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113 Treas. Regs. § 25.2702-3(b)(4).

114 Estate Planning 3 (Jan. 1996) .

115 115 T.C. 589 (2000). See also In Estate of Benjamin Shapiro, 66 TCM 1067 (1993) the Service took the position that a trust annuity for life should be valued as an annuity concurrent for a life and a term certain because the trust property was not sufficient to fund the annuity for the full extreme life expectancy of the annuitant. The court rejected the Service's position and in doing so the underlying rationale of their approach to valuing GRATs discussed above.

116 Treas. Regs. § 25.2702-3(3).

2. Selecting a term for a GRAT

In selecting a term for a GRAT, the prevailing wisdom is that the shorter the term the better.[117] Not only do short terms minimize the value of residual gifts (and the risk of adverse estate tax exposure, see below), they also increase the potential for transfer tax savings.

DRAFTING TIP
To accomplish tax savings, a GRAT must outperform the IRC § 7520 tables so that property remains at the end of the term period. Using a short term GRAT insures that the good investment performance years are not undermined by poor performance years. For the same reason, it is preferable to create several small GRATs than a single large one. In this way, the poor performance of some assets will not undermine the tax savings generated by the good performance of others. [118]

3. Estate tax exposure at death of transferor

If the grantor of a GRAT (or GRUT) dies before the end of the term interest, some (but not necessarily all) of the property will be included in the grantor's gross estate.[119] Here again, the shorter the term of the GRAT the less the risk.

COMMENT
It is possible for the grantor to retain a contingent reversion to cover this possibility. However, the reversion is not a qualified interest so it won't reduce the value of the gift at the creation of the GRAT. And the size of the reversion should not exceed the amount of property that would otherwise be includible in the grantor's gross estate. Alternatively, if the grantor is married, the marital deduction could be used to eliminate estate tax exposure at the grantor's death. This requires careful planning, however, because without more, the grantor's retained annuity right is a nondeductible terminable interest. *For more on this issue, see Ex-80, infra p. 89.*

4. Advantages of grantor trust status

Typically, the income of a short term zeroed out GRAT will not be sufficient to fund the entire annuity obligation; distributions of principal will be necessary for this purpose.

- Generally, the satisfaction of an annuity obligation with appreciated property would result in taxable gain to the trust. However, there will be no gain (or loss) if the GRAT is a grantor trust as to both accounting and corpus income.[120]
- A GRAT is probably a grantor trust in any event since income and principal are distributable to the grantor.[121]

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117 The service approved a 2 year GRAT in PLR 9239015. More recently, however, the Service has refused to issue a ruling approving a two year "zeroed out" GRAT on the grounds that the transaction lacked economic substance. See Covey, Practical Drafting, 4192 (October 1995).

118 Covey, Practical Drafting 2477 (April 1991).

119 In the case of a fixed term GRAT or GRUT, principles relating to inclusion in the related area of charitable remainder trusts should control. Thus, in the case of a GRAT, that portion of the trust property that would be necessary to produce an income stream equal to the annuity payment would be included in the gross estate under IRC § 2036(a)(1). See Rev. Rul. 82-105, 1982-1 C.B. 133. In the case of a GRUT, inclusion would be based on that portion of the trust that would be necessary to produce income equal to the adjusted payout rate. See Rev. Rul. 76-273, 1976-2 C.B. 268.

Where, the GRAT or GRUT terminates at the earlier of the grantor's death or a fixed term, the Service indicated in several rulings that inclusion might occur under IRC § 2039(a). More recently, in proposed regulations (see REG-119097-05, 72 Fed. Reg. 31487 (6/6/07), the Service has concluded that section 2036 is the proper section to apply.

120 Rev. Rul. 85-13, 1985-1 C.B. 184. See also Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (sale of insurance policy to a wholly-owned grantor trust is not a transfer for value under IRC § 101.)

- In any case, grantor trust status can be achieved in a number of ways,[122] one of the more useful of which is for the grantor to retain in a nonfiduciary capacity the power to reacquire trust property by substituting property of equal value.[123]

COMMENT
If the grantor of a GRAT has both the authority to substitute property and the cash with which to do so, the grantor should consider exercising the power to buy back highly appreciated trust property shortly before the expiration of the term period. There will be no gain on the reacquisition and the highly appreciated property will receive an estate tax basis adjustment at the grantor's death.[124]

Ex-32: G creates a grantor retained annuity trust which qualifies as a grantor trust. Each year, G pays the income taxes on the income earned by the trust. The trustee of the trust has the authority to reimburse G for these taxes but never does so. If G never requests reimbursement and the trustee never makes it, will G make a gift each year when he pays the taxes on the trust income?

5. Using notes to make the annuity payments

New final regulations now preclude a trustee of either a GRAT or a GRUT from using a note or similar instrument to make the annuity or unitrust payment. The regulation provides that:

- The annuity or unitrust payment must be made in cash or with trust assets;[125] and .
- The governing instrument of any GRAT or GRUT created after September 20, 1999,[126] must expressly prohibit the use of notes, debt instruments, options or similar financial arrangements that effectively delay the annual payment to the grantor.[127]

COMMENT
The preamble to the new regulations makes it clear that the trustee may borrow from a third party in order to pay the annuity or unitrust amount.

121 Accord PLR 9415012.

122 See generally, Covey, Practical Drafting 2465 - 2466 (April 1991); Schneider, supra note 64, at 11-44 - 11-48.

123 See IRC § 675(4)(C).

124 The current ruling policy of the Service is that the question of whether a power to reacquire is exercisable in a nonfiduciary capacity is a question of fact. Accordingly, the Service will not issue an advance ruling on the grantor trust status of a trust arising solely from a retained power to reacquire. See PLR 9416009. Accord, e.g., PLR 9505025; PLR 9437023; PLR 9437022. See also Coghill, Reevaluating the Grantor Trust Status of GRATs and QPRTs, 23 Estate Planning 51 (Feb. 1996).

125 Treas. Regs. §§ 25.2702-3(b)(1)(i); 25.2502-3(c)(1)(i).

126 Under a special transition rule, GRATs and GRUTs created before September 20, 1999 will be treated as qualified even though the governing instrument does not prohibit the use of notes provided notes or similar debt instruments may not be used after September 20th and all extant notes, options, etc., are paid in full or are terminated by December 31, 1999. See Treas. Regs. § 25.2702-3(d)(5)(ii).

127 Treas. Regs. § 25.2702-3(d)(5)(i)

6. Back loading annuity and unitrust payments

Neither a GRAT (nor a GRUT) is required to make equal payments every year of the term. Subject to the limitation in the regulations that the annuity payment not exceed the payment for the previous year by more than 120 percent, a GRAT may provide for ever increasing payments throughout its term.

COMMENT
This makes it possible to compensate for smaller payments in the early years by providing for larger payments in the latter years, a process that may be useful if the property placed in the GRAT will generate a greater return in the out years. It also produces a superior result if the GRAT outperforms the IRC § 7520 rate.[128]

F. CERTAIN INTERESTS IN CORPORATIONS OR PARTNERSHIPS

Where stock or an interest in a partnership is transferred[129] to a family member, IRC § 2701 provides that the value of any liquidation, put, call or conversion right retained by the transferor or an "applicable family member" is deemed to be zero.

Additionally, if the transferor and applicable family members are in control of the corporation or partnership, the section also assigns a zero value to any retained distribution right. There is an exception for a distribution right that meets the definition of a qualified distribution payment.[130] (See discussion of qualified payments, below.)

These rules are designed to curtail abusive corporate and partnership valuation freezes.[131]

Ex-33: D owns one-fourth of the common and all of the preferred stock of a corporation. The remaining common stock is owned by unrelated persons. The preferred stock is noncumulative and carries a liquidation and conversion privilege. It may also be "put" to the corporation for its par value. D transfers half of his common stock to his daughter.

1. Assuming the total value of the corporation is $1,200,000, what factors would influence valuation without IRC § 2701?

2. What is the value of D's gift with IRC § 2701?

3. Would the answer be different if D's brother also owned one-fourth of the common stock?

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128 See e.g., Covey, Practical Drafting 3090 (January 1993). For a detailed discussion of the numbers, see Covey, Recent Developments Concerning Estate, Gift and Income Taxation - 1993, Twenty-Eighth Annual Philip E. Heckerling Institute on Estate Planning (1994). See also Katzenstein, Running the Numbers - An Economic Analysis of GRATs and QPRTs, Thirty-Second Annual Philip E. Heckerling Institute on Estate Planning (1998).

129 The term "transfer" includes any contribution to capital, redemption, recapitalization, or other change in the capital structure of a corporation or partnership to the extent that the transferor or an applicable family member receives a retained right whose value would be affected by the rules of IRC § 2701. IRC § 2701(e)(5). For further guidance, see Treas. Regs. § 25.2701-1(b)(2)(i)(B).

130 IRC § 2701(a)(2) details four other exceptions. They include a retained interest or right for which market quotations are readily available, a retained interest if it is of the same class as the interest transferred, a retained interest if, but for nonlapsing differences in voting power and certain nonlapsing limitations on liability, it is proportionally the same as the transferred interest, or a retained right to convert to a fixed percentage or number of the class of stock transferred provided the right is nonlapsing and subject to various adjustments as provided in IRC § 2701(c)(2)(C)(iii) and (iv).

131 For an example of how IRC § 2701 applies to a complex corporate structure with four classes of stock, see PLR 9204016.

1. Definitions

a) Family member

This includes only the transferor's spouse, descendants of the transferor and the transferor's spouse, and the spouses of any of such descendants.[132]

b) Applicable family member

This includes only the transferor's spouse, the ancestors of either the transferor or the transferor's spouse and the spouses of any of them.[133]

c) Distribution right

A distribution right is any right to a distribution with respect to stock of a corporation or a partnership interest except:

1. Distribution rights of junior equity interests.[134]
2. A liquidation, put, call or conversion right.
3. A right of a partner to receive an IRC § 707(c)[135] guaranteed payment of a fixed amount.

Small Business Job Protection Act of 1996
The SBJPA of 1996 amended the definition of distribution right to include "a right to distributions with respect to any interest which is junior to the rights of the transferred interest." As a result, IRC § 2701 does not affect the valuation of a transferred interest that is senior to the retained interest, even if the retained interest is not a junior equity interest.

d) Control (for purposes of section 2701)

In testing for control, a transferor is deemed to own any interest owned by a sibling and lineal descendant of the transferor as well as any interest held indirectly through a corporation, partnership, trust or other entity.

- In the case of a corporation, control exists if the transferor owns or is deemed to own at least 50 percent (by vote or value) of the corporation's stock.
- For a partnership the test is 50 percent of the capital or profits of the partnership, although any general partner of a limited partnership is deemed to have control.

2. Qualified payments

A qualified payment is any dividend payable on a periodic basis on cumulative preferred stock (or a comparable payment on a partnership interest) payable at a fixed rate.[136] Two consequences flow from the fact that a distribution right meets the definition of a qualified payment.

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132 IRC § 2701(e)(1).

133 IRC § 2701(e)(2).

134 Instead, IRC § 2701(a)(4) provides that the common stock and junior equity interests in a partnership are deemed to be worth no less than ten percent of the total value of all equity interest plus the total outstanding indebtedness of the entity to the transferor, the transferor's spouse, their ancestors, and the spouses of the ancestors.

135 These are payments to a partner for services or for the use of capital to the extent they are determined without regard to the income of the partnership.

136 IRC § 2701(c)(3)(A). "Fixed rate" includes a dividend that is determined at a rate which bears a fixed relationship to a specified market rate. IRC § 2701(c)(3)(B). In PLR 200114004, the IRS ruled that the prepayment of a required annual distribution constitutes a qualified payment under IRC § 2701(c)(3) and Treas. Regs. § 25.2701-2(b)(6)(i)(B).

- First, the value of the right may be taken into account when valuing other interests transferred to family members.[137]
- Second, a penalty provision applies if the cumulative dividend falls into arrears for more than four years.

a) Increase for cumulative unpaid dividends

If any dividend on a qualified payment is ever more than 4 years in arrears, the taxable gifts (in the case of a lifetime transfer of the preferred stock) or the taxable estate (in the case of the death of the transferor) is adjusted upward to reflect the time value of the distributions that were in arrears for more than 4 years.[138]

This rule does not apply to a transfer to a spouse for consideration or which qualifies for the gift tax annual exclusion or the gift or estate tax marital deduction. Instead the rule is triggered when the spouse dies or transfers the stock.[139]

> ***Ex-34:*** D transfers his preferred stock at a time when the $100 cumulative dividend was 15 years in arrears. Assuming an IRC § 7520 interest rate of 10 percent, what is the adjustment that D must make to his taxable gifts?

b) Election to stop compounding

A transferor or an immediate family member may elect to stop the compounding at the time a past due dividend is paid by treating the adjustment at that time as a taxable gift.[140]

> ***Ex-35:*** The $100 dividend on D's preferred stock is paid 10 years late. Five years later, D transfers his preferred stock. Assuming an IRC § 7520 rate of 10 percent, how does the election to stop compounding apply to these facts?

c) Election in or out

A transferor or an applicable family member may elect to waive qualified payment treatment or, in the alternative, to have a nonqualified payment treated as a qualified one, to be paid in the amounts and at the times specified in the election.[141]

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137 A distribution right that consists of a qualified payment which is bundled with a liquidation, put, call, or conversion right is subject to a special rule. In that case, IRC § 2701(a)(3)(B) provides that the retained interest is valued in the manner resulting in the lowest value for all such rights.

138 For purposes of this rule, the termination of any interest is treated as a transfer. IRC § 2701(d)(5). Moreover, except in the case of the transferor's spouse, once a transfer occurs, the transferee becomes subject to the "dividend arrears" rule. IRC § 2701(d)(4)(B). In all cases, however, the increase in taxable gifts (or taxable estate) is limited on a proportional basis to the increase in value that has occurred in all equity interests that are junior to that of the transferor. Thus if T owned half of the preferred stock in the examples above, the adjustment would be limited to half of the increase in value in the common stock that occurred between the due date of the dividend and the time of the transfer of the preferred stock (or the election noted above).

139 See IRC § 2701(d)(3)(B).

140 IRC § 2701(d)(3)(A)(iii).

141 IRC § 2701(c)(3)(C). The terms of the election must be consistent with the underlying legal instrument giving rise to the distribution right. IRC § 2701(c)(3)(C)(ii).

COMMENT
As to payments that could be qualified payments, the default election is qualified for interests held by the transferor and nonqualified for interests held by applicable family members.

G. OPTIONS AND PURCHASE RESTRICTIONS

For purposes of the estate, gift and generation-skipping transfer taxes, the value of any property is to be determined without regard to any option to purchase the property or any restriction on the right to sell or use the property. There is an exception for qualifying buy-sell agreements.[142]

COMMENT
Buy-sell agreements are discussed further on p. 75.

H. LAPSING RIGHTS AND RESTRICTIONS

1. Deemed transfer of lapsing rights

If there is a lapse of any voting or liquidation right in a corporation or partnership and the holder of that right and the person's family are in control of the corporation or partnership immediately before and after the lapse, the lapse of the right is a transfer for purposes of the estate, gift and generation-skipping transfer taxes. The value of the transfer is the difference between all interests in the entity held by the holder of the lapsed right before the lapse and the value of all such interests after the lapse.[143]

> ***Ex-36:*** Father forms a limited partnership in which he and his sons are general and limited partners. Under the partnership agreement, any general partner had the right to liquidate (dissolve) the partnership. However, this right terminated at the death of the general partner. Immediately before Father's death, the value of Father's limited partnership interests (because of his right to dissolve) was worth 59 million. Because the dissolution right ended at his death, the value of Father's limited partnership interests at the moment of his death is only What impact does IRC § 2704 have on these facts?

2. Certain restrictions on liquidation

Under IRC § 2704(b), where a transferor and members of the transferor's family hold control of an interest in a corporation or partnership, the value of a transfer of an interest in the corporation or partnership to or for the benefit of a member of the transferor's family is to be determined by disregarding any restriction on the liquidation of the corporation or partnership which either lapses after the transfer or which could be removed in whole or in part by the collective action of the transferor or any member of the transferor's family.[144]

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142 IRC § 2703.

143 IRC § 2704(a).

144 See IRC § 2704(b)(2). There is an exception for commercially reasonable restrictions which arise as part of any financing transaction by the corporation or partnership. See IRC § 2704(b)(3)(A).

COMMENT
Many FLP agreements contain restrictions on limited partners' rights to have their interests redeemed or to have the entity itself liquidated. Whether these restrictions are "applicable restrictions" that must be disregarded in determining the value of transfers of partnership interests, however, depends on a variety of factors. Here are some general considerations and principals suggested by existing case law in the area: • Redemption and/or liquidation restrictions that are no different from the default rule under applicable state law are not applicable restrictions.[145] • Redemption (withdrawal) restrictions (to be distinguished from restrictions on the liquidation of the entity as a whole), may not be applicable restrictions in any event.[146] • The existence of an interest in a non-family member such as a charity may prevent a liquidation restriction from being classified as an applicable restriction since such a restriction could not be removed by the collective action of the transferor and the transferor's family.[147]

[145] See definition of applicable restriction in Treas. Regs. § 25.2704-2(b). *Accord*, Jones Estate v. Comm., 116 T.C. 121 (2001); Knight v. Comm., 115 T.C. 506 (2000);Harper Estate v. Comm., T.C. Memo 2000-202 (2000) Kerr v. Comm., 113 T.C. 449 (1999). Compare Shepherd v. Comm., 115 T.C. 376 (2000).

[146] See Harper v. Comm., T.C. Memo 2002-121 (2002); Kerr v. Comm., 113 T.C. 449 (1999), aff'd on other grounds 292 F.3d 490 (5th Cir. 2002).

[147] See Kerr v. Comm., 292 F.2d 490 (5th Cir. 2002), aff'g 113 T.C. 449 (1999).

ANSWERS—SPECIAL VALUATION RULES

Ex-19. **First question** – If D gives all of his stock to his daughter M, the value of the stock should reflect a premium because the block represents control of X Corporation. See Treas. Regs. § 25.2512-2(g). But see Simplot Estate v. Comm., 249 F.3d 1191 (5th Cir. 2001), rev'g 112 T.C. 130 (1999) (no premium for minority block of stock).

Second question – If D gives only 15 shares to M, the value should be discounted to reflect a lack of control and marketability. See e.g., Estate of Edgar V. Berg, 61 TCM 2949 (1991) rev'd on other grounds 976 F.2d 1163 (8th Cir 1992). A discount for lack of control is also available when valuing minority partnership interests. John R. Moore, 62 TCM 1128 (1991). See also TAM 9449001 (discounts allowed when D as the sole owner of stock in a closely held corporation made simultaneous and equal gifts of all of the stock to D's 11 children).

Third question – Maybe. If D gives M 40 shares, the shares represent a loss of control to D and, more importantly, the possibility of control to either of D's siblings. Thus, a willing buyer may very well offer a premium for the shares knowing that a subsequent deal at a higher premium with one of the siblings might be possible. See suggestion to this effect in Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981). See also Simplot Estate v. Comm., 112 T.C. 130 (1999); TAM 9436005 where the Service indicated that a "swing vote" premium offsets minority and marketability discounts in whole or in part.

References: For a recent case dealing with the discount for lack of marketability, see Mandelbaum v. Comm., 91 F.3d 124 (3d Cir. 1996), aff'g without opinion T.C. Memo 1995-255. See also Hall & Polacek, Strategies for Obtaining the Largest Valuation Discounts, 21 Est. Plan. 38 (Jan.-Feb. 1994)

Ex-20. **Answer –** D should claim a discount for lack of control, marketability, and the costs of partitioning a fractional undivided interest. See e.g., Samuel J. Lefrak, T.C. Memo 1993-526 (1993) (discounts of 20% for lack of control and 10% for lack of marketability allowed). The fact that D and her brother planned to jointly develop the property does not alter the situation. A court may not consider the identity of a related donee in determining fair market value. See e.g. Nancy N. Mooneyham, 61 TCM 2445 (1991). But see TAM 9336002 (discount limited to costs of partitioning).

References: On the discounts courts have been willing to grant in the valuation of undivided interests in real property, see Braswell, Valuing Fractional Interests in Real Estate for Federal Estate and Gift Tax Purposes: A Current Assessment of the Law, 34 Tax Mgmt. Memo. 275 (Sept. 1993).

Ex-21. **First question –** D should be entitled to both a minority and a marketability discount. But see Senda v. Comm., 433 F.3d 104 (8th Cir. 2006) denying a discount for stock contributed to a partnership after the partnership interests had been transferred to the children of the donors.

Second question – Probably not. Initially, the Service indicated that no discounts would be allowed on these facts which track those of Ex. 6 of Treas. Regs. § 1.701-2. In that regulation the Service stated that it would recast a transaction or series of transactions in partnership form where the transaction had "a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K...." Subsequently, however, the Service announced that it would not apply these principals to any of the transfer taxes. See IRS Announcement 95-8, 1995-7, I.R.B. 56.

Ex-22. **First question** – T's retained interests would have a combined IRC § 7520 value of $342,865 ($285,920 for his income interest and $56,945 for his reversion). Thus, under prior law, T would have made a taxable gift of $157,135 ($500,000 less $342,865).

Second question – Under the special valuation rule of IRC § 2702, the value of T's income and reversionary interests is zero. Thus, the gift to T's children is valued at the full $500,000.

Comment: The result under IRC § 2702 would be the same if instead of a reversion T had retained a testamentary power to appoint the property to his estate in the event he died during the 10 year term period. PLR 8546001.

References: For a discussion of how the IRC § 7520 value of the reversionary interest is calculated, see Covey, Practical Drafting, 2456 - 2457 (April 1991).

Ex-23. **First question** – No. Although H is an applicable family member, his income interest will be valued under IRC § 7520 rather than IRC § 2702 because H did not possess the interest before W's transfer.

Second question – No. The result is the same whether or not W makes a QTIP election for the trust. Treas. Regs. § 25.2702-2(d), Example 3.

Third question – Yes. IRC § 2702 applies because H (an applicable family member) possessed an interest both before and after the transfer. See Treas. Regs. § 25.2702-2(a)(3). See also Treas. Regs. § 25.2702-2(a)(2) which defines "transfer" to include assignments of existing trust interests.

Ex-24. **Answer –** Because of IRC § 2702, D's transfer is for partial - not full - consideration. Under the facts as given, D makes a gift of $70,000 ($100,000 - $30,000).

Ex-25. **Answer –** Under IRC § 2702(c)(2), the gift tax consequences to D are the same as if she had purchased the property in her own name and then sold a remainder interest to Son. Because of the special valuation rule provided in IRC § 2702, the remainder interest is deemed to be worth the entire value of the property. Accordingly, D makes a taxable of gift of $70,000 ($100,000 less $30,000).

Comment: What would be the estate tax consequences at D's death? Well, one would think that nothing could be included because D has made no transfer for estate tax purposes. One court, however, has held that the joint purchase can be reached under the principal of Gradow as a transfer for partial consideration. Under this view, IRC § 2036 would apply to bring in the value of the property reduced by the amount of the consideration furnished by Son. Parker v. U.S., 894 F. Supp. 445 (N.D. Ga. 1995). But see Estate of Magnin v. Comm., 184 F.3d 1074 (9th Cir. 1999); Estate of D'Ambrosio v. Comm., 101 F.3d 309 (3d Cir. 1996); Wheeler v. Comm., 116 F.3d 749 (5th Cir. 1997). On the reduction in the amount included for the consideration D received, see IRC § 2043(a).

Ex-26. **First question** – T's retained power is treated as a retained interest which must be given a zero value under IRC § 2702. Accordingly, the value of T's gift is the full value of the property he transferred to the trust. Treas. Regs. § 25.2702-6(c), Example 6.

Comment: The same example also states that no additional gift occurs when income is distributed from the trust each year. Correspondingly, however, T is not entitled to reduce his aggregate taxable gifts as a result of income distributions. The reduction of aggregate taxable gifts is explained in Treas. Regs. § 25.2702-6, discussed supra note 64.

Ex-27. **Answer –** According to a newly promulgated regulation, the answer is yes. The regulation states that the unitrust interests in a CRUT using an income exception method retained by the donor or any applicable family member will be valued at zero unless either there are only two consecutive noncharitable beneficial interests and the transferor holds the second of the two interests, or the only permissible recipients of the unitrust amount are the transferor, the transferor's U.S. citizen spouse, or both the transferor and the transferor's U.S. citizen spouse. See Treas. Regs. § 25.2702-1(c)(3).

Comment: The explanation of an earlier proposed regulation on the subject expresses the underlying concern as follows:

> To illustrate, the trustee may invest in assets that produce little or no trust income while the donor retains the unitrust interest, creating a substantial makeup amount. At the end of the donor's interest, the trustee alters the NIMCRUT's investments to generate significant amounts of trust income. The trustee then used the income to pay to the donor's daughter the current fixed percentage amount and the makeup amount, which includes the makeup amount accumulated while the donor was the unitrust recipient.
>
> The use of a CRUT as described in the above example permits the shifting of a beneficial interest in the trust from the donor to another family member and, thus, creates an opportunity for transferring property to a family member free of transfer tax that is contrary to section 2702(a)(3)(A)(iii).

Ex-28. **First question** – Assuming a 10 percent interest rate, T makes a gift at the creation of the trust of $157,135. This is $500,000 less $342,865 — the IRC § 7520 value of his retained income and

reversionary interests. There is no further gift at the time when the trust terminates and nothing will be taxed to T's estate at her later death.

Second question – No. If T dies before the expiration of the 10 year term period and the QPRT property is included in his gross estate, the gift made at the creation of the trust will not be an adjusted taxable gift. This will, in effect, restore any applicable credit amount (unified credit) he used on the gift. However, if T and his spouse elected to split the gift, the spouse's applicable credit amount is not restored. Accordingly, it is generally preferable to avoid gift-splitting when creating a QPRT.

Ex-29. **First question –** Only if the trust was created before May 17, 1996.

Second question – See TD 8743 where the Treasury in discussing the background for the regulations prohibiting the repurchase of the residence states:

Other comments suggested that the final regulations should contain an exception permitting the sale of the residence to the grantor if the need arises. Treasury and the IRS believe, however, that a rule of this nature is not necessary, since a grantor may lease the residence after the retained term from a trust or individual to which the residence passes after the expiration of the initial term. The right to lease the residence may be expressly set forth in the trust document creating the personal residence trust. If the residence is leased for its fair market value rental, the grantor will not retain the economic benefit of the property for purposes of section 2036(a), since the grantor will be paying adequate consideration for the use of the property. However, if the residence is leased from a trust that is a grantor trust with respect to the grantor, the IRS under some circumstances may contend that the grantor has retained the economic benefit of the property.

See also PLR 9249014. But see Rev. Rul. 70-155, 1970-1 C.B. 189 applying IRC § 2036(a) where rent is below market.

Third question – First of all, grantor trust status could be beneficial because it would mean that the trust would not have to pay income taxes on the rent it receives. Rev. Rul. 85-13, 1985-1 C.B. 184. However, it is the apparent view of the Service that in some instances at least, this type of transaction could give rise to inclusion of the trust in the grantor's gross estate under IRC § 2036(a). Consider the following excerpt from TD 8743:

If the residence is leased for its fair market value rental, the grantor will not retain the economic benefit of the property for purposes of section 2036(a), since the grantor will be paying adequate consideration for the use of the property. However, if the residence is leased from a trust that is a grantor trust with respect to the grantor, the IRS under some circumstances may contend that the grantor has retained the economic benefit of the property.

Ex-30. **Answer –** No. An annual withdrawal right (whether cumulative or not) is neither a qualified annuity nor a qualified unitrust interest. Treas. Regs. § 25.2702-3(b)(1)(i).

Ex-31. **First question –** The gift is valued under IRC § 7520, not IRC § 2702. Under the regulations, the value of the gift is the value of the property transferred to the trust less the value of the qualified interests in both W and H. See Treas. Regs. § 25.2702-2(d)(1), Example 7.

Second question – Maybe. The view of the Service is that a revocable spousal interest will be given a zero value if:

1. It is contingent on the first spouse dying before the expiration of the initial GRAT term; or
2. The spousal interest is not for a term certain, as would be the case if it is limited to whatever remains of the first spouse's initial term. See TAM 8941001.

This position was accepted by the Tax Court in Cook v. Comm., 115 T.C. 15 and more recently in Focardi Estate v. Comm., T.C. Memo 2006-56 (2006). The Seventh Circuit has affirmed the Tax Court decision in Cook. 269 F.3d 854 (7th Cir. 2001). The Ninth Circuit, however, has held to the contrary. Schott v. Comm., 319 F.3d 1203 (9th Cir. 2003), rev'g T.C. Memo 2001-110.

Ex-32. **Answer – No**. In PLR 9444033, the Service hinted that a gift might occur under similar circumstances. Subsequently, however, the Service issued a public ruling indicating that no gift occurs under these circumstances. Rev. Rul. 2004-64, 2004-27 IRB 27.

References: Covey, Practical Drafting, 2575 (July 1991)

Ex-33. **First question –** Without IRC § 2701, D would argue that the common stock he gave to his daughter had little or no value given the liquidation, conversion, and put features of his retained preferred stock.

Second question – Under IRC § 2701, the liquidation, conversion, and put rights are valued at zero. Otherwise, the value of the preferred and common stock is determined under general principles, not under IRC § 2701.

Third question – Yes because D would then be in control of the corporation. See "*Control*" on p. 49. As a result, the value of his preferred would be zero and the common stock he gave his daughter would be worth one-eighth of the corporation or $150,000.

Comment: In this latter case, if D subsequently transfers the preferred stock, the regulations provide for an adjustment to reflect the fact that the value of the preferred stock was previously taxed in valuing the common stock D gave away. A similar adjustment is made at D's death if the preferred stock is still owned by him. Within special rules, the gift and estate adjustments are also available where the preferred stock was owned by an applicable family member instead of D. For more on the adjustment, see IRC § 2701(e)(6) and Treas. Regs. § 25.2701-5.

Ex-34. **Answer –** D's taxable gifts will be adjusted upward by $418. ($100 invested at a compound rate of 10 percent for 15 years).

Ex-35. **Answer –** If D makes no election to stop the compounding, D's taxable gift will be adjusted upward by $257 (the difference between $100 invested at a compound rate of 10 percent for 15 years and the $100 that was paid invested at the same rate for 5 years). D could have elected to stop the compounding by reporting a deemed gift in year 10 of $159 (the interest on $100 compounded at 10 percent for 10 years).

Ex-36. **Answer –** First, the value of Father's partnership interests are included in his gross estate under IRC § 2033. These interests are valued after taking into account the lapse of the dissolution right. See Goodman v. Granger, 243 F.2d 264 (3d Cir. 1957), *cert. denied*, 355 U.S. 835 (1957). In addition, IRC § 2704(a) treats the lapse of the dissolution right as another transfer that must be included in Father's gross estate. The measure of inclusion is $26 million. This is the difference between the value of Father's interests immediately before death ($59 million) and the value of the same interests after the lapse of the dissolution right ($33 million).

III. THE FEDERAL ESTATE TAX

A. THE GROSS ESTATE

1. Property owned at death

The gross estate includes the decedent's interest in all property, tangible or intangible, which the decedent owned at death except interests that expire by reason of his death.[148]

Ex-37: At D's death, he owns a large cemetery lot worth $50,000. To what extent is the lot included in his gross estate? *Answers to the examples in this chapter begin on page 79.*

Ex-38: Father creates a trust to pay income to A for life, remainder to B.

1. What, if anything will be includible in A's gross estate when he dies?

2. If B dies while A is still living, will B's gross estate include her interest in this trust?[149]

COMMENT
Tax exposure to B can be avoided by making her interest contingent on surviving A.

2. Right of survivorship property

a) Qualifying tenancies

A qualifying tenancy is a right of survivorship tenancy where the sole tenants are husband and wife and where the survivor of them is a U.S. citizen.

For qualified tenancies, half of the property is included in the estate of the first spouse to die.[150]

COMMENT
The half taxed in the estate of the first spouse to die will also qualify for the marital deduction. Hence, the primary impact of the inclusion is not to increase taxes but to qualify half of the property for a basis adjustment at the first spouse's death.

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[148] IRC § 2033.

[149] When a decedent's gross estate includes a future interest in property, the taxes attributable to that interest may be deferred until the termination of the preceding estates. See "*Estate tax return*," p. 222.

[150] IRC § 2040(b).

Ex-39: W purchases BasisAcre in 1980 for $20,000 taking title as tenants by the entirety with her husband H. Subsequently, when BasisAcre is worth $100,000, W dies.

1. Assuming H is a US citizen, what portion of BasisAcre will be included in her gross estate?

2. Would your answer differ if W had purchased BasisAcre in 1975?

b) Nonqualifying tenancies

All other right of survivorship tenancies, including those held between spouses where the surviving spouse is not a U.S. citizen,[151] are nonqualifying tenancies.

For nonqualifying tenancies, the property is included in the estate of the first tenant to die in proportion to the amount of consideration that tenant furnished for the property's acquisition. The presumption is that the decedent furnished all of the consideration.[152]

Ex-40: Several years ago, D and her brother B inherited property as joint tenants from their mother. What portion of this property will be included in D's gross estate when she dies?

Ex-41: In 1995, D and his sister S purchased JointAcre for $100,000 taking title as joint tenants. D contributed $80,000 of the purchase price; S contributed $20,000. In 2008, when JointAcre is worth $500,000, D dies.

1. What part of JointAcre is included in D's gross estate?

2. Would the answer be different if D had given S the $20,000 she used as her contribution to the purchase price?[153]

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151 See IRC § 2056(d)(1)(B).

152 IRC § 2040(a).

153 The rule crediting the decedent with consideration provided by the surviving tenant that came from the decedent by gift does not apply when the surviving tenant is not a US citizen and the gift was made before July 14, 1988. Treas. Regs. § 20.2056A-8(a)(2).

3. Suppose the money S contributed came from income earned by S on other property that D had given her?

4. Suppose S's contribution consisted of the proceeds of sale of Xerox stock that D had originally given S a number of years earlier?

Ex-42: D and her mother, M, acquire JointAcre for $100,000 taking title as joint tenants. D pays the down payment of $20,000 and D and M sign a mortgage note for the balance. Subsequently D dies when the land is worth $150,000 and the outstanding balance on the note is $40,000.

1. Assuming the payments on the mortgage were made from D's individual funds, what portion of the property will be included in D's gross estate when she dies?

2. Suppose the mortgage payments were made from rents D and M received on a lease of JointAcre?

Ex-43: D buys a 2 bedroom home for $30,000 cash, taking title with F (D's father) as joint tenants. Subsequently, when the home is worth $40,000, F adds a third bedroom. The improvement cost $10,000 all of which was paid for by F from his own money. Still later, when the home is worth $60,000, D dies. What portion of the home is included in D's gross estate?

3. Powers of appointment

a) General powers possessed at death

A decedent's gross estate includes the value of property over which she possessed a general power of appointment at death.[154]

A general power is one which the decedent could exercise in favor of herself, her estate or the creditors of either.[155]

Exception: A power of invasion which is restricted by an ascertainable standard.[156] This includes standards such as health, support, maintenance and education.

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154 IRC § 2041(a)(2). Powers created before October 22, 1942 are subject to special rules. See IRC § 2041(a)(1).

155 IRC § 2041(b)(1).

156 IRC § 2041(b)(1)(A).

COMMENT

Whether standards other than health, support, maintenance and education are ascertainable is a question of how the standards would be interpreted by the courts of the applicable state.[157]

> ***Ex-44:*** At her death, D is the income beneficiary of a trust created by her husband. BANK as trustee has the power to distribute principal to D "for her benefit and general well being." D has the authority to remove BANK and to appoint a successor including herself.
>
> 1. Will this trust be included in D's gross estate at her death?
>
> 2. Suppose D's ability to nominate a successor was limited to an independent corporate trustee?
>
> 3. Would the result in the first question differ if the trust had been created by D's mother instead of her husband?

b) Tainted exercises and releases

A decedent's gross estate also includes property over which the decedent exercised or released a general power during life if the effect of the exercise or release is such that had the decedent transferred the appointive property it would have been included in his gross estate under other provisions of the Code.[158]

c) Lapses of general powers

A power is said to "lapse" when it expires by reason of its own terms. A lapse is treated as a taxable release to the extent the value of the property over which the lapsed power could have been exercised exceeds the greater of $5,000 or 5 percent of the aggregate value of the property over which an exercise of the power could have been satisfied.[159]

> ***Ex-45:*** D is the income beneficiary of a trust created by her mother. At D's death, the trust principal is distributable among such of D's descendants as D by will appoints with a gift in default of appointment to the descendants per stirpes. The trust further provides that D may withdraw up to $20,000 of trust principal each year. The withdrawal power is not cumulative from year to year. At the end of the first year, D allowed her withdrawal power to lapse. At that time, the value of the trust was $200,000. D dies in the second year without exercising her withdrawal power when the trust is worth $300,000.
>
> 1. What, if anything, is includible in D's gross estate?

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157 For an interesting case involving Florida law, see Estate of Vissering v. Comm., 990 F.2d 578 (10th Cir. 1993) ("continued comfort" held ascertainable).

158 See IRC § 2041(a)(2).

159 IRC § 2041(b)(2).

2. How would your answer differ if D's withdrawal power were limited to the greater of $5,000 or 5 percent of the trust?

COMMENT
If the period during which D could exercise her withdrawal power in this example had been restricted to some specific period of the year (e.g., during January) her gross estate would not including anything from this trust unless she died during the withdrawal period.

d) Contingent powers

If the exercise of a power is contingent on an event or contingency beyond the decedent's control, the power is not possessed at death unless the contingency or event has occurred at that time.[160] Otherwise, the power remains general despite the existence of the contingency.[161]

e) Special powers

With one exception, possessing, exercising, or releasing a special power will not cause the property to be included in the gross estate. The exception applies to the so-called "Delaware tax trap." The trap (and tax exposure) occurs if a special power is exercised to create a general inter vivos power in someone else.

4. Life insurance

A decedent's gross estate includes the face value of policies of insurance on his life if:

- the decedent possessed any incident of ownership in the policy at death, or
- his estate is beneficiary of the policy.[162]

Ex-46: Five years before his death, D assigned a $100,000 insurance policy on his life to his revocable inter vivos trust.

1. Will the proceeds of this policy be taxed to D at his death?

2. Would the answer change if D's trust was irrevocable?

COMMENT
By making the trust irrevocable, D escapes estate tax exposure on $100,000.[163] If D anticipates a need for the liquidity that the policy on his life could provide at his death, he could authorize the trustee of his irrevocable trust to make loans to his estate or to buy estate assets at his death. In either instance, the transactions should be conducted at arm's length.

160 E.g., Treas. Regs. § 20.2041-3(b).

161 See Estate of Kurz v. Comm., 68 F.3d 1027 (7th Cir. 1995), aff'g , 101 T.C. 44 (1993).

162 IRC § 2042.

163 The transfer of the policy to the irrevocable trust is a gift of the replacement cost of the policy. Treas. Regs. § 25.2512-6(a).

Ex-47: D dies while serving as trustee of a trust one of the assets of which is a policy of insurance on his life. Will the policy proceeds be includible in D's gross estate?

Ex-48: D dies owning stock in a corporation that owns a policy of insurance on his life. Will D's ownership interest in the corporation be equated with control over the insurance policy, thereby requiring D to include the proceeds in his gross estate?

5. Annuities and retirement plans

The gross estate includes the value of payments received by a beneficiary by reason of surviving the decedent under any form of contract or agreement if under such contract or agreement:

a) an annuity or other payment[164] was payable to the decedent (meaning he was receiving it at death); or

b) the decedent possessed the right to receive such a payment in the future.

The amount included is that portion of the payment(s) to the beneficiary that is proportionate to that part of the consideration contributed by the decedent or his employer.[165]

COMMENT
These rules apply to both survivorship annuity arrangements and to death benefits payable under deferred compensation plans.[166]

Ex-49: D's qualified pension plan provides for retirement benefits beginning at age 65 and a death benefit of $50,000 if he dies before that age.

1. If D dies under age 65 what, if anything, will be includible in his gross estate?

2. Does it matter whether D had the authority to name the beneficiary of the death benefit?

164 The "annuity or other payment" must be something other than the decedent's salary or contingent future benefits under a disability plan. See e.g., Estate of Schelberg v. Comm., 612 F.2d 25 (2d Cir. 1979); Estate of Van Wye, 686 F.2d 425 (6th Cir. 1982). See also Holz, Avoiding Estate and Gift Tax on Death Benefits, 15 Est. Planning 101 (1988).

165 IRC § 2039.

166 There are two important exceptions. An unlimited exclusion applies to decedents dying after 1982 who were in pay status as of 12/31 of that year and who had irrevocably elected the form of benefit before 1/1/83. And a $100,000 exclusion is available for decedents dying after 1984 if they were in pay status as of 12/31 of that year and who had irrevocably elected the form of benefit before 7/18/84. But see Rev. Rul. 92-22, 1992-1 C.B. 313 holding that the exclusion is lost if the proceeds are rolled over into an IRA after December 31, 1984.

6. Transfers with retained right to income or possession

The gross estate includes the value of any property transferred by the decedent with the retained right to the income or the possession and enjoyment of the property.

In the case of transfers of stock in a "controlled corporation," a retention of the right to vote the stock is deemed to be a retention of the right to possess and enjoy the stock.[167]

- A corporation is "controlled" if at any time after the transfer and within 3 years of the decedent's death, the decedent owned at least 20 percent of the combined voting power of the corporation.[168]
- The stock attribution rules of IRC § 318 apply here. A decedent is deemed to own the stock owned by his spouse, parent, children, and grandchildren.[169]

Ex-50: Several years before her death, D's brother transferred property worth $100,000 to an irrevocable trust with BANK as trustee. The trust provides that the income from the trust property is to be distributed to D for life, with remainder to D's descendants.

1. Will this trust be included in D's gross estate at her death?

2. Would your answer change if at the same time D's brother had created the trust for her, D had created a similar trust to pay the income to her brother for life with remainder to her brother's descendants?

Ex-51: D creates an inter vivos trust to pay income to Spouse for life, then to pay trust income back to D for the remainder of his life and at the death of D and Spouse, the principal is to go to their descendants. Spouse predeceases D and then D dies. Is the trust property includible in D's gross estate?

Ex-52: D transfers title to his house to Son with the "understanding" that D will continue to live in the house for as long as he wants.

1. Will the house be included in D's gross estate?

2. Would your answer differ if, after the transfer, D leased the house from Son for a reasonable rent?

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167 IRC § 2036(b)(1).

168 IRC § 2036(b)(2).

169 IRC § 2036(b)(2).

3. Suppose instead that Son paid D an amount equal to the IRC § 7520 value of the remainder interest. Can the house be included in D's gross estate at death?

Ex-53: D's transfers his ranch to his son in exchange for the Son's unsecured promissory note which obligates Son to pay D a fixed annual annuity for the balance of D's life. If the value of the annuity obligation payable to D equals the value of the ranch D transferred to Son, will anything with respect to the ranch be includible in D's gross estate at death?

Ex-54: D and Spouse each own 15 percent of the voting stock of Acme Corporation. D transfers cash in trust for the benefit of D's family. D names herself trustee. The trust is irrevocable and D has no retained interest in or power over the trust property other than as trustee. Subsequently, D uses the cash to purchase an additional 10 percent of the voting stock of Acme Corporation.

1. Does IRC § 2036(b) apply at D’s death?

2. Would the answer change if the stock purchased by D was nonvoting stock?

7. Incomplete lifetime transfers

Two separate sections require property transferred by a decedent during life to be included in the decedent's gross estate because of retained powers over the property.

- The first applies to any property transferred by the decedent over which he had at death the power to alter, amend, terminate or revoke.[170]
- The second brings into the gross estate property transferred by the decedent with the retained right to designate who is entitled to the income or possession of the property.[171]

In either case, no inclusion results if the decedent's powers are held as trustee and are restricted by a reasonably ascertainable external standard (e.g., support).[172]

170 IRC § 2038.

171 IRC § 2036(a)(2).

172 Rev. Rul. 73-143, 1973-1 C.B. 407.

Ex-55: D's spouse, S creates a discretionary trust for the benefit of her five grandchildren, naming D as trustee. As trustee, D has the power to accumulate or spray trust income and to distribute trust principal to or among the grandchildren as D determines to be in their best interests.

1. Will this trust be included in D's gross estate?

2. Would your answer change if D had created the trust?

Ex-56: D transfers property to an irrevocable trust for the benefit of his family. The instrument gives the trustee the power to spray income and principal among D's family for their benefit.

1. Is the trust includible in D's gross estate if he names himself trustee?

2. Suppose D names BANK as trustee but retains the right to remove BANK and appoint himself as successor?

3. Suppose D had no power to remove BANK but he had the power to nominate a successor including himself if BANK ever ceased to serve?

4. Suppose D could remove BANK and nominate a successor but he was limited to naming an independent successor not including himself?

Ex-57: Same as ***Ex-56***, except the trustee's only power is to spray income and principal among D's family as the trustee in its discretion considers necessary for their support.

1. Is the trust includible in D's gross estate if he names himself trustee?

2. Would the answer change if D also had the power to allocate income and expense items between the income and principal accounts?

Ex-58: Same as ***Ex-57***, except D as trustee also had the power to reacquire the trust property by substituting property of equivalent value.

1. Is the trust includible in D's gross estate if he names himself trustee?

2. Would the answer change if D held the power to reacquire as an individual instead of as trustee?

Ex-59: T creates an irrevocable trust for the benefit of his adult child C. Under the instrument, the trustee has the power to distribute income to C or to accumulate it and add it to principal. The trustee also has the power to advance principal to C. The trust is to last until C attains the age of 35 or dies, whichever first occurs. At the termination of the trust, all trust property is to be distributed to C, if living; otherwise to C's estate. T names himself trustee of the trust.

1. Is the trust includible in T's gross estate at death?

2. Suppose T had a power to accumulate income but no power to advance principal?

3. Suppose in 2, that T's power to accumulate income required the consent of C?

8. Transfers taking effect at death

The gross estate includes the value of any interest transferred by the decedent during life if:

a) the interest can take in possession only at or after the death of the decedent and

b) the decedent retained a reversion in the property the value of which immediately before death exceeds 5 percent of the value of the property. [173]

COMMENT
Reversion includes any possibility that the property (as distinguished from its income) may return to the decedent or his estate or may be subject to a power of disposition by him.

Ex-60: D transfers property in trust to pay the income to A for life, then to distribute the corpus back to D if he survives A; otherwise to X. Subsequently, D dies survived by A and X. Will any of this trust be included in D's gross estate?

9. Transfers within three years of death

The gross estate includes the amount of any gift tax paid by D on gifts by the decedent or her spouse within three years of the decedent's death.[174]

[173] IRC § 2037.

[174] IRC § 2035(b). This provision also applies to gift taxes paid by a donee in a net gift situation (Estate of Samuel C. Sachs, 88 T.C. 769 (1987), affirmed 856 F.2d 1158 (8th Cir. 1988)) as well as to taxes paid by a surviving spouse on a section 2519 transfer of a income interest in a QTIP trust (Morgens Estate v. Comm., 678 F.3d 769 (9th Cir. 2012).

- The gross estate also includes the value of any interest transferred within 3 years of death but only if retention of that interest until death would have required inclusion under IRC §§ 2036, 2037, 2038 or 2042.[175]
- For this purpose, if a decedent has transferred stock in a controlled corporation and retained the right to vote the stock, a relinquishment or cessation of the voting rights in the stock is treated as a transfer of property by the decedent.[176]

Ex-61: Two years before his death, D paid the initial premium for a policy of insurance on his life. Ownership of the policy was registered in D's name. Shortly thereafter, D transferred the policy to his daughter M. D paid the second annual premium when it became due. Subsequently D died.

1. What, if anything is includible in D's gross estate?

2. Would the answer change if D and his spouse S had elected gift splitting on the gift to M?

3. Would the answer change if M had paid the second year premium?

4. Suppose D paid both premiums but the policy was issued in M's name instead of D's?

Ex-62: Several years before his death, D purchased Blueacre for $400,000 taking title as joint tenants with Son. At that time D reported a gift to Son of $200,000. A month before his death, when Blueacre is worth $800,000, D and Son sever Blueacre into a tenancy in common. What are the gift and estate tax consequences of these events?

COMMENT
The result would be less favorable if D's spouse were not a US citizen. In that event, no gift would occur at the creation of the tenancy but a gift of $400,000 would result from the severance. Additionally, another $400,000 (plus any gift tax paid) would be includible in D's gross estate. Nevertheless, these results may still be better than retaining the joint tenancy until death. The gift at severance would qualify for a $147,000 gift tax annual exclusion.[177]

In Frank Armstrong, III, Transferee v. Comm., 114 T.C. 94 (2000) the Tax Court held the donees of a gift the taxes on which are includible in a decedent's gross estate under this rule are transferees of property included in the decedent's gross estate and are therefore personally liable for unpaid estate taxes of the decedent under IRC § 6324(a)(2).

175 IRC § 2035(a). For purposes of determining eligibility under IRC § 303(b) and IRC § 2032A, the gross estate is considered as including the value of any gift in excess of the annual exclusion made within three years of death. See IRC §§ 2035(c)(1)(A) and (B).

176 IRC § 2036(b)(3).

177 See IRC § 2523(i)(2).

10. Qualified terminable interest property

A decedent's gross estate includes the value of any qualified terminable interest property.[178] See "*Qualified terminable interest property (QTIP)*" beginning on page 87.

COMMENT
In Rev. Proc. 2001-38,[179] the Service ruled that a QTIP election is void if it was not necessary to reduce the estate tax liability of the decedent to zero. In such cases, the property in the QTIP trust will not be includible in the gross estate of the surviving spouse.

B. EXCLUSION FOR LAND SUBJECT TO A QUALIFIED CONSERVATION EASEMENT

IRC § 2031(c) provides a limited elective[180] exclusion from a decedent's gross estate for a portion of the value of land subject to a qualified conservation easement.

- The exclusion is available for decedent's dying after 1997.
- It is in addition to the exclusion for qualified family-owned business interests. (Currently repealed but subject to reinstatement in 2013).

COMMENT
A person succeeding to land for which an exclusion was allowable under IRC § 2031(c) takes a carryover basis in the portion of the property to which the exclusion applies.[181]

1. The amount of the exclusion

The amount of the exclusion is the lesser of two values:

- An absolute dollar limitation on the amount of the exclusion, called the "exclusion limitation", and
- The "applicable percentage" of the value of the land subject to a qualified conservation easement reduced by the amount of any charitable deduction allowable to the estate with respect to the land.[182]

a) Exclusion limitation

The exclusion limitation varies with the year of the decedent's death. For decedent's dying in 1998, the exclusion limitation is $100,000. It then increases by $100,000 a year until 2002, when it maxes out at $500,000.[183]

b) Applicable percentage

The maximum applicable percentage is 40 percent. However, this figure must be reduced by 2 percentage points for each percentage point (or fraction thereof) by

[178] IRC § 2044.

[179] 2001-24 I.R.B. 1335.

[180] The election to take the exclusion is made on the decedent's estate tax return. Once made, it is irrevocable. IRC § 2031(c)(6).

[181] IRC § 1014(a)(4).

[182] IRC § 2031(c)(1).

[183] IRC § 2031(c)(3).

which the value of the qualified conservation easement is less than 30 percent of the value of the land without the easement.[184]

COMMENT
The value of the land is also reduced by the value of any retained development right. See *Treatment of retained development right*, p. 66.

Ex-63: D dies owning land subject to a qualified conservation easement. The value of the easement is $243,000 and the value of the land without the easement is $1,000,000. What is the applicable percentage for purposes of the IRC 2031(c) exclusion?

2. Land for which the exclusion is available

An exclusion is available only for land subject to a qualified conservation easement. This is land that meets each of the following requirements:

- The land is located within the United States or any possession of the United States.;[185]
- The land was owned by the decedent or a member of the decedent's family for the three year period preceding the decedent's death;[186] and
- The decedent, a member of the decedent's family, or the decedent's estate has made a qualified conservation easement as of the date of the date of the election.[187]

COMMENTS
1. "Family" for this purpose includes the person's ancestors and spouse as well as the lineal descendants (and their spouses) of the person, the person's parents and the person's spouse.[188] 2. The Joint Conference Report makes it clear that it is not necessary that the qualified conservation easement be on the land as of the decedent's death. It may be created after the decedent's death by the personal representative or a family member provided it is created before the time of the election.

a) Meaning of qualified conservation easement

A qualified conservation easement means a contribution of a qualified real property interest to a charity (or other qualifying organization)[189] exclusively for a conservation purpose.[190]

- A qualified real property interest means the entire interest of the transferor, a remainder interest, or a perpetual restriction on the use to which real property may be put.[191]

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[184] IRC § 2031(c)(2).

[185] IRC § 2031(c)(8)(A)(i).

[186] IRC § 2031(c)(8)(A)(ii).

[187] See IRC §§ 2031(c)(8)(A)(iii) and (8)(C).

[188] See IRC § 2032(c)(8)(D) cross referencing IRC § 2032A(e)(2).

[189] See IRC § 170(h)(3) for the charities and organizations that qualify.

[190] See IRC § 2031(c)(8)(B).

- A conservation purpose means:
  1. The preservation of land for outdoor recreation by, or the education of, the general public;
  2. The protection of a relatively natural habitat of fish, wildlife, plants or similar ecosystem; and
  3. The preservation of open space for scenic enjoyment of the general public or pursuant to a governmental conservation policy.[192]

b) Debt financed property

The exclusion for land subject to a qualified conservation easement does not apply to the extent that the land is debt-financed property.[193]

COMMENT
The Joint Conference Report clarifies that debt-financed property is eligible for the exclusion to the extent of the net equity in the property. Thus, the report states that "if a $1 million property is subject to an outstanding debt balance of $100,000, it is treated in the same manner as a $900,000 property that is not debt-financed.

3. Treatment of retained development right

The exclusion for land subject to a qualified conservation easement is not available for the value of the land attributable to a retained development right.[194]

- A retained development right is a retained right to use land for any commercial purpose which is not subordinate to and directly supportive of the use of the land as a farm for farming purposes.[195]
- Thus, where a decedent's personal representative makes an exclusion election for land subject to a qualified conservation easement, the value of any development right retained by the decedent must be reflected in the decedent's gross estate.[196]

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191 A perpetual use restriction qualifies only if it prohibits more than a de minimis use for a commercial recreational activity. See IRC § 2031(c)(8)(B). See also IRC § 170(h)(2).

192 See IRC § 2031(c)(8)(B) cross referencing IRC § 170(h)(4)(A). For purposes of the IRC § 2031(c) exclusion, "conservation purpose" does not include the preservation of an historically important land area or a certified historic structure. IRC § 2031(c)(8)(B).

193 IRC § 2031(c)(4)(A). Debt-financed property is property which, as of the time of the decedent's death, there is an acquisition indebtedness. IRC § 2031(c)(4)(B)(i). Acquisition indebtedness is an unpaid amount of indebtedness incurred by the donor in acquiring the property or (to the extent it would not have been incurred but for the acquisition), indebtedness incurred before acquisition and reasonably foreseeable indebtedness incurred after acquisition. See IRC §§ 2031(c)(4)(B)(i) and (ii). Acquisition indebtedness also includes the extension, renewal, or refinancing of other acquisition indebtedness. IRC § 2031(c)(4)(B)(ii)(IV).

194 IRC § 2031(c)(5)(A).

195 IRC § 2031(c)(5)(D). See IRC § 2032A(e)(5) for the meaning of farming purposes.

196 See IRC § 2031(c)(7).

COMMENT
This can be avoided in whole or in part if, on or before the decedent's estate tax return is filed, every person in being who has a possessory or nonpossessory interest in the land executes an agreement to permanently extinguish some or all of the development rights.[197] The agreement must be implemented by the earlier of 2 years after the decedent's death or the date on which the land subject to the qualified conservation easement is sold.[198]

C. DEDUCTIONS TO REACH TAXABLE ESTATE

A decedent's taxable estate is calculated in two steps:

- First, funeral expenses, outstanding claims, costs of administration, uninsured casualty losses, and state death taxes (where applicable) are subtracted from the gross estate to reach the "adjusted gross estate" (AGE).
- Next, any available marital or charitable deductions are subtracted to reach the taxable estate.

1. Regulatory restrictions on the deduction of contingent or unpaid items

a) Deduct-as-you-pay rule

With some exceptions, the estate tax regulations restrict an estate's deduction for claims, debts, funeral, and administrative expenses to amounts actually paid by the estate based on a consideration of post-death facts.[199]

Amounts that are not paid and not deducted at the time of the filing of the estate tax return but which are later paid, may be accounted for by a claim for a refund by the estate. [200]

To prevent the statute of limitations from running on the estate's claim for a refund, a protective claim for a refund must be filed.[201]

b) Amounts ascertainable with reasonable certainty

Notwithstanding the general, deduct-as-you-pay rule, and subject to additional regulatory requirements, an estate may deduct an unpaid claim or expense (e.g., expenses of the PR and attorneys' fees) if the Service is satisfied that the amount to be paid is ascertainable with reasonable certainty and that the amount will be paid.[202]

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197 See IRC § 2031(c)(5)(B).

198 If not, an additional tax equal to the amount of tax that would have been due on the retained development rights subject to the agreement is imposed. The additional tax is due on that last day of the 6th month following the date on which the implementation period expired. See IRC § 2031(c)(5)(C).

199 Treas. Regs. § 20.2053-1(d)(2). The deductible amount of an expense, claim or debt which the estate pays may be determined by a final decision of a court, a consent decree, a settlement, or otherwise. See Treas. Regs. § 20.2053-1(b)(4), Ex 1 & 2. See also Treas. Regs. § 20.2053-1(b)(3). No deduction is allowed to the extent a claim or expense is or could be reimbursed or compensated by insurance. An exception applies to the extent the personal representative can establish that the burden of necessary collection efforts outweighs the benefits of collection. See Treas. Regs. § 20.2053-1(d)(3).

200 Treas. Regs. § 20.2053-1(d)(1).

201 See Treas. Regs. § 20.2053-1(d)(5). Generally, the Service may examine any item (related or not) on an estate when a claim for refund is made. See Lewis v. Reynolds, 284 U.S. 281 (1932). In Notice 2009-84, 2009-44 I.R.B. 592, the Service states that it will refrain from reviewing unrelated items for refund claims that ripen and become ready for examination after the limitations period on assessment.

202 See Treas. Regs. § 20.2053-1(d)(4)(i). See also Treas. Regs. § 20.2053-1(d)(7), Ex 1.

c) Claims aggregating less than $500,000

Notwithstanding the general, deduct-as-you-pay rule, and subject to additional regulatory requirements, an estate may deduct up to $500,000 of unpaid debts or claims.

The claims must be otherwise deductible, they must be enforceable against the decedent's estate, and their value must be determined by a "qualified appraisal" performed by a "qualified appraiser."[203]

2. Funeral expenses

Such funeral expenses as are allowable under local law are deductible in reaching the taxable estate.[204]

COMMENT
In addition to the costs of a burial, funeral expenses include expenditures for "a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family. . . ."[205]

3. Deductible claims

Most claims outstanding as of the date of the decedent's death and for which the decedent was personally liable are deductible.[206] However, claims which are founded on a promise or an agreement, are deductible only to the extent they are supported by consideration in money or money's worth.[207]

> ***Ex-64:*** Pursuant to a written property settlement entered into in conjunction with their divorce, H is obligated to transfer $100,000 to W. After the decree becomes final, but before the transfer is made, H dies. May H's estate claim a deduction for the $100,000 H owes to W?

a) Section 213(c) election

A decedent's medical expenses for his last illness are usually deductible under IRC § 2053 as a claim against the estate.

In the alternative, if the expenses are paid by the estate within one year of the decedent's death, IRC § 213(c) gives the estate an election to treat them as paid by the decedent at the time they were incurred. This may give rise to an income tax deduction on one or more of the decedent's tax returns.

To claim the expenses on the decedent's income tax return, the personal representative must waive the right to take them under IRC § 2053.[208]

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203 See Treas. Regs. § 20.2053-4(c)(1). See also Fed. Reg. 53654 – 53655 (10/20/09).

204 IRC § 2053.

205 Treas. Regs. § 20.2053-2.

206 IRC § 2053(a).

207 IRC § 2053(c)(1)(A).

208 In Rev. Rul. 77-357, 1977-2 C.B. 328, the Service ruled that "the portion of a decedent's medical expenses, which are paid by a representative within one year following the decedent's death and claimed as a deduction on the decedent's final income tax return, that does not exceed three percent of adjusted gross income and is consequently not deductible under section 213 of the Code may not be deducted as a claim against the estate under section 2053."

COMMENT
For the impact this election has on marital deduction planning, see "*Administration expenses*" on page 107.

4. Unpaid mortgages

Outstanding mortgage indebtedness is deductible only if the property is includible in the gross estate without reduction for the mortgage indebtedness. This is the case if the decedent was personally liable on the indebtedness.[209]

- Mortgage indebtedness is deductible whether the indebtedness is paid off at the decedent's death or not.
- The portion of the mortgage that is deductible is equal to the portion of the property included in the gross estate. Thus, if only half of the property is included in the gross estate, only half of the mortgage is deductible.[210]

5. Administration expenses

Administration expenses actually and necessarily incurred in the administration of the decedent's estate are deductible.[211] So are similar expenses incurred in the administration of nonprobate property[212] as well as interest incurred on:

- necessary bank loans; and[213]
- estate tax deficiencies.[214]

a) Section 642(g) election

IRC § 642(g) provides that deductions allowable under IRC § 2053 or IRC § 2054 (below) in computing the taxable estate may not be taken on the estate's income tax return (or used as an offset against the sales price of property sold by the estate in determining gain or loss) unless the right to take them under the estate tax is waived.

This limitation does not apply to deductions in respect of a decedent permitted by IRC § 691(b).

COMMENT
For the impact this election has on marital deduction planning see "*Administration expenses*" on page 107.

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209 Where there is no personal liability, the property is included in the gross estate at its net value and no deduction for the mortgage is allowable. Treas. Regs. § 20.2053-7.

210 See Rev. Rul. 79-302, 1979-2 C.B. 328. Accord TAM 200104008.

211 IRC § 2053(a)(2). The regulations limit amounts deductible as administration expenses to expenses that are actually and necessarily incurred in the collection of assets, payment of debts, and distribution of property to those entitled to it. See Treas. Regs. § 20.2053-3(a). In Millikin v. Comm., 125 F.3d 339 (6th Cir. 1997) the Sixth Circuit overruled its earlier decision in Estate of Park v. Comm., 475 F.2d 673 (1973) which had held the regulation to be invalid.

212 See IRC § 2053(b). The fact that a particular expense is allowable as a deduction under local law is not determinative of its deductibility under the estate tax. Ultimately, deductibility is a question of federal law. See e.g., Estate of Love v. Comm., 923 F.2d 335 (4th Cir. 1991).

213 E.g., to obviate the need for a forced sale of estate assets. Projected interest on loans that might never be paid because of the possibility that the loan would be repaid early is deductible only when the interest accrues. Rev. Rul. 84-75, 1984-1 C.B. 193. Projected interest may, however, be deductible if a loan note provides for fixed interest and prohibits prepayment. See Estate of Graegin, T.C. Memo 1988-477. Accord, Estate of Murphy, 2009 WL 3366099 (W.D. Ark 2009).

214 Rev. Rul. 79-252, 1979-2 C.B. 333.

Ex-65: D dies owning mortgaged real property. During administration, D's personal representative pays $3,000 for mortgage interest accrued before D's death and $2,000 for interest on the mortgage during the period of administration. To what extent are these interest payments deductible?

b) Compensatory adjustments

If the IRC § 642(g) election is made to take costs of administration on the estate's income tax return, this may increase the estate tax at the expense of the residuary or other beneficiaries. A similar result can occur with the IRC § 213(c) election. Courts in some states (but apparently not Florida)[215] have required compensatory adjustments where this occurs.[216]

DRAFTING TIP
Whatever the status of compensating adjustments under local law, a well drafted instrument should expressly provide that such adjustments are or are not to be made. In selecting an approach, keep in mind that administration will be simplified if the instrument provides that no such adjustments are to be made. • The instrument should also anticipate the IRC § 642(g) and 213(c) elections. • The personal representative should be relieved of liability for decisions made in good faith. • The PR should also be authorized to consider the estate, generation-skipping, and income tax consequences to both the estate and its beneficiaries in making the decision.

6. Elective deduction for state and foreign death taxes

An estate may elect to deduct the amount of any death tax imposed by a state or foreign country on a devise for public, charitable, or religious uses provided the taxes saved by the election:

- are equitably apportioned among all transferees of the gross estate, or
- inure solely to the benefit of the charitable transferee.[217]

7. Uninsured casualty losses

Uninsured losses arising from fires, storms, shipwrecks, or other casualties, or from theft (including embezzlement) incurred during the settlement of an estate are deductible in reaching the taxable estate.[218]

8. Gifts and bequests to charity

Bequests and nonprobate transfers to charity are deductible in reaching the taxable estate. Unlike the income tax, there is no percentage limitation on how much may be left to

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215 See Williams v. Harrington, 460 So. 2d 533 (Fla. 2d DCA 1984). But see In re Estate of Cooper, 186 So. 2d 844 (Fla. 1st DCA 1966).

216 See e.g., Estate of Warms, 140 N.Y.S. 2d 169 (Surr. Ct. N.Y. City. 1955). See also, In re Holloway's Estate, 327 N.Y.S. 2d 865 (Surr. Ct. Nassau City. 1972) requiring a similar adjustment for trapping distributions.

217 IRC § 2053(d). See also Treas. Regs. §§ 20.2053-9(b)(1), and 20.2053-10(b)(1). State death taxes for which this election is made may not be claimed as a credit under IRC § 2011. IRC § 2011(e)(1).

218 IRC § 2054.

charity and deducted. Like the income tax and the gift tax, however, a gift or bequest of a future interest to charity following a present interest in a noncharitable beneficiary is not deductible unless it is a *legal* remainder following a life interest in the decedent's personal residence or farm, or it is a transfer to:

- a pooled income fund (PIF),
- a charitable remainder annuity trust (CRAT) or
- a charitable remainder unitrust (CRUT).[219]

9. Bequests to a surviving spouse

Most bequests and nonprobate transfers to a spouse of the decedent are deductible. But this deduction is subject to a number of technical rules and limitations, particularly for bequests in trust and to spouses who are not citizens of the United States.

These and other aspects of the marital deduction are examined in detail in the next chapter.

D. CREDITS AGAINST THE TAX

After the taxable estate is determined and the gross tax calculated, a number of credits are available to reduce (but not below zero) the amount of tax due.

1. Unified credit

A unified credit is available against the estate tax.[220] The amount of the credit is equal to the "applicable credit amount" which in turn is equal to the tax under the unified rate schedule on the "applicable exclusion amount. In 2015, this latter amount is $5,430,000 so the unified credit is $2,117,800.

However, to the extent the decedent used some of his credit to offset gift tax liability during life, it will be unavailable at his death.

2. Credit for prior transfers

A limited, scaled credit is provided when property that is included in the decedent's gross estate was transferred to the decedent by someone who dies within 10 years before or within two years after the decedent.[221]

- The maximum credit is the lesser of the federal estate taxes attributable to the property in the estate of the transferor (determined on an average basis) and the federal estate taxes attributable to the property in the estate of the decedent (determined on a marginal basis).
- The actual credit is the maximum only if the transferor and decedent die within two years of each other. Thereafter, the credit declines by 20 percent of the maximum for each intervening two year period.[222]

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[219] IRC § 2055.

[220] IRC § 2010.

[221] IRC § 2013.

[222] IRC § 2013(a). The credit has been denied where the decedent and the beneficiary die simultaneously. See Estate of Carter v. U.S., 921 F.2d 63 (5th Cir.) cert. denied, 112 S. Ct. 73 (1991); Estate of Lion v. Comm., 438 F.2d 56 (4th Cir. 1971); Estate of Everard D. Marks, Jr., 94 T.C. 720 (1990).

COMMENT
No credit is available if the transferor paid no taxes by reason of the applicable credit amount (unified credit), the marital deduction, or the charitable deduction.

Ex-66: At his death, D's $7,000,000 estate was divided into two shares, a $5,430,000 credit shelter share and a $1,570,000 marital share which passed to a QTIP eligible trust for D's spouse, S.

1. If S dies six months after D in a freak and unrelated accident, will her estate be entitled to a PTP credit for her life estate in the QTIP trust?

2. Suppose S was in very poor health at D's death?

3. Suppose D and S died simultaneously and S was deemed to have survived D under the terms of D's will or local law?

3. Credit for foreign death taxes

Within limits, a credit is available for any death taxes actually paid to any foreign country in respect to property situated in that country which property is also includible in the decedent's federal gross estate.[223]

E. VALUATION OF THE GROSS ESTATE

Property is included in the gross estate at its fair market value.[224]

- In making this determination, the property must be valued on the basis of its highest and best use in the market in which the property is most commonly sold to the public.

- Discounts may be available for fractional interests in land, for blockage in the case of large blocks of stock, for lack of marketability and for minority interests in closely held businesses[225] In addition, recent authority supports a discount for the built in capital gain in either an S corporation[226] or a C corporation[227] stock. On the other

[223] IRC § 2014. In lieu of a credit, the PR may elect to deduct certain foreign taxes attributable to property passing to charity. This election is discussed further in "*Election to deduct foreign death* taxes" on p. 231.

[224] Treas. Regs. § 20.2031-1(b) defines fair market value to be "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

[225] According to the Service, no reduction in the value of stock may be claimed for capital gains that will have to be paid on liquidation of the stock. TAM 9150001. See also, Barron, "Is a Discount for Locked-In Capital Gains Tax Justified After General Utilities Repeal?", 76 J. Taxation 218 (April 1992); Kaplan and Fromm, The Impact of Taxes on the Value of Close Corporations, 19 Estate Planning 137 (May-June 1992).

[226] See Estate of Jelke v. Comm., 507 F.3d 1317, 2007 WL 3378539 (11th Cir. 2007), *rev'g* T.C. Memo 2005-131; Estate of Davis v. Comm., 110 T.C. 530 (1998).

The valuation of S corporation stock on a going concern basis involves another issue. Should the earnings of the corporation be "tax affected" to reflect the income taxes that the corporation would have paid had it been a C corporation instead. Older Tax Court cases held that the earnings should be tax affected. See e.g., Gross v. Comm., T.C. Memo 1999-254, aff'd 272 F.3d 333 (6th Cir 2001), reh'g denied (Mar 21 2002), cert. denied, 123 S.Ct. 121 (Oct. 7, 2002). More recent cases, however,

hand, the Tax Court has held that the estate tax value of an IRA may not be discounted for built in income taxes or a lack of marketability.[228]

Ex-67: At his death, D is the beneficiary of QTIP and credit shelter trusts created by his former spouse. The QTIP trust holds a 77 percent undivided interest in DiscountAcre. The remaining 23 percent interest is owned by the credit shelter trust. The trustee of both trusts is the same.

1. In valuing the QTIP trust at D's death, may a discount for an undivided interest in property be claimed?

2. Would your answer be different if D owned the other 23 percent outright?

COMMENT
The answer to the second question would be different if the marital trust was an IRC § 2056(b)(5) power of appointment trust instead of a QTIP trust. Property included in a decedent's gross estate under IRC § 2033 and IRC § 2041 must be aggregated for purposes of determining discounts.[229]

Ex-68: Five years prior to his death, D won the state lottery which entitled him or his estate to 20 annual payments of $2 million each. Under state law, D's right to the lottery winnings is nonassignable. How should the right to the remaining 15 payments be valued for estate tax purposes?

1. Alternate valuation method

IRC § 2032 provides an exception to the normal rule that the gross estate is valued as of the date of the decedent's death.

- Under the IRC § 2032 "alternate valuation method," each individual asset in the estate is valued at the earlier of 6 months after the date of death or the date the estate (or other person) disposes of the asset.[230]
- Assets the value of which are affected by the mere lapse of time are subject to a special rule. They are valued as of the date of the decedent's death with adjustment for valuation changes which are not due to the mere lapse of time.[231]

have held to the contrary. See Gross v. Comm., 272 F.3d 333 (6th Cir. 2001, aff'g T.C. Memo 1999-254 (1999); Adams v. Comm., T.C. Memo 2002-80 (2002); Dallas v. Comm., T.C. Memo 2006-212 (2006).

227 Dunn v. Comm., Dunn v. C.I.R.; Eisenberg v. Comm., 155 F.3d 50 (2d Cir. 1999), acq. 1999-4 I.R.B. 4.; Welch Estate v. Comm., 208 F.3d 213 (6th Cir. 2000); Jamison Estate v. Comm., 267 F.3d 366 (5th Cir. 2001). Compare Jelke Estate v. Comm., T.C. Memo 2005-131 (2005) (discount for built-in capital gains reduced to reflect unlikelihood of actual liquidation).

228 Kahn Estate v. Comm., 125 T.C. 227 (2005).

229 Estate of Fontana v. Comm., 118 T.C. 318 (2002). Accord, PLR 20119013..

230 "Disposes" does not include the formation of a corporation that is tax free under IRC § 351 or a tax free corporate reorganization under IRC §§ 354 or 355. Treas. Regs. § 20.2032-1(c)(1).

- The alternate valuation method is available to an estate only if using it results both in a lower gross estate and a lower combined federal estate and GST tax due.[232]

COMMENT
The valuation method used on the estate tax controls the value of property under the generation-skipping transfer tax for taxable terminations that occur by reason of the decedent's death.[233]

Ex-69: Five months after D's death, a dividend is declared and paid on stock owned by D and included in her gross estate. If a valid election is made to use the alternate valuation method, will the dividend be includible in D's gross estate?

2. Special use valuation

Under IRC § 2032A, certain real property owned[234] and used by the decedent as a farm or in a closely held business and passing to a qualified heir may be valued on the basis of its actual use rather than its highest and best use.

- Special use valuation may only be used to reduce the gross estate by $1,100,000.[235]
- And the benefits of the special valuation approach are recaptured if the qualified heir disposes of the real property or ceases to use it in the farm or business within 10 years of the decedent's death.[236]

To qualify for special use valuation:

a) At least 50 percent of the adjusted gross estate must consist of real and personal property used in a farm or closely held business and at least 25 percent of the adjusted gross estate must consist of real property so used.[237]

b) The real property must pass to a qualified heir. This includes a spouse and the decedent's grandparents or a lineal descendant thereof.[238]

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231 See e.g., TAM 9637006 (valuation of right to receive state lottery winnings payable in the form of an annuity for a term certain is based on the number of payments remaining at the decedent's death and the applicable federal rate on the alternate valuation date).

232 § 2032(c). The election to use the alternate valuation method may be made on a late filed return only if the return is filed within one year of the due date of the return (including extensions). Failure to meet this deadline is fatal. See Eddy Estate v. Comm., 115 T.C. No. 10.

233 IRC § 2641(b).

234 Including real property owned indirectly through a partnership or corporation.

235 As of 1999, this limit has been indexed for inflation in $10,000 increments. See Rev. Rul. 88-89, 1988-2 C.B. 333 (1988) for an explanation of how IRC §§ 2032 and 2032A can be used together.

236 A spouse or lineal descendant of the decedent may enter into a cash lease of the property with a member of the family of either the spouse or descendant without violating this rule. "qualified use" to include cash leases by a spouse or lineal descendant of the decedent to a member of the family of the spouse or descendant. IRC § 2032A(c)(7)(E) .

237 For purposes of the percentage tests, the decedent's gross estate includes the date of death value of any property the decedent transferred by gift within three years of death. IRC § 2035(c)(1)(B).

Note, however, that Treas. Regs. § 20.2032A-8(a)(2) which requires that the election be made as to at least 25 percent of the estate was held invalid in Miller v. U.S., 680 F. Supp. 1269 (C.D. Ill 1988).

238 Estate of David Davis, 86 T.C. 1156 (1986) invalidated the requirement in the regulations that all successive beneficiaries, no matter how remote their interests, be qualified heirs.

c) For 5 out of the 8 years before the decedent's death, the decedent or a family member must have owned the real property and used it in a farm or closely held business.

d) For 5 out of the 8 years before the decedent's death, disability or commencement of social security benefits, the decedent or a family member must have materially participated in the operation of a farm or other business.

e) The election to use IRC § 2032A must be made on a timely filed return.[239]

> ***Ex-70:*** D dies owning a 26 percent interest in a limited partnership that operated a large cattle ranch. If D's executor elects to value D's interest under IRC § 2032A, may the executor also claim a discount for lack of marketability?

3. Buy-sell agreements

For difficult to value assets, such as a decedent's interest in a closely held business, it may be desirable to enter into a buy-sell agreement. A properly constructed buy-sell agreement provides a source of liquidity for the decedent's estate and fixes the value of his interest for estate tax purposes.

a) Establishing a binding contract price

For the price in a buy-sell agreement to establish the estate tax value of an interest in a business, the agreement must:

- Restrict disposition during life,[240]
- Obligate the estate to sell at death,[241] and
- Comply with the requirements of IRC § 2703.

b) Section 2703 requirements

Section 2703 requires that the agreement:

- Be a bona fide business arrangement,
- Not be a subterfuge for a bequest to members of the decedent's family, and

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[239] Defective but timely elections may be perfected within 90 days of the date the IRS requests additional information. See IRC § 2032A(d)(3). See also Treas. Regs. § 20.2032A-8.

Under prior law, the perfection procedures were available only upon a finding of substantial compliance with the regulations. The 1997 TRA extends the subsequent submission of information procedures to any executor who makes a section 2032A election and submits the recapture agreement, without regard to compliance with the regulations. The Joint Conference Committee Report reveals that this change was intended to alter what is believed to be an unnecessarily restrictive view of the IRC § 2032A(d)(3).

On the application of IRC § 2032A(d)(3) prior to the 1997 TRA, see Estate of McAlpine v. Comm., 968 F.2d 459 (5th Cir. 1992 (failure of the beneficiaries to sign the notice of election and recapture agreement); Estate of Doherty v. Comm., 982 F.2d 450 (1992) (failure to include formal appraisal). See also Gillett, "Substantial Compliance, the 9100 Regulations, and the Special Use Election, 5 Prob. Prac. Rptr. 1 (July 1993). But see Lucas v. U.S., 97 F.3d 1401 (11th Cir. 1996) (relief denied for failure to file recapture agreement). Accord Estate of Hudgins v. Comm., 57 F.3d 1393 (5th Cir. 1995); Bartlett v. Comm., 937 F.2d 316 (7th Cir. 1991); McDonald v. Comm., 853 F.2d 1494 (8th Cir. 1988), *cert. denied* 490 U.S. 1005 (1989).

[240] E.g., Treas. Regs. § 20.2031-2(h). This requirement is satisfied by a right of first refusal. But see Blount Estate v. Comm., 438 F.3d 1338 (11th Cir. 2005), aff'g in part, rev'g in part, T.C. Memo 2004-116.

[241] This requirement is satisfied only if the estate must sell if the buyer desires to purchase. If the estate has the option of holding the interest, the buy-sell agreement does not limit value, although it would be an influencing factor. Baltimore Nat'l Bank v. U.S., 136 F. Supp. 642 (D.C. Maryland, 1955). See also Rev. Rul. 59-60, 1959-1 C.B. 237; Rev. Rul. 189, 1953-2 C.B. 294

- Be an arm's length arrangement—that is, one that the taxpayer can show could have been obtained in an arm's length bargain.[242]

F. THE ESTATE TAX RATE SCHEDULE

The rate schedule used to calculate the estate tax is found in section 2001(c). For 2015 the highest marginal rate is 40 percent.

G. COMPUTING THE ESTATE TAX

The following outline details the various steps involved in calculating the federal estate tax.

	Gross Estate	
-	IRC § 2053	Costs, claims, etc.
-	IRC § 2054	Casualty losses
=	**AGE**	Adjusted gross estate
-	IRC § 2055	Charitable deduction
-	IRC § 2056	Marital deduction
	IRC § 2058	State death taxes (post-2004 only)
=	**TE**	Taxable Estate
+	ADJ	IRC § 2701(d) adjustment[243]
+	ATG	Adjusted taxable gifts
=	**TTB**	Tentative tax base
x	IRC § 2001	Unified rate schedule
=	TET	Tentative estate tax
-	GT	Gift taxes on post-76 gifts[244]
-	CREDITS	Including applicable credit amount (unified credit)

Ex-71: Seven years before her death, D had made a large taxable gift for which she had filed a return reporting a gift tax due of $27,000. At her death, the Service seeks to include the gift in D's adjusted taxable gifts for purposes of calculating her estate tax at a much higher value than was used on D's gift tax return. May they do this?

H. APPORTIONMENT OF TAX LIABILITY

The Code provides that the federal estate tax must be paid by the personal representative and the personal representative is personally liable if he or she fails to do so.

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242 The regulations state that the three requirements of IRC § 2703 will be considered met if more than 50 percent by value of the property subject to agreement is owned by persons who are neither members of the transferor's family nor natural objects of his bounty and whose property is subject to the same restrictions as that of the transferor. See Treas. Regs. § 25.2703-1(b)(3). On these requirements see Estate of Joseph H. Lauder, 64 TCM 1643 (1992). See also, Amlie Estate v. Comm., T.C. Memo 2006-76 (2006). But see Blount Estate v. Comm., 438 F.3d 1338 (11th Cir. 1005).

243 The IRC § 2701(d) adjustment for cumulative but unpaid distributions is discussed further in "*Increase for cumulative unpaid dividends*," p. 49.

244 Pre-1977 gifts are taken into account in determining the amount of gift taxes payable on post-76 gift. See TAM 9642001.

However, the Code and the Florida apportionment statute apportion ultimate responsibility for the estate tax burden as well as the burden for other federal taxes among the estate beneficiaries. The Code provisions are summarized in the table below. The Florida apportionment statute is discussed in detail in "*Florida apportionment statute*" p. 222.

Code	Tax	Yields to contrary provision in	Specific reference required?
2032A(c)(5)	Recapture tax on 2032A property	n/a	n/a
2033A(i)(3)(F)	Recapture tax on 2033A property	n/a	n/a
2206	Estate tax on insurance proceeds	Will	No
2207	Estate tax on general powers	Will	No
2207A	Estate tax on QTIP property	Will or revocable trust	Yes
2207B	Estate tax on section 2036 property	Will or revocable trust	Yes
2603(b)	GST tax	Governing instrument	Yes

I. ESTATE TAX BASIS

Persons (including the estate) acquiring property from a decedent take a basis in that property equal to its value for estate tax purposes.[245] This will depend on the valuation method used by the estate.

Ex-72: D, a resident of a common law state, dies in 2004 owning appreciated real estate in Texas. Under the laws of Texas, the realty is owned by D and W as community property.

1. How do the basis adjustment rules of IRC § 1014 apply to this property?

2. Would you advise D and W to convert their property to tenancy in common?

COMMENT
Because the basis of loss assets is adjusted downward at death, consideration should be given to selling such assets before death.

1. Income in respect of a decedent

IRD is an item of income that is substantially earned as of death but which is not reportable on the decedent's final income tax return because of his method of accounting.[246] Items of IRD do not receive a basis adjustment at death.[247]

245 IRC § 1014.

246 IRC § 691(a).

Common examples of IRD include:

- Renewal commissions.
- Accounts receivable of cash basis professionals.
- Installment sales contracts.
- Benefits under deferred compensation arrangements.
- Alimony deficiencies.[248]
- Unreported discount in Series E or EE government bonds.

> ***Ex-73:*** At his death, the balance of T's individual retirement account is paid out in a lump sum. What are the income tax consequences to the recipient?

2. Reacquired property

No basis adjustment is available at a decedent's death for appreciated property the decedent acquired by gift within a year of death, if the decedent leaves the property to the donor of the gift or to the spouse of the donor. In such situations, the donor or spouse, as the case might be, takes a basis equal to the decedent's basis immediately before death.[249]

3. Section 2031(c) property

No basis adjustment is available for land subject to a qualified conservation easement to the extent that an election is made to take the IRC 2031(c) exclusion with respect to the land.[250]

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[247] IRC § 1014(c). The SBJPA provides that when a person acquires subchapter S stock from a decedent, IRC § 691 applies with respect to any item of IRD held by the corporation as if the decedent held a prorata share of the IRD directly. Additionally, the basis of the stock under IRC § 1014 is reduced by the value of the stock attributable to items of IRD. This parallels the treatment of IRD by partnerships and prevents decedents from using subchapter S corporations as a device for avoiding the adverse impact of IRD at their death.

[248] Kitch v. Comm., 104 T.C. 1 (1995).

[249] IRC § 1014(e).

[250] IRC § 1014(a)(3).

ANSWERS—THE FEDERAL ESTATE TAX

Ex-37. **Answer –** The lot is includible in D's gross estate but its value is limited to the salable value of the portion, if any, that is not designed for the internment of D or of members of D's family. Treas. Regs. § 20.2033-1(b).

Ex-38. **First question –** Nothing will be included in A's gross estate when he dies. His interest terminates by reason of his death. However, A's death may be a taxable termination under the generation-skipping transfer tax. See "*Taxable terminations*" on p. 129.

Second question – In the absence of a special statute, should B die while A is still alive, the actuarial value of his remainder interest would be includible in his gross estate. However, some states, including those that have enacted the Uniform Probate Code, have a statute that avoids this result. Fla. Stat. § 736.1106 (2015) is representative. That section converts B's vested remainder to a remainder that is contingent on B surviving A. And, in the absence of a contrary intent, a substitute gift is created in B's descendants should B predecease A. That is, in effect, the statute converts Father's conveyance from "To A for life, then to B" to "to A for life, then to B if B survives A, otherwise to such of B's descendants who survive A." Under this statute, nothing is includible in B's gross estate if he dies before A because his interest expires by reason of his death.

Comment: If inclusion of B's interest does occur, payment of the taxes attributable to the interest may be deferred until the expiration of A's life interest. See IRC § 6163.

Ex-39. **First question –** One-half is included.

Second question – Yes. In Estate of Gallenstein v. Comm., 975 F.2d 286 (6th Cir. 1992), the Sixth Circuit held that IRC § 2040(b) dealing with qualified tenancies does not apply to a tenancy created before 1977. Such tenancies are taxed under the consideration furnished test of IRC § 2040(a). Subsequently, the Fourth Circuit in Patten v. U.S., 116 F.3d 1029 (4th Cir. 1997) and the Tax Court in Hahn v. Comm., 110 T.C. 140 (1998) agreed. The Service's acquiescence in this view can be found at 2001-42 I.R.B. 319 (Oct. 15, 2001).

Ex-40. **Answer –** Half of it. When property subject to the consideration furnished rule of IRC § 2040(a) is acquired by gift or devise, each tenant is deemed to have contributed a proportionate part of the consideration. Treas. Regs. § 20.2041-1(a).

Ex-41. **First question –** Eighty percent. This is a nonqualified tenancy so the consideration furnished rule of IRC § 2040(a) applies. Since D furnished eighty percent of the consideration, an equivalent percentage of JointAcre is included in his gross estate.

Second question – Yes the answer would be different. IRC § 2040(a) provides that money contributed by the surviving tenant that came from the decedent by gift counts as the decedent's contribution, not the surviving tenant's. Accordingly, on the facts of this example, D would have contributed all of the purchase price and all of JointAcre would be included in his gross estate at death.

Third question – Ordinary income earned on property D gives S counts as S's contribution. Treas. Regs. § 20.2040-1(c)(5). Accordingly, D contributed eighty percent of the consideration and that percentage of the date of death value is included in D's gross estate.

Fourth question – It depends. To the extent the sales proceeds represent gain on the original asset after the asset had been given to S, the proceeds count as S's contribution. Thus, we need to know the value of the Xerox stock at the time D gave it to S. If, for example, it was worth $15,000 at that time, S will be credited with consideration equal to the $5,000 difference between the sales proceeds of $20,000 and the $15,000 value of the Xerox stock. See e.g., Rev. Rul. 79-372, 1979-2 C.B. 330.

Ex-42. **First question –** The answer is $120,000. Of the total consideration of $100,000, M is credited with $20,000. This is equal to half of the balance of the mortgage note as of the date of D's death. Accordingly, the other $80,000 came from D and D's gross estate includes 80/100ths of the

$150,000 value of JointAcre. See e.g., Rev. Rul. 79-302, 1979-2 C.B. 328; Rev. Rul. 81-183, 1981-2 C.B. 180; Rev. Rul. 81-184, 1981-2 C.B. 181.

Second question – The answer is $90,000. In addition to half the date of death balance on the note, M is credited with have of any mortgage payments that are made for income generated by JointAcre. Estate of Otte v. Comm., 31 TCM 301 (1972). Accordingly, D contributed $60,000 of the $100,000 purchase price and 60 percent of JointAcre is included in D's gross estate.

Ex-43. **Answer –** Perhaps as much as $50,000 ($60,000 less the $10,000 contributed by F). But the better answer is $48,000 (4/5ths of $60,000). At the time of the improvement, the home was worth $40,000. That amount is credited as D's contribution since he paid all of the initial purchase price. F then contributed $10,000 for the improvement so D's contribution amounted to 4/5ths ($40,000 / $50,000) of the post-improved home. See Estate of Edna V. Peters, 46 T.C. 407 (1966), aff'd Peters v. Comm., 386 F.2d 404 (4th Cir. 1967)

Ex-44. **First question –** The answer is yes provided only that if D did appoint herself successor trustee she would have the authority under local law to participate in a distribution to herself. As to this latter point, see the third question to this example.

Second question – Until recently the position of the Service was yes. See PLR 8916032. But this letter ruling was based on Rev. Rul. 79-353, 1979-2 C.B. 325 which dealt with a similar issue with respect to IRC § 2038. More recently, the Service has revoked Rev. Rul. 79-353. In Rev. Rul. 95-58, 1995-2 C.B. 191, the Service ruled that IRC § 2038 is not triggered by a retained power to remove a trustee and appoint a successor who is not related or subordinate within the meaning of IRC § 672(c). Accord Estate of Helen S. Wall, 101 T.C. 300 (1993). In PLR 9735023, the IRS extended the same principle to apply to inclusion under IRC § 2041.

Third question – In Florida at least, the result would be different. Fla. Stat. § 736.0814(2) (2015) provides that unless expressly authorized by a contrary trust provision, a trust beneficiary may not make discretionary distributions directly or indirectly to herself. This limitation does not apply to the settlor of a revocable trust, a trust where the settlor's spouse is the trustee, or any distribution for the trustee/beneficiary's health, support, maintenance, or education.

Ex-45. **First question –** The final answer is $35,000. Of this amount, $20,000 is included because D died possessing a power to withdraw that amount. An additional $15,000 is included because of the lapse of the first year's power. The $15,000 amount is calculated in the following manner:

The first-year lapse is treated as a release to the extent it exceeds the greater of $5,000 or 5 percent of the $200,000 trust. On our facts, the lapse is a release of $10,000. The regulations equate the release to a fraction of the trust, the numerator of which is the release ($10,000) and the denominator of which is the value of the trust at the time of the lapse ($200,000). Thus, the fraction is 1/20th. As to that fraction, D is treated as the transferor of the trust. Since D has a continuing power to control where the trust property goes at his death, 1/20th (or $15,000) of the trust is included in his gross estate as a result of the lapse/release. See Treas. Regs. § 20.2041-3(d)(4).

Second question – With the limited power, D's estate would include $15,000–the amount of trust property she could have withdrawn at the time of her death. The lapse in the first year has no effect because it falls within the safe-harbor of IRC § 2041(b)(2).

Ex-46. **First question –** Yes. IRC § 2042(2) defines incident of ownership to include a reversionary interest which exceeds in value 5 percent of the value of the policy immediately before the decedent's death. In turn, reversionary interest is defined to include any "possibility that the policy, or the proceeds of the policy, may return to the decedent or his estate, or may be subject to a power of disposition by him." See also Treas. Regs. § 20.2042-1(c)(4).

Second question – Maybe. Assuming the trust is the named beneficiary of the policy, the proceeds will not be taxed to D provided D has no power to affect the enjoyment of the trust property, D has no reversion in the trust worth more then 5 percent of the policy, and D's trust is not directed to use the proceeds for the indirect benefit of D's estate.

Ex-47. **Answer –** It depends. In the view of the Service, incidents of ownership D possessed as a fiduciary will not cause inclusion in his gross estate provided:

1. D did not transfer the policy to the trust;

2. could not exercise the incidents to benefit himself; and

3. does not pay for the premiums of the policy.

Rev. Rul. 84-179, 1984-2 C.B. 195 (1984).

Note: The requirement that D not pay policy premiums is unsupported by and is arguably inconsistent with case law on the subject.

See e.g., Estate of Fruehauf v. Comm., 427 F.2d 80 (6th Cir. 1970); Estate of Skifter v. Comm., 468 F.2d 699 (2d Cir. 1972); Rose v. U.S., 511 F.2d 259 (5th Cir. 1975); Estate of Connelly v. U.S., 551 F.2d 545 (3d Cir. 1977). See also Rev. Rul. 81-128, 1981-1 C.B. 469, where the Service announced that it would not follow Connelly outside of the Third Circuit.

Ex-48. **Answer –** Only if D owns more than 50 percent of the combined voting power of the corporation *and* the corporation is not the beneficiary of the policy. See Treas. Regs. § 20.2042-1(c)(6). See also Treas. Regs. § 20.2031-2(f).

For a similar issue relating to policies held by and payable to the decedent's partnership, see Rev. Rul. 83-147, 1983-2 C.B. 158. See also, PLR 9623024.

Ex-49. **First question –** The $50,000 death benefit will be included in his gross estate under IRC § 2039(a).

Second question – No. The benefit is includible whether or not D had the power to select the beneficiary.

Ex-50. **First question –** No. IRC § 2036(a)(1) does not apply to these facts because D did not transfer property and *retain* a right to income.

Second question – Yes. Under the reciprocal transfers doctrine, D will be treated as having retained the right to income in the trust she created for her brother. Accordingly, that trust will be included in her gross estate under IRC § 2036(a)(1). See U.S. v. Grace, 395 U.S. 316 (1969).

Ex-51. **Answer –** The correct answer depends on a number of factors. First, if D did not make a QTIP election under IRC § 2523(f) at the creation of the trust, he will have made a transfer with a retained right to income for a period that is not ascertainable without reference to his death and the trust will be includible in his gross estate under IRC § 2036(a)(1).

If D made a QTIP election at the creation of the trust, the answer depends on whether D's spouse made a QTIP election under IRC § 2056(b)(7) at her death. If she did, the trust will be includible in D's gross estate under IRC § 2044(a). If she didn't, IRC § 2044(c) will treat her as the transferor of the trust; D will not be viewed as having retained his income interest, and nothing will be includible in D's gross estate at his death. Treas. Regs. § 25.2523(f)-1(f), Examples 9 - 11. See also PLR 9309023.

For other rulings dealing with the same or related issues, see PLR 9140069; PLR 9109029; PLR 9026036; and PLR 8944009, each of which predated the regulation referred to in the answer.

Ex-52. **First question –** Yes. The house is includible in D's gross estate under IRC § 2036(a)(1) even though his "understanding" with his son may not be legally enforceable under local law. See e.g., Estate of Emil Linderme, 52 T.C. 305 (1969).

Second question – There are cases that say the property cannot be included in D's gross estate if he pays son a reasonable rent. E.g., Estate of Roy D. Barlow, 55 T.C. 671 (1971). However, in a recent case, the Second Circuit included in a decedent's gross estate a personal residence that had been sold by the decedent to a son for a note and which was subsequently leased back by the decedent for a reasonable rent. Although both the interest on the note and the amount of the rental payments appeared reasonable, the court recharacterized the entire transaction as an IRC § 2036(a)(1) transfer with a retained right to possession. Relevant facts included: The lease was executed two days after the sale; the term of the lease was longer than her life expectancy; the decedent used her annual exclusion to forgive both the down payment and additional amounts

principal over the two years before her death; during that period, the son paid interest only on the note; and the interest payments were almost the same as the rental payments. See Estate of Maxwell v. Comm., 3 F. 2d (2d Cir. 1993), aff'g 98 T.C. 594 (1992).

Third question – The weight of authority says no because the transfer is one for full and adequate consideration in money or money's worth. See Estate of Magnin v. Comm., 184 F.3d 1074 (9th Cir. 1999); Wheeler v. Comm., 116 F.3d 749 (5th Cir. 1997); Estate of D'Ambrosio v. Comm., 101 F.3d 309 (3d Cir. 1996), *rev'g* 105 T.C. 252 (1995); (adequacy of consideration is measured against the value of the interest transferred, not the fee interest). But see Gradow v. U.S., 897 F.2d 516 (Fed. Cir. 1990); Pittman v. U.S., 878 F. Supp. 833 (E.D. N.C. 1994). (a sale of a remainder is not supported by full consideration unless the consideration received equals the amount of estate tax exposure the transferor faced immediately before the transfer).

Ex-53. **Answer –** No. The transfer is for full an adequate consideration in money or money's worth. See e.g., Estate of Bergan v. Comm., 1 T.C. 543 (1943) acq. 1943 C.B. 2. For more on the income taxation of a private annuity arrangement, see Rev. Rul. 69-74, 1969-1, C.B. 43.

Ex-54. **First question –** Yes but the reason is somewhat convoluted. First, D is in control of Acme because her spouse's stock is attributable to her. See IRC § 318(a)(1)(A)(i). Secondly, the purchase of voting stock by the trust from funds furnished by D is an indirect retention of the right to vote the purchased stock. See Prop. Regs. § 20.2036-2(e)(2).

Second question – The answer should be different because the retention of voting stock is not a retention of the right to vote the nonvoting stock purchased in the trust. See Rev. Rul. 81-15, 1981-1 C.B. 457; Prop. Regs. § 20.2036-2(a). Accord, TAM 9543050.

Ex-55. **First question –** No. D did not die with a power to control property that D had at one time transferred so neither IRC §§ 2036(a)(2) nor 2038 apply to these facts. And, since D's power could not be exercised for his own benefit, the power would not be a general power of appointment taxable under IRC § 2041 either. On this latter point, see "*Powers of appointment*", infra p. 59.

Second question – Yes the answer changes. Not the trust in includible in D's gross estate under either IRC § 2036(a)(2) or IRC § 2038.

Ex-56. **First question –** Yes. Neither IRC § 2038 nor IRC § 2036(a)(2) make a distinction between powers held in an individual capacity or as trustee, except in the latter case, powers limited by an ascertainable standard. Since the trustee's powers in the example are not so limited, the trust property will be includible in D's gross estate.

Second question – If Bank is trustee but D has the power to remove Bank and appoint himself trustee, Bank's powers will be attributed to him and the trust property will be included in his gross estate. See Treas. Regs. §§ 20.2036-1(b)(3) 20.2038-1(a)(3).

Third question – Here D's power to become trustee is subject to a contingency that is beyond his control. That will insulate him from tax exposure under IRC § 2038. See Treas. Regs. §§ 20.2038-1(a)(3) and 20.2038-1(b) Nevertheless, the trust remains includible in his gross estate under IRC § 2036. See Treas. Regs. § 20.2036-1(b)(3). See also Farrel's Estate v. U.S., 553 F.2d 637 (Ct. Cl. 1977).

Fourth question – If D is restricted to appointing an independent trustee upon removal of Bank, the trustee's powers can not be attributed to him. Accordingly, the trust will not be included in D's gross estate. Rev. Rul. 95-58, 1995-2 C.B. 191. See also Estate of Helen S. Wall, 101 T.C. 300 (1993); Rev. Rul. 79-353, 1973-2 C.B. 325; Rev. Rul. 81-51, 1981-1 C.B. 458.

Ex-57. **First question –** Nothing is includible in D's gross estate when he dies. Even if D had the powers of the trustee, the powers are limited by the ascertainable standard of support.

Second question – The answer remains the same. The trustee's distribution powers are limited by an ascertainable standard and no combination of purely administrative powers can cause inclusion in the decedent's gross estate. See Old Colony Trust Co. v. U.S., 423 F.2d 601 (1st Cir. 1970).

Ex-58. **First question –** No. A power held as a fiduciary to substitute property of equal value does not cause the property to be included in a decedent's gross estate. Estate of Anders Jordahl, 65 T.C. 92 (1975).

Second question – No provided trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. Rev. Rul. 2008-22, 2008 WL 1771002

Ex-59. **First question –** Yes, the trust, including any accumulated income, is includible in T's gross estate under either IRC § 2036(a)(2) or IRC § 2038. Lober v. U.S., 346 U.S. 335 (1953); U.S. v. O'Malley, 383 U.S. 627 (1966)No. The power to accumulate income is a power to alter who the ultimate taker of the income might be. The same is true of the power to advance principal to C, since it is not certain that C would ultimately be entitled to the principal at termination of the trust. See Estate of Goelet v. Comm., 51 T.C. 352 (1968).

Second question – Here, IRC § 2038 only applies to bring the value of the income interest into T's gross estate. On the other hand, IRC § 2036(a)(2) will require inclusion of the entire trust. See Estate of Alexander v. Comm., 81 T.C. 757 (1983).

Third question – The answer remains the same. The fact that T's power requires the consent of someone who is economically adverse to giving it, does not the result under either IRC § 2036(a)(2) or IRC § 2038. See Treas. Regs. §§ 20.2036-1(b)(3); 20.2038-1(a).

Ex-60. **Answer –** Yes. The actuarial value of X's contingent remainder (after taking into account D's death) is includible in D's gross estate. Treas. Regs. § 20.2037-1(e), Example (3).

Ex-61. **First question –** Under the initial facts, the policy proceeds are includible in D's gross estate. So too is any gift tax paid by D on the gift.

Second question – No, the answer is the same. Gift splitting makes S the donor of half for purposes of the gift tax only. For purposes of the estate tax, D is the transferor of the entire policy. Accordingly, all of the proceeds are includible in D's gross estate. However, if calculating his estate tax, D's estate receives a credit for the gift taxes paid on both portions of the split gift. See IRC § 2001(e).

Third question – If D's daughter had paid the premium for the second year, only half of the policy proceeds would be includible in D's gross estate. Estate of Morris R. Silverman, 61 T.C. 338 (1973), aff'd 521 F.2d 574 (2d Cir. 1975).

Fourth question – If the policy was issued in M's name, even if D paid for it, nothing can be included in D's gross estate. See Estate of Perry v. Comm., 927 F.2d 209 (5th Cir. 1991); Leder v. Comm., 893 F.2d 237 (10th Cir. 1989); Estate of Eddie L. Headrick, 93 T.C. 171 (1989), aff'd 918 F.2d 1263 (6th Cir. 1990). In AOD-1991-012, the Service stated that it will no longer litigate this issue. But see TAM 9127007. See also Beehler, IRS Action Makes It Easier to Keep Proceeds Out of an Insured's Gross Estate, 75 J. Tax 284 (1991).

Ex-62. **Answer –** The severance is not a transfer subject to the gift tax and when D dies, only his half of Blueacre will be included in his gross estate. See e.g. Heasty v. U.S., 239 F. Supp. 345 (D. Kan. 1965), aff'd, 370 F.2d 525 (10th Cir. 1966), acq. Rev. Rul. 69-577, 1969-2 C.B. 173 (1969). See also Sullivan's Estate v. Comm., 175 F.2d 657 (9th Cir. 1949). IRC § 2035(a)(2) does not require a different result because the section does not mention IRC § 2040.

Ex-63. **Answer –** The answer is 28 percent determined as follows. The value of the conservation easement is 24.3 percent of the value of the land without the easement. Since this is 5.7 percentage points less than 30 percent, the maximum 40-percent applicable percentage must be reduced by 12 percentage points (2 points for every percentage point or fraction there of below 30).

Ex-64. **Answer –** Yes. See IRC § 2043(b)(2) .

Ex-65. **Answer –** The accrued interest is deductible on both the estate tax return and the estate's income tax return. The $2,000 of interest accruing after D's death is not deductible on the estate's income tax return unless the right to take it on the estate tax return is waived.

Ex-66. **First question –** The answer depends on whether D's personal representative made the QTIP election for the marital trust. If so, there will be no PTP credit both because D would have owed no estate tax at death and because the value of the property left to S (the life estate in the QTIP trust) must be reduced by the marital deduction D took. However, if no QTIP election was made, the PTP credit is available. Yes. The credit is based on the IRC § 7520 value of S's life estate. Treas. Regs. §§ 20.2013-5(a) and 5(c). For an example, see Rev. Rul. 59-96, 1959-1 C.B. 232.

Second question – The question is relevant only if we assume that no QTIP election was made.

If S is in poor health at D's death she may have an actual life expectancy that is shorter than those assumed in the tables promulgated under IRC § 7520. Nevertheless, the tables can be used unless S was suffering from a known incurable illness or deteriorating condition and the probability that S would survive D for more than a year is less than fifty percent. Treas. Regs. § 20.7520-3(b)(3). See also Rev. Rul. 96-3, 1996-2 I.R.B. 14 revoking Rev. Rul. 80-80, 1980-1 C.B. 194.

Third question – The Service contends and most courts agree that the credit is unavailable where the transferor and the decedent die simultaneously. See Estate of Carter v. U.S., 921 F.2d 63 (5th Cir. 1991); Estate of Lion v. Comm., 438 F.2d 56 (4th Cir. 1971). Accord, Rev. Rul. 66-307, 1966-2 C.B. 429. See also Prop. Regs. § 20.7520-3(b)(4), Example 1.

Ex-67. **First question –** Yes. Because a hypothetical seller could not force the other owner to sell, the value of the land in the QTIP may reflect an undivided interest discount. Estate of Eleanor O. Pillsbury, 64 TCM 284 (1992). Accord Baird Estate v. Comm., T.C. Memo 2001-258 (Sept. 28, 2001); Forbes Estate v. Comm., T.C. Memo 2001-72 (Mar. 23, 2001). But see TAM 9336002.

Second question – Not according to the Fifth Circuit and the Tax Court. In an important decision for taxpayers, the Fifth Circuit rejected the position of the Service – that blocks of stock included in the decedent's gross estate under different sections are to be aggregated for discount purposes – when one of the inclusionary sections is IRC § 2044. More recently, in a decision acquiesced in by the Service, Tax Court agreed with the Fifth Circuit. See Estate of Bonner v. U.S., 84 F.3d 196 (5th Cir. 1996); Estate of Mellinger v. Comm., 112 T.C. 24 (1999), acq., 1999-35 I.R.B. 314. But see TAM 9608001; TAM 9550002; TAM 9403002.

Ex-68. **Answer –** It depends. According to the Tax Court, the Fifth Circuit and, most recently, the Sixth Circuit, the payments must be valued under IRC § 7520 as a right to a 15 year annuity. See Gribauskas Estate v. Comm., 116 T.C. 142 (2001); Accord, Cook Estate v. Comm., 349 F.3d 851 (5th Cir 2003), *aff'g* T.C. Memo 2001-170 (2001) Negron v. U.S., 553 F.3d 1013 (6th Cir 2009), r*ev'g 502 F. Supp. 682 (N.D. Ohio 2007)* . See also, Davis v. U.S., 2006 WL 213761, 97 AFTR2d 2006-824 (D.N.H. 2006). The Second and Ninth Circuits, however, have held that the actuarial tables used to value annuities do not accurately reflect the value of the lottery payments because of the right to the payments was not assignable as a matter of state law. Accordingly, a discount for lack of marketability should be permitted. Gribauskas Estate v. Comm., 342 F.3d 85 (2003); Shackleford Estate v. Comm., 262 F.3d 1028 (9th Cir. 2001). Accord Davis v. U.S., 2005 WL 346484 (D.N.H. 1005), corrected on reconsideration, 2006 WL 213761.

Ex-69. **Answer –** No. Use of the alternate valuation method does not result in additional property interests being included in the gross estate. Thus, income that accrues after death but before the alternate valuation period expires is not included in the gross estate unless it represents otherwise included property in a different form. Treas. Regs. § 20.2032-1(d). See e.g. Estate of Johnston v. U.S., 779 F.2d 1123 (5th Cir.) cert. denied, 477 U.S. 904 (1986) (oil and gas royalties included).

Ex-70. **Answer –** Maybe. See Estate of Hoover v. Comm., 69 F.2d 1044 (10th Cir. 1995), rev'g 102 T.C. 777 (1994).

Ex-71. **Answer –** Not any longer. IRC § 2001(f) (enacted as part of the 1997 TRA) provides that the value of a gift for purposes of calculating the estate tax is its value as finally determined under the gift tax if the time for assessing a gift tax with respect to the property has expired and the value of the gift is disclosed adequately, either on the gift tax return or on a statement attached to the return. See also

Treas. Regs. § 20.2001-1(a) and (c). For guidance on what constitutes adequate disclosure, see Treas. Regs. § 301.6501(c)-1(f).

This rule applies, of course, only for purposes of determining adjusted taxable gifts. If does not apply to the valuation of a gift that is included in the decedent's gross estate. On the question of what constitutes adequate disclosure, see Treas. Regs. § 20.2001-1.

Comment: For decedent's dying after August 5, 1997 (the date of enactment of the 1997 TRA), new IRC § 7477 gives the Tax Court authority to make a declaration of the value of any gift disclosed on a gift tax return or on a statement attached to such return.

Caution: The answer to this example was different prior to the 1997 TRA. Under prior law, although IRC § 2504(c) prevented the Service from revaluing the gift for purposes of the gift tax, it did not prevent revaluation for purposes of determining adjusted taxable gifts. If the gift was revalued, however, the subtraction for gift taxes payable provided in IRC § 2001(b)(2) had to reflect the changed value. See Evanson v. U.S., 30 F.3d 960 (8th Cir. 1994); Levin v. Comm., 986 F.2d 91 (4th Cir., 1993); Estate of Inez T. Robinson, 101 T.C. 499 (1993); Estate of Frederick R. Smith, 94 T.C. 872 (1990).

Ex-72. **First question –** It depends. If the asset has appreciated, this would be a bad idea because, although only half of the community property is taxed to D at death, both halves receive an adjustment to basis. IRC § 1014(b)(6). But if the property has depreciated, the adjustment would not be desired and it would therefore be better to avoid it by converting title to a tenancy in common or a joint tenancy.

Second question – No. If D and W had converted their title to a tenancy in common, a joint tenancy, or a tenancy by the entirety, only D's one-half of the property would receive a basis adjustment at death.

Ex-73. **Answer –** Except to the extent of the decedent's nondeductible contributions, the lumpsum distribution is fully taxable as IRD. Rev. Rul. 92-47, 1992-1 C.B. 198. However, current tax exposure can be avoided if the beneficiary is T's spouse and the spouse rolls the distribution over into another IRA.

IV. USING THE MARITAL DEDUCTION

A. INTRODUCTION

Subject to the limitations of the nondeductible terminable interest rule and certain restrictions on testamentary transfers to noncitizen spouses, bequests and nonprobate transfers to a surviving spouse are deductible in reaching the taxable estate.

- The measure of the deduction is the fair market value of the property included in the decedent's gross estate and passing to the surviving spouse.[251]
- If an interest passes to the surviving spouse subject to an indebtedness, only the net value is deductible.[252]
- The same is true if the spouse must contribute to any state or federal death taxes payable by reason of the decedent's death.[253]

B. QUALIFICATION REQUIREMENTS

The underlying concept of the marital deduction is that property deductible in the estate of the first spouse becomes taxable in the estate of the survivor. In this way, the marital deduction allows deferral but not avoidance of tax responsibility.

This policy underlies the nondeductible terminable interest (NDTI) rule and its various exceptions.

Nondeductible terminable interest rule: Subject to the exceptions below, the NDTI rule states that no terminable interest given to a surviving spouse is deductible if another interest in the property passes (or has passed) from the decedent for less than full consideration to someone other than the spouse or the spouse's estate which entitles that other person to possession or enjoyment of the property after the spouse's interest terminates. For this purpose, terminable interest means an interest that will terminate on the happening of some contingency or event (or on the failure of some contingency or event).[254]

> ***Ex-74:*** D leaves property in trust to accumulate income for the life of W and at her death to distribute income and principal to W's estate. Does this trust qualify for the marital deduction? *Answers to the examples in this chapter begin on page 110.*

1. Survivorship conditions

A marital deduction is permitted for gifts to a surviving spouse that are conditioned on the spouse surviving the decedent for a stated period not to exceed six months,[255] provided the spouse does in fact survive to take the property.[256]

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[251] See IRC § 2056(b)(4).

[252] IRC § 2056(b)(4)(B).

[253] See IRC § 2056(b)(4)(A).

[254] IRC § 2056(b)(1). For the similar gift tax provision, see IRC § 2523(b).

[255] The exception also applies to gifts contingent on the spouse not dying from a common disaster. However, such clauses are not recommended. They may raise difficult questions of fact which may ultimately jeopardize the marital deduction. See Treas. Regs. § 20.2056(b)-3(c).

2. Power of appointment trust

A gift in trust qualifies for the marital deduction if, as to the trust (or some fractional or percentage portion of it),[257] the spouse has

a) the right to income for life payable at least as often as annually[258] and

b) an inter vivos or testamentary (the usual case) general power to appoint the trust property which power is exercisable alone and in all events.

Additionally, no one except the spouse may have the power to appoint the trust property away from the spouse.[259]

3. Qualified terminable interest property (QTIP)

A transfer in trust qualifies for the marital deduction if, as to the trust (or some fractional or percentage portion of it):

a) the trust income is distributable to the spouse[260] for life payable at least as often as annually, [261]

b) during the spouse's life, no one (including the spouse) has the power to distribute any trust property to anyone other than the spouse,[262] and

c) the decedent's personal representative[263] makes an election[264] to have the QTIP trust (or some portion of it) qualify for the marital deduction.[265]

Compliance with these requirements results in a marital deduction for the first spouse[266] and inclusion of the marital gift in the estate of the surviving spouse.[267]

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256 IRC § 2056(b)(3).

257 See Treas. Regs. § 20.2056(b)-7.

258 A facility of payment clause making the income payable to or for the benefit of a legally disabled spouse satisfies this requirement. Rev. Rul. 85-35, 1985-1 C.B. 328 (1985).

259 IRC § 2056(b)(5). Accord IRC § 2523(e) (gift tax marital deduction).

260 A facility of payment clause making the income payable to or for the benefit of a legally disabled spouse satisfies this requirement. Rev. Rul. 85-35, 1985-1 C.B. 328 (1985).

261 Income accrueed in the trust at the time of the surviving spouse's death need not be distributed to the spouse's estate. It may be distributed to other beneficiaries, instead. Treas. Regs. § 20.2056(b)-7(d)(4).

262 See Estate of John D. Manscill, 98 T.C. 413 (1992) (Trust did not qualify as QTIP where trustee (with the consent of the spouse) could distribute for the support of the decedent's daughter.). But see TAM 8943005 (The prohibition against the spouse having a power of appointment is there to insure that the spouse cannot appoint QTIP property without being subject to the gift tax. Accordingly, the prohibition does not apply to a general power of appointment.).

263 The personal representative must make the election even with respect to property not within the personal representative's possession or control. If there is no personal representative, the election may be made by the person in actual or constructive possession of the QTIP property. Treas. Regs. § 20.2056(b)-7(b)(3).

264 A protective election may be made if at the time the return is filed there is a bona fide issue relating to what property is includible in the gross estate or the amount or nature of the property the surviving spouse is entitled to receive. Treas. Regs. § 20.2056(b)-7(c).

265 For inter vivos gifts, the QTIP election must be made on a timely filed gift tax return, including extensions. IRC § 2523(f)(4)(A). For purposes of the estate tax, the election may be made on a late filed estate tax return provided it is the first return filed. TAM 8418005. It may not, however, be made on an amended return filed after the due date of the initial return. PLR 8746004.

On new form 706, the QTIP election is automatically made by taking the marital deduction unless the decision is made to affirmatively elect out.

266 IRC § 2056(b)(7). Accord IRC § 2523(f) (gift tax marital deduction). For decedents dying after 1981, a transfer of an interest in a joint-and-survivor annuity under which only the spouse has the right to any payments before the death of the last, qualifies for the marital deduction as a QTIP. Under the Revenue Reconciliation Act, this rule is limited to annuities that were included in the decedent's gross estate under IRC § 2039. See IRC § 2056(b)(7)(B)(ii) and. Treas. Regs. § 20.2056(b)-7(e) and (f).

267 IRC § 2044.

Ex-75: The terms of D’s QTIP trust provide for quarterly income distributions to W and that any accrued income at her death is to be distributed to D’s children. Does this trust qualify for the marital deduction?

Ex-76: At his death, T’s will divides her estate into two shares. One share equal to the estate tax applicable exclusion amount (currently $5,430,000) is placed in a discretionary trust for the benefit of T's husband, H and their kids. The balance of the estate is left to a QTIP eligible trust. The QTIP trust provides that to the extent T's executor does not make the QTIP election, the property in the QTIP trust is to pass instead to the discretionary trust.

1. Assuming the personal representative does in fact make the QTIP election with respect to half of the QTIP trust, will that portion qualify for the marital deduction?

COMMENT
Even though the gift in this example qualifies for the marital deduction, it will preclude use of the credit for previously taxed property as an effective post-mortem planning tool.

2. Would you recommend that T name her husband H as executor?

3. Suppose instead, that pursuant to an authority granted in the governing instrument, the trustee of T’s QTIP trust divided the trust into two equal shares prior to making the QTIP election. Each share was held in a separate trust with terms identical to those of the initial trust before the division. If the QTIP election is made with respect to one of the shares and not the other, will the share for which the election is made qualify for the marital deduction?

Ex-77: D leaves property in trust giving Spouse the right to income for life with remainder to daughter from a prior marriage. Applicable state law gives trustees the power to make equitable adjustments between income and principal to achieve an equitable apportionment between the income and remainder beneficiaries of the total return of the trust.

1. Will this trust qualify for the marital deduction?

2. Suppose instead that the trust provided that instead of the right to income, W had the right to a unitrust payment payable out of income or principal equal to 4 percent of the value of the trust determined annually. Will the trust qualify for the marital deduction?

Ex-78: At D's death, her IRA benefits are paid to a testamentary QTIP trust for the benefit of her U.S. citizen spouse, H. Will the IRA benefits payable to the trust qualify for the marital deduction?

Ex-79: D leaves property in trust giving Spouse the right to income for life with remainder to daughter from a prior marriage. After D's death, Spouse and Daughter enter into a court approved settlement agreement under which they waive their respective rights in the trust and split the trust property equally. Will the property passing to Spouse as a result of the agreement qualify for the marital deduction?

a) Special rule for survivor annuities

Where the decedent's gross estate includes an annuity under IRC § 2039, a surviving spouse's right to receive payments under the annuity is deemed to be a deductible QTIP interest provided:

- only the surviving spouse has the right to receive payments under the contract during the spouse's life; and
- the decedent's executor does not make a contrary election on the decedent's estate tax return.[268]

Ex-80: D transfers property to a 10-year GRAT with the remainder passing to child C at the expiration of the GRAT term. The GRAT provides that if D dies before the 10-year period is over, the remaining payments are to be made to D's spouse S. If D dies four years after the GRAT is created, will the GRAT qualify for the marital deduction in D's estate?

COMMENT
The problem illustrated in the question above, should be eliminated if S is given a contingent remainder in the GRAT in the event that D dies during the term. In that event, a devise of the remaining GRAT payments to S should qualify for the marital deduction because no one other than S or S's estate would have an interest that takes upon the termination of S's interest in the GRAT. It may also be possible for the two interests (the remainder and the remaining payments) to pass to a QTIP trust for S,

[268] IRC § 2056(b)(7)(C). In the case of an annuity interest arising under the community property laws of any state, the 1997 TRA applies this provision to annuities includible in the decedent's gross estate under IRC § 2033. Effective for decedent's dying after August 5, 1997 (the date of enactment of the Act), this change will allow a marital deduction with respect to a nonparticipant spouse's interest in an annuity attributable to community property laws where the participant spouse is the survivor.

4. Charitable remainder trusts

A marital deduction is permitted for a gift in trust where the surviving spouse is the only noncharitable beneficiary of a qualifying charitable remainder annuity or unitrust.[269]

COMMENTS
This type of marital trust differs from a QTIP trust in several respects, including: 1. Only the income interest of the spouse qualifies for the marital deduction; the remainder is deductible as a charitable deduction;[270] 2. The income interest of the spouse need not be for life; it may be for a term of years (not to exceed 20);[271] and 3. IRC § 2044 does not apply to this type of trust;[272] accordingly, only the value of the remaining term of the income interest (if any) can be included in the spouse's gross estate.

C. MARITAL GIFTS TO NONCITIZEN SPOUSES

In general, the Code denies the marital deduction for bequests to a spouse who is not a citizen of the United States unless the bequest passes (or is treated as having passed) from the decedent to a qualified domestic trust (QDOT).[273]

1. QDOT requirements

A QDOT is an ordinary trust[274] that is maintained and administered under the laws of a state of the United States or the District of Columbia and the administration of which is governed by that particular state, etc.[275] The trust must satisfy the requirements generally applicable to the marital deduction. That is, it must comply with the nondeductible

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269 IRC § 2056(b)(8). Accord IRC § 2523(g) (gift tax marital deduction).

270 Treas. Regs. § 20.2056(b)-8(a)(1).

271 Treas. Regs. § 20.2056(b)-8(a)(2).

272 IRC § 2044 applies only to QTIP property. A QTIP election may not be made for a trust described in IRC § 2066(b)(8). Treas. Regs. § 20.2067(b)-8(a)(1).

273 IRC § 2056(d). A QDOT is not necessary if the spouse becomes a citizen before the estate tax return is filed and the spouse was a resident at all times after the decedent's death and before the filing of the return. IRC § 2056(d)(4); Treas. Regs. § 20.2056A-1(b). In addition, if the decedent is not a U.S. citizen or resident but the U.S. has a treaty with the decedent's country of nationality under which some form of marital deduction is allowed, the decedent's estate may elect to take advantage of either the treaty or the QDOT provisions. Treas. Regs. § 20.2056A-1(c).

274 The meaning of ordinary trust is the same as that found in Treas. Regs. § 301.7701-4(a) except that a trust will not fail to be an ordinary trust solely because of the nature of the assets transferred to it. Accordingly, a trust that may be classified as an association for other purposes is a trust for this purpose.

IRC § 2056A(c)(3), added by the 1997 TRA, gives the Secretary regulatory authority to include within the meaning of "trust" for purposes of the QDOT rules "other arrangements which have substantially the same effect as a trust." The provision applies to decedents dying after August 5, 1997 (the date of enactment of the 1997 TRA). With respect to this change, the Joint Conference Committee Report states:

> It is anticipated that such regulations, if any, would only permit a marital deduction with respect to non-trust arrangements under which the U.S. would retain jurisdiction and adequate security to impose U.S. transfer tax on transfers by the surviving spouse of the property transferred by the decedent. Possible arrangements could include the adoption of a bilateral treaty that provides for the collection of U.S. transfer tax from the noncitizen surviving spouse or a closing agreement process under which the surviving spouse waives treaty benefits, allows the U.S. to retain taxing jurisdiction and provides adequate security with respect to such transfer taxes.

275 A QDOT may be established under the laws of any jurisdiction provided the instrument contains an effective choice of law clause designating the law of a particular state or the District of Columbia as the law governing the administration of the trust and further provided the trust is maintained in that state, etc. A trust is maintained in a state, etc., if its records (or copies of its records) are kept there. Treas. Regs. § 20.2056A-2(a).

terminable interest rule.[276] In addition, the trust must meet a number of other statutory and regulatory requirements.[277]

a) United States trustee

At least one U.S. citizen or domestic corporation[278] must serve as trustee[279] and the trust instrument must provide that no distribution (other than a distribution of income) may be made unless the U.S. trustee has the right to withhold the QDOT tax imposed on the distribution.[280]

b) Security and other provisions

To insure that the QDOT-tax will be collectible, the regulations impose security and other requirements on QDOT trusts.[281]

COMMENT
Although the regulations detail a number of governing instrument requirements, the instrument need not include the detailed provisions. It is sufficient that the instrument refer to the regulatory requirements.[282]

(1) Trusts Exceeding Two Million Dollars

If the date of death value of property in the QDOT exceeds 2 million dollars, the trust instrument must require[283] either that:

- at least one U.S. trustee be a bank; or
- at least one trustee be a U.S. branch of a foreign bank who serves with a U.S. co-trustee; or

276 Treas. Regs. § 20.2056A-2(b)(1). In addition, all assets of a QDOT must be property qualifying for the marital deduction. Treas. Regs. § 20.2056A-4(b). But see Treas. Regs. § 20.2056A-4(b)(1) (a QDOT need not meet the requirements of a marital deduction trust if the QDOT is funded solely by contributions from the surviving spouse.)

277 See generally Treas.. Regs. § 20.2056A-2(d). Even if a trust meets all other requirements, it will lose its status as a QDOT if it utilizes any device or arrangement a principal purpose of which is to avoid or prevent collection of the QDOT tax. Treas. Regs. § 20.2056A-2(d)(1)(v).

278 A domestic corporation is a corporation that is created or organized under the laws of the United States or under the laws of any state or the District of Columbia. Treas. Regs. § 20.2056A-2(c).

279 IRC § 2056A(a)(1)(A). An individual serving as the U.S. Trustee must have a tax home in the United States. Treas. Regs. § 20.2056A-2(d)(2). For the meaning of tax home, see IRC § 911(d)(3).

280 IRC § 2056A(a)(1)(B). This provision will not jeopardize the marital deduction for failing to meet the requirements of IRC § 2056(b)(5) or (6). IRC § 2056A(b)(14).

Under the 1997 TRA, A trust executed before the date of enactment of the Revenue Reconciliation Act of 1990 is deemed to meet the withholding requirement if the instrument requires that all trustees be individual citizens of the United States or domestic corporations. Moreover, because some countries do not permit U.S. trustees, the 1997 TRA gives the Treasury department regulatory authority to waive the requirement of a U.S. trustee and to provide an alternative mechanism under which the U.S. would retain jurisdiction and adequate security to impose the deferred estate tax on transfers by the surviving spouse.

281 Final regulations dealing with this area were promulgated and published in November of 1996. T.D. 8686, 61 Fed. Reg. 60551 (Nov. 1996). These regulations replace temporary and proposed regulations on the subject. See Temp. Regs. § 20.2056A-2T(d) and Prop. Regs. § 20.2056A-2(d). These provisions were promulgated under the specific statutory authority of IRC § 2056A(a)(2). The temporary regulations are effective for estates of decedents dying after February 19, 1996. Temp. Regs. § 20.2056A-2T(d)(6)(i). But see Temp. Regs. § 20.2056A-2T(d)(6)(ii) (special rule for wills and revocable trusts of persons who were incompetent on November 20, 1995) and Temp. Regs. § 20.2056A-2T(d)(6)(iii) (special rule for certain irrevocable and unamendable trusts executed before November 20, 1995.)

282 Treas. Regs. § 20.2056A-2(d)(1)(i). For sample language meeting the incorporation requirement of the regulations, see Rev. Proc. 96-54, 1996-50 I.R.B. 28.

283 At least one of these security arrangements must be in effect at all times, although the trust instrument may authorize the trustee to use different arrangements from time to time. Treas. Regs. § 20.2056A-2(d)(1)(i).

- that the U.S. trustee furnish a bond[284] or letter of credit[285] equal to 65 percent of the fair market value of the corpus of the QDOT.[286]

(2) Trusts of Two Million Dollars or Less

In lieu of a qualifying bond or letter of credit, a QDOT with 2 million or less in property may require that no more than 35 percent of the value of trust assets, determined annually on the last day of the taxable year, may consist of real property located outside the United States.[287]

COMMENT
The two million dollar threshold is determined on the basis of values as finally determined[288] for estate tax purposes and unreduced by any debt.[289] For the purpose of determining whether the QDOT exceeds this threshold, the personal representative may elect to exclude up to $600,000 of real property (wherever situated) attributable to a personal residence.[290] A similar but separate election is available for the purpose of determining the amount of the required bond.[291] Neither exclusion applies for the purpose of determining whether more than 35 percent of the QDOT assets consist of foreign real property.[292]

CAUTION
In the absence of a good faith reasonable cause, the marital deduction for property left to a QDOT will be disallowed if the assets in the QDOT are undervalued by 50 percent or more.[293]

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284 The detailed requirements for the bond and a sample form may be found in Treas. Regs. §§ 20.2056A-2(d)(1)(i)(B)(1) - (4).

285 The requirements for the letter of credit and a sample form are found in Treas. Regs. §§ 20.2056A-2(d)(1)(i)(C)(1) - (5).

286 The bond or letter of credit must remain in effect until the trust ceases to function as a QDOT and any tax due under IRC § 2056A(b) is paid or is finally determined to be zero. Treas. Regs. § 20.2056A-2(d)(1)(i)(B) and (C). In addition, a notice of a failure to renew the bond or letter of credit must be mailed to the IRS and the QDOT's U.S. trustee at least 60 days prior to the expiration of the term of the bond or letter of credit. Treas. Regs. § 20.2056A-2(d)(i)(B)(1) and (C)(1).

287 Treas. Regs. § 20.2056A-2(d)(1)(ii). If the 35 percent test is flunked because of principal distributions or because in fluctuations in currency values or the value of the trust property in general, the trustee has a one-year grace period in which to bring the trust back into compliance. Treas. Regs. § 20.2056A-2(d)(1)(ii).

288 On the meaning of "finally determined" for this purpose, see Treas. Regs. § 20.2056A-2(d)(1)(iii).

289 Treas. Regs. §§ 20.2056A-2(d)(1)(i); 20.2056A-2T(d)(1)(ii). If there is more than one QDOT, the value of all trusts are aggregated in determining whether the 2 million dollar threshold is exceeded. Treas. Regs. § 20.2056A-2(d)(1)(ii)(A). Additionally, all assets owned by a corporation with 15 or fewer shareholders or a partnership with 15 or fewer partners, are deemed to be owned directly by the QDOT to the extent of its prorata share of ownership. These rules apply with respect to a corporation only if the QDOT owns more than 20 percent of the voting stock or value in the corporation and with respect to a partnership only if the QDOT owns more than 20 percent of the capital interest in the partnership. For the purpose of determining the number of shareholders or partners, and for the purpose of determining the QDOT's voting or value interest in a corporation or the QDOT's capital interest in a partnership, stock or partnership interests owned by the surviving spouse or any member of the spouse's family within the meaning of IRC § 267(c)(4) is attributed to the QDOT. Treas. Regs. § 20.2056A-2(d)(1)(ii)(B). QDOT interests in other entities such as a trust are accorded similar treatment. Treas. Regs. § 20.2056A-2(d)(1)(ii)(C).

290 Treas. Regs. § 20.2056A-2(d)(1)(iv)(A).

291 Treas. Regs. § 20.2056A-2(d)(1)(iv)(B). In both cases, the exclusion applies to a principal residence (including reasonably appropriate adjacent land and related furnishings) as detailed in IRC § 1034 or one other residence of the surviving spouse. In either case, the residence must be available at all times for use by the spouse and may not be rented to another party. See Treas. Regs. §§ 20.2056A-2(d)(1)(iv)(D) and (E). Additionally, the exclusions cease to apply if the spouse ceases to use the residence as a principal residence or if the QDOT sells the house and fails to reinvest the proceeds in a new personal residence within the time limits and under the general principles found in IRC § 1034(b)(1). Treas. Regs. § 20.2056A-2(d)(1)(iv)(G).

292 Treas. Regs. § 20.2056A-2(d)(1)(iv)(C).

293 Treas. Regs. § 20.2056A-2(d)(1)(i)(D).

c) QDOT election

An election to treat a trust as a QDOT must be made.[294] The election must be made as to the entire trust; partial elections are not permitted.[295]

COMMENT
The prohibition against partial elections may be circumvented by splitting a trust before the election is made.[296]

d) Annual statement of continued compliance

The U.S. trustee of a QDOT must file an annual statement showing continued compliance with the QDOT eligibility requirements.[297]

2. Reformation of noncomplying marital trusts

A trust that does not meet the QDOT requirements but does meet all other requirements for a marital deduction trust may be reformed to comply with the QDOT requirements either in accordance with the terms of the governing instrument permitting such reformation or pursuant to a judicial proceeding.

The reformation must be commenced before the due date of the decedent's estate tax return (including extensions actually granted).[298]

3. Nonprobate assets

Property passing to the surviving spouse by devise, operation of law or pursuant to an annuity or other similar arrangement can qualify for the marital deduction if the spouse transfers or irrevocably assigns it to a QDOT before the due date of the decedent's estate tax return and within the time for which a QDOT election may be made.[299]

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294 The election may be made on a late filed return provided it is the first return. However, no QDOT election may be made on a return filed more than one year after the due date of the return, including extensions. IRC § 2056A(d); Treas. Regs. § 20.2056A-3(a).

A protective election may be made if there is a bona fide controversy at the time the estate tax return is filed as to the residency or citizenship of the surviving spouse, whether an asset is includible in the decedent’s gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. The protective election may be defined by means of a formula. Once made, it is irrevocable. Treas. Regs. § 20.2056A-3(c).

295 The prohibition against partial elections may be circumvented by splitting a trust before the election is made. Treas. Regs. § 20.2056A-3(b).

296 Treas. Regs. § 20.2056A-3(b). On the authority of a trustee to split a trust in Florida, see Fla. Stat. § 736.0417 (2015).

297 The reporting requirement and the contents of the required annual statement are set out in Treas. Regs. § 20.2056A-2(d)(3). See also Treas. Regs. § 20.2056A-2(d)(1)(iv)(F).

298 IRC § 2056(d)(5); Treas. Regs. § 20.2056A-4(a). An example of a provision authorizing reformation by a trustee may be found in Covey, Practical Drafting, Trust & Will Provisions 47 (1990).

Prior to the completion of a judicial reformation, the QDOT trustee is responsible for filing Form 706-QDT and for paying any IRC § 2056A estate tax that becomes due. The trustee must also comply with the annual statement requirements of Treas. Regs. § 20.2056A-2(d)(3). See Treas. Regs. § 20.2056A-4(a)(2).

299 IRC § 2056(d)(2)(B); Treas. Regs. §§ 20.2056A-2(b)(2); 20.2056A-4(b)(1). The transfer or assignment may be made by the surviving spouse, the spouse’s guardian or attorney in fact or the personal representative of the spouse’s estate. The QDOT need not meet the requirements of a marital deduction trust provided that no other property is transferred to the trust. Treas. Regs. § 20.2056A-4(b)(1).

Property irrevocably assigned but not transferred to the QDOT before the estate tax return is filed must be conveyed to the QDOT before the administration of the decedent's estate is completed. By request for a private latter ruling, the personal representative may request an extension of the time for transferring the property to the QDOT or a waiver of the actual conveyance under the circumstances and conditions set out in Treas. Regs. § 301.9100-1(a). Treas. Regs. § 20.2056A-4(b)(6).

COMMENT
The decedent need not have created the QDOT. It may be created by D's personal representative or even the surviving spouse.[300]

The transfer or assignment must be in writing and otherwise effective under local law. It must consist only of assets included in the decedent's gross estate and passing from the decedent to the spouse or from the proceeds of sale, exchange or conversion of such property. It may be of specific assets (or a fractional share of specific assets).

Alternatively, the transfer or assignment may be of a pecuniary amount provided the transfer of assignment specifies that:

- the property used to satisfy the amount have an aggregate value on the date of transfer of no less than the pecuniary amount or
- that the assets transferred be fairly representative of the appreciation or depreciation in the value of all property available for that purpose.[301]

CAUTION

When a surviving spouse transfers property to a QDOT, the property is treated as passing from the decedent to the QDOT solely for purposes of the marital deduction. In all other respects, the spouse is considered the transferor of the property.[302] If the remainder of the QDOT passes in designated shares, the transfer by the spouse could give rise to a taxable gift.[303]

- This risk would be avoided if the spouse is given a special testamentary power over the QDOT.
- Alternatively, with appropriate planning, the spouse could use a disclaimer to get the property into the QDOT.

4. Qualification of nonassignable annuities

Annuities and similar arrangements that are nonassignable under state, Federal or foreign law or under the terms of the annuity arrangement itself, may not be assigned to a QDOT.

Nevertheless, a decedent's personal representative may elect to deduct such an annuity payable to a surviving noncitizen spouse, but only if the spouse agrees:

a) to pay the deferred estate tax due on the corpus portion of each payment or

b) to "rollover" the corpus portion of each payment into a QDOT that is established for that purpose prior to the due date of the decedent's return.[304]

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300 Treas. Regs. § 20.2056A-2(b)(2).

301 See generally Treas. Regs. §§ 20.2056A-4(b)(1) - (4).

A protective assignment may be made if there is a bona fide controversy at the time the estate tax return is filed as to the extent to which property passing to the surviving spouse is includible in the decedent's gross estate. The protective assignment may be expressed as a formula. Once made, it is irrevocable. Treas. Regs. § 20.2056A-4(b)(8).

302 Treas. Regs. § 20.2056A-4(b)(5).

303 If so, the gift is valued without taking into account the special valuation rules of IRC § 2702. See Treas. Regs. § 25.2702-1(c)(8).

304 See Treas. Regs. § 20.2056A-4(c) for definitions and other technical requirements relating to the deduction for nonassignable annuities. See also Treas. Regs. § 20.2056A-4(b)(7) under which the surviving souse is given an election to treat individual retirement accounts described in IRC § 408(a) as nonassignable for purposes of this rule.

5. Tax consequences of a QDOT

In return for the marital deduction for property left to the noncitizen spouse in a QDOT, IRC § 2056A(b)(1) imposes a deferred estate tax (hereinafter the QDOT tax) on the balance of property remaining in the QDOT at the death of the surviving spouse. Each QDOT trustee is personally liable for the tax.[305]

With some exceptions, the QDOT tax is also applied to distributions[306] to the spouse during life and to the entire QDOT if it ceases to meet the eligibility requirements.

The exceptions apply to:

- distributions of income,[307]
- corpus distributions made on account of hardship,[308]
- distributions to reimburse the spouse for income taxes paid on undistributed trust income,[309] and
- distributions which occur after the trust ceases to be a QDOT.[310]

COMMENT
Regs. § 20.2056A-5(c)(2)[311] provides that distributions to the surviving spouse as the income beneficiary of a QDOT in conformance with state law that defines income as a unitrust amount or which permits the trustee to make equitable adjustments between principal and income to fulfill the trustee's duty of impartiality will be considered income for this purpose as well.

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305 IRC §§ 2056A(b)(1)(B); 2056A(b)(6). On the calculation of the tax, see generally IRC § 2056A(b)(1) and Treas. Regs. § 20.2056A-6.

New form 706-QDT is used to report distributions from a QDOT, the death of the QDOT spouse and any failure to comply with QDOT requirements. IRS Announcement 91-58, 1991-15 I.R.B. 39 (April 1991). The form is also required to report a distribution on account of hardship even though the distribution is exempt from tax. Treas. Regs. § 20.2056A-5(c)(1).

306 IRC § 2056A(b)(1)(A). When a spouse receives an in kind distribution from a QDOT, the spouse takes the basis of the QDOT increased (but not above FMV) by any QDOT tax attributable to appreciation in the value of the property after the decedent's death. IRC § 2056A(b)(13); Treas. Regs. § 1.1015-5(c)(4).

Distributions to pay for ordinary and necessary trust expenses, distributions to governmental authorities to pay taxes, and dispositions of trust assets for full and adequate consideration in money or money's worth are not distributions to the spouse and therefore do not invoke the QDOT estate tax. See Treas. Regs. §§ 20.2056A-5(c)(3)(i) - (iii).

307 IRC § 2056A(b)(3)(A). See also Treas. Regs. § 20.2056A-5(c)(2). Income for this purpose is defined generally to be trust accounting income under IRC § 643(b) except that it does not include:

- Capital gains and other items that would be allocated to corpus under local law in the absence of a provision in the trust instrument to the contrary; or
- Items of income in respect of a decedent.

But see Treas. Regs. § 20.2056A-5(c)(2) for a special rule applicable when pension, profit sharing, or individual retirement accounts or annuities are payable to a QDOT.

308 IRC § 2056A(b)(3)(B). See also Treas. Regs. § 20.2056A-5(c)(1). A distribution is made on account of hardship if it is in response to an immediate and substantial financial need relating to the spouse's (or a person the spouse is legally obligated to support) health maintenance or support alternative sources for which are not reasonably available to the spouse. In this respect, assets such as closely held business interests, real estate and tangible personal property are not "reasonably" available to meet the spouse's needs. Treas. Regs. § 20.2056A-5(c)(1).

309 IRC § 2056A(b)(15); Treas. Regs. § 20.2056A-5(c)(3)(iv).

310 IRC § 2056A(b)(12). QDOT status ceases if the surviving spouse becomes a citizen before the decedent's estate tax return is filed, and either:

1. The spouse was a U.S. resident continuously from date of decedent's death to date spouse gains citizenship, or
2. The spouse elects to treat any prior distributions from the QDOT as a taxable gift made by the spouse and any of decedent's unified credit that was applied against those distributions as a use of the spouse's unified credit.

311 2001-16 I.R.B. 1082.

COMMENT
Since distributions of principal from a QDOT (except those on account of hardship) are subject to the QDOT tax, the decedent may want to include a liberal authority to make distributions from the credit shelter trust for the benefit of the spouse. Note, however, that such distributions would effectively waste the decedent's GST exemption to the extent it had been allocated to the credit shelter trust. Consequently, consideration should be given to making liberal use of the $147,000 annual exclusion to provide the spouse with sufficient assets on which to live during life. This would minimize the need for distributions from the credit shelter trust.

a) Calculation of the tax

In general, the QDOT tax is calculated as if the property involved in the taxable event (along with any property involved in a previous taxable event) had been included in the first spouse's gross estate.[312]

- Under rules detailed in the Code and regulations, the benefits of the first spouse's unified credit and the credits for state and foreign death taxes as well as the credit for tax on prior transfers are generally available in calculating the QDOT tax.[313]
- So too are the benefits of alternate valuation and special use valuation.

b) Credit for prior transfers at death of resident alien spouse

A resident alien is taxed at death on property held worldwide.[314] Thus, if an alien surviving spouse dies a resident of the United States, property held in a QDOT will be subject to both the QDOT tax and an estate tax. In such cases, the spouse is entitled to a credit for prior transfers under IRC § 2013. The credit is available without regard to the period of survival between the death of the decedent and the spouse.[315]

COMMENT
A similar situation occurs if the surviving spouse becomes a citizen before she dies. In that event, the surviving spouse is given a credit for the prior taxes without regard to the normal time limits set out in IRC § 2013.[316]

D. PLANNING FUNDAMENTALS

If the combined adjusted gross estates of both spouses is less than a single applicable exclusion amount and the situation is not likely to change during the lifetime of the estate plan under consideration, the estates of both spouses may be planned without regard to the marital deduction. Whatever plan is adopted, neither spouse will pay taxes at death.

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312 IRC § 2056A(b)(2). See generally, Treas. Regs. § 20.2056-6. In calculating the QDOT tax on distributions, the distribution is grossed-up so that a tax is paid on the tax itself. IRC § 2056A(b)(11).

Where the triggering event occurs before the first spouse's estate tax is finally determined, the highest rates in effect at that spouse's death are used to calculate a tentative tax and a refund (with interest) is available if that ultimately proves to be too high. See IRC § 2056A(b)(2)(B).

The highest estate tax rate is also applicable if there is more then one QDOT with respect to any single decedent. This rule can be avoided by having the decedent's executor designate one U.S. trustee as the "designated filer." IRC § 2056A(b)(2)(C); Treas. Regs. § 20.2056A-9.

313 See generally IRC § 2056A(b)(10) and Treas. Regs. §§ 20.2056A-6, Treas. Regs. § 20.2056A-7.

314 IRC § 2031.

315 IRC § 2056(d)(3). See Treas. Regs. § 20.2056A-7(a).

316 Treas. Regs. § 20.2056A-7.

If the combined adjusted gross estates of both spouses (after taking into account any insurance or other death benefits payable at the death of the first spouse) are more than the applicable exclusion amount of one spouse, all taxes at the death of the first spouse may be eliminated by leaving everything to the survivor. However, this could end up wasting the advantages of the first spouse's unified credit. A better result is achieved if the marital gift is reduced to the point necessary to allow for a credit shelter share of sufficient size to fully use the unified credit of the first spouse with any excess passing to a bypass trust for other family members and/or the surviving spouse

PORTABILITY

For decedents dying after 2010, some of this downside may be mitigated by the portability provisions of TRA 2010 which permit a decedent's personal representative to elect to transfer a decedent's unused applicable exclusion amount to the decedent's surviving spouse.[317]

The portability election is important, but mostly prophactically so. For a variety of reasons, a "portability" approach to planning is less advantageous than the traditional "bypass trust" planning explored below under which the non-marital share is settled in a bypass trust at the death of the first spouse. Advantages of using a bypass trust over the portability concept include:

- The first spouse's unused applicable exclusion is fixed at that spouse's death. It is not indexed for inflation;
- With a bypass trust, appreciation in the nonmarital share is excluded from the gross estate of the surviving spouse. With a transfer of the first spouse's unused applicable exclusion amount to the surviving spouse, it is not;
- Portability is restricted to the gift[318] and estate taxes; it does not apply to the GST tax;
- The potential benefits of portability could be lost if the surviving spouse remarries and the new spouse dies before the surviving spouse has used the first deceased spouse's unused exclusion.[319]

On the other hand, leaving everything to the surviving spouse and relying on the p;ortability concept is simpler and the surviving spouse gets a basis adjustment on all of the property at his or her death, not just on the marital share.

1. Marital trusts

Typically, the share of the estate that is intended to qualify for the marital deduction is made up of a combination of outright transfers (by will or in some nonprobate form such as right of survivorship property) and a transfer to one of the trusts (hereinafter the MARITAL TRUST) discussed previously that qualify for the marital deduction.

Of the various trust alternatives, the QTIP trust is the vehicle of choice for many decedents.[320] It offers the greatest flexibility in postmortem estate planning for gift, estate,

[317] See IRC § 2010(c), as amended by TRA 2010 § 303. The eletion must be made on a timely filed estate tax return. Notwithstanding any other statute of limitations, the IRS may examine the predeceased spouse's return at any time for the purpose of determining the amount of unused exclusion that is available to the surviving spouse. IRC § 2010(c)(5)(B), as amended by TRA 2010 § 303(a).

[318] On the implementation of portability under the gift tax, see IRC § 2505(a)(1), as amended by TRA 2010 § 303(b) under which the applicable credit amount for gift tax purposes is defined by reference to the applicable credit amount under IRC § 2010(c) that "would apply if the donor died as of the end of the calendar year [in which the givt is made] . . .."

[319] Only the most recently deceased spouse's unused exclusion may be used by a surviving spouse. The rules here, however, are quite generous. For example, assume a surviving spouse who dies after having remarried. The spouse has an unused exclusion of $2 million from her first spouse and a full $5 million exclusion of her own. If the spouse's taxable estate is $4 million, is the amount of her unused exclusion that may be transferred to her second spouse only $1 million or is it $3 million? The answer is the larger number. That is, any unused exclusion is used first to offse the spouse's taxable estate and the spouses applicable exclusion amount is used only when no nused exclusion is available.

[320] Caution should be exercised here. Consideration must also be given to state death taxes. Not all states allow a marital deduction for the full value of QTIP trusts.

and generation-skipping taxes[321] and with it, the decedent can retain control over the ultimate disposition of the marital gift at the death of the surviving spouse.[322]

a) Nonincome producing property

To insure qualification of nonincome producing property placed in a QTIP trust, the spouse should have the right to require the trustee to make the trust property productive.[323]

COMMENT
It is generally preferable to phrase this as a right to compel an investment strategy for the portfolio as a whole rather than a right to compel the conversion of underperforming assets.

b) Access to trust principal

(1) Trustee's discretion to distribute principal

It is often desirable to give the trustee of a QTIP trust the authority to distribute principal to the spouse in the event the income is insufficient to provide for the spouse's needs.

(a) If the spouse is to serve as trustee of the QTIP trust:

- The power to consume or invade principal must be limited by an ascertainable standard relating to health, support, maintenance or education. Otherwise it will constitute a general power of appointment and cause taxation of the trust property in the spouse's estate whether or not a QTIP election is made.
- Alternatively, the power can be conditioned on the making of the QTIP election, in which case its exercise should be restricted to the portion of the trust for which the election is actually made.

(b) If the spouse is not the trustee, the power may but need not be restricted by an ascertainable standard.[324]

(2) Powers to withdraw principal

As long as it is conditioned on the making of the QTIP election and restricted to the portion of the trust for which the election is actually made, the spouse can be given a power to withdraw the principal of a QTIP trust.

c) Testamentary power of appointment

(1) Special power

Where ultimate control over the marital gift is not an overriding objective, giving the surviving spouse a special testamentary power of appointment over QTIP

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321 Other trust alternatives are discussed in "*Qualification requirements*" on p. 94.

322 A QTIP trust has one disadvantage over a life estate/general power of appointment trust. In the latter, the spouse may be given a special power during life to appoint to other family members. In a QTIP trust this is not allowed. The spouse may, however, have a general power to appoint QTIP property. See TAM 8943005.

323 See generally, Treas. Regs. §§ 20.2056(b)-5(f); 20.2056(b)-7(d)(2).

324 In either case, the instrument should state whether the spouse's resources are to be taken into account in the exercise of the invasion or distribution power.

property will offer greater flexibility in the handling of GST transfers that may occur at the death of the surviving spouse.

CAUTION
The power must be a testamentary power. An inter vivos power would disqualify the trust for the marital deduction.

(2) General power

The spouse could also be given a general testamentary power to appoint the property that remains in the QTIP trust at his or her death. Such a power can be useful in planning for disclaimers. See "*Extending the QTIP disclaimer period*", infra p. 237. Here again, however, the power should be conditioned on the making of the QTIP election and extend only over the portion of the trust for which the election is actually made.

2. Credit shelter trusts

Property that is not intended to qualify for the marital deduction (i.e., the applicable exclusion amount) may be left outright or in trust to other beneficiaries.

- Frequently, however, the decedent will want the nonmarital share to be available for the surviving spouse if the marital share proves to be inadequate.
- In these instances, the nonmarital share may be left to a trust for the benefit of the surviving spouse. This trust (hereinafter the CREDIT SHELTER TRUST) must be carefully drafted to insure that the trust property is not taxed in the estate of the surviving spouse.

COMMENT

Such a trust may, but need not, give the surviving spouse:

- The right to income for life. More typically, the spouse is merely one of a number of permissible recipients of the trustee's discretionary authority to distribute income.
- The right to demand such distributions of trust principal as are reasonably needed for the spouse's health, support, maintenance, and education. More typically, however, distributions of principal are left to the discretion of the trustee. The trustee's discretion need not be limited to the above standards.
- A special power to appoint trust property to family members during life or at death.

Note: The existence of this latter power can complicate disclaimer planning.

E. FORMULA CLAUSES

At the drafting stage, it is impossible to predict with accuracy the exact size of the marital gift. Among other things, the deduction needed is a function of:

- The assets included in the gross estate;
- The method used to value them;
- Whether any of the decedent's unified credit has been used for inter vivos transfers; and
- How various tax elections (such as the election to take costs of administration on the estate's income tax return) are made.

Thus, marital/credit shelter plans are typically phrased in the form of formula gifts.

1. Types of formulas

There are three basic types

a) Pecuniary marital

Also known as a "pre-residuary marital", this is a gift of a specific sum to the marital trust with the residue passing to the credit shelter trust.

> "I leave my SPOUSE an amount which will produce the largest taxable estate as to which, when considering the applicable credit amount (unified credit), there will be no federal estate tax payable by reason of my death."

b) Pecuniary credit shelter

Also referred to as "residuary marital" this is a gift of a specific sum to the credit shelter trust with the residue passing to the marital trust.

> "I leave my CREDIT SHELTER TRUST an amount equal to the largest amount that can pass free of federal estate tax under this Article by reason of the applicable credit amount (unified credit)."

c) Fractional share

This type of formula divides the residue into fractional shares: one for the marital trust and one for the credit shelter trust.

> "I leave my SPOUSE that fractional share of my residuary estate which, when considering the applicable credit amount (unified credit), will result in there being no federal estate tax payable by reason of my death. The balance of my residuary estate I leave …"

2. Formula clauses compared

Importantly, the three formula types produce the same marital deduction for the estate of the decedent. They differ, however, in a number of other respects.

a) Distribution of estate/trust income on funding

Distributions in satisfaction of each type of formula gift carry out estate income (DNI). And this is true even though the preresiduary Marital and preresiduary Family share formulas involve gifts of a pecuniary amount.[325]

Since mid-1997,[326] however, the separate share rule of IRC § 663(c) applies to estates with beneficiaries who have substantially separate and independent shares. In this regard, Treas. Regs. § 1.663(c)-4 provides that formula testamentary pecuniary gifts, including those emanating from a revocable trust,[327] and including those whose amount is not fixed as of the date of death (e.g., formula marital gifts), will be treated as separate shares.[328]

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[325] The exclusion from the DNI rules for bequests of "a specific sum of money or specific property" found in IRC § 663(a)(1) does not apply to formula marital gifts because the amount produced by the formula is dependent on post death factors such as the amount of deductible funeral expenses and various post-death tax elections (e.g., the IRC § 2032A special use valuation election and the IRC § 642(g) election to take estate administration expenses as an income tax deduction instead of on the estate tax return).

[326] See Pub. L. 105-34, August 5, 1997.

[327] And whether or not an IRC § 645 election is made.

[328] Under the regulations, a formula pecuniary bequest is a separate share if it shares ratably in appreciation (or depreciation) and is entitled to income during administration. In addition, under a special rule, a formula pecuniary bequest that shares neither in income nor in appreciation (or depreciation) is still a separate share provided the governing instrument does not direct that it is to be paid or credited in more than three installments. Treas. Regs. § 1.663(c)-4(b). Less clear is the status of a pecuniary gift that does not share in income but does share in appreciation (or depreciation) as is the case of pecuniary gifts

- As such, the ability to burden a pecuniary Marital or Family share with the taxes on income earned on the residuary estate is eliminated.
- The pecuniary Marital or Family share will be allocated only the share of estate income and deductions that the share is entitled to (if any) under the terms of the governing instrument or local law.

COMMENT
The choice of formula type and the method used to fund the marital and family shares, however, can affect how much DNI is carried out when property is distributed in-kind. The essential rule here is that in-kind distributions carry out DNI based on FMV if gain is recognized to the entity because of the distribution; otherwise the amount of DNI carried out is based on the lesser of the distributed property's FMV or basis.[329]

b) Amount of property spouse receives on distribution

1. If the value of the estate changes between the date of the decedent's death and the date of distribution, the three clauses differ in the amount that will actually be distributed to the marital and credit shelter trusts.
   - On this criteria, the pecuniary marital produces the best result because it has the salutary effect of allocating all post-death appreciation to the credit shelter share.
   - For example, if the estate tax value of a decedent dying in 2011 is $10,000,000 and the date of distribution value is $10,200,000 the division for each of the formula types on the assumption that both spouses die when the applicable exclusion amount is $5 million would be as follows:

Formula type	Marital share	Family share
Pecuniary marital	$5,000,000	$5,200,000
Pecuniary credit shelter	$5,200,000	$5,000,000
Fractional share	$5,100,000	$5,100,000

2. On the other hand, the pecuniary marital gift is worse if the estate depreciates during administration because it places the burden of the loss in value exclusively on the Family share.

   For example, if the date of distribution value declined to $9,800,000, the division for each of the formula types would be as follows.

Formula type	Marital share	Family share
Pecuniary marital	$5,000,000	$4,800,000
Pecuniarycredit shelter	$4,800,000	$5,000,000
Fractional share	$4,900,000	$4,900,000

funded at estate tax values with property that is fairly representative of appreciation or depreciation in the estate as a whole. It is possible to construe the special rule as not applying to this type of gift.

329 See "*Recognition of gain (or loss) on funding*", p. 110. See also "*Noncash distributions*", p. 197.

c) Recognition of gain (or loss) on funding

The funding of a pecuniary bequest (formula or otherwise) with property in kind is a sale or exchange.[330] Hence, an estate will realize gain or loss if the assets used to fund such a bequest have a date of distribution value that is different from the estate's basis in the assets.

(1) Gain sensitive assets

Because the estate's basis in its assets is adjusted to reflect estate tax values,[331] normally the measure of gain will be the difference between the value of an asset at the time of distribution and the value of the asset reported for estate tax purposes.[332] This will not be the case, however, for assets that do not receive an adjustment to basis at the decedent's death. Such assets include:

- Items of income in respect of a decedent,[333] many of which will have no basis at all;[334]
- Property for which a basis adjustment is denied under IRC § 1014(e);[335] and
- Land subject to a qualified conservation easement with respect to which an election was made to take an IRC § 2031(c) exclusion.[336]

Ex-81: H has an estate of $4,900,000

1. What marital formula would you recommend he use?

2. Would your choice be the same if H's spouse was not also a beneficiary of the credit shelter trust?

3. Would your answer be different if his estate were $15,000,000?

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330 Kenan v. Comm., 114 F.2d 217 (2d Cir. 1940).

331 IRC § 1014.

332 This is true even for real property valued under IRC § 2032A. Gain is recognized for IRC § 2032A property only to the extent that its fair market value on date of distribution exceeds its estate tax value determined without regard to IRC § 2032A. IRC § 1040.

333 See generally IRC § 691.

334 IRC § 1014(c).

335 IRC § 1014(e) denies a basis adjustment at death for appreciated property the decedent acquired by gift within the year prior to death if the property is left by the decedent to the donor or the spouse of the donor. A similar rule applies if the property is sold by the decedent's estate and the sale proceeds are distributed to the donor or the donor's spouse. IRC § 1014(e)(2)(B).

336 IRC § 1014(a)(3).

COMMENT
The selection of a formula type is also influenced by the desirability of protecting the credit shelter trust from loss due to depreciation in the estate during administration. • If the residue is left to the credit shelter trust, as is the case with a pecuniary marital gift, a slight decline (percentage wise) in a larger estate could decimate the credit shelter trust. • In some cases, it may be possible to avoid this by electing the alternate valuation method.

(2) Disallowance of loss under IRC § 267

An estate or trust will realize a loss if the basis of property used to satisfy a pecuniary gift is greater than the amount of the gift. Where the distributing entity is the decedent's estate, the loss may be deducted for income tax purposes.[337] In the absence of an IRC § 645 election, however, no deduction is allowable if the distributing entity is a trust (i.e., a revocable trust).[338]

(3) Techniques for avoiding gain

If the potential for recognized gain is a significant problem for an estate, a number of techniques are available to minimize the problem.

(a) Specific devises

A distribution of property in satisfaction of a specific devise of that property is not a sale or exchange. Thus, if an estate includes gain-sensitive assets, consider a specific devise of those assets to either the marital or credit shelter shares.

(b) Nonprobate transfers

Likewise, nonprobate transfers such as right of survivorship property can be used to avoid adverse tax exposure.

(c) Pick and choose

Alternatively (or in addition), the personal representative can be given discretion to choose which assets to distribute in satisfaction of pecuniary bequests. This would allow the PR to manage the gain problem either by choosing assets that have not changed in value or by matching gain assets with loss assets.

(d) Fractional share

There is no gain problem if a fractional share gift can be used instead of a pecuniary gift. The funding of a fractional share gift, whether of the marital or credit shelter portions, does not involve a sale or exchange.[339]

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337 See IRC § 267(b)(13).

338 IRC § 267(a)(1) .

339 If a fractional share formula is used, it is not necessary to distribute a fraction of each and every asset in the residue. In PLR 9143018, the Service approved a fractional share formula where the executor had the right to pick and choose the assets that satisfy the two shares. The clause need only contain language similar to that required for pecuniary gifts under Rev. Proc. 64-19. See "*Pecuniary gift funding mechanisms*" on p. 112.

(e) Funding at estate tax values

For more of this, see “*Estate tax value (“fairly representative”) funding*”, infra. p. 104.

d) Perspectives relating to administrative convenience

The various formula types differ in the burden they create on the administration of the decedent’s estate plan.

1. In this regard, pecuniary formulas, whether Marital or Family share, involve the least overhead. The primary administrative concern with pecuniary gifts is that property used to fund them must be valued at the time of funding or distribution.
2. Administration of fractional formula gifts is more complicated.
   - Unless a fractional share of each asset is distributed to each of the Marital and Family shares, implementation of a fractional share formula will require the valuation of at least some of the assets of the estate as of the date of funding.
   - Moreover, administration of a fractional share formula can get complex where partial non-pro rata funding of the Marital or Family shares is required or advisable. In such cases, the fraction will change with each distribution.

     For example, in a $10,860,000 dollar estate, the initial fraction for the Marital Share would be one-half. However, if a partial distribution of $500,000 is made to the Marital Share, the fraction of the remaining estate that must be distributed to the Marital Share changes to 45.4 percent.

3. Implementation issues

a) Pecuniary gift funding mechanisms

(1) Date of distribution (“true worth”) funding

In Florida (and most states), in the absence of a contrary provision in the governing instrument, property distributed in satisfaction of a pecuniary gift is valued at its fair market value on the date of the distribution. While this provides maximum flexibility in the selection of assets used to fund the gift, it raises the potential for capital gain to the estate upon funding as described above.

COMMENT
In the common vernacular of formula marital gifts, a formula pecuniary marital gift that is to be satisfied with property valued as of the date of distribution is referred to as a “***true worth***” formula since the funding mechanism will insure that the marital share receives property worth the amount of marital deduction taken on the estate tax return.

(2) Estate tax value (“fairly representative”) funding

Some years ago, some planners tried to eliminate the gain problem by giving the personal representative the authority to satisfy pecuniary bequests by distributing assets at their estate tax value rather than their date of distribution values. Although this eliminates the potential for capital gain, it also allows the PR to manipulate the value of the property distributed to the marital share.

- For example, assume an estate consisting of the four assets shown in the table below. Assume further that the will contains a pecuniary gift to the

decedent's spouse of $1,000,000 and authorizes the personal representative to satisfy the bequest with assets having an estate tax value of that amount.

- If the personal representative selected assets C and D for distribution to the spouse, the direction in the will would be satisfied but the spouse would only receive property worth $500,000 at date of distribution values.

	Value on date of	
Asset	**Death**	**Distribution**
A	$500.000	$1,100,000
B	$500.000	$600,000
C	$500.000	$250,000
D	$500.000	$250,000
Total	**$2,000,000**	**$2,200,000**

(a) Revenue procedure 64-19

In Revenue Procedure 64-19,[340] the Service ruled that this ability to underfund the marital bequest violated the nondeductible terminable interest rule.[341] Except as described below, the revenue procedure applies to any pecuniary marital gift (formula or otherwise) which the personal representative can satisfy with property valued at estate tax value.

COMMENT

The revenue procedure does not apply to pecuniary gifts with a true worth funding mechanism. Nor does it apply to fractional share gifts provided the shares are funded with a pro-rata portion of each asset available for distribution..

(b) Using estate tax values

Even if a pecuniary marital gift can be satisfied with property at estate tax values, the marital deduction will be allowed if the governing instrument or state law requires the personal representative to choose assets in funding the gift that

- are fairly representative of the appreciation or depreciation in the estate as a whole;[342] or
- have a minimum worth at the date of funding equal to the value of the marital deduction taken.[343]

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340 1964-1 (Part 1) C.B. 682.

341 With a pecuniary credit shelter formula, if an estate declines in value during administration, all post-death depreciation will fall on the marital share. The Service agrees that the possibility that this might result in an underfunding of the residuary marital gift does not jeopardize the deductibility of the gift under the principles of Rev. Proc. 64-19, 1964-1 (Part 1) C.B. 682. See Rev. Rul. 90-3, 1990-1 C.B. 175.

342 Many states have statutes imposing this duty on the personal representative. See e.g., Cal. Prob. Code App. § 21120 (West 1991); Fla. Stat. § 733.810(2) (2015).

343 See e.g., N.Y. Est. Powers & Trusts Law § 2-1.9(b)(2) (McKinney 1981).

CAUTION
This type of "minimum worth" clause should be avoided. It is problematic under the generation-skipping transfer tax. Additionally, a minimum worth clause cannot be used with a pecuniary credit shelter gift, or for that matter, with a pecuniary marital gift if the residue is left to charity. In both cases, the ability to overfund the pecuniary gift is by reverse implication an ability to underfund the residuary gift.

b) Problem assets

Some assets should not be used to fund the marital deduction at all. Others should be used only as a last resort.

(1) Terminable interests

The marital deduction will be disallowed to the extent the fund from which the marital gift can be satisfied includes property (i.e., terminable interests) for which no deduction is allowable.[344] Accordingly, formula clauses should provide that the marital gift is to be satisfied only from assets that qualify for the marital deduction.

(2) Tainted assets

As for assets that should be avoided if possible, the list includes:

- Property for which a tax credit is allowable for estate tax purposes (e.g., real property located on a foreign country or jurisdiction.)[345] This property is to be avoided because the credit is not available if the property passes in a deductible form to the decedent's spouse.
- Insurance policies on the life of the surviving spouse. This property is to be avoided because putting it in the marital trust will subject the proceeds to taxation at the death of the spouse.
- Property the decedent acquired from the surviving spouse by gift within a year of the decedent's death. This property is to be avoided because such property does not receive a basis adjustment at the decedent's death if it is left to a trust for which a marital deduction is taken.[346] Moreover, since the funding of the pecuniary gift is itself a sale or exchange, use of this type of property would cause an immediate recognition of the gain (determined without the basis adjustment) to the estate.

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344 IRC § 2056(b)(2).

345 See IRC § 2014.

346 See IRC § 1014(e).

COMMENT
There is no basis adjustment available for items of income in respect of a decedent either.[347] Accordingly, the use of IRD items to fund a pecuniary marital gift would involve some of the same tax concerns. Nevertheless, it may not be wise to absolutely prohibit their use in funding a pecuniary marital gift because in some instances intentional recognition of the income element of IRD would be useful. Such might be the case where the estate had large passive activity losses that would otherwise go unused.

4. Administration expenses

a) Introduction

Assuming it has not been used in whole or in part to shelter taxable gifts from the gift tax, the unified credit can be used to pass an amount equal to the applicable exclusion amount to a decedent's family or Family Trust free from estate taxes.

- However, this amount must be reduced if estate administration expenses which are not deductible for estate tax purposes under IRC § 642(g) are charged to and paid from the Family Share.
- The result, is more complicated, however, when estate administration expenses are charged to and paid from the Marital Share.[348]

b) The "Hubert" Case

The issue can be brought into clearer focus with a simple example. Assume a decedent dies in 2011 with an estate of $10,000,000 and a will that divides this into marital and family shares of $5,000,000 each. Now also assume that there are costs of administration of $100,000 that must be paid. The question is, what is the impact of paying those costs from the marital share?

- One possibility is that the allowable marital deduction must be reduced to $4,900,000 reflecting the fact that the marital share is burdened by the obligation to pay the costs. In that event, there will be no further consequences as long as the costs are taken as an estate tax deduction under IRC § 2053. The 706 will report a gross estate of $10,000,000 and deductions of $5,000,000 (marital of $4,900,000 and costs of $100,000) leaving a taxable estate of $5,000,000 and no taxes due.
- Suppose, however, that the IRC § 642(g) election is made to deduct the costs on the estate's income tax return. In that event, total deductions on the 706 will be limited to the $4,900,000 marital deduction leaving a taxable estate of $5,100,000. At this point, either of two things will occur. Either that will be the end of the story with the result that estate taxes will be payable at the decedent's death,[349] or an additional $100,000 will be taken from the family share to restore the marital

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347 See IRC § 1014(c). See also IRC § 691.

348 If charging the Marital Share with these expenses requires a reduction in the amount of the allowable marital deduction, the expenses will ultimately be borne by the Family Share because the marital formula will siphon additional property out of the Family Share to restore the Marital Share to the size necessary to eliminate taxes. But this will not occur if charging the expenses to the Marital Share does not require a reduction in the allowable marital deduction.

Existing authorities suggest that a reduction in the allowable marital deduction is required when estate administration expenses (other than post-death interest) is charged to the principal of the marital share. Where the expenses are charged to the income, however, a reduction is required only if the charge constitutes a "material limitation" of the spouse's right to income. See Treas. Regs. § 20.2056(b)-(4)(a); Rev. Rul. 93-48, 1993-2 C.B. 270. See also Estate of Hubert v. Comm., 117 S.Ct. 1124 (1997).

349 See Treas. Regs. § 20.2056(b)-4(d)(5), Ex. 6

deduction to the amount necessary to eliminate all taxes.[350] The prevailing wisdom is that the latter will occur where the estate plan uses a marital formula that is intended to eliminate all taxes. Either way, the situation is not ideal.

So, the issue arises, is there a way that the costs of administration can be charged to and paid from the marital share without having to reduce the marital deduction from $5,000,000 to $4,900,000? In Estate of Hubert v. Comm.,[351] the Supreme Court held that there was; the marital deduction need not be reduced where costs of administration attributable to the marital gift are charged to and paid from the income earned during administration on the marital share.[352]

c) The Hubert Regulations

In the aftermath of the Hubert case, the Service issued regulations dealing with the area.[353] Under these regulations, all administration expenses are categorized either as estate transmission expenses or as estate management expenses.

- Estate transmission expenses are all estate administration expenses that are not estate management expenses.[354]
- Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisor fees, stock brokerage commissions, custodial fees and interest."[355]

In general, the regulations require that the marital (or charitable) deduction must be reduced dollar for dollar for any of the following that are charged to and paid from either the income or the principal of the marital (or charitable) share:

- All costs of administration attributable to interests other than the marital (or charitable) gift;[356]
- Estate transmission expenses whether or not the expenses are deducted on the estate tax return; and[357]
- Estate management expenses which are claimed as a deduction on the 706.[358]

On the other hand, no reduction is required for estate management expenses attributable to the marital (or charitable) gift tht are paid from either the income or the

[350] See Treas. Regs. § 20.2056(b)-4(d)(5), Ex. 5.

[351] 117 S.Ct. 1124 (1997).

[352] Even before the taxpayer victory in Hubert, several cases had held that the marital deduction need not be reduced when post-death interest (e.g., on taxes deferred under IRC § 6166), is charged to the income of the marital share. In Rev. Rul. 93-48, 1993-2 C.B. 270., the Service conceded this issue and went even further by ruling that the marital deduction need not be reduced for post-death interest charged to either the income or the principal of the marital share. This ruling has been rendered obsolete, however, by the issuance of the final Hubert regulations discussed in the text.

[353] The regulations, which also deal with the similar issue that can arise with respect to the charitable deduction, apply to the estates of decedents dying on or after December 3, 1999. Treas. Regs. §§ 20.2055-3(b)(7); 20.2056(b)-4(d)(6).

[354] See Treas. Regs. § 20.2056(b)-4(d)(1)(ii). Accord, Treas. Regs. § 20.2055-3(b)(1)(ii).

[355] Treas. Regs. § 20.2056(b)-4(d)(1)(i). Accord, Treas. Regs. § 20.2055-3(b)(1)(i).

[356] Treas. Regs. § 20.2056(b)-4(d)(1)(iii)(4). Accord, Treas. Regs. § 20.2055-3(b)(4).

[357] Treas. Regs. § 20.2056(b)-4(d)(2). Accord, Treas. Regs. § 20.205-3(b)(2).

[358] Treas. Regs. § 20.2056(b)-4(d)(3). Accord, Treas. Regs. § 20.2055-3(b)(3). This restriction finds its primary significance in estate of decedent's who have used their full unified credit during life. See Treas. Regs. § 20.2056(b)-4(d)(5), Example 4.

principal of the marital (or charitable) share provided the election is made to take the expenses on the estate's 1041 instead of the 706.[359]

d) Planning guidelines

The implications of the Hubert regulations can be summarized in the following general guidelines:

- First, management expenses attributable to the marital share should NOT be taken on the 706. Instead, these expenses should be taken on the 1041 and should be charged to the marital share. This will allow the estate the immediate benefit of an income tax deduction without a corresponding reduction in the marital deduction.
- Transmission and management expenses that are taken on the 706 should be charged to the marital share. Although this will reduce the marital deduction, it will not increase taxes and it will preserve the full amount of the credit shelter share.
- Transmission expenses that are taken on the 1041 should be charged to the credit shelter share. Otherwise, the marital deduction will be reduced and estate taxes will be increased.

In the last case, the decision to claim the expenses on the 1041 involves a tradeoff. Taking them on the 1041 provides an immediate income tax savings to the estate. But this comes only at the expense of either increased estate taxes (generally a poor tradeoff since the marginal estate tax bracket in most taxable estates will be higher than the marginal income tax bracket for the estate) or a reduced credit shelter trust.

e) Special rule for outright pecuniary marital or charitable gifts

In Florida and many states, in the absence of a contrary provision in the will, recipients of outright pecuniary gifts are not entitled to share in estate income earned during the administration of the estate.[360] In such situations, the regulations provide that no marital or charitable deduction is available for the income earned on the gift during administration. As a consequence, estate transmission or management expenses can and should be paid from that income without affecting the amount of the marital or charitable deduction allowable to the estate.[361]

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359 Treas. Regs. § 20.2056(b)-4(d)(3). Accord, Treas. Regs. § 20.2055-3(b)(3).

360 See Fla. Stat. § 738.201(3) (2015).

361 See Treas. Regs. § 20.2056(b)-4(d)(5), Ex. 7.

ANSWERS—USING THE MARITAL DEDUCTION

Ex-74. **Answer –** Yes. This trust qualifies because no one (other than the spouse or the spouse's estate) has an interest in the trust. See Treas. Regs. § 20.2056-2(b)(1)(i) - (iii).

Ex-75. **Answer –** Probably. In Estate of Rose D. Howard, 91 T.C. 329 (1988), the Tax Court held that the QTIP requirements are satisfied only if local law or the governing instrument require that income accrued as of the spouse's death (i.e., stub income) be payable either to the spouse's estate or as the spouse might appoint under a general power of appointment. Subsequently, the Court of Appeals for the Ninth Circuit reversed the Tax Court on this point holding that accrued income may be distributable to other beneficiaries without jeopardizing the marital deduction. Estate of Howard v. Comm., 910 F.2d 633 (9th Cir. 1990). This is the position taken in the regulations. Treas. Regs. § 20.2056(b)-7(d)(4). Accord Estate of Shelfer v. Comm., 86 F.3d 1045 (11th Cir. 1996), *rev'g* Estate of Lucille P. Shelfer, 103 T.C. 10 (1994), decided before the final marital deduction regulations were issued.

Reference: For estates outside of the Ninth Circuit, the Service has extended procedural relief for taxpayers who have relied on the proposed regulation. See Notice 90-46, 1990-28 I.R.B. 11 (1990).

Drafting tip: A special provision covering the issue is not necessary in Florida. Florida law provides that accrued income is payable to the income beneficiary's estate. Fla. Stat. § 738.303(2) (2015)

Ex-76. **First question –** Yes. See Treas. Regs. §§ 20.2056(b)-7(d)(3) and 20.2056(b)-7(h), Example 6.

Comment: The position taken in the new regulation is consistent with several case decisions. See e.g., Estate of Spencer v. Comm., 43 F.3d 226 (6th Cir. 1995), rev'g T.C. Memo 1992-579 (1992); Estate of Robertson v. Comm., 15 F.3d 779 (8th Cir. 1994), rev'g 98 T.C. 678 (1992); Estate of Clayton v. Comm., 976 F.2d 1486 (5th Cir. 1991), rev'g 97 T.C. 327 (1991); Estate of Willis E. Clack, 106 T.C. 131 (1996), acq'd AOD 1996-011 (1996).

Second question – This could be a problem. As executor, H would have the ability to make the partial QTIP election that would result in property being added to a trust for which he is a named beneficiary. Particularly if H is also serving as trustee of the discretionary trust (and perhaps even if he isn't), the entire package could be viewed as a general power of appointment that would either result in a gift at the time the partial QTIP election itself is made (or perhaps later when H as trustee exercises his discretion to distribute property to one of the kids) or estate tax exposure to H at his death.

Third question – It depends. A single QTIP trust may be divided into two trusts with identical terms in anticipation of making a partial election provided: (1) the severance occurs pursuant to an authority granted in the governing instrument or under applicable state law, (2) the severance occurs before the end of estate administration, and (3) the two shares are funded on the basis of fair market values on the date of the division.

Comment: It is not necessary to fund the shares with a pro rata portion of each asset. Treas. Regs. § 20.2056(b)-7(b)(2)(ii).

Ex-77. **First question –** Yes in states such as Florida which have enacted the Uniform Prudent Investor Act and the Revised Uniform Principal and Income Act. For taxable years ending after January 2, 2004, Treas. Regs. § 1.643(b)-1 now provides that provisions under local law allowing an allocation of amounts between income and principal for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust for the year will be will be recognized for purposes of defining income in subparts A through D of Subchapter J. Since "income" for purposes of the marital deduction eligibility of a marital trust is based on the definition of income under IRC § 643, it follows that a similar power in a marital trust is not a problem. Any doubt about this is erased by new Treas. Regs. §§ 20.2056(b)-5(f)(1) and 20.2056(b)-7(d)(1).

Comment: Normally, the power to adjust is a two way street. In appropriate circumstances, it can be exercised to treat items traditionally treated as principal (such as capital gains) as income, or it could be used to treat traditional income as principal. In Florida, however, it is not permissible to use a power to adjust in a marital trust to reclassify traditional income as principal, even if the

reclassification is necessary for the trustee to comply with his duty to administer the trust impartially. See Fla. Stat. § 738.104(3)(a) (2015). With the issuance of the new regulations, this restriction is not necessary and should be repealed.

Second question – Similar answer. The new regulations also permit a deduction for a unitrust interest in a total return trust. See Treas. Regs. § 1.643(b)-1 ("a state statue providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.") See also Treas. Regs. §§ 20.2056(b)-5(f)(1); 20.2056(b)-7(d)(1). On the ability to convert certain income rule trusts to unitrusts in Florida, see Fla. Stat. § 738.1041 (2015)

Ex-78. **Answer –** It depends. Until recently, available authority suggested that the IRA benefits will qualify for the marital deduction only if both the beneficiary designation under the IRA and the QTIP trust contain a provision requiring that the greater of the income earned by the IRA or the minimum required distribution for the year under IRC §§ 401(a)(9) or 408(a)(6) be distributed to H at least as often as annually. See Rev. Rul. 89-89, 1989-2 C.B. 231. See also PLR 9738010 allowing a marital deduction for IRA benefits payable to an inter vivos QTIP trust.

In Rev. Rul. 2000-2, 2000-3 I.R.B. 305, however, the Service ruled that the income in excess of the required minimum distribution may be left in the IRA as long as the spouse had the right to demand that it be withdrawn.

Ex-79. **Answer –** Maybe not. These facts are similar to those of Estate of Carpenter v. Comm., 52 F.3d 1266 (4th Cir.) where the court held that amounts passing to a spouse as a result of a settlement of a will controversy are deductible only if (1) they pass as a consequence of a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate and (2) prior to the settlement, the spouse had an enforceable right under state law to a deductible interest. Since the spouse in Carpenter did not have a general power of appointment over the trust, the court disallowed the marital deduction. An argument that the spouse's interest in the trust could have qualified for the marital deduction had a QTIP election been made was rejected because no such election was made and the argument was not raised in the Tax Court.

Moral: Make the QTIP election.

Ex-80. **Answer –** The answer is no because inclusion of the GRAT occurs under IRC § 2036(a)(1) instead of IRC § 2039. Treas. Regs. § 20.2036-1(c)(3) Hence, the fact that the remainder in the GRAT passes to someone other than S violates the nondeductible terminable interest rule of IRC § 2056(b)91).

Ex-81. **First question –** Pecuniary marital may be the best choice. The necessity of managing the gain problem makes small pecuniary bequests preferable to large ones. As long as the estate is less than twice the amount of the applicable exclusion amount for the year of the decedent's death, the pecuniary marital formula results in a smaller pecuniary bequest than a pecuniary credit shelter clause. It also has the advantage of putting all post-death appreciation in the credit shelter share.

Second question – Maybe. If the surviving spouse is not also a beneficiary of the credit shelter trust, a fractional share (or a "fairly representative pecuniary marital") gift may be preferable because post death appreciation or depreciation will be shared ratably by the marital and nonmarital shares. With a pecuniary gift, appreciation or depreciation is passes or is charged to the residuary portion.

Third question – Yes. Now a pecuniary credit shelter or fractional share formula looks more attractive. As the estate rises in value over an amount equal to twice the applicable exclusion amount, the amount of pecuniary bequest in the pecuniary marital formula increases, thereby making it more difficult to manage. With a pecuniary credit shelter bequest, the pecuniary amount will never exceed the applicable exclusion amount for the year of death, regardless of the size of the estate. If even this size of a pecuniary gift is troublesome, a fractional share formula could be used.

V. GENERATION-SKIPPING TRANSFER TAX

Historical leniency in the rules which define the federal gross estate makes it possible for a trust beneficiary to have a substantial interest in (and authority over) trust property without causing the property to be included in the beneficiary's gross estate at death. Thus, without subjecting the child to estate tax exposure at death, a parent could create a trust for his child with the child having any or all of:

- the right to trust income for life;
- the right to demand such corpus as is reasonably necessary for the child's health, support, maintenance and education; and
- one or more inter vivos or testamentary special powers of appointment.

In like manner, at the child's death the trust could continue for the life of the settlor's grandchild and at his death for the life of that child's child, and so on. The Generation-Skipping Transfer [GST] tax was enacted to place a tax cost on this kind of transfer.

A. OVERVIEW OF IMPORTANT TERMS

A general (albeit simplistic!) statement of the GST tax would be that it applies whenever property is transferred (directly or from a trust or a trust equivalent) to a person who is two or more generations younger than the transferor.

Examples of generation-skipping transfers include:

- an outright gift or bequest to a grandchild of the donor or testator;
- a distribution from a trust to the settlor's grandchild; or
- a termination of a life interest in a child when the remainder interest is in a grandchild.

Application of the GST tax to these and other transfers requires a mastery of several key terms and concepts.

1. Skip person

The GST tax applies only to transfers to persons who are two or more generations younger than the transferor. Such a person is called a "skip person."

Grandchildren and great-grandchildren are skip persons. So are grand-nephews and nieces.

A trust can also be a skip person. A trust is a skip person if:

- all persons having an interest in the trust are skip persons (e.g., a trust for the exclusive benefit of grandchildren and their descendants), or
- no one has a present interest and no distributions to non-skip persons can ever occur (e.g., a trust for the ultimate benefit of minor grandchildren where no distributions can be made until they attain the age of majority).[362]

[362] IRC § 2613(a); Treas. Regs. § 26.2612-1(d). In the application of this test, a possibility that property will be distributed to a skip person is disregarded if the probability of the distribution occurring is less then 5 percent. Treas. Regs. § 26.2612-1(d)(2)(ii).

2. Trust

A distribution from or a termination of an interest in a trust may be a taxable event under the GST tax. For this purpose, a trust includes "any arrangement (other than an estate) that has substantially the same effect as a trust."[363]

COMMENT
Under IRC § 645, certain electing qualified revocable trusts are treated and taxed as if they were part of a decedent's estate. See "*Qualified revocable trusts*", p. 167, for the details. This treatment applies, however, only for purpose of the income tax; it does not apply for purposes of the GST tax.

"Trust" includes:

- legal term and life interests,
- insurance and annuity contracts,
- custodianships,[364] and
- outright bequests where the identity of the taker is contingent upon the occurrence of a future event.

Exception: An exception applies to a testamentary transfer that is contingent upon an event that must occur within 6 months of the transferor's death.

> ***Ex-82:*** T devises the residue of his estate per stirpes to such of his descendants as survive him by nine months. T is survived by a child C and a grandchild GC. What are the consequences under the GST tax if C dies 8 months after T? *Answers to the examples in this chapter begin on page 133.*

COMMENT
The result is different if C dies within 90 days of T. See ***Ex-86***, p. 118.

3. Interest in trust

In determining whether a trust is a skip person and in applying a number of other provisions of the GST tax, it is necessary to identify who has an "interest in trust."

A person has an interest in a trust only if:

- she has a present right to receive income or principal; or
- she is a current permissible distributee of trust property.[365]

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363 Treas. Regs. § 26.2652-1(b)(1).

364 See Treas. Regs. § 26.2652-1(b)(2), Example 1.

365 IRC § 2652(c)(1); Treas. Regs. § 26.2612-1(e)(1). A charity has an interest if the charity has the right to current distributions of income or principal or the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. IRC § 2652(c)(1)(C); Treas. Regs. § 26.2612-1(e)(1)(iii).

Ex-83: T transfers property in trust to pay the income to C for life, remainder to GC.

1. Do either C or GC have an interest in this trust?

2. Would the answer change if GC had a power to withdraw $14,000 from the trust for a 60 day period after the transfer by T?

a) Nominal interests

In some situations, imposition of the GST tax is deferred as long as a non-skip person continues to have an interest in trust.[366] To prevent abuse, the Code provides that an interest is to be disregarded if it is used primarily to postpone or avoid the GST tax.[367] This is the case if a significant purpose for the creation of the interest is the postponement or avoidance of the GST tax.[368]

b) Support obligation

A person whose legal obligations could be satisfied out of trust income or principal has an interest in trust.

Exception: A person does not have an interest in trust merely because a trustee has the discretionary authority to make distributions in satisfaction of the person's obligation of support.[369]

4. Transferor

The identity of the transferor determines who meets the definition of a skip person and whose exemption must be allocated to a transfer if it is to be exempted from the tax. In general, the transferor is the person who was most recently subject to the federal estate or gift tax on the property.[370]

COMMENT
If the donor's spouse consents to split the gift, each spouse will be treated as the transferor of half.[371]

a) Estate or gift tax exposure

Whenever a transfer is made in trust the initial transferor will be the testator in the case of a testamentary transfer or the donor in the case of an inter vivos one.

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366 For more on this, see "*Terminations where nonskip persons have an interest*" on p. 130.

367 IRC § 2652(c)(2). Treas. Regs. § 26.2612-1(e)(2)(ii).

368 The regulatory test focuses on *a* rather than *the* significant purpose. Under this test, an interest is disregarded if it serves several significant purposes only one of which is to postpone or avoid the GST tax.

369 IRC § 2652(c)(3); Treas. Regs. § 26.2612-1(e)(2)(i). See also Treas. Regs. § 26.2612-1(f), Example 15.

370 Treas. Regs. § 26.2652-1(a)(1). See also, PLR 9622035 (except to the extent the proceeds are attributable to pain and suffering or reimbursement for medical expenses, a decedent is not the transferor of wrongful death proceeds payable to a skip person at the decedent's death).

371 IRC § 2652(a)(2); Treas. Regs. § 26.2652-1(a)(5). This is true even though the interest the consenting spouse is actually deemed to have transferred under IRC § 2513 is less than half of the total value of the property transferred as would be the case with the creation of a ten year GRAT with the remainder in a third person. See Treas. Regs. § 26.2652-1(a)(6), Examples 2 and 11.

- Thereafter, if the trust property is subject to either the gift or the estate tax, the transferor will be redetermined and any previously allocated exemption to the trust will be lost.[372]
- Thus, if a trust beneficiary has a general power to appoint trust property, the beneficiary will become the transferor at the earlier of her death or when she exercises or releases the power.[373]

Ex-84: T leaves property in a trust the terms of which give Child an income interest for life and a joint power exercisable with BANK to appoint trust property at her death to her creditors. In default of appointment the trust continues for Grandchild for life with remainder to Great-grandchild.

1. Will either child's death or a subsequent distribution to Grandchild be a taxable event under the GST tax?

2. Suppose Child and BANK could appoint "only to the extent the aggregate federal estate tax and GST tax due as a result of the child's death can be reduced." Is this type of "formula general power of appointment clause" an effective means of avoiding GST taxes at the child's death?

COMMENT
Intentionally subjecting property to the estate tax may yield a better result than having it subjected to the GST tax. In addition to the formula approach illustrated in the previous example, other methods of doing this include: 1. The trustee could have authority to distribute principal to beneficiaries. 2. Trustees could be authorized to create a general power in a beneficiary (or to terminate one that was previously created at the drafting stage).[374] 3. A beneficiary with a special power of appointment could exercise the power to create a general inter vivos power in someone else.[375]

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[372] A redetermination of the transferor does not occur upon the transfer of a term interest in a trust by the holder of the term interest since the transfer, although subject to the gift tax, does not affect the rights of other beneficiaries. Treas. Regs. § 26.2651-1(a)(6), Example 4.

[373] The regulations provide that an exercise of a nongeneral power of appointment is treated as a transfer subject to the gift or estate tax by the holder of the power if the power is exercised in a manner that postpones vesting for a period exceeding that permitted by the common law Rule Against Perpetuities, measured from the creation of the power. Treas. Regs. § 26.2652-1(a)(4). In effect, the holder of the power is treated as having retransferred the property to the trust. To accommodate those states that have enacted the Uniform Statutory Rule Against Perpetuities, the regulations also provide that the retransfer rule is not triggered by an exercise that can postpone vesting for a term of years that will not exceed 90 years. This rule does not, however, apply to an exercise which can postpone vesting for a period measured by the longer of the common law rule or 90 years. See Treas. Regs. § 26.2652-1(a)(6), Examples 9 and 10.

[374] There is some potential risk in doing either of these. It is possible that a trustee's power to create a general power is itself a general power in the beneficiary. And care must be exercised to insure that an authority in a trustee to terminate a general power does not result in a taxable lapse if the authority is exercised. For more on these matters, see e.g., Covey, Practical Drafting 2053 (January 1990).

[375] See IRC §§ 2041(a)(3) and 2514(d).

Ex-85: T creates a discretionary trust for the benefit of his children and grandchildren. The children and grandchildren have Crummey withdrawal powers. What impact will the lapse of these powers have on the identity of the transferor of this trust for GST tax purposes?

b) Reverse QTIP election

Normally, the surviving spouse becomes the transferor of a QTIP trust for which the first spouse elected to take the marital deduction. However, a separate "reverse" QTIP election is available under the GST.[376] When made, the election results in the decedent being treated as the transferor of the QTIP trust for GST purposes.

- The election is made on the gift or estate tax return on which the QTIP election is made.[377]
- It must be made as to all property in the trust.[378]
- Once made, the election is irrevocable.[379]

COMMENT
The IRS may grant a discretionary extension of time under Treas. Regs. §§ 301.9100-1 and -3 for making the reverse QTIP election.[380] For more on the planning considerations involved in the use of the reverse QTIP election, see "*Planning For The GST Tax*", beginning on p. 137.

B. GENERATION ASSIGNMENT

The GST tax is concerned only with transfers to persons who are two or more generations below the generation assigned to the transferor.

Thus, each person with an interest in a trust must be assigned to a generation so that a determination can be made whether transfers to that person would invoke a tax.[381]

1. Lineal descendants, spouses and other persons

a) **Lineal descendants** of the transferor's grandparents or of the grandparents of the transferor's spouse are assigned to the generation that their relationship would intuitively dictate.

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376 IRC § 2652(a)(3).

377 Treas. Regs. § 26.2652-2(b). The reverse QTIP election may not be made with respect to property qualifying for the marital deduction under IRC § 2056(b)(5). Treas. Regs. § 26.2652-2(a). If a protective QTIP election is made, a protective reverse QTIP election must also made if the election is to be effective. Treas. Regs. § 26.2652-2(b).

378 Treas. Regs. § 26.2652-2(a). A special transitional rule applies in the case of QTIP for which a reverse QTIP election under IRC § 2652(a)(3) was made prior to December 27, 1995. As to such trusts, the transferor or the transferor's personal representative may elect to treat the trusts as two separate trusts -- one with a zero inclusion ratio and one with an inclusion ratio of one. The election must be filed in the same place in which the original return was filed on or before June 23, 1996. The election is made by attaching a statement to a copy of the return on which the reverse QTIP election was made. The statement must identify the values of the two separate trusts. See Treas. Regs. § 26.2652-2(c).

379 Treas. Regs. § 26.2652-2(a).

380 See e.g., PLR 200118037 (five year extension).

381 See generally, IRC § 2651.

COMMENT
In the application of this rule, adopted persons are treated as natural kindred and relatives of the half-blood are treated as relatives of the whole-blood.[382]

b) **Charities and spouses** (current and former) of the transferor are assigned to the same generation as the transferor.[383]

c) **Current or former spouse of a lineal descendant** of a transferor is the same generation as the lineal descendant.[384]

d) **Other natural persons** are assigned to a generation by age differential.

- Persons whose age is within twelve and a half years of the transferor are assigned to the transferor's generation.
- Persons whose age is from twelve and a half to thirty-seven and a half years of the transferor are assigned to a generation one below or above that of the transferor.
- Thereafter, a new generation occurs at twenty-five year intervals.[385]

2. Exception for predeceased ancestor

In the case of a direct skip to or for the benefit of a lineal descendant of the transferor (or the current or former spouse of the transferor) the generation assignment of the donee is determined by disregarding the generation of any predeceased individual who is both an ancestor of the donee and a descendant of the transferor (or the spouse).[386]

For events occurring after 1997, the rule also applies to taxable terminations and distributions. In addition, the rule covers situations where certain collateral heirs of the transferor (or the current or former spouse of the transferor) predecease.

COMMENT
With respect to taxable terminations and distributions, the rule applies only when the predeceasing parent was dead at the time the gift or estate tax was first imposed with respect to the transferor's transfer to the trust. With respect collateral kindred, the rule applies only if: 1. The transferor had no descendants alive at the time of the transfer; and 2. The predeceasing person is a descendant of the parent of the transferor (or of the current or former spouse of the transferor).

382 IRC § 2651(b)(3).

383 IRC §§ 2651(e)(3); 2651(c)(1).

384 IRC § 2651(c)(2).

385 IRC § 2651(d).

386 IRC § 2651(e); See also Treas. Regs. § 26.2612-1(a)(2). In the case of a direct skip to a trust, the altered generation assignment continues to apply to terminations of interests in and distributions from the trust. If a transferor makes an addition to an existing trust which would have qualified for the predeceased parent rule had it been made to a separate trust with identical terms, the addition is treated as being held in a separate trust for GST tax purposes. Treas. Regs. § 26.2612-1(a)(2)(ii). For more on the rules applicable to a single trust that is treated as two or more separate trusts, see "*Single trust treated as separate* trusts," infra p. 156.

Note: IRC § 2612(c)(2) referred to in this note was eliminated by the 1997 TRA. Former subsection (c)(3) was renumbered as (c)(2). The new expanded predeceased ancestor rule may be found in IRC § 2651(e).

Ex-86: T's will provides for a bequest of $100,000 to her daughter C if she survives T by 120 days; otherwise the $100,000 is to go to C's child GC. T and C die simultaneously and under state law, C is deemed to have predeceased T.

1. Is the bequest to GC a direct skip?

2. Suppose C survived T but only for 30 days?

3. Suppose C survived T by 100 days?

4. Suppose C filed a qualified disclaimer of her interest under T's will seven months after T's death?

Ex-87: T devises property to a QTIP trust to pay the income to Spouse for life, then to distribute all property per stirpes to such of T's lineal descendants as survive Spouse. No election under IRC § 2652(a)(3) is made with respect to this trust. If, at the death of Spouse, T's descendants are two children, C-1 and C-2, and GC (the child of deceased child, C-3),

1. Will the one-third passing to GC be a taxable event under the GST tax?

2. On the assumption that C-3 died before T, would the answer change if T's personal representative had made an election under IRC § 2652(a)(3)?

3. Suppose in this latter case, that C-3 had survived T but had predeceased Spouse. Assume further that T dies in 1998. Would the result be the same?

DRAFTING TIP
In the third scenario, the GST could have been avoided had Spouse been given a special testamentary power of appointment. She could have exercised the power to appoint the trust property in equal shares to C-1 and C-2 and then made a compensating gift in the form of a direct skip to GC from independent sources.

3. Multiple skips

Where property held in trust is subject to a GST and thereafter remains in the trust, the generation of the transferor is dropped down to the generation immediately above the highest generation of any person holding an interest in the trust.[387]

COMMENT
This rule does not change the transferor. It changes only the generation to which the transferor is assigned..

Ex-88: T creates a trust to pay income to C for life, then to GC for life, then to GGC in fee. After the trust is created, C dies. Thereafter, the trustee distributes trust income and some trust principal to GC. Still later, GC dies and the trust property is distributed to GGC. What are the GST tax consequences of C's death, the distributions to GC, and the termination of the trust at GC's death?

COMMENT
The result in this example would be similar if C was not a beneficiary and the initial income interest went to GC. In that event, the creation of the trust would be a direct skip and the generation assigned to T would be one generation above GC. Accordingly, subsequent distributions to GC would not be taxable distributions because GC would no longer be a skip person.[388] Note that this effect can be used as a planning technique. Suppose for example, that the initial beneficiaries of the trust had been T's great-grandchildren and more remote descendants but that the trust provided that a year after the trust is created, T children and grandchildren also become beneficiaries. Under the multiple skip rule, subjecting the trust to the GST tax as a direct skip at its creation will mean that the generation assigned to T would change to that of his grandchildren immediately after the creation of the trust with the result that subsequent distributions to grandchildren and great-grandchildren will not be taxable events.

C. TRIGGERING EVENTS

There are three triggering events under the GST tax:

- direct skips,
- taxable terminations, and
- taxable distributions.

1. Direct skips

A direct skip occurs when a transfer, that is subject to the gift or estate tax, is made to a skip person.[389]

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[387] IRC § 2653. If no person holds an interest, the generation of the transferor is dropped down to the generation immediately above the highest generation of all persons who may subsequently hold an interest in the trust. Treas. Regs. § 26.2653-1(a).

[388] Treas. Regs. § 26.2653-1(b), Example 1.

[389] IRC § 2612(c).

An outright gift or bequest to a grandchild whose parents are still alive is an example.[390] So too is a transfer to a trust that is itself a skip person.

> ***Ex-89:*** GP transfers property to a revocable inter vivos trust retaining the income for life with remainder to GC. Does a taxable event occur at GP's death and if so, what kind?

> ***Ex-90***: GP creates a trust to pay the income to C for life, remainder to GC. Both C and GC have Crummey withdrawal powers. Is the creation of this trust a taxable event under the GST tax?

2. Taxable terminations

In general, a taxable termination occurs at the termination of any interest in a trust.[391]

In most instances, this occurs at the expiration of an interest because of the death of its owner or because of the failure of some contingency. But a distribution from a trust can also be a taxable termination. This will be the case when:

- A partial distribution of trust property is made to a skip person at the death of a lineal descendant of the transferor;[392] or
- A total distribution of all trust property to a skip person.

COMMENT
For this purpose, a total distribution occurs even though the trustee retains sufficient funds to pay the expenses of winding up the trust or to pay the GST taxes on the distribution.[393]

> ***Ex-91:*** Parent creates a trust for Child for life, then to grandchild for life with remainder to great-grandchild. Child dies. Some years later, but during grandchild's lifetime, the trustee makes a discretionary distribution to great-grandchild. What are the GST tax consequences of these events?

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390 Treas. Regs. § 26.2612-1(f), Example 1. A gift to a Great-grandchild yields the same tax. That is, there is no penalty imposed for double skips. Treas. Regs. §§ 26.2612-1(a)(1), 26.2612-1(f), Example 2.

391 Where more than one interest terminates at the same time as a result of the same event, there is only one taxable termination. Treas. Regs. § 26.2612-1(b)(3). See also Treas. Regs. § 26.2612-1(f), Example 10.

392 Treas. Regs. § 26.2612-1(b)(2).

393 Treas. Regs. § 26.2612-1(f), Example 9.

COMMENT
To present a more complete picture, here is the proper classification of a number of other events that might occur relating to the trust described in this example: 1. A distribution to child during her life is not a GST; child is not a skip person. 2. A partial distribution to grandchild during child's life is a taxable distribution. 3. A total distribution to grandchild during child's life is a taxable termination. 4. No distribution to grandchild after child's death is a GST because the generation assigned to transferor will be changed at child's death to that of child under the multiple skip rule of IRC § 2653.

Ex-92: Grandparent transfers property in trust to spray the income to such one or more of Grandparent's descendants as are from time to time living. At the death of the first of grandparent's two children, half of the trust principal is to be distributed to grandchildren. At the death of the second of the children, the trust is to terminate and all remaining trust property is to be distributed to the grandchildren. Classify the GST event that occurs at the death of the first child.

a) Trusts which can't benefit skip persons

No taxable termination occurs at the termination of an interest if at no time thereafter a distribution (including a terminating distribution) may be made to a skip person.[394]

Thus, no taxable termination will occur at the death of a life tenant if:

- the trust terminates at that point in favor of nonskip persons; or
- the trust continues for the exclusive benefit of nonskip persons.

CAUTION
This will not be the case if the trust continues for nonskip persons one or more of whom has a power of appointment (general or special) that could be exercised in favor of a skip person.

b) Terminations where nonskip persons have an interest

No taxable termination occurs at the termination of an interest if one or more nonskip persons continue to have an interest in the trust.[395] In that event, the GST tax is deferred until the termination of all interests in nonskip persons.

COMMENT
In the application of this rule, an interest is disregarded if a significant purpose for its creation is the postponement or avoidance of the GST tax.[396]

[394] Treas. Regs. § 26.2612-1(b)(1)(iii). A possibility of a distribution to a skip person is disregarded if there is less than a 5 percent probability that the distribution will occur. Treas. Regs. § 26.2612-1(b)(1)(iii).

[395] Treas. Regs. § 26.2612-1(b)(1)(ii).

Ex-93: Grandparent transfers property in trust to spray the income to such one or more of Grandparent's descendants as are from time to time living. At the death of the last of Grandparent's two children, all trust principal is to be distributed to grandchildren.

1. Does a GST event occur at the death of the first of Grandparent's children?

2. How about at the death of the second child?

DRAFTING TIP
In this last example, if the second child had a special power to appoint the trust property at his death, it might be possible to further defer the taxable termination by having the child appoint an income interest in the property to a nonskip person such as the child's spouse or a charity,[397] with the remainder going to Grandchild. For this to work, however, it would have to be shown that postponement of the GST tax was not a principal purpose of the appointment.

COMMENT
Where a taxable termination is unavoidable, consideration should be given to selling any low basis assets before the termination occurs. This will save GST taxes on the income taxes payable on the sale.

c) Terminations subject to estate or gift tax

In general, no taxable termination occurs at the termination of an interest if the termination is subject to either the gift or the estate tax. Instead, the termination will result in a new transferor being determined with respect to the trust.[398]

Exception: In the case of a QTIP trust for which the election to have the first spouse treated as the transferor is made pursuant to IRC § 2652, even though the QTIP property is taxable in the estate of the surviving spouse, the first spouse remains the transferor for GST purposes. Accordingly, a taxable termination can occur at the death of the surviving spouse. (See *Ex-87, p. 118.*)[399]

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396 Treas. Regs. § 26.2612-1(e)(2)(ii).

397 Although the charitable interest need not be a qualifying lead interest, distributions of income to the charity must be required. A discretionary interest in a charity does not give the charity an "interest" in the trust. IRC § 2652(c)(1)(B).

IRC § 2654(a)(2) provides for a basis adjustment to fair market value for taxable terminations that occur as a result of someone's death. This adjustment will be available where the appointment is made for the life of an individual nonskip person but not where the appointment is to a charitable lead trust.

398 IRC § 2612(a); Treas. Regs. § 26.2612-1(b)(1)(i).

399 See Treas. Regs. § 26.2652-1(a)(6), Example 6; Rev. Rul. 92-26, 1992-1 C.B. 314.

3. Taxable distributions

A taxable distribution occurs when a distribution of income[400] or corpus of a trust is made to a skip person and the distribution is neither a direct skip nor a taxable termination.[401]

> ***Ex-94:*** Parent creates a trust to pay the income to Child for life with remainder to Grandchild. During Child's life, the trustee is directed to distribute $14,000 annually to Grandchild to help defer her living expenses in Europe where she is attending school.
>
> 1. Will the distributions be a taxable event under the GST tax?
>
> 2. Would the answer be the same if the Grandchild had been given a Crummey withdrawal power over $14,000 and the distribution occurred as a consequence of her exercise of the withdrawal power?

COMMENT
In this last case, if Grandchild permitted the withdrawal power to lapse, she would be treated as having received a distribution from the trust to the extent the power exceeds the greater of $5,000 or 5 percent of the value of the trust.[402]

D. EXEMPTIONS AND EXCLUSIONS

Much like the gift tax, the GST tax has a set of exclusions and exemptions. These include exclusions for medical and tuition payments, an exclusion similar to the gift tax annual exclusion and the all important per transferor GST exemption ($5,430,000 for 2015).

1. Section 2503(e) equivalents

Transfers or distribution which if made inter vivos would qualify for the IRC § 2503(e) gift tax exclusion are excluded from the GST tax.[403]

COMMENT
Accordingly, consideration should be given to expressly authorizing the trustee to pay such expenses with respect to skip persons in any trust for which skip persons are potential beneficiaries and which is not otherwise exempt from the GST tax

2. Section 2503(b) exclusion

A lifetime direct skip is exempt from the GST tax to the extent it qualifies for the IRC § 2503(b) gift tax annual exclusion.[404]

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400 The GST tax imposed on distributions of trust income is deductible but only to the extent such tax is imposed on a transfer which is included in the gross income of the distributee. IRC §§ 164(a)(5); 164(b)(4). For guidance on the deduction, see IRS Announcement 91-43, IRB 1991-11 at 29.

401 IRC § 2612(b). A distribution from one trust to another trust is a taxable distribution only if the recipient trust is itself a skip person. Treas. Regs. § 26.2612-1(c)(2). For the rules for determining when a trust is a skip person, see "*Skip person*", infra p. 120.

402 See Treas. Regs. §§ 26.2612-1(c)(1); 26.2652-1(a)(6), Example 5.

403 IRC § 2611(b)(1).

- For this rule to apply to a gift in trust the gift must be tax-vested in a single beneficiary.
- This requires that the trust be for the exclusive benefit of a single beneficiary during life and that the trust property be includible in the beneficiary's gross estate if the beneficiary dies before termination.[405]

CAUTION
The typical irrevocable life insurance trust with Crummey invasion powers does not meet these requirements. To exempt the trust from GST tax exposure, the inclusion ratio of the trust must be kept at zero through periodic allocations of the transferor's GST exemption. This may require filing gift tax returns even though they might not otherwise be required.

3. GST exemption

Every person has a cumulative lifetime exemption that may be used to shelter transfers from the GST tax.[406] Use of the exemption and the rules relating to its allocation are examined further in "*The GST Exemption*" on page 137.

COMMENT
The amount of the GST exemption is tied to the amount of the applicable exclusion amount under the estate tax. Accordingly, it is $5,430,000 for 2015. [407]

E. COMPUTING THE GST TAX

The GST tax is calculated by multiplying the taxable amount times the applicable rate.

1. Taxable amount

The taxable amount is the fair market value of the property subject to the direct skip, taxable distribution or taxable termination.[408]

- For taxable terminations and distributions, (but not direct skips) the taxable amount also includes the money that will ultimately be used to pay the GST tax.
- Accordingly, for a residuary bequest to a skip person, the taxable amount is that portion of the residue which when subjected to the GST tax will leave enough in the residue to pay the tax involved.

Ex-95: In 2011, D dies with a will in which he leaves the residue of his estate (worth $2,400,000 after payment of estate taxes but before reduction for any GST tax on the transfer) to GC. Assuming no GST exemption is allocated to this transfer, what is the taxable amount for this testamentary direct skip?

404 IRC § 2642(c)(1).

405 IRC § 2642(c)(2); Treas. Regs. § 26.2642-1(c)(3).

406 IRC § 2631(a).

407 Under a special rule, the GST exemption for 2010 is $5,000,000.

408 In the case of taxable distributions and taxable terminations, the taxable amount is determined by deducting various expenses. See IRC §§ 2621(a); 2622(b). If any of these expenses would also be deductible for purposes of the trust's income tax, they may be deducted for that purpose only if an election waiving them for purposes of the GST tax is made. IRC § 642(g).

2. Applicable rate

The applicable rate is equal to the maximum estate tax rate (40 percent for 2015)[409] times the inclusion ratio.[410]

COMMENT
Accordingly, if the inclusion ratio is zero, so is the applicable rate. Conversely, if the inclusion ratio is one, the applicable rate is equal to the maximum estate tax rate.

3. Inclusion ratio and applicable fraction

The inclusion ratio is equal to one minus the applicable fraction.[411]

- The numerator of the applicable fraction is the GST exemption allocated to the trust or direct skip.
- The denominator is equal to the GST value of the property transferred to the trust (or involved in the direct skip) reduced by any federal or state death taxes charged to and actually recovered from the trust and any charitable deductions allowed with respect to the property.

In the case of a direct skip, the denominator is also reduced by any portion of the transfer that is a nontaxable gift.[412]

COMMENT
This reduction is available for a direct skip to a trust only if the trust is tax-vested in the individual. This requires that the trust be for the exclusive benefit of a single beneficiary during life and that the trust property be includible in the beneficiary's gross estate if the beneficiary dies before termination.[413]

Ex-96: In 2015, T transfers $14,000 to a trust for his grandchild. The trust qualifies for the annual exclusion under IRC § 2503(c).

1. What is the applicable fraction for this trust?

2. How would your answer change if the transfer had been $16,000?

Ex-97: T transfers $70,000 to a newly created trust for his five children and grandchildren. The children and grandchildren have Crummey withdrawal powers so T is entitled to 5 annual exclusions for his transfer. Since all of the transfer is excluded from the gift tax, T need not worry about the transfer for purposes of the GST tax either, right?

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409 The maximum estate tax rate is the maximum rate set forth in IRC § 2001(c) without regard to IRC § 2001(c)(3). Treas. Regs. § 26.2641-1.

410 Under a special rule, the applicable rate for GST events that occur in 2010 is zero.

411 The applicable fraction is rounded to the nearest one-thousandth. Treas. Regs. § 26.2642-1(a).

412 A gift to an individual is nontaxable to the extent it qualifies for the IRC § 2503(b) annual exclusion (after taking into account the split gift provision) or it qualifies for the IRC § 2503(e) exclusion for direct payments of college tuition or medical expenses. Treas. Regs. §§ 26.2642-1(c)(1) and (3).

413 IRC § 2642(c)(2); Treas. Regs. § 26.2642-1(c)(3). Charitable lead annuity trusts are subject to special treatment. See IRC § 2642(e); Treas. Regs. § 26.2642-3.

4. GST value of lifetime transfers

For purposes of calculating the denominator of the applicable fraction, the value of property transferred during life is its fair market value on the effective date of the allocation.[414]

Timely filed returns: For allocations made on a timely filed gift tax return, this means the value of the denominator will be determined by the fair market value as finally determined for purposes of the gift tax.[415]

Late returns: In the case of an allocation made after the due date of the gift tax return, this will be the date on which the allocation is actually made.

- However, a transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made.
- This election is not effective with respect to a life insurance policy or a trust holding a life insurance policy if the insured has died.[416]

COMMENT
This election is convenient since it will seldom be possible to know the value of a transfer on the day that an allocation becomes effective.

5. GST value of testamentary transfers

With some qualifications, estate tax value is used to value the denominator of the applicable fraction of property included in a decedent's gross estate.

COMMENT
This includes the effect of any special valuation methods actually elected by the estate, although qualified real property may be valued using IRC § 2032A only if the required recapture agreement specifically provides for recapture of the GST tax.[417]

a) Pecuniary bequests to skip persons

If a pecuniary bequest is satisfied in cash, the value of the transfer for purposes of calculating the denominator of the applicable fraction is the amount of the pecuniary bequest.

This is also true of pecuniary bequests that are satisfied in kind provided the bequest is satisfied:

1. at date of distribution values, or
2. with property that is fairly representative of the net appreciation and depreciation in all of the assets that could have been used to satisfy the bequest.[418]

Otherwise, the value of the bequest for purposes of determining the denominator is the date of distribution value of the property used to fund the bequest, not the amount of the pecuniary bequest itself.[419]

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414 Treas. Regs. § 26.2642-2(a)(1).

415 Treas. Regs. § 26.2642-2(a)(1).

416 Treas. Regs. § 26.2642-2(a)(2). The election is not effective until it is actually filed with the IRS. The election is made on the Form 709 by stating that the election is made, the applicable valuation date, and the fair market value of the assets as of that date. Treas. Regs. § 26.2642-2(a)(2).

417 IRC § 2624(b) and (c). See also Treas. Regs. § 26.2642-2(b)(1).

418 Treas. Regs. § 26.2642-2(b)(2)(i).

COMMENT
These rules are present in graphical format in Appendix A-4 – "*Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death*", infra p. 282.

b) Residual transfers following pecuniary bequests to nonskip persons

(1) Where pecuniary bequest is satisfied in cash

The value of a residual transfer following a pecuniary bequest that is satisfied in cash is the estate tax value of all of the property that could have been used to satisfy the pecuniary amount (e.g., residue plus property used to satisfy the pecuniary gift) reduced by the value of the pecuniary amount.

If the pecuniary bequest carries an appropriate interest rate, its value is the face amount of the bequest; otherwise its value is based on present value using the applicable IRC § 7520 rate.[420]

COMMENT
A pecuniary bequest carries an appropriate interest rate if: • it carries a statutory rate of interest under local law or a rate that falls between 80 and 120 percent of the applicable IRC § 7520 rate;[421] or • the entire bequest is funded (or property is irrevocably set aside for later funding) within 15 months of the decedent's death;[422] or • the governing instrument or applicable local law requires that the executor or trustee allocate to the pecuniary payment a prorata share of the income earned by the estate or trust during the period between valuation and funding.[423]

(2) Where pecuniary bequest is satisfied in kind

In the case of a residual transfer following a pecuniary bequest that may be satisfied in kind, the regulations provide that the value of the denominator for purposes of determining the applicable fraction is the date of distribution value of the property used to satisfy the residual transfer unless the pecuniary gift must be satisfied

(a) with property using date of distribution values or

(b) with property that is fairly representative of net appreciation or depreciation.[424]

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419 Treas. Regs. § 26.2642-2(b)(2)(ii).

420 Treas. Regs. § 26.2642-2(b)(3)(i).

421 Treas. Regs. § 26.2642-2(b)(4)(i).

422 Treas. Regs. § 26.2642-2(b)(4)(ii)(A).

423 Treas. Regs. § 26.2642-2(b)(4)(ii)(B).

424 Treas. Regs. § 26.2642-2(b)(3)(ii).

COMMENT

Assuming one of these is met, what is the appropriate method for valuing the residuary transfer? Apparently the bequest will be valued as if it were satisfied in cash. That is, if the bequest carries an appropriate interest rate, its value will be the face amount of the bequest; otherwise its value will be based on present value using the applicable IRC § 7520 rate.

COMMENT

These rules are presented in graphical format in Appendix A-5 – "*Determining the Denominator of the Applicable Fraction for Residuary GST Gifts at Death*", infra p. 283.

6. Charitable lead annuity trusts

In determining the applicable fraction with respect to a charitable lead annuity trust:

a) the denominator of the fraction is the value of the property immediately after the termination of the charitable interest,[425] and

b) the numerator is the adjusted GST exemption. This is equal to the GST exemption allocated to the transfer increased by an amount equal to the interest that would accrue to the exemption had it been invested at a rate equal to that used to determine the charitable deduction for the actual period of the charitable annuity.[426]

Ex-98: T transfers $1,000,000 to a CLAT which pays an 8% lead interest to Charity for 20 years. Payments are made in one installment at the end of the year. The remainder at the expiration of the 20 year term goes to T's grandchild GC.

1. Assuming an IRC § 7520 interest rate of 7.2 percent, what is the amount of the charitable deduction T may claim on his gift tax return?

2. Assuming T allocates GST exemption to this trust in an amount equal to the taxable gift, what will be the adjusted GST exemption for this trust at the expiration of the lead interest?

CAUTION

If this compounding produces an exemption greater than that needed to yield a zero inclusion ratio, the excess is lost.[427]

3. Could T use a formula allocation to avoid the over or under allocation of GST exemption to the CLAT?

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[425] Treas. Regs. § 26.2642-3(a)(2).

[426] Treas. Regs. §§ 26.2642-3(a)(1); 26.2642-3(b). In the case of a late allocation, the compounding begins on the date of the allocation.

[427] Treas. Regs. § 26.2642-3(b).

7. Redetermination of the applicable fraction

After a transfer to a trust is made, a number of events can occur which require that the applicable fraction be redetermined. Three of the more common of such events include:[428]

- a subsequent allocation of additional exemption,[429]
- the addition of more property to a trust,[430] and
- a consolidation of two or more trusts with the same transferor.[431]

In each case:

a) the denominator of the new applicable fraction will equal the value of the property in the trust after the event causing the redetermination, and

b) the numerator will equal the sum of the value of the nontax portion of the trust and any additional exemption allocated at the time of the event.[432]

COMMENT
The nontax portion is equal to the old applicable fraction times the value of the trust immediately before the event.

Ex-99: During life, T creates a GST trust of $200,000 and allocates $100,000 of exemption to it resulting in an inclusion ratio of one-half. Subsequently, when the trust is worth $500,000, T allocates an additional $100,000 of exemption to the trust. What is the redetermined applicable fraction and the resulting inclusion ratio for this trust?

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428 Other events which require a redetermination of the applicable fraction include distributions of property to a skip person during an ETIP and the imposition of a recapture tax under IRC § 2032A. As to the former, see Treas. Regs. § 26.2642-4(b), Example 5.. As to the latter, see Treas. Regs. § 26.2642-4(a)(4).

429 Treas. Regs. § 26.2642-4(a). This includes a subsequent allocation of exemption at the death of the transferor to a trust created by the transferor and which is included in the transferor's gross estate and with respect to which an allocation was previously made at a time when the trust was not subject to an ETIP. Treas. Regs. § 26.2642-4(a)(3). This situation might arise where exemption is allocated upon the transfer of an insurance policy to in insurance trust and the policy proceeds are subsequently included in the transferor's gross estate under IRC § 2035.

430 Treas. Regs. § 26.2642-4(a)(1).

431 Treas. Regs. § 26.2642-4(a)(2).

432 In the case of a consolidation of two or more trusts, the numerator of the new applicable fraction will equal the sum of the nontax portions of all of the trusts being consolidated. Treas. Regs. § 26.2642-4(a)(2).

Ex-100: In 1993, T creates a Crummey trust and funds it with property worth $10,000. T makes a timely allocation of $10,000 of exemption to the trust resulting in an applicable fraction of 1 and an inclusion ratio of zero. In 1994, when the trust is worth 15,000, T makes an additional transfer to the trust of $10,000. What is the redetermined applicable fraction for this trust?[433]

F. TRANSFERS BY NONRESIDENT ALIENS

IRC § 2663 authorizes the Service to promulgate regulations applying the GST tax to transfers by nonresident aliens (NRA). The regulations do this but only with respect to transfers by the NRA that are subject to the Federal estate or gift tax.[434]

COMMENT
Every NRA transferor is allowed a GST exemption of $5,430,000. Under the 1997 TRA, the exemption was indexed for inflation in $10,000 increments beginning in 1999.

Ex-101: T (a NRA) transfers property worth $600,000 to GC. Two thirds of the property is property situated in the United States (and therefore subject to the Federal gift tax) and one third is property situated outside the United States (and therefore not subject to the Federal gift tax. To what extent is the transfer subject to the GST tax?

1. Transfers of both U.S. and foreign situs property

In the case of transfers in trust that consist only partly of property subject to the Federal gift or estate taxes, then numerator of the applicable fraction is determined under a special rule.

- The numerator is equal to the sum of the GST exemption allocated to the trust plus the value of the nontax portion of the trust.[435]
- The nontax portion of the trust is a fraction of the trust the numerator of which is the value of the property that is not subject to the Federal gift or estate taxes and the denominator of which is the value of the entire trust.[436]

433 For an example of a Crummey trust involving both timely and late allocations of GST exemption, see Treas. Regs. § 26.2642-4(b), Example 2.

434 Treas. Regs. §§ 26.2663-2(b)(1); 26.2663-2(b)(2). See Treas. Regs. § 26.2652-1(a)(2) for the rules controlling when a transfer of property is subject to the gift or estate taxes. See also Treas. Regs. § 26.2663-2(e) for a transitional rule applicable to GST exemption allocations on transfers by an NRA which occurred after December 23, 1992 and before December 27, 1995.

435 Treas. Regs. § 26.2663-2(c)(1)(i).

436 Treas. Regs. § 26.2663-2(c)(2).

Ex-102: T (a NRA) transfers property worth $500,000 to a trust to pay income to C for life, remainder to GC. Of the total transfer, only $400,000 consists of property subject to the Federal gift tax.

1. What is the applicable fraction for this trust if T allocates no exemption to the trust?

2. What is the applicable fraction if T allocates $100,000 of GST exemption to the trust on a timely filed gift tax return?

3. What is the applicable fraction if T allocates $100,000 of GST exemption to the trust in 1999 when the trust is then worth $800,000?

2. Transfers by an NRA during an ETIP

The ETIP rules apply to a transfer by a NRA only if the property transferred is subsequently included in the transferor's gross estate. Otherwise, the nontax portion of the trust and the applicable fraction are determined as of the date of the initial transfer.[437]

Ex-103: T (a NRA) transfers property worth $500,000 to a 10 year grantor retained annuity trust with remainder at the expiration of the term period to go to GC. Of the $500,000 transferred to the trust, only $400,000 is subject to the Federal gift tax. T allocates $100,000 of GST exemption to the transfer on a timely filed gift tax return.

1. What is the applicable fraction if T dies in year 6 and $500,000 of the then $800,000 value of the trust is included in T's gross estate?

2. What would be the applicable fraction if T survives the term period and the trust terminates in favor of GC at that time?

G. EFFECTIVE DATES OF GST TAX

In general, the generation-skipping transfer tax applies to testamentary transfers after October 22, 1986, and to lifetime transfers after September 25, 1985.[438] Correspondingly, it does not apply to irrevocable transfers made on or before that date.[439]

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437 Treas. Regs. § 26.2663-2(c)(1)(3).

438 In addition, the GST tax does not apply to:

- Testamentary transfers under a will executed before October 23, 1986, if the decedent died before 1987.
- Transfers under a trust to the extent the trust property is included in the decedent's gross estate, the GST is caused by the decedent's death, and the decedent was incompetent to change the trust on October 22, 1986 and at all times thereafter.

439 See generally, Treas. Regs. § 26.2601-1. This shelter extends to the income and appreciation as well, but not to post September 25 additions. See E Norman Peterson Marital Trust, 102 T.C. 790 (1994) (failure to exercise a general power of appointment in trust created before September 26, 1985 is a constructive addition to the trust, citing Temp. Regs. § 26.2601-1(b)(1)(v)(A). Compare PLR 9627020 (waiver of IRC § 2207A recovery right from QTIP trust is not a constructive addition).

COMMENT
From a tax standpoint, grandfathered trusts should be kept in existence as long as possible. In this regard, it may be possible to avoid a scheduled termination of a grandfathered trust by exercising a special power of appointment to appoint the trust property in continuing trust. If this is attempted, care must be exercised to insure the appointment complies with the Rule Against Perpetuities.

Ex-104: Prior to 1985, T created a trust in which his child C had a life interest and a general testamentary power of appointment. In default of appointment, the trust was to continue for the benefit of C's descendants for as long as the Rule Against Perpetuities allows.

1. If C dies without exercising his power, will the trust remain grandfathered under the GST tax?

2. If C exercised his power to appoint trust property to his grandchildren, will the GST tax apply to the appointment?

COMMENT

The Service has issued final regulations[440] which attempt to clarify when modifications of grandfathered trusts can be made without affecting the grandfathered status of the trust. Under the regulations, a safe harbor is provided for:

- Modifications occurring through court orders in construction proceedings that resolve genuine ambiguities in trust terms;
- Modifications occurring through court-approved settlements of bona fide controversies over the administration or terms of a trust but only if the settlement results from an arm's-length negotiation and falls within the reasonable outcomes under the governing instrument and applicable state law;
- Distributions of principal to a new trust for the benefit of succeeding generations provided that vesting of principal is not postponed beyond the perpetuities period applicable to the distributing trust; and
- Any other modification that neither shifts beneficial interests down generations nor postpones vesting of a beneficial interest beyond the originally applicable perpetuities period.

With respect to this last criteria, Regs. § 26.2601-1(b)(4)(i)(D)(2) provides that administration of a trust in conformance with applicable state law that defines the term income as a unitrust amount, or which permits the trustee to make equitable adjustments between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will not be considered to shift a beneficial interest in a trust. [441]

440 Treas. Regs. § 26.2601-4(b)(4).

441 See also the example under Treas. Regs. § 26.2601(b)(4)(i)(E).

ANSWERS—THE GST TAX

Ex-82. **Answer –** The alternate gift on the basis of the survivorship condition is treated as a transfer in trust under the GST tax. Accordingly, C's death results in a taxable termination of his interest. Had the survivorship period been six months or less, no taxable termination would have occurred at C's. See Treas. Regs. § 26.2652-1(b)(2), Examples 2 and 3.

Ex-83. **First question –** C has an interest in the trust because C is a current distributee of trust income. GC, however, has no interest in the trust. Treas. Regs. § 26.2611-1(f), Example 14.

Second question – Yes, the answer would change. GC would have an interest in the trust because GC would have a right to current distributions. See Treas. Regs. § 26.2612-1(f), Example 3.

Ex-84. **First question –** No in both cases. Since Child's testamentary power is a general power, IRC § 2041 will require the trust property to be included in her gross estate at her death. At that point, Child becomes the transferor of the trust. Treas. Regs. § 26.2652-1(a)(1). Consequently, distributions to Grandchild after the death of Child are not subject to the GST.

Second question – Apparently, yes. See PLR 9527024.

Ex-85. **Answer –** The lapse of the Crummey powers will cause the holder to become the transferor of the property subject to the lapse only to the extent the lapse exceeds the greater of $5,000 or 5 percent of the value of the trust property. Treas. Regs. § 26.2652-1(a)(6), Example 5.

Ex-86. **First question –** No. The predeceased ancestor rule applies when C dies simultaneously with the transferor and is presumed by state law or the terms of the instrument to have predeceased T.

Second question – The predeceased ancestor rule also applies if C dies within 90 days of T and is treated as having predeceased under the governing instrument or applicable local law. Treas. Regs. § 26.2612-1(a)(2)(i).

Third question – The predeceased ancestor rule does not apply if C actually survives T by more than 90 days. Treas. Regs. § 26.2612-1(a)(2)(i). Nevertheless, because the condition placed on C is less than 6 months, C will not be viewed as having an interest in the bequest. As a result, the distribution to GC is a direct skip, not a taxable termination.

Fourth question – Likewise, the predeceased ancestor rule does not apply when C actually survives but is treated as having predeceased under local law as a result of a qualified disclaimer. Treas. Regs. § 26.2612-1(a)(2)(i). However, because C disclaimed, the GST tax will be applied as if C never had the disclaimed interest. Accordingly, the taxable event under the GST tax will be a direct skip; not a taxable termination. See Treas. Regs. § 26.2612-1(e)(3).

Comment: There may be an exception. Suppose the devise was "to C" or "to C if she survives me"? Suppose further that C survived T by only a month. The Service has indicated informally that the predeceased ancestor rule would apply if C's personal representative made a qualified disclaimer within 90 days of T's death.

Ex-87. **First question –** No. In the absence of an IRC § 2652(a)(3) election, Spouse will be treated as the transferor of the QTIP trust. Since the QTIP property is taxable in Spouse's estate, the transfer to GC constitutes a direct skip to which the predeceased ancestor rule of IRC § 2612(c)(2) applies. Rev. Rul. 92-26, 1992-1 C.B. 314. See also Treas. Regs. § 26.2612-1(f), Example 5.

Second question – It depends on when T died. With an IRC § 2652(a)(3) election, T will be treated as the transferor of the QTIP trust. Therefore, the event at Spouse's death is a taxable termination, not a direct skip.

If T died before 1998, the predeceased child rule of IRC § 2612(c)(2) would not apply. See Treas. Regs. § 26.2652-2(d), Example 1. Accord Rev. Rul. 92-26, 1992-1 C.B. 314.

However, after 1997, the predeceased ancestor rule applies to taxable terminations and distributions (as well as to direct skips) provided the ancestor is dead at the time the transfer creating the interest occurs. Since C-3 died before T, the predeceased ancestor rule would

apply and GC would not be a skip person. Accordingly, no taxable termination occurs at Spouse's death.

Third question – The result here is different. Even after 1997, for the predeceased ancestor rule to apply to a taxable termination or distribution, the ancestor has to be dead at the time the transfer for which a gift or estate tax is imposed is made with respect to the trust. Technically, that occurred twice – once at T's death and again at the death of Spouse. But IRC § 2651(e)(1)(B) provides that it is the earlier one that matters. Accordingly, the predeceased ancestor rule does not apply.

Comment: A somewhat similar situation can arise where T creates a 10 year GRAT with the remainder going to GC. Under prior law, if T died before the expiration of the 10 year term so that the property was included in T's gross estate, the predeceased ancestor rule applied if C (GC's parent) predeceased T, whether or not C was alive at the initial creation of the trust. After 1997, the predeceased ancestor rule applies only if C dies before the creation of the trust. It does not apply if C is alive at that time but dies before T.

Ex-88. **Answer –** A taxable termination occurs at the death of Child. Thereafter, the generation assignment of the transferor is deemed to be that of Child. IRC § 2653. Consequently, distributions to grandchild after child's death are not subject to the GST tax. However, a second taxable termination occurs at the death of grandchild when the trust terminates in favor of great-grandchild. See Treas. Regs. § 26.2653-1(b), Example 2.

Ex-89. **Answer –** Assuming GP's parents are alive at GP's death, a direct skip occurs at that time. The event is a direct skip because the trust property is subject to the estate tax at GP's death. IRC §§ 2036(a)(1); 2038. However, if P (GC's parent and GP's child) is dead at GP's death, the predeceased child rule will insulate the transaction from the GST tax. IRC § 2612(c)(2).

Ex-90. **Answer –** No. Even though GC is a skip person, the trust is not because a nonskip person C has an interest in the trust. Treas. Regs. § 26.2612-1(f), Example 3.

Ex-91. **Answer –** The facts indicate two taxable events under the GST tax -- a taxable termination at the death of Child and a second event when the distribution is made to great-grandchild. That distribution is classified as a taxable termination if all trust property was distributed; otherwise it is a taxable distribution. See Treas. Regs. § 26.2612-1(f), Examples 8, 9, and 12.

Ex-92. **Answer –** The distribution at the death of the first child is a taxable termination because it occurs at the death of a lineal descendant of the transferor. This is true even though Grandparent's second child, a nonskip person, continues to have an interest in the remaining trust property. See Treas. Regs. § 26.2612-1(f), Example 11.

Ex-93. **First question –** No. No distribution occurs at the death of the first child and that child's death is not a taxable termination because her sibling (a nonskip person) continues to have an interest in the trust.

Second question – Yes. A taxable termination will occur when the second child dies.

Ex-94. **First question –** Yes. The annual distributions to grandchild are taxable distributions because they are neither direct skips nor taxable terminations. Accord Treas. Regs. § 26.2612-1(f), Example 12.

Second question – Yes, the answer is the same. See Treas. Regs. § 26.2612-1(f), Example 13.

Ex-95. **Answer –** The answer is $1,777,778 on which D's estate will owe GST taxes of $622,222. The former number is calculated by dividing the residue ($2,400,000) by one plus the applicable rate. Since the transfer occurs in 2011 and no GST exemption is allocated to the transfer, the applicable rate is .35 and the dividend in the calculation is 1.35.

Ex-96. **First question –** On these facts, the denominator of the applicable fraction is zero (the value of the property transferred less the nontaxable portion). The inclusion ratio is also zero. See Treas. Regs. §§ 26.2642-1(c)(3); 26.2642-1(d), Example 2.

Second question – As a lifetime direct skip, T is deemed to have allocated $2,000 of GST exemption to this transfer unless he elects otherwise. Assuming he doesn't, the inclusion ratio will remain zero. But if T elects not to allocate exemption, the numerator of the applicable fraction is zero and the denominator is $2,000. This yields an applicable fraction of zero and an inclusion ratio of one. Treas. Regs. § 26.2642-1(d), Examples 3 and 4.

Ex-97. **Answer –** Wrong! Since the trust is not "tax vested" in a single beneficiary, no portion of this transfer is a nontaxable gift for purposes of the GST tax. Unless exemption is allocated to this transfer, the trust will have an inclusion ratio of one.

Ex-98. **First question –** The charitable deduction for T's transfer to the CLAT would be $834.504, resulting in a taxable gift at the creation of the trust of $165,496 ($1,000,000 - $834,504).

Second question – If T filed a timely gift tax return and allocated $165,496 of exemption to this trust, the adjusted GST exemption at the expiration of the 20 year lead interest would equal $664,788 ($165,496 plus interest at the rate of 7.2 percent compounded annually for 20 years). Accordingly, the CLAT would not have a zero inclusion ratio if the value of the property in the trust at the expiration of the lead interest exceeded that amount.

Third question – No. Formula allocations made with respect to a charitable lead annuity trust are valid only if they are dependent on values as finally determined for Federal estate or gift tax purposes as opposed to the value of the CLAT at the expiration of the lead interest. Treas. Regs. § 26.2632-1(b)(2)(i).

Ex-99. **Answer –** The new numerator of the applicable fraction is $350,000 ($100,000 plus the old fraction of 1/2 times $500,000) and the denominator is $500,000 (the value of the trust at the time of the allocation). The new applicable fraction is 7/10 and the new inclusion ratio is 3/10. See Treas. Regs. § 26.2642-4(b), Example 1.

Ex-100. **Answer –** It depends. If T fails to allocate additional exemption to the trust, the applicable fraction will change to 3/5 ($15,000 divided by $25,000) and the inclusion ratio will change to 2/5. If T makes a timely allocation of an additional $10,000 of exemption, the applicable fraction will remain at 1 ($25,000/$25,000) and the inclusion ratio will remain zero. Accord, Treas. Regs. § 26.2642-4(b), Example 2.

Ex-101. **Answer –** Only two-thirds of transfer is subject to the GST tax. Treas. Regs. § 26.2663-2(b)(1). See also Treas. Regs. § 26.2663-2(d), Example 1.

Ex-102. **First question –** The applicable fraction is 2/10ths determined as follows:

The nontax portion of the trust is $100,000/$500,000 or 20 percent. The applicable fraction is the value of the nontax portion (20 percent of $500,000) divided by $500,000 (the value of the property transferred to the trust). Treas. Regs. § 26.2663-2(d), Example 4.

Second question – The applicable fraction is 4/10ths determined as follows:

The numerator of the applicable fraction is equal to the sum of $100,000 (the value of the nontax portion, see previous question) and the $100,000 of exemption allocated to the transfer. The denominator of the applicable fraction is $500,000, the value of the property transferred to the trust. See Treas. Regs. § 26.2663-2(d), Example 3.

Third question – The applicable fraction is $260,000/$800,000 (.325) determined as follows:

The $260,000 numerator of the applicable fraction is equal to the $100,000 exemption allocation plus the value of the recomputed nontax portion of the trust. This latter is equal to 20 percent of the $800,000 date of allocation value of the trust. The denominator of the fraction is the same $800,000. Treas. Regs. § 26.2663-2(d), Example 5.

Ex-103. **First question** – The applicable fraction is .50 determined as follows:

Since the property is included in T's gross estate, the ETIP rule applies and the nontax portion of the trust as well as the applicable fraction are determined at T's death. At that time, the nontax portion is $300,000/$800,000 (or .375). The denominator of the applicable fraction is $800,000 and the

numerator is $400,000. This latter is the $100,000 of exemption plus $300,000 (the value of the nontax portion of the trust). Treas. Regs. § 26.2663-2(d), Example 6.

Second question – The applicable fraction is 1, determined as follows:

Since T survived the term of the trust, nothing was includible in his gross estate. Accordingly, the nontax portion and the applicable fraction are determined at the time of the initial transfer to the trust. The nontax portion is .8 ($400,000/$500,000). The denominator and numerator of the applicable fraction are both $500,000. The numerator is equal to $400,000 (the value of the nontax portion) plus the $100,000 of exemption allocated to the transfer. Treas. Regs. § 26.2663-2(d), Example 7.

Ex-104. **First question** – No. See Peterson Marital Trust v. Comm., 78 F.3d 795 (2d Cir. 1996).

Second question – Not according to the 8th and 9th Circuit. See Simpson v. U.S., 183 F.3d 812 (8th Cir. 1999); Bachler v. U.S., 281 F.3d 1078 (9th Cir. 2002), rev'g 126 F. Supp.2d 1279 (N.D. Cal 2000).

Caution: New Treas. Regs. § 26.2601-4(b)(4) is inconsistent with the result in the Simpson and Bachler cases. The validity of the GST effective date regulations was sustained by a divided Tax Court in Estate of Gerston v. Comm., 127 T.C. 139 (2006). More recently, the Tax Court decision was affirmed by the Sixth Circuit in Estate of Gerston v. Comm., 507 F.3d 435, 2007 WL 3307024 (6th Cir. 2007).

VI. Planning For The GST Tax

The primary consideration in planning for the GST tax is to insure that the GST tax exemption is effectively utilized.

- This in turn requires a consideration of how the exemption is allocated and the rules relating to when a single trust may be split into (or be treated as) two or more separate trusts.
- For married persons, the reverse QTIP election must also be considered.

A. The GST Exemption

Every person has a cumulative lifetime exemption ($5,430,000 for 2015) that may be used to shelter transfers from the GST tax.[442] Use of the exemption is discretionary; it must be allocated[443] to a particular transfer before the exemption becomes effective. [444]

1. GST exemption basics

The key to the effectiveness of the GST exemption lies in the following truism relating to the calculation of the GST tax.

No GST tax occurs on distributions from or terminations of interests in a trust having an inclusion ratio of zero.

And this is true regardless of the value of the property in the trust at the time of the distribution or termination. Thus, careful use of the exemption allocation can be used to shelter GSTs of far greater value than the exemption itself.

COMMENT
When exemption is allocated to property held in trust, the allocation applies to the trust itself rather than to any particular assets in the trust.[445] Accordingly, an inclusion ratio of zero is achieved only when the exemption allocated to the trust equals the GST value of the property transferred to it.

Ex-105: Grandparent transfers $5,430,000 in trust to pay income to Parent for life, remainder to Grandchild. Grandparent elects to allocate all $5,430,000 of his exemption to this transfer. Subsequently, Parent dies. At that time the trust is worth $20,000,000? What is the inclusion ratio for this trust at Parent's death. *Answers to the examples in this chapter begin on page 163.*

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442 IRC § 2631(a). Under the TRA 2010, the amount of the GST exemption is indexed for inflation from 2010 beginnin in 2012.

443 In many cases, the GST exemption is automatically allocated unless a contrary intention is expressed in the donor's gift or estate tax return. See "*Allocating the exemption*", beginning on p. 148.

444 Under TRA 2010, the GST exemption for transfers in 2010 is also $5,000,000. However, if the transfer is a GST event (that is a direct skip, taxable distribution, or taxable terminatin) the rate of tax for the event is zero.

445 Treas. Regs. § 26.2632-1(a).

2. Allocating the exemption

In general, the GST tax exemption may be allocated to a GST by the transferor or the transferor's executor at any time from the date of the transfer to the due date of the transferor's estate tax return (including extensions actually granted).[446]

The procedures for making the allocation and its impact if made, vary with the type of transfer and the timing of the allocation.

TRA 2010
Under Treas. Regs. § 301.9100-3, the Service may extend the time for making certain regulatory elections when the time for making the election is not prescribed by statute. With the enactment of TRA 2010, for GST events occurring prior to 2013, IRC § 2642(g)(1) deems the exemption allocation to be regulatory and directs the IRS to issue regulations detailing the circumstances and procedures under which an extension of time will be granted. The IRS has done this in Notice 2001-50, 2001-34 I.R.B.189. In addition, IRC § 2642(g)(2) now provides that substantial compliance with the statutory and regulatory rules for allocating the GST exemption is sufficient.[447]

a) Allocations during the transferor's life

(1) Allocations during the estate tax inclusionary period

Except in the case of a QTIP trust for which the IRC § 2652(a)(3) reverse QTIP election is made, an elective or automatic allocation of GST exemption during an ETIP does not become effective until the ETIP terminates.[448]

(a) ETIP Defined

The estate tax inclusionary period (ETIP) is that period of time after a lifetime transfer when any portion of the transfer would be includible in the gross estate of the transferor or the transferor's spouse other than by reason of IRC § 2035.[449]

Exceptions

1. An ETIP does not arise because of a power of withdrawal in the transferor's spouse if:
   - the power does not exceed the greater of $5,000 or 5 percent of the trust corpus, and
   - the power lapses within 60 days after the transfer to the trust.[450]
2. Transferred property is not considered as being includible in the gross estate of the transferor or the transferor's spouse if "the possibility that the property will be included is so remote as to be negligible."[451]

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446 IRC § 2632(a). Timely and late allocations made during the transferor's life are made on Form 709. After the transferor's death, Form 709 is used to make a timely allocation to a lifetime transfer that is not included in the transferor's gross estate. Form 706 is used to make all other allocations. Treas. Regs. §§ 26.2632-1(b), 26.2632-1(d). For additional guidance, see Treas. Regs. § 301.9100-7T. In PLR 9433013, the Service denied relief for a late allocation under Treas. Regs. § 301.9100-1 because the time for making the allocation is fixed by statute.

447 In particular, IRC § 2642(g)(2) states that "[a]n allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a particular transfer or trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio."

448 Nevertheless, the allocation during the ETIP is irrevocable. IRC § 2642(f)(1); Treas. Regs. § 26.2632-1(c)(1). Direct skips during an ETIP are treated as having occurred at the expiration of the ETIP. Treas. Regs. § 26.2632-1(c)(4).

449 Treas. Regs. § 26.2632-1(c)(2)(i)(A).

450 Treas. Regs. § 26.2632-1(c)(2)(ii)(B).

(b) Termination of ETIP

An ETIP terminates at the earlier of:

- The death of the transferor;
- The time at which no portion of the property would be includible in the gross estate of the transferor (other than by reason of IRC § 2035); or

COMMENT
For this purpose, the donor spouse is treated as the transferor of both portions of a split gift.

- The time that a taxable event actually occurs, but only with respect to the property involved in the taxable event.[452]

Ex-106: T transfers $50,000 to a discretionary trust for her husband and their 9 children and grandchildren. Each of the beneficiaries has a Crummey withdrawal power over $5,000. Will an allocation of exemption by T at the creation of the trust be effective?

Ex-107: T transfers property to an inter vivos QTIP trust.

1. When does the ETIP period end for this transfer if T makes both a gift tax QTIP election under IRC § 2523(f) and the reverse QTIP election under IRC § 2652(a)(3)?

2. Suppose T did not make the reverse QTIP election?

3. Suppose T did not make a QTIP election for gift tax purposes?

Ex-108: T transfers $500,000 to a grantor retained annuity trust with a 10 year term. At the expiration of the term, the trust property is to pass to his Grandchild. T's spouse consents to split the gift.

1. When will the ETIP period for this transfer end?

2. Suppose that three years after the creation of the GRAT, T sells the annuity interest to child C?

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451 This test is met if there is less than a 5 percent probability of inclusion. Treas. Regs. § 26.2632-1(c)(2)(ii)(A).

452 With respect to an ETIP arising because of an interest or power held by the transferor's spouse, on the first to occur of the spouse's death or the time at which no portion of the property would be includible in the spouse's gross estate (other than by reason of IRC § 2035). Treas. Regs. § 26.2632-1(c)(3).

COMMENT
In *Ex-108*, if T dies during the term of the GRAT, the trust property will be taxed in his estate and the transfer to Grandchild will qualify as a direct skip. If T survives the term period, however, the distribution to Grandchild will not qualify as a direct skip. As a result, unless C was dead at the creation of the trust (in which case the predeceased child exception would apply), the GST tax will be calculated on a tax inclusive basis. All things considered, it would be better for T to make his generation-skipping transfers in other ways.

(2) Automatic allocation to lifetime direct skips

If a direct skip occurs during the life of the transferor, any unused GST exemption is automatically allocated to the transfer.[453] A transferor may prevent this automatic allocation by indicating that intent on a Form 709 or by timely reporting the transfer and paying the appropriate GST tax.[454]

> ***Ex-109:*** T transfers $50,000 to a trust in a direct skip. T does not file a timely gift tax return electing out of the automatic GST allocation rule. Subsequently, after the due date for a gift tax return has passed, T and T's spouse file an initial gift tax return on which T's spouse consents to split the gift. Whose unused GST exemption is automatically allocated to this transfer?

(3) Automatic allocation to indirect skips

Under IRC § 2632(c), in the absence of a contrary election, the unused portion of a transferor's GST exemption[455] is automatically allocated to indirect skips made by the transferor during life. In general, the allocation is effective at the time of the indirect skip.

(a) Indirect skip defined

(i) In General

An indirect skip is any transfer of property (other than a direct skip) to a GST trust that is subject to the gift tax.[456] A GST trust is any trust that could have a GST event with respect to the transferor.[457]

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453 IRC § 2632(b); Treas. Regs. § 26.2632-1(b)(i). The automatic allocation is effective as of the date of the transfer to which it relates.

454 Treas. Regs. § 26.2632-1(b)(1)(i). A Form 709 is timely filed if it is filed on or before the date prescribed in IRC § 6075(b) for reporting a taxable gift (including any extensions actually granted). The automatic allocation (or the election to prevent one) is irrevocable after that date. Treas. Regs. § 26.2632-1(b)(1)(ii). But see Treas. Regs. § 26.2632-1(b)(1)(iii) (an election to prevent automatic allocation filed on or before January 26, 1996, does not become irrevocable until July 24, 1996.

455 The unused portion of the transferor's GST exemption is the portion of the exemption that has not previously been allocated (automatically or otherwise). See IRC § 2632(c)(2).

456 IRC § 2632(c)(3)(A).

457 IRC § 2632(c)(3)(B)

(ii) EXCEPTIONS

The term GST trust does not include any of the following trusts:

a) **Exception 1:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to (or may be withdrawn by) one or more nonskip persons:

- Before they attain the age of 46; or
- On or before one or more dates specified in the instrument that will or (as specified in regulations) reasonably may be expected to occur before the nonskip persons attain the age of 46.[458]

b) **Exception 2:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to (or may be withdrawn by) one or more nonskip persons who survive the death of a person specified in the instrument by name or class description who is more than 10 years older than the nonskip person or persons.[459]

c) **Exception 3:** A trust where the instrument provides that more than 25 percent of the trust corpus must be distributed to the estate or estates of (or is subject to a general power of appointment held by) one or more nonskip persons if one or more of them dies on or before a date or event described in a) or b) above.[460]

d) **Exception 4:** A trust any portion of which would be included in the gross estate of some nonskip person other than the transferor if such person died immediately after the transfer to the trust.[461]

e) **Exception 5:** A charitable lead annuity trust, a charitable remainder annuity trust, or a charitable remainder unitrust.[462]

f) **Exception 6:** A charitable lead unitrust the noncharitable beneficiary of which is a nonskip person.[463]

> ***Ex-110:*** H establishes an irrevocable trust for his child. The trust provides for an outright distribution to the child at age 40. If the child dies before that age, all trust property is to be distributed to the child's issue.[464]
>
> 1. Is this trust a GST trust to which the automatic allocation rules apply?

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458 IRC § 2632(c)(3)(B)(i).

459 IRC § 2632(c)(3)(B)(ii).

460 IRC § 2632(c)(3)(B)(iii).

461 IRC § 2632(c)(3)(B)(iv).

462 IRC § 2632(c)(3)(B)(v).

463 IRC § 2632(c)(3)(B)(vi).

464 This and the other examples dealing with the new automatic allocation of GST exemption to indirect skips are based on examples created by David Dreyer of Jones Foster Johnston & Stubbs, P.A. Many thanks for his generous permission to use them.

2. Would the answer change if the instrument provided that outright distribution to the child could be suspended by the trustee if the child becomes disabled or frequently uses illegal substances?

Ex-111: H establishes an irrevocable trust for the benefit of W for life, and at her death, outright to H's issue, per stirpes. W is age 30, and H has 3 children ages 18, 21, and 25.

1. Is this trust a GST trust to which the automatic allocation rules apply?

2. Would the answer change if W had a testamentary power of appointment exercisable in favor of H's issue?

Ex-112: H establishes an irrevocable trust for the benefit of W for life. At W's death, the property is to be divided among H's issue, per stirpes and distributed one-half at age 30 and the balance at age 35. If any beneficiary survives W, and dies before reaching 35, the beneficiary has a general power of appointment over that beneficiary's portion. W is age 41, and the children are 21, 25 and 30. Is this trust a GST trust to which the automatic allocation rules apply?

Ex-113: H establishes an irrevocable trust for the benefit of child for life, and upon child's death to grandchildren. The trust provides that child has the right to appoint trust assets in favor of creditors of the child's estate over any portion of the trust for which a GST tax would otherwise be incurred in the absence of such power. Is this trust a GST trust to which the automatic allocation rules apply?

(iii) SPECIAL RULE FOR LIMITED WITHDRAWAL AND OTHER POWERS

In determining whether a trust is a GST trust to which the automatic allocation rules apply:

- Property is not considered to be includible in the gross estate of, or subject to a right of withdrawal by, a nonskip person if or to the extent the power does not exceed the amount of the gift tax annual exclusion.

- It is to be assumed that powers of appointment held by nonskip persons will not be exercised.[465]

> ***Ex-114:*** H establishes an irrevocable pot trust for the benefit of his 10 grandchildren and their descendants and funds the trust with $100,000. All 10 grandchildren have Crummey withdrawal powers. Will GST exemption be automatically allocated to this trust at its creation?

> ***Ex-115:*** H establishes an irrevocable pot trust for the benefit of his children and their descendants. The trust is to last as long as permitted by state law.[466] H's child has a Crummey withdrawal right which is limited to the amount of a single annual exclusion. The child also has a special testamentary power of appointment to appoint trust property.
>
> 1. If the child's withdrawal power lapses after 30 days, is this trust a GST trust to which the automatic allocation rules apply?
>
> 2. Would the answer change if child's power was a hanging power?

(b) Special rule for transfers involving an ETIP

With respect to transfers to which the ETIP rules of IRC § 2642(f) apply, the transfer itself is deemed to occur at the expiration of the ETIP. Accordingly, the value of the property involved in the transfer and probably the question of whether the transfer itself is an indirect skip (see below) is to be determined at that time.[467] For more on the ETIP rules, see "*Allocations during the estate tax inclusionary period*", supra p. 138.

> ***Ex-116:*** H establishes a QPRT to last for the shorter of H's life or for a period of 10 years. At the termination of the trust, the trust property is distributable to H's child if H survives to the date or termination; otherwise the trust is to revert to H's estate. Will GST exemption be automatically allocated to this trust at its creation?

> ***Ex-117:*** In 1999, H (age 60) established a $800,000 zeroed-out GRAT, retaining a qualified annuity interest

[465] IRC § 2632(c)(2)(B) (flush language at the end).

[466] Which in Florida is 360 years. See Fla. Stat. § 689.225(2)(f) (2015).

[467] See IRC § 2632(c)(4).

for 5 years. The GRAT provides that at the termination of the term, the trust assets are to be distributed to H's child, but if the child is deceased to the child's issue. H's child was 30 years old at the inception of the trust. H's child dies in 2002. At that time, the property in the GRAT is worth $500,000. At the expiration of the 5 year term, the GRAT (worth $300,000) is distributed to C's child. How do the new automatic allocation rules of IRC § 2632(c) apply to these facts?

(c) Electing in or out of the automatic allocation rules

IRC § 2632(c)(5)(A) provides that an individual may elect not to have the automatic allocation rules apply to a GST trust where they otherwise would apply or to elect to have rules apply to a trust where they would otherwise not apply. Either election may be made as to a specific transfer, or if preferred, as to all transfers made to a particular trust.[468]

Ex-118: In December of 2001, H transfers $100,000 to an irrevocable insurance trust which meets the definition of a GST trust. On April 16th of 2002, the value of the trust is $20,000. Can H make a late allocation of $20,000 of exemption or do the new automatic allocation rules preclude doing this?

(4) Retroactive allocations

Under IRC § 2632(d),[469] a transferor may make a retroactive allocation of his or her unused GST exemption to a previous transfer in trust if:

- A beneficial interest (current or future) is held by a nonskip person who is a child, niece, nephew, or child of a first cousin of either the transferor or of the transferor's current or former spouse; and
- The beneficiary dies before the transferor.

The allocation must be made on a timely filed gift tax return for the year of the nonskip person's death. The determination of the amount of the transferor's unused GST exemption and the effective date of the retroactive allocation of it both occur immediately before the death of the nonskip person. The allocation itself, however, is based on the gift tax value of the transferred property at the time of the original transfer.[470]

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468 The election out of the automatic allocation rules with respect to a particular indirect skip may be made on a timely filed gift tax return for the calendar year the transfer is made (or deemed to be made under the ETIP rule). IRC § 2632(c)(5)(B)(i). The election out of automatic allocations for a particular trust or into automatic allocation for a particular transfer or trust may be made on a timely filed gift tax return for the calendar year for which the election is to become effective. IRC § 2632(c)(5)(B)(ii).

469 With the enactment of TRA 2010, this section applies to transfers made from 2001 to the end of 2012.

470 For additional discussion of new IRC § 2632(d), see Harrington, McCaffrey, Plaine & Schneider, Generation-Skipping Transfer Tax Planning After the 2001 Act: Mostly Good News, Vol. 95 No. 3 J. Tax. 143 at 160 (September 2001).

Ex-119: T transfers property worth $100,000 to a discretionary trust for the benefit of T's spouse S and his child C. The trust provides that all trust property is to be distributed to C at S's death or, if C is not living, to C's children then living. No GST exemption is allocated to the trust at the time of its creation. C dies several years later, survived by T, S, and a child GC. At that time, the property in the trust is worth $500,000.

1. May T make a retroactive allocation of GST exemption to this trust?

2. How much exemption must T allocate to give the trust a zero inclusion ratio?

(5) Other lifetime allocations

For lifetime GSTs for which an automatic allocation is not in effect, an election to allocate GST exemption may be made on a timely filed Form 709[471] (in which case it is effective as of the date of the transfer) or on a late Form 709 (in which case it is effective from the date of filing).[472]

In either case, the allocation, which may be expressed as a formula, is void to the extent:

- it is made to a trust having no GST tax potential, or
- it exceeds the amount necessary to obtain an inclusion ratio of zero.[473]

b) Allocations after the death of the transferor

A transferor's personal representative may allocate any unused GST exemption at a transferor's death.[474] An attempted allocation is void to the extent it is made with respect to a trust that has no GST tax potential.[475]

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471 A voluntary allocation of GST exemption must state the value of the assets in the trust to which the exemption is being allocated if either:

- the trust will have an inclusion ratio other than zero, or
- regardless of the inclusion ratio, the allocation is not made on a timely filed Form 709. Treas. Regs. § 26.2632-1(b)(2)(i).

An allocation may be modified on a subsequent amended Form 709 only if the form is filed before the last date on which a timely-filed form could be filed. See Treas. Regs. §§ 26.2632-1(b)(2)(ii), 26.2632-1(b)(2)(iii), Examples 1 and 2. After that date, the allocation is irrevocable. Treas. Regs. § 26.2632-1(b)(ii).

472 A late allocation made at the same time as an event giving rise to a taxable event is treated as occurring immediately prior to the event. See Treas. Regs. §§ 26.2632-1(b)(2)(ii)(A)(1); 26.2632-1(b)(iii), Example 4. If it is unclear whether an allocation is late or timely, the allocation is effective first to the extent it would be timely for any transfer disclosed on the return, then as a late allocation and finally as to any transfer not disclosed on the return as to which the allocation would be timely. Treas. Regs. § 26.2632-1(b)(2)(ii). For an example applying this priority scheme, see Treas. Regs. § 26.2642-4(b), Example 4.

473 Treas. Regs. § 26.2632-1(b)(2)(i). See also Treas. Regs. § 26.2642-4(b), Example 3. This rule does not apply to charitable lead annuity trusts. See Treas. Regs. § 26.2642-3(b) discussed infra p. 137.

474 In general, the allocation with respect to property included in the transferor's gross estate is made on the transferor's estate tax return and is effective as of the date of the transferor's death. As for lifetime transfers that are not included in the transferor's gross estate, a timely allocation of exemption is made on Form 709 and a late allocation is made on Form 706. A timely allocation is effective as of the date of the transfer. A late allocation is effective as of the date the allocation is filed. Treas. Regs. § 26.2632-1(d)(1).

475 Treas. Regs. § 26.2632-1(d)(1).

If the time for filing the transferor's estate tax return passes without his personal representative having allocated all of his exemption, any unused exemption is automatically allocated:

1. first to testamentary direct skips and
2. then to transfers in trust that have a potential for subsequent GST tax exposure,[476] other than a QTIP trust for which no reverse QTIP election is made.[477]

Within each category, the allocation is made prorata on the basis of the values of the nonexempt portion of each transfer.

COMMENT
A prorata allocation across several transfers is unwise because no distribution or termination in any trust will be entirely tax free. It is a better use of the exemption to allocate it so that one or more trusts are entirely exempt. To do this, the executor must make an affirmative allocation on a timely filed estate tax return. An allocation is void if the Form 706 is filed late.[478]

B. Single Trust Treated as Separate Trusts

Generally a single trust must be treated as one trust for purposes of the GST tax. However, in three situations explored next, a single trust is treated as two or more separate trusts.[479]

COMMENT

Where separate treatment applies the inclusion ratio for each share is determined separately of the other shares. Unless the governing instrument provides otherwise, however:

- Additions to and distributions from the trust are allocated prorata among the separate trusts,[480] and
- Any automatic allocation of GST exemption is allocated prorata among the separate shares.[481]

1. Single trust with multiple transferors

If a single trust has more than one transferor, the portion of the trust attributable to each transferor is treated as a separate trust.[482]

> ***Ex-120:*** H dies with a will that creates a QTIP eligible trust of $1,500,000 for the benefit of his spouse W. H's personal representative makes a partial QTIP election with respect to 2/3rds of this trust.

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476 IRC § 2632(e).

477 Treas. Regs. § 26.2632-1(d)(2) exempts from automatic allocation "any trust that will have a new transferor with respect to the entire trust prior to the occurrence of any GST with respect to the trust." A trust is also exempted from automatic allocation if during the 9 month period after the transferor's death, no GST has occurred and after such period no GST is possible.

478 Treas. Regs. § 26.2632-1(d)(2).

479 The effect of separate treatment is limited to the GST tax. It does not apply for other purposes such as the filing of returns, the payment of tax or for the computation of any other tax. Treas. Regs. §§ 26.2654-1(a)(1)(i); 26.2654-1(a)(2)(i).

480 Treas. Regs. § 26.2654-1(a). See also Treas. Regs. § 26.2654-1(a)(5), Example 7.

481 Treas. Regs. § 26.2654-1(a)(4). A pro rata allocation may be avoided by exercising the election to opt out of the automatic allocation. The transferor can opt out as to either share.

482 Treas. Regs. § 26.2654-1(a)(2). See also Treas. Regs. § 26.2652-2(c) creating a special transitional rule for certain QTIP property under which a single trust is treated as having two separate transferors.

1. Assuming no reverse QTIP election is made, how is this trust treated for GST tax purposes?

2. Suppose that at W's death some years later, when the value of the property in the QTIP trust is $1,800,000, W dies with a will that leaves an additional $600,000 to this trust. What portion of the trust is W the transferor of after the additional contribution?

2. Substantially separate and independent shares

Each share of a single trust that consists substantially of separate and independent shares for different beneficiaries is treated as a separate trust.[483]

COMMENT
The phrase "substantially separate and independent shares" has the same meaning as provided in Treas. Regs. § 1.663(c)-3 subject to the added requirement that the shares must exist at all times after the creation of the trust. A trust that is includible in its entirety in the gross estate of its grantor is treated as created at the date of the grantor's death.

Ex-121: T creates a trust to last until his grandchild attains majority or dies. Until that time the trust income is to be distributed equally to T's child (or his estate) and the grandchild. No distributions of principal may be made until the trust terminates. At termination, the trust principal is to be divided equally between the child and the grandchild (or their estates). Does this trust qualify for separate share treatment under the GST tax?

Ex-122: T creates a trust for the benefit of children and grandchildren. The trustee has discretion to spray income and principal among the beneficiaries until the youngest child attains age 21 at which time the trust provides that separate shares are to be maintained for each line of lineal descent. Will the separate shares be treated as separate trusts for purposes of the GST tax?

3. Certain pecuniary gifts from trusts

A required pecuniary gift at the death of the transferor from a trust includible in the transferor's gross estate is a separate and independent share if:

a) The trustee is required to pay appropriate interest to the beneficiary,[484] and

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483 Treas. Regs. § 26.2654-1(a)(1)(i).

484 See the comment under "*Residual transfers following pecuniary bequests to nonskip persons*", supra p. 136 for the meaning of "appropriate interest."

b) If the gift is payable in kind at other than date of distribution values, the trustee is required to allocate assets fairly representative of the appreciation or depreciation in the trust as a whole.

> ***Ex-123:*** At her death, T's revocable inter vivos trust divides into two shares on the basis of a formula gift that allocates a pecuniary amount to T's surviving spouse and a residual amount to a credit shelter trust. The terms of the trust authorize the trustee to fund the gift in cash or in kind using date of distribution values. Will the pecuniary gift to the spouse be treated as a separate share?

COMMENT
For a graphical treatment of the GST consequences of various pecuniary gifts from a trust, see "*Appendix A-2 – Distribution of Pecuniary Gift From Inter Vivos Trust Included in Gross Estate*", infra p. 280.

C. DIVISION OF SINGLE TRUST INTO SEPARATE TRUSTS

A single trust with separate shares or multiple transferors may be divided into separate trusts at any time.[485] Otherwise, the rules which control the ability to sever a trust for GST tax purposes will depend on when the severance is attempted.

1. Regulatory severances

Under the regulations, a division of a single trust into separate trusts will be recognized for purposes of the GST tax only if the trust was included in the transferor's gross estate (or was created under the transferor's will) and:

a) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or

b) The instrument does not direct or require severance but the severance occurs pursuant to a discretionary authority granted under either the governing instrument or under local law; and

1. The terms of each new trust provide for the same succession of interests and beneficiaries as the original and

2. The severance occurs (or a reformation proceeding, if required, is commenced) prior to the due date of the transferor's estate tax return (including extensions) and either

   - the new trusts are severed on a fractional basis; or

   - in the case of a severance on the basis of a pecuniary amount, the severance by that method is required by the terms of the governing instrument and the pecuniary payment meets the requirements for a pecuniary payment from a trust to be treated as a separate share.[486]

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485 Treas. Regs. § 26.2654-1(a)(3). Thus, the service has ruled that a single trust with two transferors may be segregated into separate trusts with two different inclusion ratios. See PLR 200039003.

486 See "*Certain pecuniary gifts from trusts*," on p. 157.

Where a valid severance occurs, GST exemption may be allocated to either or both of the separate trusts.[487]

COMMENTS
A fractional severance need not be funded pro rata with a portion of each asset provided only that funding is based on the fair market values on the date of severance or in a manner that fairly reflects the appreciation or depreciation in the value of the assets as of that date.[488]

Ex-124: T's will leaves the residue of his estate to his revocable inter vivos trust.

1. If T's trust contains a formula pecuniary marital gift under which the trust is divided into separate QTIP and credit shelter trusts, will the division be recognized as creating two separate trusts for GST tax purposes?

2. Suppose that after the initial split, T's personal representative divides the QTIP trust into two shares, one consisting of $400,000 and one holding the balance. As to the former, the personal representative makes an IRC § 2652(a)(3) reverse QTIP election. Will the split of the QTIP trusts be recognized for GST purposes?

COMMENT
The detailed rules dealing with trust severances are presented in graphical format in "*Appendix A-1 – Severing Trusts Included in the Gross Estate*", infra p. 279.

2. Qualified (i.e., statutory) severances

IRC § 2642(a)(3) provides a statutory basis for dividing trusts for GST tax purposes.

Under the section, a trust severance will be recognized for GST tax purposes if it is a "qualified severance". A qualified severance means the division of a trust and the creation of two or more trusts by any means available under the governing instrument or local law[489] if:

a) The severance is effective under local law;[490]

b) The single trust is divided on a fractional basis;[491]

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487 Treas. Regs. § 26.2654-1(b)(3).

488 Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(1). As written, the regulations do not appear to apply the appropriate interest or funding requirements to a mandatory severance.

489 Including court ordered severances. Treas. Regs. § 26.2642-6(d)(1). On the authority to split trusts under the Florida Trust Code, see Fla. Stat. § 736.0417 (2015), effective July 1, 2007. On the authority to split trust under prior law, see Fla. Stat. § 737.403(1)(b) (2015) and (c).

490 Treas. Regs. § 26.2642-6(d)(2).

491 Pecuniary severances are not permitted. However, formula severances are. Thus a severance could be phrased in terms of a fraction with a numerator equal to a transferor's unused GST tax exemption and a denominator equal to the fair market value of the trust's assets as of the date of severance. Treas. Regs. § 26.2642-6(d)(4).

c) Funding of the severed trust commences immediately and is completed within a reasonable time not to exceed 90 days after the date of the severance;[492]

COMMENT
It is not necessary to fund the trust with a pro rata percentage or portion of each asset. Non-pro rata funding is permissible provided the trust receives the appropriate fraction or percentage of the total (undiscounted)[493] fair market value of the trust assets as of the date of severance.[494]

d) The terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust;[495] and

e) If the trust to be severed has an inclusion ratio of either 0 or 1, the resulting trusts must have the same inclusion ratio as the original trust;[496] and

Ex-125: T establishes a trust with income and principal distributable in the discretion of the trustee to or for the benefit of T's two children (C1 and C2) and their descendants. The trust which has an inclusion ratio of 1 is to last until the death of the last of T's two children at which time trust income and principal is to be distributed to T's descendants per stirpes (i.e., half to C1's descendants and half to C2's descendants). If T splits the trust into two trusts, both with an inclusion ratio of 1, but one of which provides for discretionary distributions of income and principal to C1 and his descendants with remainder to C1's descendants at his death and the second of which provides similarly for C2 and C2's descendants, will the split constitute a qualified severance?

Ex-126: T establishes a trust with income payable to child C for life with remainder at C's death to such of C's descendants as C appoints by will. The trust further provides however, that if the inclusion ratio of the trust at C's death is greater than 0, C's power may also be exercised in favor of the creditors of his estate as to the fraction of the trust equal to the trust's inclusion ratio. If, at a time when the inclusion ratio of the trust is .60, will a severance of the trust on a 40/60 basis where C's power to distribute to the creditors of his estate extends only to the 60 percent trust be a qualified severance?

Ex-127: T establishes a 10-year trust with income payable in equal shares to N (a nonskip person) and S (as skip person). At the expiration of the 10-year term, trust principal is distributable half to N (or to N's descendants) and half to S (or to S's descendants). The trust has an inclusion ratio of .50. If Trustee splits the trust in a qualified severance into two trusts, one for N and his descendants and one for S

492 The date of a severance is either the date selected by the trustee as of which the trust assets are to be valued for purposes of the severance or the court-imposed date of funding in the case of a court ordered severance. Treas. Regs. § 26.2642-6(d)(3).

493 The prohibition against using discounted values appears in Treas. Regs. §§ 26.2642-6(d)(4) and 26.2642-6(k)(1).

494 Treas. Regs. § 26.2642-6(d)(3). See also Treas. Regs. § 26.2642-6(j), Ex. 5. In general, a non-pro rata funding of a qualified or regulatory severance will not result in a sale or exchange for income tax purposes provided the severance and the non-pro rata funding of it are authorized by an applicable state statute or by the governing instrument. Treas. Regs. § 1.1001-1(h)(1)..

495 Treas. Regs. § 26.2642-6(d)(5).

496 Treas. Regs. § 26.2642-6(d)(6)

and her descendants, what advice would you give Trustee to minimize GST tax implications of the split?

D. MARRIED PERSONS

Where the combined estates of both spouses is less than a single GST exemption, their estates may be planned without concern for the GST. The automatic GST exemption allocation rules will eliminate all potential GST exposure.

For marital estates larger than a single GST exemption, the primary planning objective is to fully utilize the GST exemption of both spouses through the creation of one or more trusts that are totally exempt.

1. Planning for the death of the less wealthy spouse

If the less wealthy spouse dies first, some of that spouse's GST exemption will be wasted if that spouse does not have an estate in excess of the GST exemption. This "order of death" risk can be eliminated either

- by making split gifts or
- by making inter-spousal gifts.[497]

COMMENT
When using inter-spousal gifts to eliminate the order of death risk, the gift to the spouse may be made to an inter vivos QTIP trust for which no IRC § 2652(a)(3) election is made.

DRAFTING TIP
The spouse's PR will have to allocate the spouse's GST exemption to the trust. Authority to make an allocation to a trust created by the first spouse should be included in the instrument. If the beneficiaries of the QTIP trust are different from the beneficiaries of other trusts created by the surviving spouse, presumably the PR must first allocate the spouse's exemption to the spouse's trust(s). Consequently, it will usually be impossible to predict with total accuracy how much exemption will be allocated to an inter vivos QTIP. Accordingly, the trustee should be given the authority to split the trust before the allocation is made and the authority to terminate any nonexempt trust arising from the split that proves to be uneconomically small. ***Note***: *A provision in the Florida Trust Code empowers trustees to sever trusts for any reason unless that authority is expressly prohibited in the trust instrument.*[498]

2. Integrating the GST exemption and the marital deduction

After the "order of death" risk is covered, a few simple clauses (and decisions) are needed. Among the most important are:

- Use a QTIP trust for the marital gift. This makes it possible to use the reverse QTIP election to fully utilize the GST exemption at the death of the first spouse.

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497 If the donee spouse is not a U.S. citizen, the marital deduction may not be used to insulate interspousal gifts from the gift tax. Instead, the $147,000 annual exclusion for gifts to noncitizen spouses must be used.

498 See Fla. Stat. § 736.0417 (2015), effective July 1, 2007. On the authority to sever trusts under prior law, see Fla. Stat. § 737.402(2)(bb) (2015), effective October 1, 1995. See also Fla. Stat. § 737.403(1)(a) (2015).

- Include a clause giving the personal representative the authority to allocate a decedent's GST exemption to any trust for which the decedent is the transferor for GST purposes and another one authorizing the personal representative to consider taxes of the decedent, his spouse, and their families in making the QTIP elections for the estate and GST taxes. Additional clauses should relieve the personal representative of liability for decisions made in good faith and clarify whether compensating adjustments are or are not to be made.
- The trustee of the QTIP trust should have the authority to split the QTIP trust into two trusts prior to making the estate tax and IRC § 2652(a)(3) QTIP elections.[499] This is necessary because the reverse QTIP election must be made as to an entire trust. If a pecuniary split is to be used, it must be required in the instrument. Otherwise a fractional split will be necessary. In this latter case, the trustee should have the authority to make nonprorata allocations of trust property to the two shares.[500]
- The QTIP trust(s) should provide that to the extent practical, distributions of principal to the surviving spouse should be made out of trusts whose inclusion ratio is greater than zero. This also means that one goal in our planning will be to minimize allocation of GST exemption to QTIP trusts. QTIP trusts must distribute income currently to the surviving spouse.
- Likewise, the trusts and the surviving spouse's will should, to the extent possible, provide that any taxes attributable to QTIP property at the death of the spouse be paid by a QTIP trust whose inclusion ratio for GST purposes is greater than zero. For more on this see the John and Mary Sample scenario beginning on the next page.
- A clause in the QTIP trust should be included directing where QTIP property is to go in the event the spouse makes a qualified disclaimer of some or all of her interest in the QTIP trust.
- Finally, the trustees of all trusts created in the estate plan should be given the authority to merge trusts with an inclusion ratio of either zero or one into a single trust with the same inclusion ratio.

3. Using a partial disclaimer as an alternative

A partial disclaimer of the QTIP trust may be used as an alternative to the reverse QTIP election.

One **advantage** of a partial disclaimer is that the disclaimed property will be removed from the strictures of the QTIP trust. Disclaimed property could be added to the credit shelter trust. Alternatively, decedent's will could direct that a separate "disclaimer trust" be created to hold the property.

One **possible disadvantage** is that property disclaimed from the QTIP trust will no longer qualify for the estate tax marital deduction. Thus, a disclaimer should only be used where it is otherwise contemplated that some taxes should be paid at the death of the first spouse.

4. Complying with the Rule Against Perpetuities

All things being equal, exempt trusts should be drafted to last as long as possible. The primary limiting factor on trust duration is the Rule Against Perpetuities.

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499 This effectively circumvents the prohibition against partial IRC § 2652(a)(3) elections. See Treas. Regs. §§ 26.2652-2(a), 26.2654-1(b)(1).

500 See Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(1). This regulation is discussed further at page 158. On the authority of a trustee of a Florida trust to split trusts, see the "*Note*" in the Drafting Tip on p. 162.

5. GST case study — John and Mary Sample

Consider the initial planning and postmortem decisions of John and Mary Sample. They have estates of $15,000,000 and $1,500,000 respectively. John has used $200,000 of his applicable exclusion amount for gifts to his children. John and Mary have reciprocal estate plans. Each leaves $200,000 outright to the survivor with the residue going to a revocable inter vivos trust. The trust is also named beneficiary of any insurance policies on the life of the decedent. For illustration purposes, the numbers generated below assume that John and Mary each die in a year when the applicable exclusion amount is $5,000,000.

a) The marital deduction plan

John’s pour over will devises his probate estate to his revocable Living Trust. If Mary predeceases John, the property in the revocable trust is to be held in continuing trust for John's surviving descendants from time to time living. If Mary survives John, the trust contains a formula gift under which John’s $14,800,000 trust is divided into a $4,800,000 Family Trust and a $10,000,000 Marital Trust. It is anticipated that both trusts will continue after the death of John and Mary for the benefit of their descendants from time to time living.

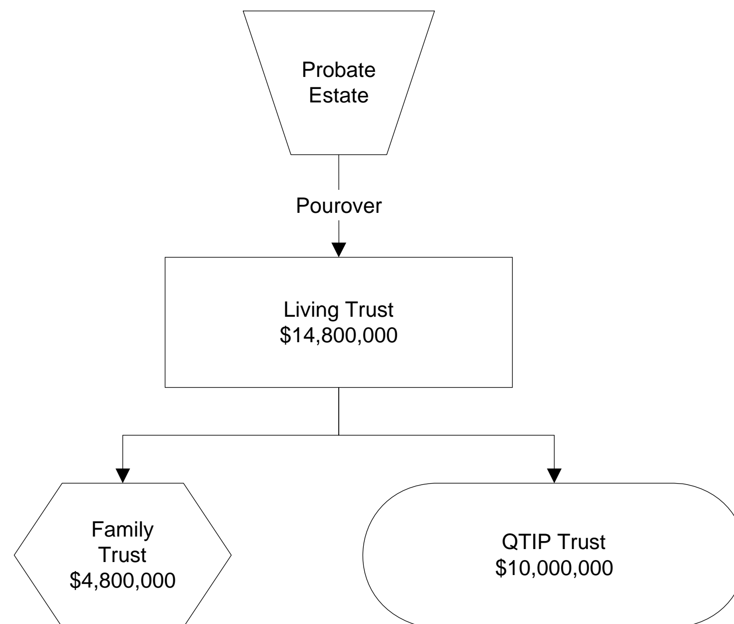

Fig. 1 At death, John's revocable trust splits into marital and nonmarital shares.

John has used $200,000 of his applicable exclusion amount for gifts to children.

b) Insuring recognition of the Marital/Family share split

The initial concern with plans of this type is whether the split of the revocable trust into two trusts will be honored for GST tax purposes. If it isn’t, an automatic or directed allocation of $4,800,000 of exemption to the Family Trust will not result in a zero inclusion ratio since the Family and QTIP trusts would be treated as a single trust for GST purposes.

(1) Appropriate interest

The severance of the living trust will not normally meet the requirements for a qualified severance under new IRC § 2642(a)(3). In many cases, the division between family and marital shares will be accomplished by way of a pecuniary

formula. Qualified severances must be done on a fractional basis. In addition, it would rarely be the case that the Family and QTIP trusts would provide for the same succession of interests as is required for a qualified severance. Accordingly, the severance into family and marital shares must be done in accordance with the detailed regulatory requirements for when a split of a trust included in the transferor's gross estate will be recognized for GST purposes. These rules are summarized in graphical form in Appendix A-1, infra p. 279.

Among the requirements is that pecuniary gifts carry appropriate interest under applicable state law or the terms of the governing instrument. Because it is often unclear whether the appropriate interest requirement is met under state law,[501] particularly when the pecuniary gift appears in a revocable trust, the instrument should be drafted to insure compliance with the appropriate interest requirement.

COMMENT
The provision under discussion here can provide either that the pecuniary gift is to share in fiduciary income or that it is to bear interest. In general, the former will be preferable because the Trust gets a deduction when it distributes income. No deduction is available if a trust pays interest on a pecuniary gift.

(2) Providing for an eligible funding mechanism

In addition to the appropriate interest requirement discussed above, the split of a revocable trust into Marital and Family Trusts must be accomplished by an appropriate funding mechanism. (See the graphical decision tree in Appendix A-1, infra p. 279.)

- In the case of a fractional share formula, it is not necessary to fund the two shares with a pro rata portion of each asset. The instrument (or state law)[502] can permit non-pro rata funding provided the instrument requires either that the assets be valued at date of funding values or that the assets selected be fairly representative of the net appreciation or depreciation in the value of all trust assets available for funding.[503]
- In the case of a pecuniary formula, the instrument must provide that assets used to fund the pecuniary gift in kind be valued either on the date of funding or in a manner that fairly reflects the net appreciation of depreciation in the value of all assets available for funding.[504]

COMMENT
With one exception, the funding mechanism in a marital formula gift will comply with the GST tax requirements if it meets the requirements for the marital deduction. A pecuniary formula gift with minimum worth funding is the exception. That funding mechanism is not allowable for GST tax purposes. Accordingly, its use in any estate with even a potential for GST tax exposure is problematic.

501 The requirement is met if state law provides that the pecuniary gift bears interest or that a pro rata share of fiduciary accounting income is to be allocated to the gift. For a chart summarizing the law of all 50 states on this, see Covey, Practical Drafting 4853 – 4863 (April 1997).

502 On the authority of a trustee or personal representative to make non-pro rata distributions in Florida, see Fla. Stat. § 733.810(5) (2015).

503 Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(1).

504 See Treas. Regs. § 26.2654-1(b)(1)(ii)(C)(2). See also Treas. Regs. § 26.2654-1(a)(1)(ii).

c) Reverse QTIP election options

Before the time for filing John's estate tax return, John's personal representative must decide how to allocate John's GST exemption. Two approaches are considered. One allocates exemption to the Family trust and the other doesn't.

- Under both, John's personal representative will split John's QTIP Eligible trust into an Exempt QTIP trust and a Nonexempt QTIP trust.
- Using the reverse QTIP election to make John the transferor, John's personal representative will then allocate John's GST exemption to the Exempt QTIP trust giving it an inclusion ratio of zero.

(1) Nonexempt Family Trust

Under the first of the two approaches, John's personal representative will split the trust so that the Exempt QTIP trust will be sufficiently large to use all of John's GST exemption. Assuming no exemption has been used previously, this will require a trust of $5,000,000.

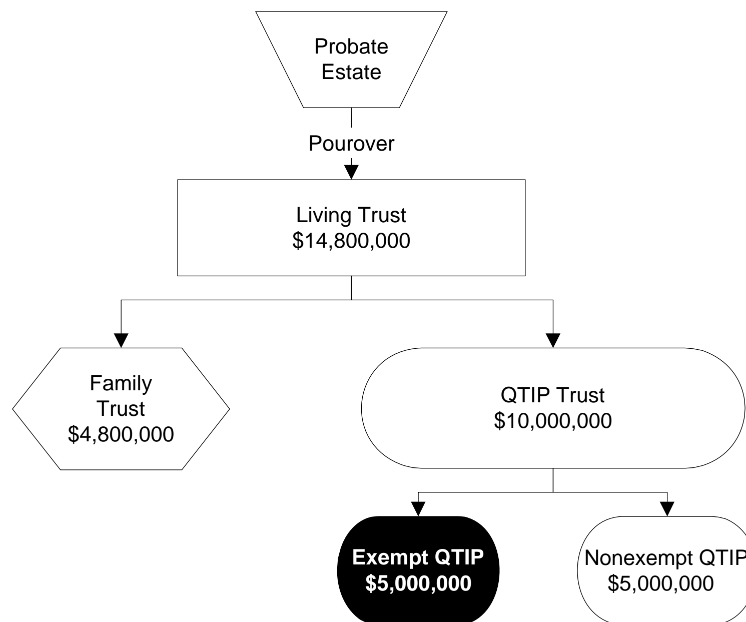

Fig. 2 Reverse QTIP with no GST exemption allocated to Family trust

COMMENT
This approach leaves the property in the Family trust available for the use of nonskip persons without wasting John's GST exemption. This would be particularly useful if John's spouse was not a US citizen. In that case, it may be better to use the Family trust to provide for the spouse during life because distributions of principal from either of the QTIP trusts would be subject to a QDOT-estate tax.[505]

(2) Exempt Family

Under the second approach, $4,800,000 of John's $5,000,000 exemption would be allocated to the Family trust and the reverse QTIP election would be used to

[505] See "*Tax consequences of a QDOT*" on p. 103.

create an Exempt QTIP trust equal to the remaining $200,000 of John's exemption.

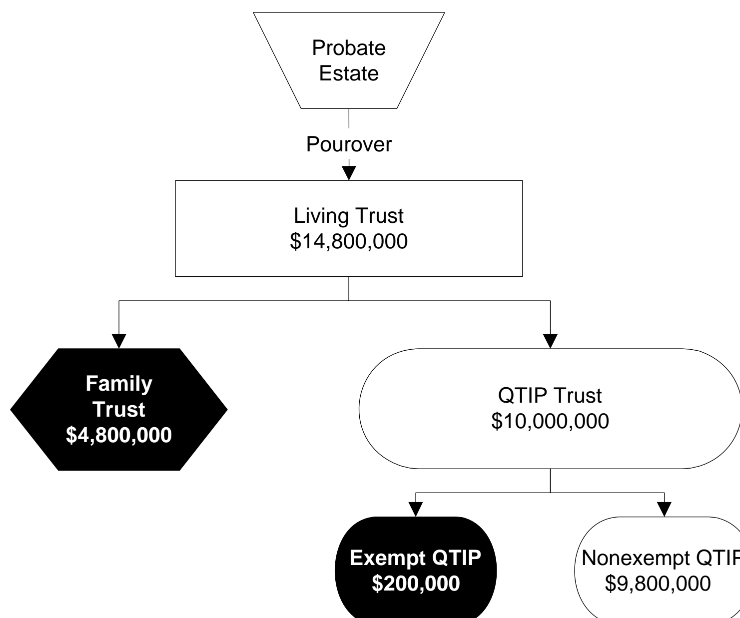

Fig. 3 Reverse QTIP with exempt Family trust

(3) Comparing approaches

Of the two approaches to using John's GST exemption, the second will generally be the preferable.

- Distributions to skip persons from the Family Trust during the life of the surviving spouse may be necessary or desirable. If the Family Trust is exempt, those distributions may be made tax free.
- Additionally, exempting the Family Trust makes greater use of the exemption because both the principal and the trust income can be used for skip persons. The income of a QTIP trust must be distributed to the surviving spouse.

(4) Unification of GST exemption and Unified Credit

Since 2004, the amount of the GST exemption has been tied to the amount of the estate tax applicable exclusion amount. In some cases, this will mean that the value of the Family Trust will exactly equal the amount of GST exemption and it will be unnecessary to make any reverse QTIP election to avoid wasting GST exemption.

- This will not always be the case, however, because taxable gifts to nonskip persons during the decedent's life may consume unified credit resulting in a Family Trust that is smaller than the remaining GST exemption.
- Then too, it is possible for the Family Trust to exceed the remaining GST exemption. This could occur, for example, if the decedent allocated GST exemption to nontaxable gifts to a Crummy trust created during life.[506] In

[506] See IRC § 2642(c)(2) discussed in "*Section 2503(b) exclusion*" on p. 133.

that event, it may be necessary to split the Family Trust in anticipation of an allocation of GST exemption at the decedent's death.

d) Formulating the split

Since a reverse QTIP election cannot be made with respect to only a portion of a trust, if the above plan is to be properly implemented, the QTIP trust must be severed into exempt and nonexempt portions prior to the making of the reverse QTIP election. The severance raises a number of drafting issues.

(1) Mandatory or discretionary severance

While it is permissible to merely authorize the severance in anticipation of the election, it is probably preferable to require it. Accordingly, what is needed is a provision that directs the severance of any trust where the GST exemption to be allocated to the trust exceeds the value of the property in the trust.

(2) Fractional or pecuniary severance

One of the advantages of directing severance before the allocation of GST exemption is that the severance can be accomplished within the strictures of the regulations as opposed to the qualified severance rules of IRC § 2642(c)(3).[507] This avoids the requirement in that section that the severance be done on a fractional basis. As the decision tree in Appendix A-1, infra p. 279 suggests, with appropriate attention to the funding mechanism, either a fractional or a pecuniary severance is permissible. In either case, the severance method should be specified in the instrument.

(3) The funding methodology

It is critical that the instrument provide for a valid funding method for the severance. If it doesn't, the severance will not be recognized for GST tax purposes and the allocation of exemption to the "exempt" portion will not result in a zero inclusion ratio.

COMMENT
The allowable funding methodologies depend on the type of severance (pecuniary or fractional). See the decision tree in Appendix A-1, infra p. 279.

507 Under the qualified severance rules of IRC § 2642(c)(3) it is possible to sever a trust on a fractional basis after GST exemption has been allocated to it if the result is a trust with an inclusion ratio of other than 1 or 0. See "Qualified (i.e., statutory) severances" on p. 159.

e) Integrating Mary's exemption

At Mary's death, her revocable inter vivos trust will begin with a balance of $1,700,000 representing the $1,500,000 with which she started plus the $200,000 outright bequest she received from John. At that point, it may be necessary or advisable for Mary's personal representative to allocate some of her GST exemption to the John's nonexempt QTIP trust. In graphical form, the plan would look as shown below where it is assumed that Mary dies in 2008 when the GST exemption is at $5 million.

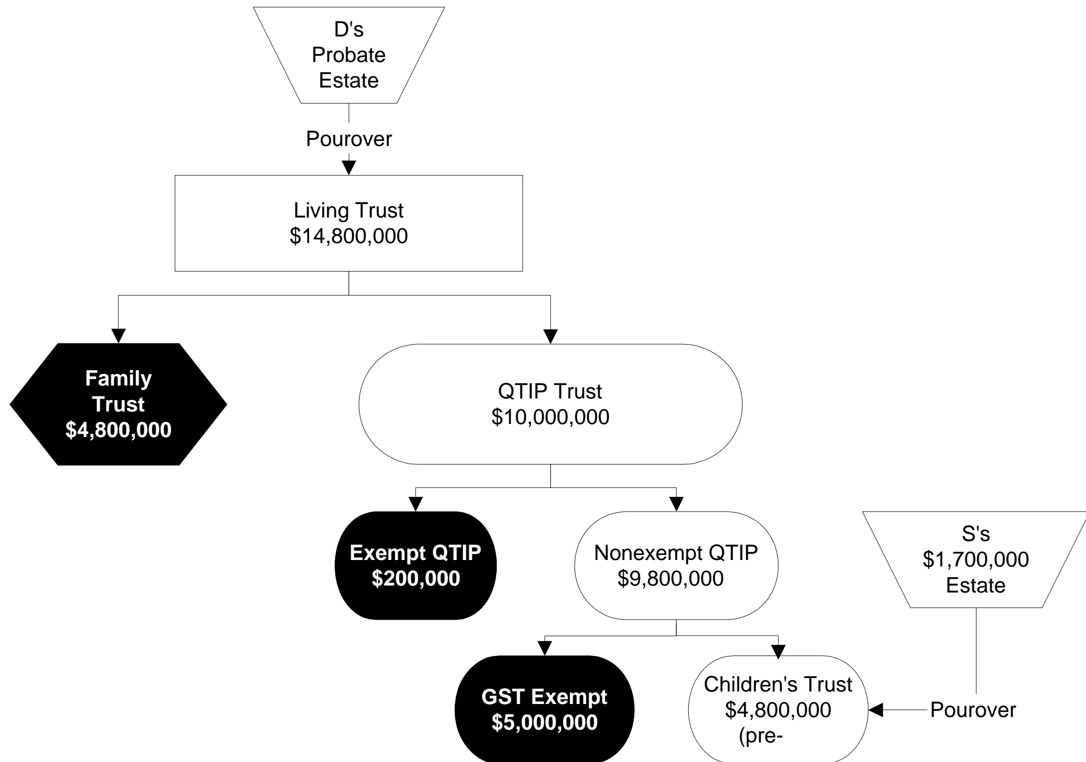

Fig. 4 At Mary's death before taxes are apportioned

f) Planning for Mary's taxes

At her death, Mary will be taxable on her own estate and all of the bottom line trusts in Fig. 4 except the Family Trust. She will have an estate of $11,700,000 on which she will owe taxes of $2,345,000, none of which is attributable (on a marginal basis) to Mary's own property.[508]

(1) In Mary's plan

Unless Mary waives the right of contribution provided in IRC § 2207A, her estate can seek contribution for the taxes attributable to John's QTIP trusts from the trustees of those trusts. So Mary's will should expressly instruct her personal representative to exercise the right of contribution. In addition, Mary's will

[508] IRC § 2207A gives Mary's personal representative a right of contribution from John's QTIP trust for her estate taxes attributable to the property in the QTIP trusts. The contribution is measured on a marginal basis. It is equal to the excess of Mary's taxes with the QTIP property included over what her taxes would have been without the QTIP property. Since Mary's estate without the QTIP property ($1,700,000) is less than the $3,500,000 applicable exclusion amount at her death, none of the $5,040,000 of taxes is attributable to Mary's own property.

should provide that the any taxes attributable to her own property should be paid from the nonexempt portion of her estate.

(2) In John's plan

John's plan can facilitate Mary's right of contribution for the taxes attributable to his QTIP trusts by directing the trustee of the trusts to either pay the taxes directly or to distribute property to Mary personal representative for the purpose of paying the taxes. To avoid wasting GST exemption, however, John should direct that the taxes are to be paid from his nonexempt QTIP trust rather than from one to which his exemption has been allocated.[509]

g) Other drafting considerations

Some additional clauses can be helpful in facilitating this type of plan. Note that since it will always be unclear which spouse will die first, the following should appear in the Wills (or revocable trusts) for both spouses.

(1) Direction to sever nonexempt QTIP

John's trust instrument should direct the trustee of the nonexempt QTIP trust to sever that trust upon certification by the surviving spouse's Personal Representative of the amount of GST exemption that will be allocated to the trust. Again, the severance should be required and an appropriate severance methodology should be specified to insure that the severance will be respected for GST tax purposes.

(2) Authority to allocate exemption to trust created by spouse

Mary's personal representative should be given the authority to allocate GST exemption to the nonexempt QTIP trust (that is to a nonexempt trust that is includible in her gross estate under IRC § 2044).

(3) Discretionary distributions from marital trusts

John's Will or Trust should include a provision setting the priority for discretionary distributions to Mary. In this regard, note that what began as a single QTIP trust could wind up as any of the following:

(a) A QTIP trust for which the QTIP election was made and which is not exempt from the GST tax (MD);

(b) A QTIP trust for which no QTIP election was made and which is not exempt from the GST tax (NMD);

(c) A QTIP trust for which the QTIP election was made but which is exempt from the GST tax (MDX);

(d) A QTIP trust for which no QTIP election was made but which is exempt from the GST tax (NMDX)

In general, distributions to Mary should come first from the MD trust and only as a last resort from the NMDX trust. As between the NMD and MDX trusts, the choice is less clear. Distribution priority from these trusts could be left to the discretion of the trustee.

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[509] Despite some early concerns on the point, it is now clear that such a provision will not be treated as a constructive addition to John's exempt QTIP trusts. Treas. Regs. §§ 26.2652-1(a)(3), Treas. Regs. § 26.2652-1(a)(5), Examples 6 and 7. See also PLR 9627020 (waiver of recovery rights under IRC § 2207A is not a constructive edition to pre-GST tax trust).

(4) Discretionary distributions to persons other than the spouse

The Will or Trust should direct that distributions to other beneficiaries be made from a nonexempt trust unless the distribution would be a taxable distribution under the GST tax in which case it should be made from an exempt trust.

(5) Merger of like trusts at Mary's Death

At Mary's death, it may be advisable to merge John's Family and exempt QTIP trusts into a single trust. If the beneficiaries of John's and Mary's trusts are similar, the merger could also include the exempt trust although this single trust would be treated as two separate trusts for GST purposes.[510] In any event, an authority to merge trusts should be included in the trust instruments.

h) Other planning considerations

(1) Eliminating the order of death risk

An order of death risk is present whenever one of the spouse's estate is not large enough to utilize the full GST exemption. In that case, GST exemption will be wasted if the less wealthy spouse dies first. This risk can be eliminated by having the wealthy spouse create an inter vivos QTIP trust for the less wealthy spouse. Assuming no reverse QTIP election is made, this will allow the less wealthy spouse to allocate exemption to the QTIP trust in the event he or she were to die first.

> ***Ex-128:*** T creates and funds a revocable living trust that provides that if T's spouse S predeceases him, S will have a general testamentary power to appoint property from T's trust in an amount equal to the difference between S's remaining applicable exclusion amount and S's taxable estate. S then dies with a will that exercises the power to appoint the specified amount to her estate. S's will then leaves the estate to a Family Trust for the benefit of T and other family members.
>
> 1. Is the property appointed from T's revocable trust at S's death includible in S's gross estate?
>
> 2. Does T make a gift to S at her death?

COMMENT
Assuming you are comfortable relying on a private ruling, the technique illustrated in this example is a useful means of planning for the order of death risk. For a similar technique using a joint revocable trust that could be used when neither spouse has sufficient property to fully fund a Family Trust, see PLR 9308002.

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510 Treas. Regs. § 26.2654-1(a)(2).

(2) Integrating a partial QTIP election

All planning so far has assumed that John would use the marital deduction at his death to eliminate all estate taxes. But if Mary dies shortly after John, the combined taxes to the couple could be less if John eschews marital deduction in favor of the IRC § 2013 credit for prior transfers.

In such a case, John's personal representative can use a partial QTIP election to achieve the desired result.[511]

First, John's QTIP eligible trust would be split into three shares:

- a $200,000 share which will qualify for the marital deduction, and
- another share of sufficient size to claim any additional marital deduction that John wants, and
- a third trust to hold the balance.

The estate taxes generated by the partial QTIP election would be paid from this last trust.

i) Integrating a partial disclaimer

If the decision to utilize the IRC § 2013 credit is made within 9 months of John's death, a partial disclaimer may be used instead of a partial QTIP election.

Mary's disclaimer will be a partial disclaimer so it must be phrased as a fraction or percentage of John's QTIP eligible trust.

John's plan must anticipate the possibility that Mary would make a qualified disclaimer. There are two approaches.

1. One would be to provide that any portion of the QTIP disclaimed by Mary is to be added to the Family Trust. The augmented Family Trust would then split to accommodate John's GST exemption allocation.
2. Alternatively, John's plan could call for the creation of a separate Disclaimer trust to hold the disclaimed property. Then the Disclaimer trust would split to accommodate the GST exemption allocation.

The first approach is available only if Mary has no power of appointment over the Family trust and any powers she might have as trustee are restricted by an ascertainable standard.[512] In the more common case where either of these is not the case, a separate Disclaimer trust must be created to avoid disqualification of the disclaimer under IRC § 2518. In either case, the taxes generated by the disclaimer would be paid out of nonexempt property.

E. UNMARRIED PERSONS

Where an unmarried person's estate is certain to be less than the GST exemption, the estate may be planned without any consideration for the GST. Such trusts as are likely to be created will not last for several generations and the automatic GST exemption allocation rules will exempt any that do.

For larger estates, the threshold concern is planning for the effective use of the GST exemption. The considerations will be similar to those facing Mary in the preceding case study. That is:

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511 Indeed this is the only approach available if the decision to pay taxes occurs after the 9 month period for qualified disclaimers.

512 See IRC § 25.2518-2(e)(5), Ex. 4 and 5.

- Typically the estate should be divided into two shares, an exempt share and a nonexempt share.
- The division may be made by way of formula although the drafting of an appropriate formula is not a trivial task. It must take into account the possibility that the decedent may have made inter vivos gifts to which she or her personal representative will allocate some of the GST exemption.[513]

COMMENT
In selecting between a pecuniary and fractional share formula, keep in mind that the funding of a pecuniary bequest is a sale or exchange. All things considered, the fractional share formula may be the best choice. There is no gain on funding and post death appreciation and depreciation are shared ratably by the exempt and nonexempt portions.

DRAFTING TIP
If a fractional share formula is used, the instrument should authorize the executor or trustee to select the assets to be distributed to the exempt and nonexempt funds, subject to the requirement that the fiduciary select assets that are fairly representative of the net appreciation of depreciation of the fund as a whole.

513 For an example of a formula clause see Plaine, The Million Dollar Question Under the Generation-Skipping Transfer Tax, 24 University of Miami Institute on Estate Planning IRC § 408.1 (1990).

ANSWERS—PLANNING FOR THE GST TAX

Ex-105. **First question –** Zero. No GST tax is payable at the death of Parent even though the value of the trust property at that time exceeds $5,430,000.

Ex-106. **Answer –** It depends. The allocation is effective only if the period in which the withdrawal power lapses is 60 days or less. Otherwise, the withdrawal power in T's husband will create an ETIP which will not terminate until the power lapses. Treas. Regs. § 26.2632-1(c)(2)(ii)(B).

Ex-107. **First question –** T may allocate exemption to the transfer without regard to the ETIP restrictions. Treas. Regs. § 26.2632-1(c)(2)(ii)(C).

Second question – If the reverse QTIP election is not made, the surviving spouse is the transferor and the ETIP terminates at the death of the surviving spouse.

Third question – If T did not make a gift tax QTIP election, there is no ETIP at all since the trust will not be included in the estate of either spouse. Accordingly, T may allocate exemption immediately to the trust.

Ex-108. **First question –** The IRC § 2642(f)(1) ETIP for both portions of the gift ends at the earlier of T's death or the expiration of the 10-year term. See Treas. Regs. §§ 26.2632-1(c)(3), Treas. Regs. § 26.2632-1(c)(5), Examples 1 and 3.

Second question – Whether or not the transfer by T is for full consideration, the ETIP will end at the time of the sale because thereafter nothing would be included in T's gross estate (except perhaps by reason of IRC § 2035). See Treas. Regs. § 26.2632-1(c)(5), Example 4.

Ex-109. **Answer –** T and T's spouse will each have $25,000 of exemption automatically allocated to the transfer to the trust. Treas. Regs. § 26.2632-1(b)(2)(iii), Example 5.

Ex-110. **First question –** No. Exception 1 (IRC § 2632(c)(2)(B)(i)) applies.

Second question – Probably. The power to withhold distributions means that Exception 1 no longer applies unless the yet to be issued regulations make an exception for this common type of provision. Accordingly, consideration should be given to opting out of the automatic allocation rules. See "*Electing in or out of the automatic allocation rules*", infra p. 154.

Ex-111. **First question –** No. Exception 2 applies. W is more than 10 years older than the youngest of H's children and that child is entitled to more than 25 percent of the trust at W's death.

Second question – No, the answer remains the same because it is assumed that W's power will not be exercised. See IRC § 2632(c)(3) (flush language at the end).

Ex-112. **Answer –** Yes (for the reasons detailed below) but it shouldn't be. Here again, consideration should be given to opting out of the automatic allocation rules. See "*Electing in or out of the automatic allocation rules*", infra p. 154..

Exception 1 doesn't apply because in most cases W's death could not be reasonably expected to occur before the kids reach 46. Exception 2 doesn't apply either. Although W is more than 10 years older than the children, the only portion of the trust that (as of the trust's creation) is certain to be distributed at her death is half of the oldest child's one-third portion of the trust. That would amount to 16.7 percent of the trust, well short of the 25 percent required by the exception. Finally, Exception 4 doesn't apply either because no portion of the trust would be included in a nonskip person's estate if the nonskip person died immediately after the transfer to the trust.

Comment: The result in this example is different if two or more of H's children were 30 at the creation of the trust, or if one of the children was 35 at that time. In either of these scenarios, Exception 2 would apply and the trust would not be a GST trust.

Ex-113. **Answer –** No. A GST trust is a trust that has the potential of having a GST event with respect to the transferor. See IRC § 2632(c)(3)(B). Because of the general power to appoint to creditors, no GST

event could ever occur with respect to this trust where H would be the transferor of the event. So this is not a GST trust.

Ex-114. **Answer –** Yes, but not under the indirect skip rule of IRC § 2632(c). This trust is a skip person because all beneficiaries having an interest in the trust are skip persons. See IRC § 2613(a) discussed in "*Skip person*", supra p. 120. Accordingly, exemption is automatically allocated under IRC § 2632(b).

Ex-115. **First question –** Yes because the child's withdrawal power is ignored for purposes of determining whether a nonskip person has a right of withdrawal under Exceptions 1 or 2 and for purposes of determining whether a portion of the trust is includible in a nonskip person's gross estate under Exception 4. See IRC § 2632(c)(3) (flush language at the end).

Second question – Maybe. In the first year of the trust, child's withdrawal right can be ignored for the purposes described in the first question because it will not exceed a single gift tax annual exclusion. If a portion of the power hangs into the second year, however, the child's power will exceed a single annual exclusion and the trust will no longer be a GST trust under Exception 4. That is, a portion of the trust would be included in the child gross estate immediately after the transfer to the trust in the second year.

Note also, that it is possible that the trust will not be a GST trust in the first year either. Although the child's withdrawal power is ignored for purposes of Exceptions 1, 2 and 4, it is not ignored for purposes of determining whether more than 25 percent of the trust corpus is subject to a general power of appointment held by a nonskip person. (See Exception 3).

Ex-116. **Answer –** No because this trust has no potential for a GST event.

Ex-117. **Answer –** First, the trust is a GST trust because property at the expiration of the term could be distributed to a skip person (as in fact happened under the facts). The trust involves an ETIP because the trust would be included in H's gross estate were he to die during the five year term. IRC § 2632(c)(4) provides that the indirect skip to the trust is deemed to occur at the termination of the ETIP. That happens at the end of the term when the property is distributed to the grandchild. The automatic allocation occurs immediately before that distribution. The property subject to the indirect skip is valued at the same time. So, only $300,000 of exemption will be allocated.

Ex-118. **Answer –** Before 2001, H could have allocated to the $20,000 value on April 16th by waiting to that date to file his 709. This (alone) won't work now because if the 709 is not filed on time, the automatic allocation rules will apply and $100,000 will be allocated to the trust. To accomplish what H wants, he must first file a timely 709 and elect out of the automatic allocation rules as to this transfer. Then he must file another 709 on April 16th to make the late allocation. If H anticipates that the issue will be recurring each year he transfers money to the trust for the payment of premiums, H should elect out of the automatic rules as to all transfers to the trust.

Ex-119. **First question –** Yes, provided only that T has unused GST exemption with which to make the allocation.

Second question – The answer is $100,000. That amount of exemption will give the trust a zero inclusion ratio.

Ex-120. **First question –** This trust will be treated as two trusts with W as the transferor of a two-thirds share and H as the transferor of a one-third share. If W later makes an addition to the trust, the relative shares of A and B must be recalculated. See Treas. Regs. § 26.2654-1(a)(5), Example 5.

Second question – The answer is 3/4ths. When an individual makes an additional contribution to a trust of which the individual is not the sole transferor, the portion of the trust attributable to each separate trust is determined by multiplying the new value of the single trust ($2,400,000) by a fraction the numerator of which is the value of the separate trust immediately after the contribution (2/3rds of $1,800,000 plus $600,000) and the denominator of which is the total value of all property in the single trust after the contribution ($2,400,000). See Treas. Regs. §§ 26.2654-1(a)(2)(ii); 26.2654-1(a)(5), Example 6.

Ex-121. **Answer –** Yes. The shares of the child and the grandchild are separate and independent shares. See Treas. Regs. § 26.2654-1(a)(5), Example 1. But see also Example 2 (separate treatment is not permitted when the trustee has the power to spray income in the final year of the trust).

Ex-122. **Answer –** No because the shares did not exist from and at all times after the creation of the trust. Accordingly, any allocation of GST exemption to one of the shares will apply with respect to all of the shares which will be viewed as a single trust. Treas. Regs. § 26.2654-1(a)(5), Example 8.

Comment: On the possibility that this trust could be severed into separate trusts for GST tax purposes, see "*Qualified (i.e.*, statutory) severances", infra p. 159.

Ex-123. **Answer –** Only if the division into shares occurs within 15 months of T's death or the governing instrument or local law require the trustee to pay an appropriate interest on the gift.

Comment: What is the significance of separate share treatment in this example? If separate treatment is not available, the property used to satisfy the bequest to the spouse will be in the denominator of the applicable fraction of the residual trust. In this case, a correspondingly higher amount of exemption would have to be allocated to the residual trust to achieve a zero inclusion ratio and much of that exemption would be wasted on the distribution to the spouse.

Ex-124. **First question –** Yes. See Treas. Regs. § 26.2654-1(b)(4), Example 2.

Second question – Yes, assuming the funding requirements for discretionary splits are complied with.

Ex-125. **Answer –** Yes, provided that each trust contains a gift over to the other trust in the event that there are not surviving descendants of a child at the child's death. See Treas. Regs. § 26.2642-6(j), Ex. 2. See also the requirements for a severance of a discretionary trust to qualify as a qualified severance in Treas. Regs. § 26.2642-6(d)(5).

Ex-126. **Answer –** Assuming all of the other requirements for a qualified severance are met, the answer is yes. See Treas. Regs. § 26.2642-6(j), Ex 10..

Ex-127. **Answer –** Well, first of all, since the trust has an inclusion ratio of .50, one of the trusts after the severance must have a 0 inclusion ratio and one must have an inclusion ration of 1. Since S is a skip person, the Trustee should designate S's trust as the one having the 0 inclusion ratio. The regulations provide that a qualified severance is deemed to precede any GST event that results from the severance itself. See Treas. Regs. § 26.2652-6(g)(2). Accordingly, no GST tax will be due as a consequence of the trust severance. Accord Treas. Regs. § 26.2642-6(j), Ex. 8..

Ex-128. **First question –** According to the Service, the answer is yes. PLR 200403094.

Second question – Yes, but the gift qualifies for the gift tax marital deduction. PLR 200403094.

Accord on both principles, TAM 200604028.

VII. ESTATES AND ORDINARY TRUSTS

A. OVERVIEW OF SUBCHAPTER J

The basic body of law that controls the income taxation of most fiduciary entities[514] is found in Subchapter J of the Code.

With some exceptions, Subchapter J treats estates and trusts as both separate tax entities and as conduits through which tax responsibility flows to their beneficiaries.

- As separate entities, estates and ordinary trusts must determine, report, and pay tax on their taxable income.[515]
- As conduits, they receive a deduction for income they distribute to a beneficiary.[516] This income is then reportable by the beneficiary[517] on his or her individual tax return with its character (e.g., dividend, interest, capital gain, etc.) as well as its tax status (taxable or tax exempt) determined at the entity level.[518]

B. CLASSIFICATION OF TRUSTS

Subchapter J divides trusts into four categories:

- ordinary trusts which like estates are subject to the conduit and distribution principles described above,
- grantor and controlled trusts the income and deductions of which are taxed directly to the grantor or person in control,
- qualified revocable trusts which are treated as if they are a part of a decedent's estate,and
- charitable remainder trusts which are subject to special treatment under IRC § 664.

1. Ordinary trusts

As a convenience, the term "ordinary trust" is used to refer to those trusts the taxation of which is controlled by the conduit and distribution principles of Subchapter J.

Ordinary trusts are either simple or complex. A trust is complex if it fails to meet the definition of a simple trust. A trust is simple if:

- it is required to distribute all fiduciary accounting income currently;

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[514] Some fiduciary arrangements are not subject to Subchapter J. The realized income of guardians, conservators, and similar fiduciaries is taxed directly to the ward. Treas. Regs. § 1.641(b)-2(b). The same is generally true of custodianships created under the Uniform Gifts to Minors Act, although custodial income that is used to satisfy a parent's support obligation is taxable to the parent. The justification for this is that custodianships are just another more flexible form of guardianship. See Anastasio v. Comm., 67 TC 814 aff'd, 573 F.2d 1287 (2d Cir. 1977) (custodial income taxed to minor); Rev. Rul. 59-357, 1955 CB 131; Rev. Rul. 56-484, 1956-2 CB 23 (custodial income taxed to parent).

Recently, most states have replaced the Uniform Gifts to Minors Act with the Uniform Transfers to Minors Act. See e.g., Fla. Stat. ch. 710 (2015). The newer Act makes several liberalizing changes, one of which is that custodianships can last to age 21, an age which is beyond the age of majority in most states. It has been suggested that this change might result in these custodianships being taxed as trusts. Norman H. Lane & Howard M. Zaritsky, Federal Income Taxation of Estates and Trusts ¶1.09[4][c][ii]. Certainly such a result was not contemplated by the drafters of the new Act. And it would be most unfortunate. It would add complexity and expense to an arrangement the primary utility of which is its simplicity and economy. The fact remains that, as is the case with the older Act, legal title to custodial property is vested in the minor, not in the fiduciary. Accordingly, these arrangements seem more closely analogous to guardianships than to trusts.

[515] IRC § 641(a).

[516] IRC §§ 651, 661.

[517] IRC §§ 652(a), 662(a).

[518] IRC §§ 652(b), 662(b).

- it does not make any distributions in excess of its current income; and
- it does not make any distributions to charity.[519]

Thus, in this context, "simple" means that the trust presents none of the complexities of a trust that accumulates income, distributes principal, or has charitable beneficiaries.

COMMENT
A trust can be a simple trust in one year and a complex trust in another. For example, a trust that is required to distribute all income currently and which does not have charitable beneficiaries is a simple trust for any year in which it makes no distributions in excess of its fiduciary accounting income and a complex trust in any year in which it does.[520]

2. Grantor and controlled trusts

Grantor and controlled trusts are a special class of trust the income and deductions of which are reportable on the individual tax returns of the grantor (or person in control) as if he or she were the owner of the trust property. These trusts fall outside the normal conduit and distribution principles applicable to ordinary trusts because the trust itself is not a separate tax entity.

COMMENT
This may actually be beneficial. The relatively steep rates applicable to ordinary trusts may mean that taxes on trust income would be less if the income is taxed directly to the grantor or a trust beneficiary.

3. Qualified revocable trusts

Effective August 5, 1997, new IRC § 645 gives a decedent's executor (if any) and the trustee of the decedent's "qualified revocable trust" an election to have the trust assets treated and taxed as if they are part of the decedent's estate.

a) A qualified revocable trust is any trust (or portion thereof) which as of a decedent's death was treated under IRC § 676 as being owned by the decedent by reason of a power in the decedent (as opposed to the decedent's spouse).[521]

b) The election must be made before the due date (including extensions) of the estate's income tax return for the first taxable year.

c) The election is effective for all taxable years ending before:
   - Two years after the date of the decedent's death if no estate tax return is required to be filed; or
   - Six months after the date of the final determination of estate tax liability where a return is required.

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519 See IRC § 651(a) and Treas. Regs. § 1.651(a)-1.

520 Treas. Regs. § 1.651(a)-1.

521 IRC § 645(b)(1). The Joint Conference Committee Report indicates that the election will have the effect of making the following provisions applicable to the qualified revocable trust:

- The ability to take a charitable deduction for amounts permanently set aside for charity;
- The waiver of the active participation requirement in the passive loss rules of IRC § 469 for two years after the decedent's death; and
- The ability to amortize reforestation expenditures under IRC § 194.

Note, however, that the Report also states the separate share rule generally will apply when a qualified revocable trust is treated as part of the decedent's estate. See "*Allocating DNI: Separate share rule*" p. 192.

COMMENT
A recent amendment to IRC § 645 clarifies that it applies only for purposes of the income tax. For other taxes, particularly the GST tax, the trust remains a separate entity from the decedent's estate.

4. Qualifying charitable remainder trusts

No charitable deduction is available for a transfer of a remainder interest to charity unless it follows a legal life estate in a personal residence or farm or it is a transfer in trust that meets the definition of:

- a pooled income fund,
- a charitable remainder unitrust, or
- a charitable remainder annuity trust.

Although distributions from a pooled income fund are subject to the normal rules of subchapter J, distributions from a charitable remainder annuity or unitrust are not.

Instead, the distributions are subject to a special priority scheme under which distributions are classified as ordinary income, capital gain, tax exempt income and principal in that order of priority.[522]

C. THE VARIOUS SHADES OF INCOME

Distributable net income [DNI] is an artificial concept that Subchapter J uses to implement the conduit and distribution principles. DNI serves several functions:

- It determines the amount of any distribution deduction available to an estate or trust;[523]
- It determines the amount and character of income distributed to the beneficiaries;[524] and
- It determines which of several beneficiaries is taxed on distributed income.[525]

1. Accounting and taxable income compared

According to IRC § 643(b), when used in that portion of Subchapter J that defines and implements the conduit and distribution principles, "income" means fiduciary accounting income — that is: "the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."[526]

This is a matter of considerable importance because accounting income can and usually does differ from taxable income. For example, taxable income includes a number of items that are considered principal for accounting purposes. Common examples of this "corpus income" include gains from the sale or disposition of capital assets, depreciation recapture, and undistributed income from S corporations.[527]

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522 IRC § 664. The entity itself is tax exempt.

523 IRC §§ 651, 661.

524 IRC §§ 652, 662.

525 IRC § 662.

526 In most states, fiduciary accounting income is determined under the Revised Uniform Principal and Income Act. See e.g., Fla. Stat. § 738.101 - .804 (2015).

527 For a list of other examples of corpus income, see Norman H Lane & Howard M. Zaritsky, Federal Income Taxation of Estates and Trusts ¶3.05.

On the expenditure side, whether an expense affects accounting income turns on whether it is chargeable to income or principal, not whether it is deductible for tax purposes. The test is exactly the opposite for taxable income. Taxable income takes into account all deductible expenses, whether or not they are properly allocable to income under local law.

COMMENT

As a general rule, trust provisions that depart fundamentally from traditional principles of income and principal (as set out above) will not be recognized for purposes of Subchapter J. Newly issued regulations, however, provide that amounts allocated between principal and income pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust for the year. Under this provision, recognition will be given to a state law that:

- Defines income as a unitrust amount from 3% to 5% of the annual fair market value of the trust assets; or
- Permits a trustee to make equitable adjustments between income and principal to fulfill the trustee's duty of impartiality between income and remainder beneficiaries.[528]

2. The hybrid nature of DNI

An additional level of complexity is added by distributable net income. DNI is a hybrid of taxable income and accounting income. Possessing elements of both, it is identical to neither. Like accounting income, DNI normally excludes capital gains and includes tax exempt income. Like taxable income, DNI takes into account deductible expenses whether they are chargeable to income or to principal for accounting purposes. The following table shows how various items of receipts and expenditures can affect DNI, taxable income (TI), and IRC § 643(b) (fiduciary accounting) income.

Item	Impact on DNI, 643(b) & Tax Inc.	Conclusion
Tax exempt income	Tax exempt income (typically interest on state and local bonds) increases both DNI and 643(b) income. It does not increase taxable income.	Taxable income can be less than either DNI or accounting income.
Capital gains	Capital gains increase taxable income but not DNI or 643(b) income.	Taxable income can be greater than DNI or accounting income.
Corpus income (other than capital gains)	Corpus income other than capital gains increases both DNI and taxable income but does not affect 643(b) income. Examples include depreciation recapture and undistributed income from S corporation stock.	Accounting income can be less than either taxable income or DNI.
Nondeductible expense charge-able to income.	This category includes expenditures for life insurance and nondeductible personal interest. These expenses reduce 643(b) income but not DNI or TI.	
Deductible expenses chargeable to corpus	Expenses which are deductible for tax purposes but which are chargeable to corpus for accounting purposes reduce both DNI and TI but do not affect 643(b) income. An example might be the fiduciary's fee which in many states is chargeable at least in part to principal.	Accounting income can be greater than either taxable income or DNI.

528 Treas. Regs. § 1.643(b)-1.

D. ESTATES AND TRUSTS AS SEPARATE TAX ENTITIES

As separate tax entities, estates and ordinary trusts must determine, report, and pay tax on their income.

- The question of what constitutes gross income is the same for these entities as it is for other taxpayers.
- The determination of taxable income and the calculation of the tax due on it is somewhat more complicated because estates and ordinary trusts are subject to a number of rules that are not applicable to other kinds of taxpayers.

1. Rate schedule

Estates and trusts are subject to their own separate rate schedule.[529] As is true of most other rate schedules, all income is taxed at one of five rates. The rates for trusts and estates, however, are compressed so that the highest rate of 35 percent applies to all taxable income over $12,300.[530]

2. Deductions

Estates and trusts must itemize deductions. In the process they, are subjected to a number of special rules.

Areas affected include:

- the personal exemption,
- the 2-percent floor for miscellaneous deductions,
- the deduction for charitable contributions,
- the treatment of net operating losses, and
- the deductions for depreciation, amortization and depletion.

a) Deduction in lieu of a personal exemption

Estates and trusts receive no personal or dependency exemptions. Instead, they receive a deduction the amount of which varies with the type of entity.

- For estates, the deduction is $600.
- For trusts the deduction is either $300 or $100 with the larger amount available only if the trust is required to distribute all fiduciary accounting income currently.[531] This would include all simple trusts and some complex trusts as well.

COMMENT
Under new IRC § 645, certain electing "qualified revocable trusts" are treated and taxed as if they were part of a decedent's estate. See "*Qualified revocable trusts*", p. 167. This would mean that the trust and the estate would receive only a single $600 deduction.

[529] IRC § 1(e).

[530] As a relief provision for the retroactive changes in the tax rates introduced by the 1993 Omnibus Budget Reconciliation Act, P.L. 103-66 (1993), new IRC § 1(d) gave taxpayers an election to pay any increase in taxes caused by the retroactive change in three annual installments beginning on the due date of the taxpayer's 1993 tax return (determined without extensions). This relief provision is not available to trusts and estates. IRC § 1(d)(7)

[531] IRC § 642(b). The deduction in lieu of a personal exemption is not subject to the 2-percent floor of IRC § 67(a).

b) Two percent floor for miscellaneous deductions

IRC § 67(a) imposes a floor on the deductibility of certain miscellaneous expenses.[532] In the case of estates and trusts, however, IRC § 67(e) makes the floor inapplicable to:

1. the deduction for property paid or permanently set aside for charity,
2. the deduction for distributions, and
3. the deduction for costs of administration that would not have been incurred were the property not held in an estate or trust.

Ex-129: During the year, a trustee pays investment fees for investment advice from a professional investment manager. Are these fees subject to the 2-percent floor of IRC § 67(a)? *Answers to the examples in this chapter begin on page 191.*

c) Charitable deduction

The charitable deduction available to an estate or trust is both more liberal and more restrictive than that of individuals.

More liberal:

1. There is no ceiling on the amount an estate or trust may deduct in any single year.[533]
2. Estates may deduct money permanently set aside (or used directly by the entity) for charitable purposes.[534]
3. Either an estate or a trust may elect to deduct a charitable contribution in the taxable year preceding the one in which it is made.[535]

COMMENT
Under new IRC § 645, certain electing "qualified revocable trusts" are treated and taxed as if they were part of a decedent's estate. See "*Qualified revocable trusts*", p. 167 for the details. Accordingly, such trusts will qualify for a set aside deduction the same as estates.

More restrictive:

1. The charitable deduction for estates and trusts is available only if the contribution is made from gross income.[536] Thus, if a trust or estate has tax exempt income for the year of the contribution, a prorata portion of the deduction will be disallowed.[537]

[532] Generally, these expenses are deductible only to the extent they exceed 2 percent of the taxpayer's adjusted gross income for the year.

[533] The charitable deduction for estates and trusts is authorized by IRC § 642(c) not IRC § 170. Deductions under IRC § 642(c) are allowable without regard to the 2-percent floor of IRC § 67(a).

[534] IRC § 642(c)(2). This rule also applies to a trust if it was created before 1969.

[535] IRC § 642(c)(1). See also Treas. Regs. § 1.642(c)-1(b).

[536] IRC §§ 642(c)(1), 642(c)(2).

[537] See Treas. Regs. § 1.642(c)-3(b). The portion lost is equal to the charitable contribution multiplied times a fraction the numerator of which is the amount of tax exempt income and the denominator of which is the DNI of the entity before allocation of expenses. See Treas. Regs. § 1.662(b)-2.

2. A charitable deduction is allowable only if the contribution is made "pursuant to the governing instrument."[538]

Ex-130: Bank is the trustee of a discretionary trust that authorizes but does not require distributions to charity. If Bank exercises its discretion to make a distribution to a qualifying charity, will the trust be entitled to a charitable deduction for the distribution?

Ex-131: B is the income beneficiary of a trust the instrument of which makes no mention of distributions to charity. B is also the donee of a general power of appointment over trust property. Will the trust be entitled to a charitable deduction if B exercises her power to appoint trust property to charity?

d) Net operating losses

Estates and trusts may deduct net operating losses like other taxpayers.[539] That is, they may carry them back three years and forward up to fifteen years.[540]

COMMENTS
1. Where the loss is carried back, it may have the effect of eliminating taxable income that had previously been distributed and taxed to a beneficiary. In that case, the beneficiary may claim a refund.[541] 2. Unused losses in the final year pass through to the beneficiaries. See "*Carryover of excess deductions*" on page 188.

e) Cost recovery deductions

The Code and Regulations provide that the deductions for depreciation, depletion, and amortization are to be allocated between a trust (or estate) and its beneficiaries in proportion to the fiduciary accounting income retained by or distributed to each.[542]

COMMENT
This allocation is made outside the normal conduit principles. Beneficiaries may claim the deduction even if it exceeds the amount of fiduciary income they receive.

Exception: As to trusts, if the governing instrument or local law directs or permits the trustee to maintain a reserve for depreciation, depletion, etc., the cost recovery

538 IRC §§ 642(c)(1), 642(c)(2).

539 IRC § 642(d); Treas. Regs. § 1.642(d)-1.

540 See IRC § 172(b).

541 Rev. Rul. 61-20, 1961-1 CB 248.

542 See IRC §§ 642(e), 642(f), 611(b)(3), 167(h). See also Regs. §§ 1.167(h)-1, 1.611-1(c)(4), 1.611-1(c)(5), 1.642(f)-1.
Since the allocation is based on fiduciary accounting income, no allocation of cost recovery deductions results from a distribution which the trustee properly allocates to the principal account for fiduciary accounting purposes. This is true even though the distribution carries out DNI (and taxable income) to the beneficiary.

deduction is first allocated to the trust to the extent of any reserve taken for the year. Any excess is allocated on the basis of fiduciary accounting income.[543]

> ***Ex-132:*** A trust has an available depreciation deduction of $70,000 for the year. Pursuant to a provision in the governing instrument, the trustee withholds $30,000 as a depreciation reserve. Twenty percent of the balance of fiduciary income is distributed to beneficiary A; thirty percent is distributed to beneficiary B; and the balance is retained in the trust. How should the deduction for depreciation be allocated?

COMMENT
If B in the above example had been a charity, the $12,000 of depreciation deduction allocated to it would have been wasted. Nevertheless, the allocation must be made in the manner shown.[544] An attempt to provide otherwise in the trust instrument will not be given effect.[545]

3. Other limitations on deductions

The Code imposes three limits on the deductions of a trust or estate that are either not applicable to other taxpayers or which take on special significance as they apply to these entities. These include

- a prohibition against the deduction of certain expenses for both estate and income tax purposes,
- the disallowance of certain expenses to the extent they are incurred for the production or maintenance of tax exempt income, and
- the disallowance of certain losses incurred on transactions between a trust, its grantor, and its beneficiaries.

a) Prohibition against double deductions

According to IRC § 642(g), deductions allowable under IRC § 2053 or IRC § 2054 in computing a decedent's taxable estate may not be taken as a deduction (or used as an offset against the sales price of property in determining gain or loss) on the income tax return of the estate or any other person unless the right to take them under the estate tax is waived.[546]

1. Among others, the expenses covered by the section include the fees of a personal representative and other professionals for both the estate and any inter vivos trusts included in the gross estate of the decedent. Costs incurred in the selling of property incident to the settlement or distribution of the estate are also covered.

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543 Treas. Regs. §§ 1.167(h)-1(b), 1.611-1(c)(4)(ii). A simple trust may provide for a depreciation reserve without violating the requirement that it be required to distribute all accounting income currently. Treas. Regs. § 1.651(a)-2.

544 Treas. Regs. § 1.642(e)-1.

545 Treas. Regs. §§ 1.167(h)-1(b), 1.611-1(c)(4).

546 The decision to waive the right to take deductions on the decedent's estate tax return may be made on an item by item basis. The factors that enter into the decision and the impact a waiver can have on the economic interests of the estate beneficiaries is discussed further in conjunction with the estate tax deduction for costs of administration.

2. The limitation does not apply to deductions in respect of a decedent permitted by IRC § 691(b).

COMMENT
The impact of this waiver on marital deduction planning is discussed in "*Administration expenses*" on page. 107.

b) Expenses attributable to tax exempt income

Under IRC § 265 of the Code, no deduction is permitted for interest used to purchase or carry tax exempt securities or for expenses relating to the production, management or conservation of tax exempt income.

As it applies to trusts and estates, IRC § 265 disallows a deduction for

1. all interest and expenses directly related to tax exempt income, and
2. for a prorata portion of any indirect expenses. [547]

> ***Ex-133:*** For the year, a trust has rental income of $22,000, tax exempt interest of $33,000, and dividends of $55,000. The trustee's fee for the year is $10,000. Under state law, the fee is chargeable half to income and half to principal. What portion of the fee is deductible for income tax purposes?

c) Loss transactions between related taxpayers

IRC § 267 disallows a loss deduction for the sale or exchange of property between related parties.

- For this purpose, related parties includes a trustee and the trust's grantor as well as the trustee and the trust beneficiaries.[548]
- For taxable years beginning after August 5, 1997, the term also includes an estate and it's beneficiaries (including a testamentary trust).
- With respect to an estate, however, an exception applies to sales or exchanges realized on the distribution of property in satisfaction of a pecuniary bequest. Losses realized on such transactions remain deductible even after August 5, 1997.[549]

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[547] The method of allocating indirect expenses to tax exempt income differs with the type of expense. For recurring expenses such as the fiduciary's annual fee, the allocation is based on the ratio of tax exempt income to DNI with both figures being determined before direct expenses are taken into account. See Treas. Regs. §§ 1.652(b)-3(b), 1.652(c)-4, 1.662(c)-4. For termination commissions and other end of entity expenses, an historical approach is used. The allocation is based on the ratio of tax exempt income received over the lifetime of the entity to total income realized by the entity increased by realized and unrealized capital gains. Fabens v. Comm., 519 F.2d 1310 (1st Cir. 1975), approved in Rev. Rul. 77-466, 1977-2 CB 83.

[548] As it relates to trusts, the relationships to which IRC § 267 applies are described in IRC § 267(b)(4) - (8). In addition to the relationships in the text, a fiduciary of a trust and a fiduciary or beneficiary of another trust, are related if the same person is a grantor of both trusts. Also, a fiduciary of a trust and a corporation are related if more than 50 percent in value of the outstanding stock is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust.

[549] IRC § 267(b)(13).

COMMENT
Concern for IRC § 267 is greatest in those marital deduction estate plans where a revocable inter vivos trust is used in conjunction with a pour over will. Typically, the marital and credit shelter gifts are included in and are funded from the trust. In the absence of an IRC § 645 election, if either the marital or credit shelter gift is a pecuniary amount, no deduction will be allowed if the share is funded with loss property even though the deduction would be allowable for a comparable plan using a will with testamentary trusts.

E. ESTATES AND TRUSTS AS CONDUITS

Estates and trusts that distribute income serve as conduits through which tax responsibility flows to the beneficiaries who receive it.

This result is achieved:

- by requiring the beneficiaries to report on their individual tax returns any income distributed to them, and
- by giving the entity a distribution deduction for the same amount.

1. How Subchapter J relates to Section 102

All estates and most trusts involve gratuitous transfers to which IRC § 102 of the Code potentially applies.

a) IRC § 102(a) excludes from gross income property acquired by "gift, bequest, devise, or inheritance."

b) But IRC § 102(b) provides that the exclusion does not apply to the income earned on a gift etc., or to a gift of income itself.

In the context of an estate or trust, therefore, every distribution raises a threshold issue: When is a distribution exempt as the gift itself and when is it a taxable distribution of income earned on a gift?

With some exceptions,[550] Subchapter J answers this question by ignoring the underlying source (income or principal) of the distribution. Instead, every distribution is deemed to consist of income to the extent the entity has DNI for the year.[551]

2. Distributable net income

According to IRC § 643(a), DNI is derived from the taxable income of the entity determined without regard to the deduction in lieu of a personal exemption and without taking into account any deduction for distributions.

This "modified taxable income" is then:

- decreased by any capital gains, and
- increased by any tax exempt income and deductible capital losses for the year[552]

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550 For the exceptions, see "*Distributions which do not carry out DNI*" on p. 194.

551 IRC § 652 (simple trusts); IRC § 662 (complex trusts and estates).

552 In addition, simple trusts receive a downward adjustment for any extraordinary dividends and taxable stock dividends that the trustee allocates in good faith to principal.

The calculation of DNI for foreign trusts is subject to special rules. See IRC § 643(a)(6). See also new IRC § 643(a)(7), added by the SBJPA of 1996, which authorizes the IRS to issue regulations to deal with abusive situations arising with respect to foreign situs trusts and other situations arising under IRC §§ 641 – 682 of the Code. The regulations, if issued, will have the "force of statutory law."

Each of these adjustments is intended to bring DNI more in line with income for fiduciary accounting purposes.

a) Tax exempt income

One important difference between taxable income and fiduciary accounting income is that the latter includes tax exempt income such as interest paid on state and local bonds.

- To make DNI reflect this, IRC § 643(a)(5) provides that in reaching DNI, the modified taxable income of the estate or trust is to be increased by any tax exempt income (net of allocable expenses)[553] for the year.
- The regulations state further that the tax exempt income is also to be reduced by any amount that would have been deductible as a charitable contribution but for the requirement of IRC § 642(c) that the charitable deduction is limited to items of gross income.[554]

b) Capital gains and losses

In the absence of a contrary provision in the governing instrument, capital gains and losses are usually charged to principal for fiduciary accounting purposes.[555]

- In recognition of this, IRC § 643(a)(3) provides that capital gains and losses are normally to be excluded from DNI.[556]
- That is, DNI is determined by reducing taxable income by any included gains and increasing it by any deducted losses for the year.

Exceptions: The general rule, notwithstanding, DNI will include capital gains to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion authorized by applicable local law or the governing instrument):

- Allocated to income;[557]
- Allocated to corpus but treated by the fiduciary on the trust records, books and tax returns as part of a distribution to a beneficiary;[558] or
- Allocated to corpus but actually distributed to the beneficiary[559] or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[560]

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553 These are the expenses that would have been deductible for tax purposes but for IRC § 265.

554 Treas. Regs. § 1.643(a)-5(b).

555 See e.g., Fla. Stat. § 738.501(2) (2015).

556 Accord, Treas. Regs. § 1.643(a)(3).

557 For trusts where income is defined as a unitrust amount under a state statute, a discretionary power to allocate gains to income must be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over DNI determined without the gains. Treas. Regs. § 1.643(a)-3(b)(1). For illustrations of when gains are allocated to income, see Treas. Regs. § 1.643(a)-3(e), Examples 4, and 11 – 13.

558 See Treas. Regs. § 1.643(a)-3(e), Examples 1 – 3.

559 Under this test, gains for the final year of the trust are included in DNI. See Treas. Regs. § 1.643(a)-3(e), Examples (7) and (8). For the application of this principle to a trust that terminates periodically, see Treas. Regs. § 1.643(a)-3(e), Examples (9) and (10).

Note: DNI also includes capital losses in the final year but only to the extent of gains for the year. IRC § 643(a)(3); Treas. Regs. § 1.643(a)-3(d). Unused losses in the final year pass through to the beneficiaries. See "*Carryover of excess deductions*" on page 202.

560 See Treas. Regs. § 1.643(a)-3(e), Examples 5 and 6.

c) Extraordinary and taxable stock dividends

In the case of a simple trust, DNI excludes any undistributed extraordinary dividends or taxable stock dividends credited in good faith by the fiduciary to corpus pursuant to local law or the governing instrument.[561]

3. The distribution deduction

To the extent an estate or trust makes a distribution that carries out DNI, the entity will receive a deduction for the distribution.[562]

The amount of the distribution deduction available to estates and trusts is limited by the taxable component of DNI.[563]

As a result, there is no deduction for:

- distributions that do not carry out DNI,
- distributions of tax exempt income, or
- distributions in excess of DNI.

a) Special limitation for simple trusts

The deduction available to simple trusts is subject to a further limitation. It may not exceed the amount of fiduciary accounting income for the year.[564]

As a practical matter, the impact of this limitation is twofold.

1. Since a simple trust can distribute no more than its fiduciary accounting income, the trust will have undistributed DNI for any year in which its DNI exceeds its accounting income. The taxable component of the undistributed DNI will be taxed to the trust.
2. Since a simple trust must distribute all of its fiduciary accounting income currently, it will make distributions in excess of its DNI in any year in which its accounting income exceeds its DNI. When this occurs, the excess is exempt from taxation under IRC § 102 as a gift, devise or inheritance.[565]

b) Distributions after the close of the taxable year

As a matter of administrative convenience, fiduciaries frequently postpone distributions until after the close of the taxable year. A question then arises whether the entity may deduct (and whether the beneficiary must report) the delayed distribution as if it actually occurred during the taxable year.

1. **Simple trust:** In the case of a simple trust, to delay a distribution for other than reasons of administrative necessity or expediency would be wrongful. Accordingly, the regulations require a simple trust to deduct distributions whether or not they are actually made as of the close of the taxable year.[566]

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561 IRC § 643(a)(4).

562 IRC §§ 651(a); 661(a). The distribution deduction under these sections is allowable without regard to the 2-percent floor of IRC § 67(a).

563 IRC §§ 651(b); 661(c). The taxable component of DNI is equal to DNI reduced by any tax exempt income (net of expenses).

564 IRC § 651(a).

565 See Treas. Regs. §§ 1.652(a)-2, 1.652(c)-4. This is true even if the trust has undistributed DNI for a prior year. Simple trusts are not subject to the throwback rule. See "*Accumulated income*," on p. 202.

566 Treas. Regs. § 1.651(a)-2. A beneficiary of a simple trust is taxable on income required to be distributed even if the beneficiary declines to accept the distribution. Stuart A. Seligson, 63 TCM 3101 (1992).

2. **Complex trusts and estates:** Complex trusts and estates have greater flexibility. They have a choice of when to take the deduction.

   - At the election of the fiduciary (trustee or personal representative), amounts paid to beneficiaries within the first 65 days after the close of the taxable year may be treated as if they were made on the last day of the trust taxable year.[567]
   - To the extent the election is made, the amount is deductible by the trust orestate and taxable to the beneficiary in the elective year, not the actual year of distribution. To the extent the election is not made, the year of actual distribution controls.

4. Allocating DNI: The tier system

If aggregate distributions exceed DNI for the year, DNI must be allocated among the beneficiaries to whom distributions were made.

In the case of simple trusts, the Code provides for a straightforward allocation based on the percentage of accounting income distributed to each beneficiary.

For estates and complex trusts, the allocation of DNI is controlled by a "tier system."

- Mandatory distributions payable only out of accounting income are assigned to the first tier. These distributions consume DNI first.
- Discretionary distributions (and required distributions of principal) fall within the second tier. Second tier distributions carry out DNI only to the extent some remains after accounting for first tier distributions.

If there are multiple beneficiaries in either tier, the DNI available to that tier is allocated among them in proportion to the amount distributed to each.

a) Distributions to charity

Application of the tier system takes on an added level of complexity if the estate or trust makes a deductible distribution to charity. The Code provides that DNI for purposes of the first tier is to be computed without regard to the charitable deduction. In effect, this creates an intermediate third tier.

b) Classification of annuities

Depending on the circumstances and the discretion of the fiduciary, annuities (required periodic payments) can fall either in the first or the second tier.

1. An amount that is required to be distributed but which may be paid out of either income or corpus is a first tier distribution "to the extent that such amount is paid out of income for the taxable year."[568]
2. An annuity (other than one that is payable only out of principal) is paid out of income "to the extent there is income (as defined in IRC § 643(b)) not paid, credited or required to be distributed to other beneficiaries for the taxable year."[569]

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[567] The election, which may be partial, is made by checking a box on the fiduciary income tax return.

[568] IRC §§ 661(a)(1), 662(a)(1).

[569] Treas. Regs. § 1.662(a)-2(c).

COMMENT
Under this test, the classification of an annuity may depend on how a fiduciary treats tier two distributions.

Ex-134: A trust has DNI and accounting income for the year of $100,000. The trust is required to distribute half of its accounting income to A and an annuity of $50,000 a year out of income or principal to B. In addition, the trustee has the discretion to distribute income or principal to C. If the trustee distributes $50,000 to C, is B's annuity a first or second tier distribution?

5. Allocating DNI: Separate share rule

In determining the amount of DNI allocable to beneficiaries of a single trust, the shares of a single trust with more than one beneficiary are treated as separate trusts if the beneficiaries have substantially separate and independent shares.[570]

Effective August 5, 1997, the separate share rule applies to estates as well.[571]

COMMENTS

The separate share rule is mandatory. However, it applies only for purposes of allocating trust (or estate) DNI among the separate shares.

- It does not apply for the purpose of filing returns or the payment of tax.
- It does not give the trust (or estate) more than one personal exemption.
- It does not apply for purposes of allocating unused loss deductions pursuant to IRC § 642(h) among beneficiaries at the termination of a trust or estate.[572]

The Service has issued regulations covering the applicability of the separate share rule to estates. See Treas. Regs. § 1.663(c)-4 and Examples 2 – 4 in Treas. Regs. 1.663(c)-5. Under these regulations, the marital and credit shelter shares of an estate are treated as separate shares. So too is a spouse's elective share. Moreover, the regulations make it clear that if a separate share is not entitled to share in fiduciary accounting income, as is true of the elective share and (in the absence of a contrary direction in a will) outright pecuniary bequests in Florida, distributions in satisfaction of the share will not carry out estate DNI.

Ex-135: T creates a trust for the benefit of his two minor children, A and B. The instrument directs that the trust property is to be divided into two equal shares, one for each child. as to each share, the income is to be accumulated until the child attains age 21, at which time the trust may distribute the income and principal of the share to the beneficiary as the trustee deems advisable for the beneficiary's comfort and support. At the earlier of the date upon which the beneficiary attains the age of 40 or dies, all remaining trust property in that beneficiary's share is to be distributed to the beneficiary, if living,

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[570] IRC § 663(c); Treas. Regs. § 1.663(c)-1.

[571] With respect to the extension of the separate share rule to estates, the Joint Conference Committee Report states:

> There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries.

[572] Treas. Regs. § 1.663-1(b).

otherwise to the beneficiary's estate. Several years after the creation of the trust, when A is 25, the trustee distributes $15,000 to A, allocating $10,000 to income and $5,000 to principal. Total trust DNI for the year is $20,000.

1. To what extent will the distribution to A carry out trust DNI?

2. Would the answer change if the trust provided that in the event that A died before age 40, her share was to be added to B's share of the trust?

3. Suppose the instrument authorized distributions from B's share for A's support should A's other resources be inadequate to support her?

4. Suppose the instrument said nothing about separate shares but merely provided that each beneficiary was to receive half of any principal and accumulated income at termination

6. The character of distributed income

The mere fact that a beneficiary receives a distribution that carries out DNI does not necessarily mean the beneficiary will have taxable income in an equivalent amount.

- The character of distributed income (rents, dividends, etc.) flows through to the beneficiary from the entity.
- Thus, if forty percent of DNI consists of tax exempt interest, an equivalent percentage of the distributed DNI will be exempt in the hands of the beneficiary.

COMMENT
The same is generally true when distributions are made to several beneficiaries. The DNI carried out to each as well as any retained in the estate or trust, will be deemed to consist of a prorata portion of each of the items that make up DNI.

Ex-136: The terms of a trust provide that the first $50,000 of any income each year is to be distributed in equal shares to A and B. Additionally, the trustee has the discretionary authority each year to distribute up to $75,000 out of income or principal to C and/or D. Pursuant to this authority, the trustee distributes $45,000 to C and $30,000 to D. Both distributions are charged to principal. During the year, the trust has rental income of $22,000, tax exempt interest of $33,000, dividends of $55,000 and capital gains of $11,000. The trustee's fee for the year is $10,000, allocable under local law half to income and half to principal. In addition, pursuant to authority in the instrument, the trustee allocates $3000 of trust income as a reserve against depreciation. The available depreciation deduction for the year is $9,000. On these facts:

1. What is the accounting income for the year?

2. If "tentative taxable income" is defined to be taxable income without regard to the deduction for distributions, what is the trust's modified (tentative) taxable income?

3. What is the trust's DNI?

4. What are the first tier distributions and how are they taxed?

5. What are the second tier distributions and how are they taxed?

6. How is the depreciation deduction allocated?

7. What is the trust's taxable income for the year?

7. Distributions which do not carry out DNI

To the extent an estate or trust has DNI for the year, the general rule is that all distributions carry out DNI. There are, however four important exceptions.

The distribution rules of Subchapter J do not apply to:

- property which was never part of the estate subject to administration;
- distributions of money or property in satisfaction of pecuniary or specific gifts;
- distributions of items of income in respect of a decedent, or
- distributions to charity.

In each of these cases, the beneficiary treats the property as a tax free distribution of a gift, devise, bequest or inheritance. Concomitantly, there is no distribution deduction at the entity level.

a) Homestead and other nonprobate property

It is axiomatic that property that is not subject to administration at the death of a decedent cannot be distributed from the estate to a beneficiary. For this reason, Subchapter J does not apply to property passing by right of survivorship.[573]

And a similar rule applies to the homestead in Florida. At least where the decedent is survived by a spouse or minor child, it is well settled that the homestead is not an asset subject to administration in this state.[574]

b) Distributions in satisfaction a spouse's elective share

Under newly promulgated regulations,[575] the elective share right of a surviving spouse is treated as a separate share of the estate. Moreover, if as is true of Florida's elective share, the spouse is not entitled to share in estate income, distributions in satisfaction of the share will not carry out DNI.

c) Specific and pecuniary gifts

Distributions of property described in IRC § 663(a) do not carry out DNI.

- They constitute gifts, devises or inheritances that are exempt from taxation under IRC § 102(a).
- Nor, of course, are such distributions deductible by the entity.

IRC § 663(a) applies to distributions made in satisfaction of a gift or bequest of a specific sum of money or of specific property, provided:

1. The distribution is made in not more than three installments;[576] and
2. In the case of a pecuniary gift, the amount of the gift is ascertainable at the death of the decedent and the governing instrument does not require that it be paid only from income.[577]

> ***Ex-137:*** D's will includes a bequest of "assets, in cash or in kind or partly in each, the selection of which shall be in the absolute discretion of my executor, with a fair market value on the date of distribution equal to $20,000." Will a distribution of property in satisfaction of this bequest carry out DNI?

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573 Or, indeed to "the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees." Treas. Regs. § 1.661(a)-2(e).

574 E.g., Spitzer v. Branning, 135 Fla. 49, 184 So. 770 (1938); Raulerson v. Peeples, 77 Fla. 207, 81 So. 271 (1919); Walker v. Redding, 40 Fla. 124, 23 So. 565 (1898).

575 See Treas. Regs. § 1.663(c)-4. See also Treas. Regs. § 1.663(c)-5, Ex. 7.

576 The regulations interpret this requirement to mean only that the instrument must not provide for payments in more than three installments. Treas. Regs. § 1.663(a)-1(a). If the instrument is silent on the manner of payment, the gift or bequest will be deemed payable all at once and the fact that it is actually funded in more than three installments is not relevant. Treas. Regs. § 1.663(a)-1(c)(1)(iii). Moreover, the three-installment restriction does not apply to bequests of personal and household effects and automobiles even if they are payable over more than three installments. Treas. Regs. § 1.663(a)-1(c)(1)(i).

577 Treas. Regs. § 1.663(a)-1(b).

Ex-138: As the beneficiary of a trust created by her mother, D exercises her special testamentary power of appointment to appoint $100,000 to her brother and PaisleyAcre to her sister. Will the distributions from the trust in satisfaction of these appointments carry out trust DNI?

Ex-139: D's will contains a pecuniary marital bequest of "the amount which when considering the applicable credit amount (unified credit), will produce the largest taxable estate I can have without paying estate taxes at my death."

1. Will DNI be carried out when this bequest is funded?

2. Would your answer change if the will also contained the following language: "I direct may personal representative to fund this marital gift in a manner that prevents estate income from passing out of my estate as a consequence of the funding?

COMMENT
The same is true in Florida of distributions in satisfaction of the family allowance because the amount of the family allowance is within the discretion of the court.

d) Income in respect of a decedent

Although the Code contains no express provision to that effect, the Service and at least one Circuit Court agree that the distribution rules of Subchapter J do not apply to items of income in respect of a decedent (IRD).[578]

Rather, except in the situation where the distribution itself is taxable as a sale or exchange by the estate or trust,[579] a distribution of IRD produces neither a deduction for the entity nor income to the beneficiary.

COMMENT

IRD is income that is substantially earned as of a decedent's death but which is not reportable on the final income tax return because of the decedent's method of accounting.[580]

There are numerous, but some of the more common include:

- renewal commissions,
- accounts receivable of cash basis professionals,
- installment sales contracts,
- survivorship annuities in deferred compensation arrangements, and
- unreported discount in Series E or EE government bonds.

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578 Rollert Residuary Trust v. Comm., 752 F.2d 1128 (6th Cir. 1985). See also PLR 9108027.

579 See "*Sales or exchanges: The Kenan rule*" on p. 197.

580 IRC § 691(a).

e) Distributions to charity

IRC § 663(a)(2) disallows a distribution deduction for amounts paid or permanently set aside for charitable purposes.

- The apparent purpose of this provision is to prevent an estate or trust from deducting the distribution twice: once as a distribution and again as a charitable contribution.
- But the section is not so limited. The distribution deduction is disallowed for amounts paid or set aside for charity even if they do not qualify for a charitable deduction.[581]

F. NONCASH DISTRIBUTIONS

When an estate or trust makes a distribution of property other than cash, two questions arise.

- First, to what extent will the distribution result in recognized gain or loss to the distributing entity?
- Secondly, how is the distribution to be treated under the conduit and distribution principles of Subchapter J?

In both cases, the answer depends on a number of factors including the nature of the gift being satisfied (*i.e*., pecuniary or not), the type of distributing entity (*i.e*., estate or trust) and whether an election under IRC § 643(e)(3) is in effect for the year.

1. Gain or loss to the distributing entity

The general rule is that no gain or loss is realized when an estate or trust distributes property to its beneficiaries. Instead, the sole tax significance of the distribution comes from an application of the conduit principle to the distribution. But there are two important exceptions. Gain or loss will be realized by an estate or trust if

- it enters into a sale or exchange with its beneficiary or
- an election under IRC § 643(e)(3) is in effect for the year.

a) Sales or exchanges: The Kenan rule

As mentioned, a trust or estate will realize gain or loss if it sells or exchanges property to a beneficiary. The sale or exchange need not involve cash. In what has come to be called the "Kenan" rule, gain or loss is realized if a distribution of property other than cash is made in satisfaction of a gift of a pecuniary amount or of other specific property, or of a beneficiary's right to a distribution of accounting income.[582]

This treatment is separate and apart from the treatment of the distribution under the conduit and distribution principles of Subchapter J. Indeed, the Kenan rule applies even if the distribution is otherwise excludable from those principles by virtue of IRC § 663(a)(1).

[581] See the parenthetical in IRC § 663(a)(2). Accord, Crown Income Charitable Fund, 98 T.C. 327 (1992). Compare Treas. Regs. § 1.663(a)-2.

[582] The rule derives its name from Kenan v. Comm., 114 F.2d 217 (2d Cir. 1940); Treas. Regs. § 1.661 (a)-2(f)(1). See also Treas. Regs. § 1.661(a)(2)(f)(1).

COMMENT
In some situations, it is possible for an estate to minimize the adverse impact of a Kenan distribution by matching gain property with loss property. The later will give the estate a loss deduction that can be used to offset gains from other property. In the absence of an IRC § 645 election, this flexibility is not available for trusts.[583] Instead, to generate an offsetting loss deduction, a trust for which an IRC § 645 election has not been made must sell the loss property to an unrelated party and then distribute the proceeds of sale in satisfaction of the pecuniary gift.

b) Section 643(e)(3) election to treat distribution as a sale

Under IRC § 643(e)(3), a trustee or personal representative has an election to treat an in-kind distribution as if it was a sale to the beneficiary followed by a distribution of the sales proceeds. Unfortunately, the election is subject to a number of restrictions that undermine its usefulness as a planning tool.

1. First, the election is available only for distributions that are not treated as a sale under the Kenan rule.[584] Thus, it may not be used to avoid gain that would otherwise have to be recognized.
2. Secondly, the election is available only for distributions that are not excludable under IRC § 663(a)(1) as a specific gift of property.[585]
3. Finally, and most importantly, the election may not be made on an asset by asset basis. If made, the election applies to all distributions made by the trust or estate during the taxable year.[586]

COMMENT
One potential use for the election can be seen in the case where an estate or trust has other unused capital losses for the year. By making the IRC § 643(e)(3) election, the entity may be able to generate capital gains against which the losses can be offset immediately. This may be preferable to carrying the losses over to future years.[587]

2. Distribution and conduit principles

Noncash distributions receive one of three possible treatments under the distribution and conduit principles.

a) If the distribution qualifies for the IRC § 663(a)(1) exclusion, no DNI is carried out to the beneficiary. Correspondingly, the entity gets no distribution deduction.

b) If the exclusion is not applicable, the DNI carried out to the beneficiary is based on the "amount distributed." The amount distributed is the full fair market value of the property if, as a result of the Kenan rule or the IRC § 643(e)(3) election, the distribution is taxed as a sale by the entity.[588]

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583 See IRC § 267 discussed in "*Loss transactions between related taxpayers*" on p. 187.

584 See S. Rep. No. 169, 98th Cong., 2d Sess., 246 (1984); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984, pp. 253-254.

585 IRC § 643(e)(4).

586 IRC § 643(e)(3)(B).

587 Note, however, that the converse is not true. IRC § 643(e)(3) does not allow a loss that would otherwise be disallowed by IRC § 267. Thus, if a trust has gains for the year, the IRC § 643(e)(3) election may not be used to generate offsetting losses.

588 IRC § 643(e)(3)(A)(iii).

c) In the more common case where it is not, the Code limits the amount distributed to the lesser of fair market value of the property or its basis in the hands of the distributing entity.[589]

Ex-140: A trust with DNI for the year of 90 makes a discretionary distribution of 100 in cash to beneficiary A and stock worth 100 with a basis of 50 to beneficiary B.

1. How will the distribution to B be treated if an IRC § 643(e)(3) election is in effect?

2. How will it be treated if no election is in effect?

DRAFTING TIP
The decision to make or not to make the IRC § 643(e)(3) election can have an impact on the allocation of DNI among trust beneficiaries. To the extent this yields a benefit to some beneficiaries at the expense another, it is possible that the trustee would be required to make a compensating adjustment. As is true of all cases where a compensating adjustment might be required, the governing instrument should expressly state whether the adjustment is or is not to be made.

3. Basis of distributed property

The basis of property distributed in kind to a beneficiary of a trust or estate is equal to the basis of the property in the hands of the distributing entity plus any gain and minus any loss recognized to the entity as a result of the distribution.

This is a universal rule.

- It applies to distributions that are excluded from the conduit principal by virtue of IRC § 663(a)(1).
- It also applies to distributions subject to the Kenan rule and to distributions for which an IRC § 643(e)(3) election is in effect.

COMMENT
However, in these latter two cases, if a trust makes a distribution for which a loss is disallowed under IRC § 267, any gain realized by the beneficiary on a subsequent sale or exchange need not be recognized to the extent of the disallowed loss.[590]

Ex-141: In satisfaction of a pecuniary gift, a trustee distributes stock worth 100 with a basis of 120 to beneficiary B. If B sells the stock for $150,000, what is her gain on the sale?

589 IRC § 643(e)(2).

590 IRC § 267(d).

G. MISCELLANEOUS SPECIAL PROVISIONS

1. Selection of a taxable year

Generally, distributions of income are taxable to the beneficiary in the taxable year of the beneficiary in which the taxable year of the estate or trust ends. This may not be the same calendar year in which the entity earned the income or even in which the distribution to the beneficiary occurred.

An estates is free to fashion its affairs to defer taxes through a prudent selection of a taxable year. An estate may elect a fiscal year ending on the last day of any month within 12 months of D's death.[591]

The rule for trusts is more restrictive. Ordinary trusts are required to use a calendar taxable year for any taxable year ending after 1986.[592]

> ***Ex-142:*** D dies February 1 of year 1. Her personal representative elects a fiscal year ending January 31 of year 2. Thus, the return is due on May 15 of year 2. Before the end of the first fiscal year, D's estate distributes estate income to beneficiary, B. Assuming B is a calendar year taxpayer, in what taxable year must B report the distribution?

> ***Ex-143:*** D dies February 9, 1998. Administration of his estate is expected to last about 14 months. On March 15, 1998, D's PR selects a fiscal year ending March 31 and makes a series E election to report a large amount of accrued income. What income tax consequences flow from these decisions?

2. Estimated taxes

Most trusts must pay estimated taxes for any taxable year beginning after 1986.[593]

- An exception exists for grantor and controlled trusts which receive a pour over from the decedent's will or, where there is no will, which are primarily responsible for paying taxes, debts and administration expenses.
- As is the case with estates, these trusts need not pay estimated taxes for any taxable year that ends within two years of the decedent's death.[594]

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591 IRC § 441(b). Grantor and controlled trusts are not so limited. A wholly grantor or controlled trust may adopt the taxable year of its "tax owner." Rev. Rul. 90-55, 1990-2 C.B. 161 (1990).

592 IRC § 645. Prior fiscal year trusts had two taxable years ending in 1987: A normal fiscal year and a short "transition year" necessitated by the change to a calendar year.

At the election of the beneficiary, the income from the short transition year may be reported ratably over a 4 year period beginning in 1987 or all in the following year.

Notice 88-45, 1988-1 C.B. 529 (1988) states that the four-year spread is terminated if the beneficiary dies during the spread period. In that event, the untaxed portion of the trust's DNI is included in the beneficiary's last income tax return.

593 IRC § 6654(l). Payments are due by the 15th day of the fourth, sixth, ninth and thirteenth months.

594 IRC § 6654(l)(2).

Ex-144: D dies May 10, 1998. The estate elects a fiscal year ending July 31. When must the estate pay estimated taxes?

COMMENT
Electing a long initial fiscal year will postpone the day of reckoning for estimated tax payments. For example, had D's estate elected a fiscal year ending April 30, estimated taxes would not have to be paid until the estate's fiscal year ending April 30, 2001.

3. Pass-through of excess estimated tax payments

In calculating its liability for estimated taxes, an estate or trust may take into account a distribution deduction for discretionary distributions only to the extent the distribution has been made on the due date of the installment.[595]

If later discretionary distributions are made, the estate or trust may find that its estimated tax payments exceed its tax liability for the year. Where this occurs, a trust may elect to treat any portion of the excess payment as a payment of estimated tax by a beneficiary of the trust. An estate has the same election for any taxable year that is reasonably expected to be its last.[596]

Amounts assigned to a beneficiary are treated as distributions to the beneficiary on the last day of the trust's taxable year. Thus, the election itself can have indirect tax consequences to the entity and its beneficiaries.

CAUTION
For a trust that has otherwise distributed all of its current income, the election amounts to a distribution of principal. In the absence of authority to distribute principal, such an election could be wrongful. Even if authority exists, the election could turn a simple trust into a complex one.

4. Carryover of excess deductions

Beneficiaries who succeed to the property of an estate or trust at termination of the entity inherit any unexpired net operating loss (NOL) and capital loss carryovers[597] as well as the excess, if any, of the entity's non-business deductions over its gross income for the year of termination.[598]

- The latter are deductible as miscellaneous itemized deductions for the taxable year of the beneficiary in which the final taxable year of the entity ends.

595 Notice 87-32, 1987-1 C.B. 477 (1987).

596 IRC § 643(g). The election is made on a separate form filed before the 65th day following the close of the taxable year. The elected amount is treated as if it were paid by the beneficiary on January 15th of the following taxable year. Thus, the election can not be used to eliminate a penalty for underpayment of estimated taxes that would otherwise be payable by the beneficiary.

597 IRC § 642(h)(1). As a general rule, the deductions are inherited prorata by the residuary beneficiaries in the case of an estate or by the remaindermen in the case of a trust although in either case, other beneficiaries will inherit the deductions to the extent the entity lacks sufficient property to fully fund their bequests. IRC § 642(h).

598 IRC § 642(h)(2). The excess deductions are determined without taking into account the entity's deduction in lieu of a personal exemption and any charitable contributions for the year.

- Capital losses and NOLs may be used in that year or they may be carried over to later years, the former indefinitely and the latter for the remaining term of the 15 year carryover period.[599]

COMMENT
Arranging the end of administration to occur in a short final fiscal year in which the bulk of administration expenses are paid will maximize the amount of expenses that may be carried over to the beneficiaries. However, any decision to do this must be weighed carefully with the possibility that otherwise fully deductible expenses may be subjected to the 2-percent floor for miscellaneous deductions if they are carried over to the beneficiaries.

H. ACCUMULATED INCOME

In any year in which a trust or estate distributes less than its current DNI, the excess is accumulated in and taxed to the entity.

- Under prior law, subject to the two exceptions noted below, if in a subsequent year a trust made a distribution of accumulated income,[600] taxation of the distribution was controlled by the "throwback rule."[601]
- The 1997 TRA eliminated the throwback rule for distributions from most trusts after August 5, 1997.

COMMENT

The throwback rule continues to apply with respect to foreign trusts, domestic trusts that had at one time been treated as a foreign trust, and domestic trusts created before March 1, 1984, which would have been treated as a multiple trust under IRC § 643(f) had that section been applicable to it.

The actual mechanics of the throwback rule are complex and technical enough that they are best left to accountants.[602] Basically, the rule requires the beneficiary to report the distribution (increased by the taxes paid by the trust in the year of accumulation) as a distribution of income.[603]

- The beneficiary's tax is determined using a special averaging rule which disregards the high and low tax years in the five years immediately preceding the distribution and averages the increase in taxes that would have resulted had the accumulation distribution been made in each of the remaining three years.
- The amount thus determined is then reduced (but not below zero) by the taxes initially paid by the trust.[604]

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599 In the case of an NOL, inheritance by the beneficiary does not restart the carryover period. But see Dorfman v. Comm., 394 F.2d 651 (2d Cir. 1968) holding invalid Treas. Regs. § 1.642(h)-1(b) which states that the entity's final year and the beneficiary's first both count as separate years in calculating the carryover period.

600 A distribution of accumulated income occurs when a complex trust with undistributed DNI from prior years makes a distribution in excess of its DNI for the current year. Exceptions apply to excludable distributions under IRC § 663 and to distributions which do not exceed fiduciary accounting income for the year. IRC § 665(b).

601 See generally, IRC §§ 665 - 667.

602 Those who wish to delve deeper should read Norman H. Lane & Howard M. Zaritsky, Federal Income Taxation of Estates and Trusts ¶¶6.01 - 6.08. See also, Knickerbocker, Subchapter J — Throwback Rules, Estates, Gifts and Trusts, 170-4th TM.

603 The year of accumulation is determined on a first accumulated first distributed basis. IRC § 665(b).

604 IRC § 666(e). Both the increase and the credit for taxes paid by the trust are determined on a marginal basis. The taxes are equal to the difference between the taxes actually paid by the trust and the taxes that would have been paid had the accumulated income been distributed currently. See Treas. Regs. § 1.665(d)-1(a). In making the calculations, the tax to the trust is determined without taking into account any credits. IRC § 665(d).

Both the increase in the amount of the distribution and the subtraction for taxes paid by the trust in the year of accumulation are denied to a beneficiary who receives distributions of income accumulated in the same year from two or more other trusts.

1. Unborn and underage beneficiaries

As a matter of legislative grace, the throwback rule did not apply to distributions of accumulated income to a beneficiary who was not alive or who was under the age of twenty-one in the year of accumulation.[605]

In the application of the exception, it is the year of accumulation, not the year of distribution, that controls. Distributions to a beneficiary after the beneficiary had attained 21 were exempt from the throwback rule to the extent the distribution was made from income accumulated before that age.[606]

2. Estates and simple trusts

The throwback rule was also inapplicable to distributions from estates and most simple trusts.[607]

IRC § 667(c). This rule, which effectively results in double taxation of the same income, should and usually can be avoided by staggering distributions from the multiple trusts so that distributions from no more than two trusts occur in any single year.

605 IRC § 665(b). For this purpose, and for the purposes of the throwback rule generally, the year of accumulation is determined on a first accumulated, first distributed basis.

606 IRC § 665(b).

607 A simple trust will be subject to the throwback rule only if it has "outside income." Outside income includes income in respect of a decedent, income from unrealized receivables, and income from trapping distributions from a trust, but not from an estate. See Treas. Regs. § 1.665(e)-1A(b).

ANSWERS—ESTATES AND ORDINARY TRUSTS

Ex-129. **Answer –** Until recently, the answer was in doubt. According to the 6th Circuit, the answer was no. But the Service, the Court of Claims and the Second Circuit disagreed. Compare O'Neill Irrevocable Trust v. Comm., 994 F.2d 302 (6th Cir. 1993), rev'g 98 T.C. 227 (1992), nonacq. 1994-38 I.R.B. 4 (Sept. 1994) with N.A. Mellon Bank v. U.S., 47 Fed. Cl. 186 (Ct. Fed. Cl. 2000) and Rudkin Testamentary Trust v. Comm., 467 F.3d 149 (2d Cir. 2006). The answer has now been resolved (in favor of the Service's view) by the Supreme Court. See Knight v. Comm., 128 S.Ct. 782, 76 USLW 4048 (2008).

Ex-130. **Answer –** Yes. The requirement that a charitable contribution be "pursuant to the governing instrument" does not mean that the distribution must be required. A discretionary distribution qualifies so long as the instrument authorizes distributions to charity. Old Colony Trust Co. v. Comm., 301 U.S. 379 (1937).

Ex-131. **Answer –** No. The distribution is not "pursuant to the governing instrument" as IRC § 642(c)(1) requires. Weir Foundation v. United States, 362 F. Supp. 928 (SDNY 1973), aff'd, 508 F.2d 894 (2d Cir. 1974).

Ex-132. **Answer –** The trust is allocated a depreciation deduction of $50,000 ($30,000 for the reserve and half of the balance). A is allocated a depreciation deduction of $8,000 (20 percent of $40,000) and the balance of $12,000 (30 percent of $40,000) is allocated to beneficiary B.

Ex-133. **Answer –** $7,000. Thirty percent of the trusts accounting income is tax exempt income, so an equivalent percentage of the fee is nondeductible under IRC § 265.

Ex-134. **Answer –** It depends. The annuity distributed to B will be a first tier distribution if the distribution to C is charged to principal and a second tier distribution if it is charged to income.

Ex-135. **First question –** For purposes of allocating DNI, this trust will be treated as two trusts. Since A and B have equal separate and independent shares in the trust income and principal, half of the trust DNI will be allocated to each. Accordingly, the distribution to A carries out half of the DNI or $10,000. The balance of the distribution ($5,000) is treated as a distribution of A's share of the principal. See Treas. Regs. § 1.663(c)-3(a). Accord, Treas. Regs. § 1.663(c)-4, Example.

Second question – No, the answer is the same. It determining whether a trust has separate shares, it is immaterial where accumulated income and trust principal go at the termination of the beneficiary's interest in the share. Treas. Regs. § 1.663(c)-3(a).

Third question – The answer here depends. The ability to distribute some or all of B's share to A will preclude separate share treatment unless the trustee's discretion is circumscribed by an ascertainable standard *and* the possibility that the power would be exercised is remote. This would be the case, for example, if the trustee's power in this question required that A's other resources be considered and A's other resources are so substantial as to make any exercise of the power remote. See Treas. Regs. § 1.663(c)-3(d).

Fourth question – It is not necessary for the instrument to state that there are to be separate shares. However, in the absence of such a statement, applicability of the separate share rule will depend on whether distributions from the trust reflect separate shares. For example, if the instrument requires that each beneficiary's share of the trust be adjusted to reflect distributions of income and corpus, the trust will be treated as having separate shares. See Treas. Regs. § 1.663(c)-3(a) and (b).

Ex-136. **First question –** Accounting income for the year is $102,000. This figure assumes that capital gains are allocable to principal under local law and that there is nothing in the governing instrument to the contrary. This is the general rule. Accounting income is determined as follows:

Receipts		
Rent		$22,000
Tax exempt interest		$33,000
Dividends		$55,000
Subtotal		$110,000
Expenses		
Depreciation reserve	$3,000	
Trustee's fee	$5,000	
Subtotal		($8,000)
Accounting income		$102,000

Second question – As indicated in the problem, the term tentative taxable income refers to the taxable income of the trust determined without regard to the deduction for distributions. That is, this is the taxable income of the trust were it to make no distributions. The figure reflects the deduction in lieu of a personal exemption and the deduction for the trustee's fee whether allocable to income or corpus. However, since 30 percent of accounting income consists of tax exempt interest, 30 percent of the deduction for the fee will be disallowed. The tentative taxable income is $71,900, determined as follows:

Gross income		
Rent		$22,000
Capital gains		$11,000
Dividends		$55,000
Subtotal		$88,000
Deductions		
Personal exemption	$100	
Depreciation	$9,000	
Trustee's fee	$7,000	
Subtotal		($16,100)
Accounting income		$71,900

Third question – Distributable net income is equal to the tentative taxable income decreased by capital gains and increased by the personal exemption, the exempt income net of allocable expenses, and the deduction for depreciation. This latter must be added back because allocation of the depreciation deduction occurs outside the normal DNI rules. DNI is $100,000, determined as follows:

Tentative taxable income			$71,900
Less capital gains			($11,000)
Subtotal			$60,900
Plus			
Tax exempt income	$33,000		
Expenses	($3,000)		
Net		$30,000	
Depreciation		$9,000	
Personal exemption		$100	
Subtotal			$39,100
Distributable net income			$100,900

Fourth question – A and B are first tier beneficiaries whose distributions will carry out a full complement of DNI. They each receive $25,000. Since DNI is more than this, neither A nor B will have received principal. Instead, the character of their distributions is based on the composite character of DNI. A and B will each receive dividends of $12,500, rents of $5,000 and tax exempt interest of $7,500, determined as follows. Of the total DNI of $100,000, $20,000 or 20% is rental income, $50,000 or 50% is taxable dividends and $30,000 or 30% is tax exempt interest. These figures are determined as follows:

	Rent	Dividend	Exempt	Total
Gross receipts	$22,000	$55,000	$33,000	$110,000
Less indirect expenses	($2,000)	($5,000)	($3,000)	($10,000)
Net DNI	$29,000	$50,000	$30,000	$100,000
Tier 1 distributions				
Beneficiary A	$5,000	$12,500	$7,500	$25,000
Beneficiary B	$5,000	$12,500	$7,500	$25,000
Total	$10,000	$25,000	$15,000	$50,000
Subtotal				
Tier 2 DNI	$10,000	$25,000	$15,000	$50,000

Fifth question – After accounting for first tier distributions, there remains $50,000 of DNI. All will be carried out by the distributions to second tier beneficiaries C and D. As the amount distributed to them bears a 3 to 2 ratio, they will share in the various components of DNI in that ratio as well. Distributions to C and D in excess of their aliquot share of DNI constitutes a tax free distribution of principal. The result is as follows:

		C		D
Second Tier Distributions		$45,000		$30,000
Aliquot DNI				
Rents	$6,000		$4,000	
Dividends	$15,000		$10,000	
Tax exempt	$9,000		$6,000	
Total DNI distributed		($30,000)		($20,000)
Principal distributed		$15,000		$10,000

Sixth question – Next consider the allocation of the deduction for depreciation. Of the total depreciation of $9,000, $3,000 stays at the trust level because of the reserve for depreciation. The balance of $6,000 is allocated on the basis of accounting income. A and B will receive a deduction of $1,471 each and the trust will receive the balance. C and D do not share in the depreciation because their distributions came from principal. The figures are determined as follows:

	A	B	C	D	Trust	Total
Accounting income	$25,000	$25,000	$0	$0	$52,000	$102,000
As percentage of total	24.51%	24.51%	0%	0%	50.98%	100%
Depreciation allocation						
Aliquot share of $6,000	$1,471	$1,471	$0	$0	$3,058	$6,000
Reserve of $3,000					$3,000	$3,000
Total deduction	$1,471	$1,471	$0	$0	$6058	$9,000

Seventh question – After accounting for all distributions, the trust will receive a distribution deduction of $70,000, representing the taxable component of DNI. This will produce taxable income for the trust of $4,842 determined as follows:

Gross income		
Rent	$22,000	
Capital gains	$11,000	
Dividends	$55,000	
Subtotal		$88,000
Deductions		
Trustee's fee	$7,000	
Personal exemption	$100	
Depreciation deduction	$6,058	
Distribution deduction	$70,000	
Subtotal		($83,158)
Taxable income		$4,842

Ex-137. **Answer –** Yes. In PLR 9218076 the Service ruled that distributions pursuant to a testamentary power of appointment cannot qualify as a gift of a "specific sum of money or of specific property" because the amount of money and the identity of the specific property contained in the appointment were not ascertainable under the terms of trust as of the date of its inception.

Ex-138. **Answer –** No. The distribution is excluded under IRC § 663(a) as a distribution of a pecuniary amount. Rev. Rul. 86-105, 1986-2 C.B. 82 (1986).

Ex-139. **First question –** Yes. A pecuniary gift is not ascertainable at the death of a decedent if the amount of the gift (as opposed to the selection of the assets distributed to satisfy it) can vary with post-death decisions or events. Thus, distributions in satisfaction of a formula pecuniary marital or credit-shelter gift will carry out DNI because (among other things) the amount of the gift is a function of the amount of administration costs and where the personal representative elects to deduct them. Treas. Regs. § 1.663(a)-1(b).

Second question – No. The question of whether DNI is carried out on the funding of a gift turns on the nature of the gift, not the intent of the decedent.

Ex-140. **First question –** If an IRC § 643(e)(3) election is in effect for the year, the distribution to B will trigger a capital gain of $50 to the trust. This gain will not increase DNI if, as is usually the case, capital gains are corpus for fiduciary accounting purposes. Still assuming the election is in effect, the amount distributed to B will equal the 100 fair market value of the property with the result that the available DNI will be divided equally between A and B.

Second question – If no election is in effect, the amount distributed to B will be 50. The distribution to A will carry out 60 in DNI and the distribution to B will carry out 30.

Ex-141. **Answer –** When the stock is distributed to B, the loss of 20 on the distribution is disallowed under IRC § 267 and B's basis in the stock is 100. However, gain on the subsequent sale need not be recognized by B to the extent of the loss disallowed by IRC § 267. Accordingly, only 30 of the 50 gain must be recognized.

Ex-142. **Answer –** The income will be year 2 income to B and the tax on the income will not be due until April 15th of year 3. This results in a deferral of tax responsibility for 11 months — May 15 of year 2 to April 15 of year 3.

Ex-143. By electing a fiscal year that ends on March 31, estate income is spread over three taxable years. The first year is a short year extending from February 9, 1988 to March 31, of 1988. All of the Series EE income is reportable in this year. The second year is a full 12 months. It begins on April 1, 1988 and ends on March 31, 1989. The final year (another short one) begins April 1, 1989 and end 30 days later on April 30, 1989.

Ex-144. **Answer –** The estate must begin paying estimated taxes in its fiscal year ending July 31, 2000.

VIII. GRANTOR AND CONTROLLED TRUSTS

A. INTRODUCTION

A grantor trust is a trust the income and deductions[608] of which are reportable by the grantor as if the grantor continued to own the trust corpus.[609] This status results because the grantor or the grantor's spouse[610] continues to have beneficial enjoyment or control over the trust property.

COMMENT
A trust can be a grantor trust as to accounting income, corpus income, or both. In this last case, the trust is said to be a fully grantor trust. *A fully grantor trust is the alter ego of the grantor.* Thus exchanges of property between the grantor and the trust do not give rise to taxable gain or loss.[611]

B. REVERSIONARY TRUSTS

With but two exceptions, IRC § 673(a) provides that a grantor is treated as the owner of any portion of a trust created after March 1, 1986[612] in which the grantor (or a spouse with whom the grantor lives) retains a reversionary interest in either the corpus or the income of the trust.

COMMENT
A reversionary trust is not necessarily a grantor trust as to all of the trust. If the reversion exists only as to a fractional portion of the trust, the grantor is the owner only of that portion. More commonly, the reversion may exist in trust income or principal but not both. A reversion over income only results in the trust being a grantor trust only with respect to fiduciary accounting income. A reversion in corpus generally makes the trust a grantor trust as to both fiduciary and corpus income.

1. Reversions at the death of descendant under 21

As the first of two exceptions to the general rule that a retention of a reversion by the grantor (or a spouse) will trigger grantor trust status, subsection (b) of IRC § 673 provides that a trust is not a grantor trust solely because the grantor (or a spouse with whom the grantor lives) retains a reversion that takes effect at the death of a beneficiary before attaining the age of 21.

The exception applies only to a transfer to a lineal descendant of the grantor and even then only if the descendant holds all of the present interests in the trust.[613]

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608 The Committee Report to the 1986 Code states that the administration expenses of a grantor trust are subject to the 2-percent floor of IRC § 67(a). And Temp. Regs. § 1.67-1T provides that the floor is applied at the beneficiary rather than the entity level.

609 On the reporting requirements for grantor trusts, see Treas. Regs. § 1.671-4.

610 IRC § 672(e) provides that a grantor is treated as holding any power or interest held by any individual who either was the spouse of the grantor at the time the power or interest was created or who later became the spouse of the grantor. In the case of an individual who later became the grantor's spouse, attribution of the spouse's interests and powers occurs only during the periods after the person became the spouse of the grantor. IRC § 672(e)(1)(B). A grantor and power-holder are not considered married if they are legally separated under a decree of divorce or of separate maintenance. IRC § 672(e)(2).

611 Rev. Rul 85-13, 1985-1 C.B. 184. See also Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (sale of insurance policy to insured's grantor trust is not a transfer for value under IRC § 101). On the use of this principal to use an installment sale to an intentionally defective irrevocable trust (IDIT) as an alternative to a grantor retained annuity trust, see Michael D. Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT, Estate Planning 3 (Jan. 1996).

612 Trusts created before March 1, 1986 are subject to different rules. See generally, Lane & Zaritsky, Federal Income Taxation of Estates and Trusts ¶8.04. If a pre-1986 trust is extended after 1986, IRC § 673(d) provides that the extension is to be treated as a new transfer but only for the period after 1986.

2. De minimis reversions

Without more, it is possible that grantor trust status could be triggered by the accidental retention of a reversionary interest that is only remotely possible to take in present possession.

In anticipation of this, IRC § 673(a) contains a de minimis rule.

- A reversionary interest in a portion of a trust will not trigger grantor trust status if the reversion is worth 5 percent or less of the initial value of that portion.[614]
- In applying this test, discretionary powers are presumed to be exercised in such a manner that they maximize the value of the reversion in the grantor or the grantor's spouse.[615]

COMMENT
From a tax standpoint, the retention of any reversion, including one in the event of the early death of a descendant as allowed by IRC § 673(b), has little to commend it. Assuming the trust beneficiaries are members of the grantor's family—a relatively safe assumption in most cases—the retained reversion will not depress the value of the gift for purposes of the gift tax. And it is virtually certain to trigger partial grantor trust status under other grantor trust sections. See in particular IRC § 677(a), discussed infra p. 197.

C. REVOCABLE TRUSTS

Under IRC § 676(a), a grantor is treated as the owner of a trust if someone can revoke the trust and thereby revest title to the trust property in the grantor or the grantor's spouse. The typical "living trust" is the most common example. But IRC § 676 is much broader than this. It applies both to powers of revocation and to powers to terminate, alter, amend, appoint, or modify that can be exercised in such a manner as to revest trust property in the grantor or spouse.[616]

1. Powers held by others

IRC § 676(a) applies to virtually any power to revest title in the grantor (or spouse).

- It does not matter whether the power is held by the grantor, some other person, or jointly by the grantor and someone else.
- The only significant qualification is that the section is not triggered by a power the exercise of which requires the consent of someone who is economically adverse to its exercise.[617]

2. Contingent and postponed powers

For IRC § 676(a) to apply, the power of revocation need not be presently exercisable.

- The section applies even though exercise of the power is postponed to some point in the future or is subject to some contingency.

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613 IRC § 673(b).

614 IRC § 673(a).

615 This rule is intended to prevent grantors from depressing the value of their reversions by giving trustees discretionary powers to distribute to others.

616 Treas. Regs. § 1.676(a)-1; Gurich v. Comm., 295 F.2d 845 (1st Cir. 1961).

617 A power of revocation held by or which requires the consent of an adverse party (other than the grantor's spouse) does not make the trust a grantor trust under IRC § 676(a). Treas. Regs. § 1.676(a)-1.

- The only exception is found in IRC § 676(b). There it is provided that a future or contingent power will not trigger IRC § 676(a) if it would not have triggered IRC § 673 had it been a reversion.

Ex-145: G transfers property in trust to pay the income to A for life, then to pay the income to A Jr. for life with remainder at the death of A Jr. to such of A Jr.'s descendants as are alive at that time. The trust instrument further provides that at any time after A's death, the trustee may terminate the trust in which event the trust property is to be distributed to G or G's estate. To what extent, if any, will G be taxed as owner of this trust?

COMMENT
On the possibility G's reversion in this example might create an estate tax inclusion period under the GST tax, see "*Allocations during the estate tax inclusionary period*" on page 138.

D. TRUSTS FOR THE GRANTOR OR SPOUSE

Under IRC § 677(a), a grantor trust includes a trust the income of which (without the consent of an adverse party) is or may be:

1. distributed to the grantor or the grantor's spouse, or
2. accumulated for later distribution to the grantor or the grantor's spouse, or
3. applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.[618]

In the application of these rules, it is generally the existence of the power, not its exercise, that is important.[619] Thus, IRC § 677(a) contemplates that a grantor could be taxed on income that she never actually receives.

Moreover, the regulations state that IRC § 677(a) applies to constructive distributions (those made "on behalf of the grantor or his spouse in obedience to his or her direction")[620] as well as to distributions of income in discharge of a legal obligation of the grantor or the grantor's spouse.[621]

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618 An exception exists for income that may be used for the payment of premiums on insurance policies that are irrevocably payable to charity. IRC § 677(a)(3).

The addition of language referring to the grantor's spouse in IRC § 677 was added by the Tax Reform Act of 1969. As amended by that Act, the spousal provisions apply only in the case of trusts created after October 9, 1969. As to those trusts, the regulations state that a person is considered to be the grantor's spouse only during the period that he or she is married to the grantor. Treas. Regs. § 1.667(a)-1(b)(2). Where the grantor and his spouse have divorced, this regulation could be seen as inconsistent with the attribution of spousal interests and powers to the grantor under IRC § 672(e). Divorce does not terminate the attribution under that section.

619 This principal has not been carried to the logical extreme of making a trust a grantor trust merely because it might purchase an insurance policy on the life of the grantor or the grantor's spouse. IRC § 677(a) applies only if the trust (or another trust that is owned by the grantor of the grantor's spouse) actually owns an insurance policy for some part of the year. See e.g., Corning v. Comm., 104 F.2d 329 (6th Cir. 1939); Rev. Rul. 66-313, 1966-2 C.B. 245.

Additionally, the fact that a distribution to beneficiary's estate might actually result in the grantor taking it the beneficiary's heir-at-law is disregarded in the application of IRC § 677. Treas. Regs. § 1.677(a)-1(c).

620 Treas. Regs. § 1.677(a)-1(c).

621 Treas. Regs. § 1.677(a)-1(d).

Ex-146: G creates a trust naming Bank as trustee. Bank has the discretionary power to distribute income to G's mother M for 10 years with any income not so distributed to be accumulated and added to corpus. At the expiration of the ten year period, the trust property including accumulated income is to be distributed to G's spouse. To what extent, if any, will G be taxed as owner of this trust?

Ex-147: G creates a trust for the benefit of his family. None of the named beneficiaries is G or his spouse. However, among the property G transfers to the trust is land that is subject to a mortgage on which G is personally liable. Will this cause a problem under the grantor trust rules?

1. Discretionary power to satisfy grantor's support obligation

Some relief from the rigors of IRC § 677(a) is provided by IRC § 677(b). If the only power is a discretionary power to distribute or apply income for the support of someone the grantor (or the grantor's spouse) is legally obligated to support, IRC § 677(b) provides that the income of the trust is taxed to the grantor if and only to the extent the power is in fact exercised for that purpose.[622]

COMMENT
This rule applies to a discretion held in whole or in part by the grantor or the grantor's spouse only if the power is held as a trustee or co-trustee.

Ex-148: G creates a trust with Bank as trustee. Bank is to accumulate income until G's minor daughter attains age 21 except that Bank may, in its discretion, distribute so much income to the daughter as it deems necessary for the daughter's support or welfare. When the daughter attains 21 or at her death if earlier, the trust property including accumulated income is to be distributed to the daughter if living; otherwise to her estate.

1. To what extent is this a grantor trust?

2. Would the answer change if it was G (or G's spouse) rather than Bank who had the authority to direct that trust income be distributed for the support of the daughter?

[622] For a state by state examination of a parent's support obligation, see Blake, Parent's Legal Obligation of Support After the Braun Decision, 10 Tax Mgmt. Est. Gifts & Tr. J. 154 (1985).

The special rule of IRC § 677(b) is limited to discretionary distributions of income. If income must be applied for the support of a person the grantor or the grantor's spouse is legally obligated to support, the grantor is taxed on the income under IRC § 677(a). Treas. Regs. § 1.677(b)-1(f). And distributions from other than current income do not trigger either IRC § 677(a) or (b).

2. Powers equivalent to de minimis reversions

Like a number of other grantor trust sections, IRC § 677(a) includes a de minimis exception.

A power is excepted if it can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that were the power a reversion, the grantor would not be treated as the owner under IRC § 673.

CAUTION
This exception does not mean that a presently exercisable power is excepted if the income it affects cannot be distributed to the grantor or the grantor's spouse for some extended period of time. Rather, it applies only if the power itself cannot become exercisable until after a period of sufficient length to make it de minimis.

Ex-149: G creates a trust to pay the income to A (age 20) for life, then if G is still living Bank has the authority to distribute income to G for life and at the death of G, the principal and any accumulated income is to pass in fee to X Charity. If the IRC § 7520 rate is 10 percent, is this a grantor trust?

Ex-150: G creates a trust for A (age 21) with Bank as trustee. As long as A is alive, Bank has the power to distribute such amounts of income to A as it determines with any income not so distributed to be added to corpus. At the death of A, the trust is to terminate and all trust property including any accumulated income is to be distributed to G if living; otherwise to his then living heirs-at-law.

1. How do the grantor trust provisions apply to this trust?

2. Would the answer be different if the trust provided that any accumulated income at A's death was to be distributed to A's estate?

E. DISCRETIONARY TRUSTS FOR OTHERS

IRC § 674(a) states that a grantor owns any portion of a trust over which any nonadverse party has the power (without the consent of an adverse party) to affect the beneficial enjoyment of the trust income or principal.

COMMENT
This rule is noteworthy for its breadth. 1. It applies to powers to distribute, to allocate, to accumulate, or to appoint. 2. It is not limited to powers to alter who is entitled to trust income. It applies to powers that can affect only the time of enjoyment. 3. And it applies to powers held by any nonadverse party, whether that person is the grantor, a trust beneficiary, or some other third party and whether the power is held as an individual or a trustee.

Considering its breadth, were there no exceptions, IRC § 674(a) would make a grantor trust out of virtually all inter vivos trusts. Fortunately, the Code contains a smorgasbord of exceptions. Before considering them, however, two words of caution are in order.

- First, some of the exceptions are applicable only to powers held by persons other than the grantor or the grantor's spouse. In such cases, where a power is vested in the office of the trustee, that power will be imputed to the grantor if the grantor (or the grantor's spouse) has an unrestricted authority to remove, substitute, or add trustees which can be exercised to make either the grantor or the grantor's spouse a trustee.[623]
- Secondly, none of the exceptions discussed below apply if any person has the power to add new beneficiaries to the trust other than to provide for afterborn or afteradopted children.[624]

1. Powers of independent trustees

The most important exception to the general rule of IRC § 674(a) is found in IRC § 674(c). This section provides that a grantor will not be taxed as the owner of a trust merely because an independent trustee has either or both of

a) the power to distribute, apportion, or accumulate income or

b) the power to distribute or spray corpus to or among trust beneficiaries and other designated persons.

To qualify as independent, the trustee or trustees must not be the grantor or a cohabitant spouse of the grantor and, if multiple trustees are named, no more than half of them may be related or subordinate parties who are subservient to the wishes of the grantor.[625]

- Related parties include only the parents, descendants, and siblings of the grantor.
- Subordinate parties include the grantor's employees and may include a corporation and its employees if the grantor is either a significant shareholder or a corporate executive.

Ex-151: G creates a trust for the benefit of her adult children and their descendants. G names her sister, S as trustee. As trustee, S has the power to spray income and principal among the children and their descendants as S in her discretion deems advisable for their best interests.

1. Is this a grantor trust?

2. Would the answer change if B (G's brother-in-law) was named co-trustee?

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623 See Treas. Regs. § 1.674(e)-2(a).

624 So important (and universal) is this restriction that, in a model of cautious redundancy, the restriction is stated no less than five separate times. See IRC §§ 674(b)(5), 674(b)(6), 674(b)(7), 674(c), and 674(d).

625 Subservience to the wishes of the grantor is a question of fact. Related and subordinate parties are presumed subservient, but the presumption is rebuttable.

> **COMMENT**
>
> The use of an independent trustee is by far the simplest, surest, and most flexible way to create a discretionary trust without violating the grantor trust rules. The trustees powers may include the discretion to spray or accumulate, they may extend over income or principal or both, accumulated income need not ultimately be distributed to any particular beneficiary, and the trustee's powers need not be restricted by any standard. The only practical limit is that the powers must be exercisable only in favor of trust beneficiaries. These are the persons who are designated in the instrument by name, description, class membership, or otherwise as beneficiaries of the trust

2. Limited power of trustee other than grantor (or spouse)

If an independent trustee is not an option, it is still possible to create a discretionary trust without violating the grantor trust rules.

Under IRC § 674(d), a grantor is not taxed as the owner of a trust merely because a trustee (other than the grantor or the cohabitant spouse of the grantor) has a power to distribute, apportion, or accumulate trust income to or among beneficiaries if such power is limited by a reasonably definite external standard which is set forth in the trust instrument.

- This exception is more restrictive than that applicable to independent trustees both in the fact that the discretionary power may exist over trust income only and in the requirement that the power be limited by a reasonably definite external standard.
- On this latter point, the regulations state that a standard is reasonably definite if the trustee can be held legally accountable for complying with it. Examples of reasonably definite standards include powers to distribute, apportion or accumulate for emergencies, education, support, maintenance, health, reasonable support and comfort, and to maintain the accustomed standard of living of trust beneficiaries. Standards such as pleasure, desire, and happiness are not reasonably definite.[626]

3. Powers that anyone may possess

IRC § 674(b) contains a group of eight exceptions to the general rule of IRC § 674(a).

The first two of the exceptions serve merely to correlate IRC § 674 with other grantor trust principles.

- IRC § 674(b)(1) insures that powers eligible for favorable treatment under IRC § 677(b) are taxed under that section rather than under IRC § 674(a).
- IRC § 674(b)(2) provides an exception for de minimis powers. It excepts any power the exercise of which (as opposed to the effects of an exercise of which) can only affect beneficial enjoyment of the income after the expiration of a period of sufficient length that had the power been a reversion the grantor would not have been taxed as owner under IRC § 673.

The remaining six exceptions are examined below. These exceptions share the common feature that the powers and discretions they describe may be safely held by any person, including the grantor or a spouse of the grantor.

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[626] Treas. Regs. §§ 1.674(b)(5)(ii),1.674(d)-1. An otherwise definite standard will be rendered indefinite if the trust instrument provides that the determination of the trustee shall be conclusive with respect to an exercise or nonexercise of the power. Treas. Regs. § 1.674(b)(5)(ii).

a) Testamentary powers

In general, IRC § 674(b)(3) provides that a grantor will not be taxed as owner of a trust merely because some person has a testamentary power of appointment over the trust property.

However, the exception does not apply to a power to appoint accumulated income held by the grantor or the grantor's spouse if the power can be exercised over income that was or could have been accumulated without the approval or consent of an adverse party.

> ***Ex-152:*** G creates a trust with Bank as trustee to pay (or accumulate) income to A for life and at A's death to distribute principal and any accumulated income to such persons as A shall by will appoint.
>
> 1. Does A's power make this a grantor trust under IRC § 674(a)?
>
> 2. Would the answer differ if G named her spouse trustee?

b) Power to allocate among charitable beneficiaries

IRC § 674(b)(4) exempts from the powers that trigger grantor trust status under IRC § 674(a) a power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a charitable purpose.[627]

The exception applies both to powers to allocate income and principal among charitable entities and to powers to select the persons who are to benefit from a charitable objective.

> ***Ex-153:*** G creates a trust with Spouse as trustee to use the income and principal to provide scholarships at the University of Chicago for such deserving students as Spouse from time to time selects. Does the fact that Spouse may select the charities rather than allocate among those designated in the instrument make this a grantor trust under IRC § 674(a)?

c) Power to distribute or advance corpus

Under IRC § 674(b)(5), any person (including the grantor or the grantor's spouse) may have a power to distribute corpus without causing the grantor to be taxed as owner of the trust.

1. If the power is limited by a reasonably definite standard, the power may be exercisable in favor of any person who has a beneficial interest in the income or principal of the trust.[628]

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627 The section defines charitable purpose as one specified in IRC § 170(c).

628 IRC § 674(b)(5)(A). On what constitutes a reasonably definite standard, see Treas. Regs. § 1.674(b)(5)(ii) and the discussion of IRC § 674(d), in "*Limited power of trustee other than grantor (or spouse)*" on p. 214.

2. If the power is not limited by a definite standard, it is safe only if it is exercisable in favor of an income beneficiary whose share of future distributions will be proportionately reduced as a result of the distribution of corpus.[629]

Ex-154: G creates a trust with Spouse as trustee. Spouse is to divide trust income among such of G's adult children as are from time to time living and at the death of the last to distribute principal to G's grandchildren. Spouse has the power to pay the medical bills of any child or grandchild.

1. Does Spouse's power make this a grantor trust?

2. Would the answer change if Spouse could also pay the medical bills of the spouses of G's children and grandchildren?

Ex-155: G creates a trust with Spouse as trustee. Spouse is to distribute trust income in equal shares to G's two adult children for 10 years, then to distribute trust principal in equal shares to G's grandchildren. G reserves the right to distribute up to half of the trust principal during the 10 year period to each child although any such distribution will reduce subsequent payments of income or corpus to the child. Does G's power to advance principal make this a grantor trust?

d) Power to accumulate temporarily

IRC § 674(b)(6) excludes from the general rule of IRC § 674(a) certain powers given to any person, including the grantor, to withhold income temporarily from a beneficiary who would otherwise be entitled to receive it.

Basic requirement: The basic requirement of IRC § 674(b)(6), to which there are two major exceptions, is that any income withheld must ultimately be distributable to the beneficiary, the beneficiary's estate, or to the appointees (or takers in default) of a qualifying power of appointment held by the beneficiary.

COMMENT
For this purpose, a power is a qualifying power of appointment if it is either a general power, or it is a special power which excludes as possible appointees no one other than the beneficiary, the beneficiary's estate and the creditors of either.

Exceptions:

1. An exception applies when a current income beneficiary fails to survive a date of distribution that could reasonably be expected to have occurred within the beneficiary's lifetime. In that event, the instrument may provide that accumulated income is to pass to designated alternate takers[630] whose shares are

[629] IRC § 674(b)(5)(B).

[630] Alternatively the instrument may make the accumulated income payable pursuant to an exercise (or in default of an exercise) of any kind of power of appointment held by the deceased beneficiary.

irrevocably specified in the trust instrument. The designated alternate takers need not be beneficiaries of the trust; but they may not include the grantor, the grantor's spouse or the estates of either.

2. A second exception applies when the distribution of accumulated income is to occur at the termination of the trust or in conjunction with a distribution of principal that is augmented by the accumulated income. In either instance, the instrument may provide that the accumulated income is to be distributed in specified shares to the current income beneficiaries.

Ex-156: G creates a trust with Spouse as trustee to pay the income to his adult son A for life, then to divide the income among such of A's now living children as are from time to time living until the last of the children is twenty-one years of age, then to distribute the trust principal, per stirpes to A's then living lineal descendants. During A's life, Spouse in her discretion may accumulate any or all of the income that would otherwise be payable to A. At A's death, any such income is to be distributed to such persons (excluding only A's estate and the creditors of his estate) as A by will appoints, and in default of appointment the accumulated income is to be added to the corpus of the trust.

1. Will the Spouse's accumulation power turn this into a grantor trust?

2. Would the result be different if the instrument provides that at A's death, any accumulated income was to be added to corpus?

3. What if the instrument provided that if A dies before G's father, any income accumulated during A's life is to be paid to father at that time?

Ex-157: G creates a trust naming Spouse as trustee. Spouse is directed to distribute the trust income in equal shares to G's two adult daughters until the younger daughter attains the age of 25. G reserves the power to direct Spouse to withhold any portion of either daughter's income and to add it to corpus. When the younger daughter attains 25, the trust is to terminate and the trust corpus is to be divided equally between the two daughters or their estates. Does this trust qualify for the IRC § 674(b)(6) exception?

e) Power to accumulate during disability or minority

IRC § 674(b)(7) provides an exclusion for a power to accumulate and add income to corpus during any period that the beneficiary who would otherwise be entitled to it is either under a legal disability or is under the age of 21. This exclusion makes it possible to avoid outright distributions to these classes of beneficiaries.

COMMENT
Since income accumulated under this exception is to be added to corpus, it will ultimately be distributed to the persons designated to take trust principal. This can be anyone. It need not be the underage or disabled beneficiary or even the estate of that beneficiary.

f) Power to allocate between income and principal

IRC § 674(b)(8) states that a grantor will not be taxed as the owner of a trust merely because a trustee[631] has "[a] power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language."

F. TRUSTS WITH PROHIBITED ADMINISTRATIVE POWERS

A trust where the settlor (or a spouse with whom he lives) without the consent of an adverse party:

1. has the power to purchase trust property for less than full consideration;[632]
2. has the power to borrow assets without adequate interest or security except where a trustee (other than the grantor or his spouse) is authorized under a general lending power to make loans to any person without regard to interest or security; or [633]
3. has in fact borrowed the corpus or income and has not completely repaid the loan, including interest, before the beginning of the taxable year;[634]
4. the power to vote stock in a corporation in which grantor and the trust have a significant voting interest;[635]
5. the power to direct or veto investments of a trust fund consisting of stock in a corporation in which the grantor and the trust have a significant voting interest;[636]
6. the power to reacquire trust property.[637]

Ex-158: Grantor borrows the entire trust corpus at a market rate of interest in January. Will Grantor be taxed as owner of this trust if she repays the loan before the close of the taxable year?

Ex-159: Grantor creates an irrevocable trust for the exclusive benefit of his descendants. Bank is trustee. Grantor retains the power to substitute trust property with other property of an equivalent value. Is the trust a grantor trust?

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631 Neither IRC § 674(b)(8) nor the regulations under it limit the section to powers held by trustees. But there is widespread agreement that giving it to someone in their individual capacity could be problematic. See e.g., Lane & Zaritsky, Federal Income Taxation of Estates and Trusts ¶9.03[3] (1988); Zaritsky, Grantor Trusts: Sections 671 - 679, TM 452-2d (1990).

632 IRC § 675(1).

633 IRC § 675(2).

634 IRC § 675(3).

635 IRC § 675(4)(A).

636 IRC § 675(4)(B).

637 IRC § 675(4)(C).

G. FOREIGN TRUST WITH U.S. GRANTOR AND BENEFICIARY

A foreign trust created by a U.S. person which trust has one or more U.S. beneficiaries is treated as a grantor trust.[638]

Comment
Only a U.S. citizen, resident, or domestic corporation can be taxed as the owner of a trust under the grantor trust rules.[639] An exception applies to: • A trust that is revocable by the grantor without the consent of any person other than a related or subordinate party who is subservient to the grantor;[640] or • A trust (or trust portion) if distributions during the grantor's life are limited to the grantor or the grantor's spouse.[641]

H. CONTROLLED AND RELATED TRUSTS

A person other than the grantor or a spouse with whom he lives will be taxed as the owner of a trust if:

1. The person is a US beneficiary who has transferred property, directly or indirectly, to a foreign person who would have otherwise been subject to the grantor trust rules.[642] An exception applies for gifts of $10,000 or less, or
2. The person is the beneficiary of an electing qualified subchapter S trust,[643] or
3. The person has the power acting alone to vest the corpus or income in himself, or the person "partially released or otherwise modified" such a power while retaining an interest prohibited under rules *2a - 2e*, above.[644] Generally, it is the existence of the power rather than its exercise that counts. But, if the beneficiary's power may only be exercised to apply income for the support of a person the beneficiary is legally obligated to support, the income is taxable to the beneficiary if and only to the extent it is used for that purpose.

638 IRC § 679. The Service has issued regulations dealing with when a foreign trust with a U.S. Grantor and a U.S. beneficiary is to be treated as a grantor trust under IRC § 679. See Regs. §§ 1.679-1 - 1.679-7.

639 See IRC § 672(f)(1). In general, the new rule applies to transfers to new or existing trusts on or after August 20, 1996. An exception applies to transfers made before September 20, 1995, to certain revocable or discretionary trusts for the benefit of the grantor or the grantor's spouse. See SBJPAN IRC § 1904(d)(1) and (2).

Note: The purpose of these rules is to prevent foreign grantors from establishing grantor trusts with foreign-situs property so that income could be distributed to a U.S. beneficiary free of U.S. tax. See Rev. Rul. 69-70, 1969-1 C.B. 182.

In the case of trusts covered by this rule, any U.S. beneficiary is deemed to be the grantor of the portion of the trust to the extent the beneficiary has made a direct or indirect transfer of property (other than a transfer that qualifies for the annual exclusion or one made for full and adequate consideration) to the foreign grantor. IRC § 672(f)(5).

640 IRC § 679(f)(2)(A)(i).

641 IRC § 679(f)(2)(A)(ii).

642 IRC § 672(f). Example: S and D are foreign persons. S makes a gift to D (or to D's foreign spouse) who then creates a grantor trust with S as beneficiary. Thereafter S moves to the United States.

643 IRC § 1361(d)(2). Qualified subchapter S trusts are discussed further in "*Qualified subchapter S trusts*" on p. 253.

644 IRC § 678(a).

ANSWERS—GRANTOR AND CONTROLLED TRUSTS

Ex-145. **Answer –** The answer depends in part on the IRC § 7520 interest rate. Assuming a rate of 10 percent, this is a grantor trust as to fiduciary income if A is older than 34 at the creation of the trust. If A is younger than 35, IRC § 676(b) applies and the trust will become a grantor trust as to fiduciary income only at the death of A when the trustee's termination power becomes presently exercisable. In either case, G will be taxed as the owner of corpus income. See IRC § 677(a) discussed in "*Trusts for the grantor or spouse*" on p. 210.

Ex-146. **Answer –** This is grantor trust as to both the income and the principal portions. G is taxed on all accounting income because the trustee has the authority to accumulate it for later distribution to G's spouse. The fact that the trustee chooses not to accumulate it is irrelevant. G is also taxed on all principal income such as capital gains because that income will also remain in the trust for eventual distribution to G's spouse. IRC § 677(a).

Ex-147. **Answer –** If the instrument directs or permits the trustee to use trust income to make the payments on G's note, G will be taxed on the accounting income of the trust as owner under IRC § 677(a). He will not be taxed on items of corpus income such a capital gains because these can not be used to service his debt.

Ex-148. **First question –** Here, IRC § 677(b) provides that G is taxed if and only to the extent the Bank distributes income for the support of the daughter.

Note: If income is in fact used for the daughter's support, there is an irrebuttable presumption that it was distributed for that purpose. Treas. Regs. § 1.677(b)-1(a).

Second question – Yes. G would be taxed as the owner of the income portion of this trust under IRC § 677(a). IRC § 677(b) is not applicable to a power held by the grantor or the grantor's spouse unless that power is held as a trustee.

Ex-149. **Answer –** Only if and when A dies survived by G. Until then, Bank's power to distribute to G is de minimis. IRC § 677(a) is not triggered by a de minimis power to distribute income to the grantor.

Ex-150. **First question –** Assuming an IRC § 7520 interest rate of 10 percent, the reversion retained by G would not trigger IRC § 673. Nevertheless, G is the owner of this trust under IRC § 677(a) because the trustee has the present power to accumulate income and any income accumulated may ultimately be distributed to G.

Second question – Yes. Although G remains owner of corpus income including capital gains because they are accumulated in the trust and may ultimately be distributed to him, he is no longer the owner of the fiduciary income of the trust.

Ex-151. **First question –** Assuming the presumption that S is subservient to G's wishes is not rebutted, the answer is yes. G is taxed as the owner of the accounting and principal income of this trust under IRC § 674(a).

Second question – Yes, the answer would be different. B is not a related party. IRC § 674(c). However, if B ceases to serve as co-trustee, the trust will be a grantor trust unless and until a successor independent trustee is appointed to replace him.

Ex-152. **First question –** No. A's testamentary power to affect beneficial enjoyment will not make G the owner of any portion of this trust. IRC § 674(b)(3) provides an exception for testamentary powers.

Second question – Yes. The exception for testamentary powers provided by IRC § 674(b)(3) does not apply to powers held by the grantor or a spouse of the grantor. Accordingly, G's testamentary power to affect beneficial ownership of accumulated income makes her the owner of this trust under IRC § 674(a).

Ex-153. **Answer –** No. This power falls within the IRC § 674(b)(4) exception for powers to select beneficiaries. See Thompson v. U.S.,. 209 F. Supp 530 (ED Tex. 1962).

Ex-154. **First question –** No. IRC § 674(b)(5) provides an exception for powers that are restricted by a reasonably definite standard.

Second question – Yes. If Spouse could also pay the medical bills of persons who are not otherwise beneficiaries, G would be taxed as the owner of the trust under IRC § 674(a). See Treas. Regs. § 1.674(b)-1(b)(5)(iii), Example (1).

Ex-155. **Answer –** No. IRC § 674(b)(5)(B) provides an exception for this power because the recipient beneficiary's share of the trust is adjusted to reflect the distribution. See Treas. Regs. § 1.674(b)-1(b)(5)(iii), Example (3).

Ex-156. **First question –** No. Spouse's accumulation power is excluded under IRC § 674(b)(6).

Second question – Yes. Under these facts, Spouse's accumulation power is not excepted under IRC § 674(b)(6) because A has no power of appointment over the accumulated income and it is not distributable to A or A's estate. See Treas. Regs. § 1.674(b)-1(b)(6)(i).

Third question – Since A is likely to survive his grandfather, this is not a grantor trust. See Treas. Regs. § 1.674(b)-1(b)(6)(ii), Example (3).

Ex-157. **Answer –** Yes. Even though a nonprorata accumulation would result in a shifting of accumulated income from one daughter to the other at the termination of the trust, G's power is excluded under IRC § 674(b)(6). See Treas. Regs. § 1.674(b)-1(b)(6)(ii), Example (1).

Ex-158. **Answer –** Yes. The grantor is taxed as the owner of the trust for the entire year. IRC § 675(3); Rev. Rul. 86-82, 1986-1 C.B. 253 (1986).

Ex-159. **Answer –** Yes. See IRC § 675(4)(C). The Service has applied this section in a number of letter rulings. See e.g., PLR 9239015; PLR 9240816.

IX. POSTMORTEM TAX PLANNING

A. FILING REQUIREMENTS

Under the Code and regulations, personal representatives, trustees, beneficiaries and sometimes even life insurance companies may be responsible for filing a variety of tax returns relating to transactions that occur before, at, or after a decedents death.

Possibilities include

- income tax returns for the decedent and estate,
- gift and estate tax returns including returns for distributions from or terminations of qualified domestic trusts, and
- returns for inter vivos and testamentary generation-skipping transfers. In each case, any taxes due must be paid on or before the due date for the return.

1. Income tax returns of decedent and estate

A decedent's death closes his or her taxable year and the personal representative must file the decedent's final income tax return[645] as well as the income tax returns for the estate.

- The former is due at the usual time, typically April 15th of the year following death.[646]
- The estate's income tax return is due on the 15th day of the fourth month after the close of its taxable year.[647]
- In either case, the Service may in its discretion grant an extension of up to 6 months for the time for filing the return.[648]

CAUTION
An extension in the time for filing is not an extension for paying any tax due.[649] An extension of up to 6 months in the time for paying is available only upon a showing of undue hardship.[650]

2. Estate tax return

The personal representative is also required to file the decedent's estate tax return.

A return must be filed if the gross estate exceeds the applicable exclusion amount.[651] Absent extensions, the return and tax are due 9 months after the decedent's death. An

645 IRC § 443(a)(2). For taxable years beginning after 1997, a decedent's death will also close the taxable year (with respect to the decedent) of any partnerships in which the decedent was a partner. IRC § 706(c)(2).

646 Although death closes the decedent's taxable year, it does not accelerate the due date of his final income tax return. IRC § 6072(a).

647 IRC § 6072(a). An estate is a recognizable tax entity but only during the period of administration and settlement of the estate. IRC § 641(a)(3). At that time, the fiduciary relationship of the personal representative ends and the personal representative must file a notice of termination.

648 IRC § 6081(a). As an exercise of this discretion, the Service grants an automatic four month extension for the filing of any income tax return. The return filer need only file form 4868 and comply with the other procedural requirements of the regulations. Treas. Regs. § 1.6081-4.

649 Treas. Regs. § 1.6081-1(a).

650 IRC § 6161(a); Treas. Regs. § 1.6161-1(b).

651 IRC § 6018(a).

automatic extension of 6 months for the filing a a decedent's estate tax return is provided for by Regulation.[652]

An extension or deferral of the tax itself is available in the following cases.

- Upon a showing of reasonable cause the Service may grant an extension for the payment of any part of the estate tax (or any installment thereof) for a period not to exceed 10 years.[653]
- At the election of the personal representative, payment of taxes attributable to any future interest may be extended until 6 months after the termination of any precedent interests.[654]
- Also at the election of the personal representative, estates consisting largely of an interest in a closely held business may defer payment of the taxes attributable to that interest for up to five years and/or may pay the taxes in up to ten annual installments.[655]

TRA 2010
For decedents dying from January 1, 2010 to December 16, 2010, TRA 2010 section 301(d) extends the estate tax return and payment date to no earlier than September 19, 2011.[656]

3. Gift tax returns

A gift tax return must be filed for any year in which a donor's gifts (other than those qualifying for the marital deduction) exceed:

- the allowable exclusions under IRC §§ 2503(b) and 2503(e);
- the gift tax marital deduction; or
- in the case of a transfer of the donor's entire interest in property, the gift tax charitable deduction.[657]

If a donor dies: The personal representative must file it for him.[658] The return is due on the earlier of April 15th of the year following the gift or the due date of the decedent's estate tax return.[659]

Extensions:

For filing: An extension in the time for filing is available for a period up to 6 months,[660] although a separate request is frequently unnecessary because an extension

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652 See Treas. Regs. §§ 20.6075-1; 20.6081-1. See also 6081(a).

653 IRC § 6161(a)(2).

654 IRC § 6163(a). At the expiration of that period, an additional extension not to exceed 3 years is available upon a showing of reasonable cause. IRC § 6163(b). In either case, interest paid on the deferred taxes is deductible under the income tax. IRC § 163(h)(2)(E).

655 IRC § 6166. This section is discussed further in "*Deferral of tax payments*" on page 257.

656 The same extension applies to the filing of the carryover basis report under IRC § 6018 for estates where the election is made to have the carry over basis rules apply.

657 IRC § 6019. IRC § 6019(3) which eliminates the filing requirement for charitable gifts was added by the 1997 TRA. It applies only if the transfer consists of the donor's entire interest in the property. Accordingly, it does not apply to split interest charitable transfers. An exception is made for irrevocable transfers of real property easements that qualify for a charitable deduction under IRC § 2522(d).

658 See Treas. Regs. § 25.2502-2.

659 IRC § 6075(b)(1) and (3).

to file either the decedent's income tax return or the estate tax return is automatically an extension to file the decedent's gift tax return.[661]

For paying: An extension of up to 6 months in the time for paying the tax is available, but only upon a showing of undue hardship.[662]

4. Returns for the QDOT deferred estate tax

Events giving rise to a QDOT deferred estate tax are reported on Form 706QDT by the trustee of the QDOT, not by the decedent's personal representative.

When: Except in the year of the spouse's death, the return for distributions[663] must be filed on or before April 15th of the year following the distribution.[664] The return for distributions in the year of the spouse's death is due at the earlier of the date for other distributions or 9 months after the death of the spouse.[665] This latter date also applies to the return for any tax imposed at the death of the spouse.[666]

Extensions:

For filing: In all cases, at the discretion of the Service, an extension of up to 6 months for the time for filing is available[667] as is an extension in time for payment.

For paying: The payment date for the tax on distributions may be extended up to 6 months.[668] A ten year extension is available for the tax on property remaining in a QDOT at the death of the surviving spouse.[669] In appropriate circumstances, the tax attributable to a closely held business may also be deferred for five years and/or paid in ten annual installments pursuant to IRC § 6166.[670]

5. GST tax returns

The "who", "what", and "when" of the filing requirements for the GST tax vary considerably with the type of triggering event involved. The detail appears in the chart below.

Extensions:

For filing: In all cases, the Service may grant an extension of up to 6 months for the time indicated for filing a return.[671]

For paying: In most cases, the Service may grant an extension of similar length for the time for paying the tax.[672] However, more liberal rules apply to generation-skipping transfers that occur at the same time and as a result of the death of an

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660 IRC § 6081(a).

661 Treas. Regs. § 25.6075-1(b).

662 IRC § 6161(a).

663 Although a distribution on account of hardship is exempt from taxation, it must nevertheless be reported on Form 706QDT. Treas. Regs. § 20.2056A-5(c)(1).

664 IRC § 2056A(b)(5)(A).

665 IRC § 2056A(b)(5)(A).

666 IRC § 2056A(b)(5)(B).

667 IRC § 2056A(b)(5); Treas. Regs. §§ 20.2056A-11(a) and (b).

668 Treas. Regs. § 20.2056A-11(c)(2).

669 IRC § 2056A(b)(10)(C); Treas. Regs. § 20.2056A-11(c)(1).

670 IRC § 2056A(b)(10)(A). IRC § 6166 is discussed further in "*Deferral and installment payment of* taxes" on page 257.

671 IRC §§ 2661(1); 6081(a).

672 IRC §§ 2661(1); 6161(a)(1).

individual.[673] For reasonable cause, the payment of the tax on such transfers may be extended for up to 10 years.[674] Additionally, in appropriate circumstances, the tax attributable to a closely held business may be deferred for 5 years and/or paid in 10 annual installments.[675]

Triggering event	Filing requirements
Taxable distribution	The recipient of the distribution must file Form 706GS(D) and pay the tax. The trustee must file Form 706GS(D-1). Both forms must be filed on or before April 15th of the year following the distribution.[676]
Taxable termination	The trustee must file Form 706GS(T) and pay the tax on or before April 15th of the year following that in which the termination occurred.[677]
Inter vivos direct skip	The transferor must file Form 709 and pay the tax on or before April 15th of the year following the gift. If the transferor dies before making the return, the personal representative must make it for her. In this latter case, the return is due no later than the due date for the transferor's estate tax return.[678]
Testamentary direct skip of property subject to administration	The personal representative must file Form 706 and pay the tax within 9 months of the decedent's death.[679]
Direct skip of property held in a trust or trust arrangement that is included in a decedent's gross estate.	Normally, the personal representative must compute the tax on Schedule R-1 of Form 706 and forward it to the trustee who must file the form and pay the tax within 9 months of the decedent's death.[680] However, in the case of property worth less than $250,000 held in a trust arrangement, the personal representative must file form 706 and pay the tax due.[681]

TRA 2010

For GST events (direct skips, taxable distributions or taxable terminations) that occur after 2009 but before December 17, 2010, the due date for reporting the transaction on the appropriate return is extended to no earlier than September 19, 2011.[682] Note however, that this extension does not appear to apply for purposes of making timely allocations of GST exemption for to elect in or out of the automatic allocations for indirect skips.[683]

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673 IRC § 2661(2).

674 IRC § 6161(a)(2).

675 IRC § 6166. IRC § 6166 is discussed further in "*Deferral and installment payment of* taxes" on page 257.

676 Treas. Regs. 26.2662-1(b)(1); 26.2662-1(c)(1)(i). If the recipient is legally or mentally incapable of making the return, it may be made by the recipient's guardian, or if none, by a person charged with the care of the recipient's person or property. Treas. Regs. § 26.2662-1(c)(4)(i).

677 Treas. Regs. 26.2662-1(b)(2); 26.2662-1(c)(1)(ii).

678 Treas. Regs. 26.2662-1(b)(3)(i); 26.2662-1(c)(1)(iii).

679 Treas. Regs. 26.2662-1(b)(3)(ii)(A); 26.2662-1(c)(1)(v).

680 Treas. Regs. 26.2662-1(b)(ii)(B); 26.2662-1(c)(1)(iv).

681 Treas. Regs. § 26.2662-1(c)(2)(iii). The personal representative has a right of recovery from the trustee if the property continues to be held in a trust arrangement or from the beneficiary if it isn't. Treas. Regs. § 26.2662-1(c)(2)(v).

682 This a reporting requirement only since TRA 2010 section 302(c) aprovides that the inclusion ratio to be used for any GST event that occurs during 2010 (all of 2010, not just before December 17, 2010) is zero.

683 The GST exemption is tied to the applicable exclusion amount under section 2010(c). IRC § 2631(c). Accordingly the exemption for GST events occurring in 2010 is $5 million.

Ex-160: In January of 1993, trustee makes a taxable distribution of $50,000 to skip person, S. What return must be filed to report the distribution, who is responsible for filing it, and when is it due? *Answers to the questions in this chapter begin on page 221.*

Ex-161: In January of 1993, nonskip person and life tenant L of a discretionary trust dies and all remaining trust principal and income is distributed to skip person S. What return must be filed to report this taxable termination, who is responsible for filing it, and when is it due?

Ex-162: In January of 1993, GP makes a $100,000 gift to GC, a skip person. What return must be filed to report this taxable termination, who is responsible for filing it, and when is it due?

Ex-163: GP dies with a will which contains a bequest of $100,000 to GP, a skip person. What return must be filed to report this taxable termination, who is responsible for filing it, and when is it due?

Ex-164: At GP's death, $100,000 is distributed from GP's living trust to GC, a skip person. What return must be filed to report this taxable termination, who is responsible for filing it, and when is it due?

Ex-165: At D's death, the proceeds of an insurance policy owned by her and taxed in her estate are paid equally to X and Y, both of whom are skip persons. Who is responsible for filing the return for this direct skip and what return(s) must be filed?

B. Collection Issues

1. Request for prompt assessment

Normally the Service has three years from the later of the date that a return is filed or the date that it is due to assess or begin collection of any income, gift, estate or generation-skipping transfer tax.[684]

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[684] IRC § 6501(a).

- In the case of income, gift, and some GST taxes, the personal representative can cut the three year period in half by filing a request for a prompt assessment of the tax.[685]
- A request for prompt assessment is not available for the estate tax, including the deferred tax on QDOT property, or for any GST tax occurring at the same time as and as a result of the death of an individual.[686]

2. Liability for taxes due

The person responsible for filing a tax return is also primarily and personally liable for any taxes due.[687]

- Thus, a decedent's personal representative is personally liable for all taxes (income, gift or generation-skipping transfer) that the decedent owed at death as well as for the income taxes of the decedent's estate, the decedent's estate taxes, and for some generation-skipping transfers that occur at his death.[688]
- In like fashion, the trustee of a QDOT is primarily and personally liable for any deferred estate tax relating to the trust property.

3. Discharge from personal liability

The personal representative can apply for discharge from personal liability for the decedent's income, gift and pre-death GST tax liabilities. The personal representative will be released from liability if he is not notified of an amount due within 9 months of the request or upon payment if the notification is received.[689]

A personal representative, trustee, or other fiduciary may also apply for a discharge from personal liability for a decedent's estate taxes, including the deferred estate tax on QDOT property.[690] The Service must generally notify the applicant of any tax owing within 9 months of the request. The applicant is then relieved of liability after he pays what is due and posts a bond for any taxes extended under IRC §§ 6161, 6163, or 6166.

4. Tax liens

IRC § 6324(a) imposes a lien on the gross estate of a decedent for a period of 10 years or until the estate tax is paid or becomes uncollectable by reason of lapse of time. A similar lien applies to gifts,[691] and to property involved in a generation-skipping transfer[692] or QDOT distribution or termination.[693] In special situations, IRC § 6325(b) provides for the discharge of property from the tax lien.

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685 IRC §§ 6501(d); 2661(1).

686 IRC §§ 6501(d); 2661(2).

687 But see IRC § 2654(d) which relieves a trustee of personal liability for increases in the GST tax attributable to transfers to the trust during the life of the transferor for which no gift tax return was filed or to an erroneous inclusion ratio that is determined by reference to the transferor's gift tax return. See also Treas. Regs. § 26.2662-1(c)(3).

688 31 U.S.C. §3713(b). To assume the responsibilities of and to act as the personal representative of a decedent's estate, the PR must provide the Service with notice of his fiduciary capacity. IRC § 6903(a).

689 IRC § 6905(a).See also IRC § 2661(1). There is no statutory or regulatory provision for the discharge of personal liability of the personal representative for the income taxes of his estate or for any GST tax occurring at the same time and on account of his death.

690 IRC §§ 2204; 2056A(b)(6).

691 IRC § 6324(b).

692 See IRC § 2661(2) and Treas. Regs. § 26.2662-1(f).

693 See IRC § 2056A(b)(8).

Ex-166: D dies on June 30, 1984. On June 10, 1994, the government sends a notice of levy and sometime after June 30, 1994 attempts execution. Is the government's action timely?

C. TAX ELECTIONS AND DECISIONS

The Code provides a number of post mortem tax elections that can significantly affect income and transfer tax liability.[694] This section explores those elections and the factors that should be considered in their exercise.

1. Decedent's income tax

a) Joint return with surviving spouse

If decedent's spouse does not remarry before the end of her taxable year, the personal representative may file a joint return with the spouse.[695]

Advantages: Advantages of a joint return include the availability of the split rates and the use of the decedent's excess charitable or capital loss deductions against the survivor's income.

Disadvantage: A possible disadvantage is the joint and several liability the estate assumes with the surviving spouse.

COMMENT
If the surviving spouse needs income to fully utilize the decedent's excess deductions, it may be possible to generate income by making a distribution of DNI from the estate. As for the concern about liability, the innocent spouse provision[696] should protect the estate if the spouse is the personal representative and principal beneficiary.

b) Section 213 medical expense election

Medical expenses of D paid within one year of D's death may be treated as paid when the expenses were incurred. As a result, these expenses become deductible on one or more of D's individual income tax returns. To do this, the personal representative must file both

1. a statement that the item of medical expense has not been allowed as a deduction under IRC § 2053 and
2. a waiver of the right to deduct them under that section.

The election may be made on an item by item basis.[697]

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694 Under Treas. Regs. § 301.9100-1, the Service may grant an extension in the time fixed by regulation (or ruling, notice, procedure, or announcement) for the making of a tax election provided the time for making the election is not expressly prescribed by statute, the request for extension is made in a timely manner, and the granting of an extension would not jeopardize the interests of the government. For the procedural requirements and the standards the Service will use to determine whether to grant an extension, see Rev. Proc. 92-85, 1992-2 C.B. 490.

695 IRC § 6013(a)(2).

696 IRC § 6013(e).

697 IRC § 213(c)(2). According to the Service, deductibility of medical expenses under IRC § 2053 is subject to the same percentage of adjusted gross income limitations as those applicable to deductibility under the income tax. Rev. Rul. 77-357, 1977-2 C.B. 328.

Ex-167: Under the 1986 Code, the highest marginal income tax bracket is 39 percent. The highest marginal estate tax bracket is 55 percent. Does this mean that it is always preferable to take the deduction for medical expenses on the estate tax return?

DRAFTING TIP
The decedent's will should include language that authorizes the personal representative to consider both the income and the estate tax consequences to the estate and all of its beneficiaries in making the decision where to take the deduction for medical expenses.

COMMENT
The impact of this election on marital deduction planning is discussed in Section 642(g) election on p. 69.

c) Series E or EE government bonds

A taxpayer may elect to report all accrued increase in Series E or EE government bonds as income.[698]

- Once this election is made, the taxpayer must report the amount that accrues each year as income.
- However, a decedent and his estate, beneficiaries, and trusts are all different taxpayers for this purpose.
- Hence, the election may be arranged so that the accrued interest is reportable by a taxpayer who has little other income or who has otherwise unusable deductions.
- For example, if the decedent has not elected during life, his personal representative may do so on his final return for bonds included in his probate estate or in a revocable trust.
- Alternatively (or in addition) the decedent's estate (or trust) may elect on its tax return.
- And, when the bonds are distributed to a beneficiary, the beneficiary has yet another election.

COMMENT
Recognition of any accrued increase in Series E or EE bonds may be avoided at maturity by rolling the bonds over into Series H bonds.

2. Gift tax

a) Election to split gifts with spouse

The split gift provision applies to gifts made by D or his spouse before D's death for which a return is not due until after death.[699]

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698 IRC § 454(a).

699 IRC § 2513.

1. If the spouse was the donor, the decedent's personal representative must consent to the election.
2. Where the decedent was the donor, the surviving spouse must consent.

In either case, any gift tax paid by D or his estate on either portion will come back into his gross estate.

COMMENT
In making the decision whether to split gifts, consideration must be given to both the applicable credit amount (unified credit) and the GST exemption. This latter is important because the split gift decision controls the identity of the transferor for GST tax purposes.

b) Gift tax QTIP election

A decedent may have made gifts to a QTIP trust for the benefit of the surviving spouse for which a gift tax return must be filed after the decedent's death. If so, the personal representative must make the QTIP election if the transfers are to qualify for the gift tax marital deduction.[700]

3. Estate's income tax

a) Qualified revocable trust election

New IRC § 645, created by the 1997 TRA and effective August 5, 1997, gives a decedent's executor (if any) and the trustee of the decedent's "qualified revocable trust" an election to have the trust assets treated and taxes as if they were part of the decedent's estate. See "*Qualified revocable trusts*" p. 167.

The election must be made before the due date (including extensions) of the estate's income tax return for its first taxable year. Once made, the election is irrevocable. It is effective for all taxable years of the estate ending before:

- Two years after the date of the decedent's death if no estate tax return is required to be filed; or
- Six months after the date of the final determination of estate tax liability where a return is required.

b) Partnership basis election

The death of a partner will cause a step up (or down) in the basis of the estate in the partnership interest. However, an adjustment to the basis of partner's interest in the partnership assets occurs only if an IRC § 754 election is filed.

1. The election must be filed in a writing accompanying the partnership's tax return for the year of the decedent partner's death.
2. The effect of the election is to step up (or down) the basis of the partner's estate in the partnership property.
3. The basis is adjusted only as it relates to the decedent partner's interest in the partnership assets.

> ***Ex-168:*** D's estate includes $100,000 representing his ¼th interest in a partnership. The partnership has an asset worth $200,000 with a basis of $40,000. Assuming the partnership sells the asset for

[700] IRC § 2523(f)(4)(A).

$200,000, what impact would an IRC § 754 election have on the tax treatment of the sale?

c) Selection of fiscal year

An estate may select a fiscal year. This election and how it can be used to defer and minimize taxes is discussed in "*Selection of a taxable year*" on page 187.[701]

d) Administration expenses

An estate may elect to take certain costs of administration as a deduction on the estate's income tax return rather than as a deduction on the decedent's estate tax return. This election is discussed in "*Section 642(g) election*" on page 69.

e) Accrued gain on government bonds

An estate may elect to report accrued gain on Series E or EE government bonds as income. This election is discussed in "*Qualified revocable trust election*" on page 217.

f) Election to report gain on distributions in kind

An estate may elect to report gain on in-kind distributions of property. This election and the effect it has on the amount of estate DNI that is carried out by the distribution is discussed in "*Section 643(e)(3) election to treat distribution as a sale*" on page 185.

g) Pass-through of estimated taxes

An estate's election to treat excess estimated tax payments as payments of estimated taxes by its beneficiaries is discussed in "*Pass-through of excess estimated tax payments*" on page 188.

4. The estate tax

a) Qualified conservation easements

For appropriate estates, the personal representative must decide whether to make an election to exclude a portion of land subject to a qualified conservation easement. See "*Exclusion for land subject to a qualified conservation easement*", p. 64.

b) Valuation methods

The personal representative must decide whether to use either or both of the special valuation methods for the estate tax. Valuation methods are discussed in "*Valuation of the gross estate*" on page 72.

c) Medical expenses

The personal representative must decide how to treat any unpaid medical expenses of the decedent. They may be deducted as claims against the estate. Alternatively, at the election of the personal representative, they may be deducted on the decedent's income tax return. This matter is discussed further "*Section 213 medical expense election*" on page 215.

d) Election to deduct foreign death taxes

The personal representative may elect to deduct the amount of any death tax imposed by a state or foreign country on transfers for public, charitable, or religious purposes,

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[701] For the effect the fiscal year selection has on the need for estates to pay estimated taxes, see Estimated taxes on p. 201.

provided the resulting decrease in taxes inures solely to the benefit of the eligible transferee.[702] If the taxes are taken as a deduction, they may not be taken as a credit.[703]

e) QTIP election

The personal representative must decide whether and to what extent the QTIP election should be made to qualify the decedent's QTIP trusts for the estate tax marital deduction.

f) Paying tax with flower bonds

Certain treasury bonds may be redeemed by the personal representative at their face value in payment of the federal estate tax bill of the decedent. To qualify, the bonds must have been included in the decedent's gross estate. The value of the bonds for estate tax purposes is their face value, whether or not the personal representative actually redeems them in payment of the estate tax.[704]

5. QDOT estate tax

The code provides that the benefits of IRC §§ 303 and 6166 are available when a QDOT tax is imposed at the death of the surviving spouse if those sections would have been applicable to the estate of the spouse had the property been taxed in his or her estate.[705]

6. The GST tax return

a) Allocation of million dollar GST exemption

The personal representative must decide how best to utilize any remaining GST exemption and to effect the allocation of the exemption to achieve that result. The GST exemption is discussed in "*GST exemption*" on page 124.

b) Reverse QTIP election for GST

The personal representative must decide whether and to what extent the reverse QTIP election should be made to make the decedent the transferor of a QTIP trust for purposes of the GST tax. For more on this matter, see "*Exception for predeceased ancestor*" on page 117 and "*GST case study — John and Mary Sample*" on page 153.

c) Alternate valuation method

For taxable terminations that occur by reason of the decedent's death, a decision must be made whether to value the property for purposes of the GST using IRC § 2032 of the estate tax.[706]

d) Expense deduction election

For taxable terminations and distributions, a decision must be made whether to take deductions permitted by IRC §§ 2621(a)(2) and 2622(b) against the GST tax or on the trust's income tax return.[707]

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702 IRC § 2053(d).

703 IRC § 2011(e)(1).

704 See Weld v. U.S., 55 F.3d 623 (Fed. Cir. 1995), aff'g 31 Fed. Cl. 81 (1994).

705 IRC §§ 2056A(b)(10)(A) and (B).

706 IRC § 2624(c).

707 IRC § 642(g).

D. PENALTIES AND ADDITIONS TO TAXES

Except where otherwise indicated, the following penalties and additions to tax apply to the income, gift, estate and generation-skipping transfer taxes.

1. Failing to file

In the absence of reasonable cause, there is a penalty of 5 percent per month up to a maximum of 25 percent for failing to file a required return.[708]

COMMENT
Except where there is a legitimate question of law whether a return is required,[709] reliance by a taxpayer on the advice of counsel is NOT reasonable cause.[710]

If the failure to file is fraudulent, the penalty is 15 percent per month up to a maximum of 75 percent.

2. Failing to pay

In the absence of reasonable cause, there is a penalty of one-half percent per month up to a maximum of 25 percent for a failure to pay a tax due.[711]

3. Accuracy related penalties

IRC § 6662 provides for the following accuracy related penalties.[712]

a) The penalty for negligent or intentional disregard of the rules is 20 percent of underpayment.[713]

b) In the absence of reasonable cause, the penalty for valuation overstatements or understatements of more than $5,000 is 20 percent if the reported valuation is 50 percent or less of true valuation and 40 percent if the reported valuation is 25 percent or less of true valuation (gross valuation misstatement).[714]

4. Fraud

There is a penalty of 75 percent of any underpayment resulting from fraud.[715]

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708 §6651(a)(1).

709 See Estate of Eugene E. La Meres, 98 T.C. 294 (1992) (reliance on advice of counsel that second extension would be granted was held to be reasonable cause).

710 Boyle v. U.S., 469 U.S. 241 (1985).

711 §6651(a)(2).

712 The penalties may be avoided with adequate disclosure of by showing good faith and reasonable cause. See Treas. Regs. § 1.662-3(a).

713 Underpayment includes both the basic tax and any interest due on the tax.

714 §6662(g). For a case where this penalty was applied, see Morton v. Comm., TC Memo 1997-166.

715 §6663. Accuracy related penalties do not apply to any portion of an underpayment that is subject to the fraud penalty.

ANSWERS—POSTMORTEM TAX PLANNING

Ex-160. **Answer –** S, as the recipient of the distribution must file Form 706GS(D) and pay the tax. The trustee must file Form 706GS(D-1). Both forms must be filed on or before April 15th of the year following the distribution. Treas. Regs. §§ 26.2662-1(b)(1); 26.2662-1(c)(i).

Ex-161. **Answer –** The trustee of the trust must file Form 706GS(T) and pay the tax on or before April 15th of the year following that in which the termination occurred. Treas. Regs. §§ 26.2662-1(b)(2); 26.2662-1(c)(ii).

Ex-162. **Answer –** The transferor must file Form 709 and pay the tax on or before April 15th of the year following the gift. If the transferor dies before making the return, the personal representative must make it for her. In this latter case, the return is due no later than the due date for the transferor's estate tax return. Treas. Regs. §§ 26.2662-1(b)(3)(i); 26.2662-1(c)(iii).

Ex-163. **Answer –** The personal representative of GP's estate must file Form 706 (or 706NA) and pay the tax within 9 months of GP's death. Treas. Regs. §§ 26.2662-1(b)(3)(ii); 26.2662-1(c)(v).

Ex-164. **Answer –** The personal representative must compute the tax on Schedule R-1 of Form 706 and forward it to the trustee who must file the form and pay the tax within 9 months of the decedent's death. Treas. Regs. § 26.2662-1(c)(iv).

Ex-165. **Answer –** It depends. If the face amount of the policy is less than $250,000, D's personal representative must report this direct skip on D's form 706 (or 706NA). If the face amount of the policy equals or exceeds $250,000, the personal representative must compute the tax on Form 706 (or 706NA), Schedule R-1 and forward it to the insurance company, who, as the trustee of the trust arrangement, must file the form with the service. Treas. Regs. § 26.2662-1(c)(iii). See also Treas. Regs. § 26.2662-1(c)(iv) (special rule for pre-June 24, 1996 transfers of less then $100,000 from a trust arrangement).

Ex-166. **Answer –** Probably not. The estate tax lien attaches automatically at the decedent's death. U.S. v. Blakeman, 997 F.2d 1084 (5th Cir. 1993), cert denied, 114 S. Ct. 687 (1994). The Ninth Circuit has indicated that a notice of levy will toll the running of the 10 -year period. The Fourth, Seventh, and Eighth Circuits, however, have held that the government must execute the lien within the 10-year period. Compare Chevron, U.S.A., Inc. v. U.S., 705 F.2d 1487 (9th Cir. 1983) with U.S. v. Davis, 52 F.2d 781 (8th Cir. 1995); U.S. v. Potemken, 841 F.2d 97 (4th Cir. 1988); U.S. v. Cleavenger, 517 F.2d 230 (7th Cir. 1975).

Ex-167. **Answer –** Not necessarily. The size of the decedent's estate may be such that no estate taxes will be due even without the deduction for medical expenses. Then too, if the decedent's estate plan involves a formula marital gift designed to eliminate all estate taxes at death, any "costs" associated with taking the deduction on the income tax return will be deferred until the death of the surviving spouse. Moreover, the amount of property that can pass tax free to the decedent's family under the applicable credit amount (unified credit) is reduced dollar for dollar by any medical expenses that are not deducted on the estate tax return.

Ex-168. **Answer –** Without an IRC § 754 election, a sale of that asset for $200,000 would result in a $40,000 gain to each partner. With an election, the basis of D's estate (or successor) in the asset would be increased to $50,000 and no gain or loss would be realized.

X. SPECIAL ESTATE PLANNING TOPICS

A. FLORIDA APPORTIONMENT STATUTE

1. Introduction

Florida's newly revised section 733.817 (hereinafter, the "apportionment statute") provides rules for the apportionment of the net tax[716] imposed as a result of the decedent's death by any state,[717] the United States or any country or political subdivision.[718]

2. Attributing taxes to particular property interests

The initial step in the application of Florida's apportionment statute is to determine (with respect to each separate tax being apportioned) the net tax attributable to each interest.

By default, this is done using an average apportionment methodology under which the tax attributable to each interest included in the measure of the tax[719] is determined by the proportion that the value that that interest bears to the value of all similar interests.[720]

COMMENT
With respect to the federal estate tax, the term "included in the measure of the tax" does not include either adjusted taxable gifts or any item that is initially deductible from the gross estate. With respect to the latter, where an election is required for a deduction (*e.g.*, QTIP), the item is excluded only if the election is allowed.[721]

a) Qualified terminable interest property

Taxes (federal and state) attributable to property included in the gross estate under IRC § 2044 (QTIP property) are determined on a marginal basis. The tax is equal to the excess of the tax actually payable over the tax that would have been payable had the QTIP property not been included in the surviving spouse's gross estate.[722]

Ex-169: T (a widower) dies in 1997 with a gross estate of $2.1 million, consisting of $1 million held in a QTIP trust created by T's former spouse, a $500,000 insurance policy on T's life for which his daughter is the named beneficiary, and $600,000 of cash and marketable securities titled in T's own name. The QTIP trust provides that property held in the trust at T's death is to pass to T's children in equal shares. T's will leaves $250,000 to

716 "Net tax" means the net tax payable after taking into account all applicable credits, except – with respect to the federal estate tax – the credit for foreign taxes. Fla. Stat. § 733.817(1)(f) (2015). Except as otherwise indicated, the term "tax" in this outline refers to "net tax."

717 State is defined to include the District of Columbia and the Commonwealth of Puerto Rico. Fla. Stat. § 733.817(1)(m) (2015).

718 See Fla. Stat. § 733.817(1)(n) (2015). The revised version discussed in this outline becomes effective on October 1, 1998. A former version of section 733.817 applies to decedents dying prior to that date.

719 With respect to the federal estate tax, the term "included in the measure of the tax" does not include either adjusted taxable gifts or any item that is initially deductible from the gross estate. With respect to the latter, where an election is required for a deduction (*e.g.*, QTIP), the item is excluded only if the election is allowed. Fla. Stat. § 733.817(1)(d) (2015).

720 Fla. Stat. § 733.817(3) (2015). Value for this purpose is defined to be the pecuniary worth of an interest after deducting any debt, expense or other deduction chargeable to it for which a deduction was allowed in determining the tax. Reductions in value are not allowed for liens or encumbrances paid from other interests or by reason of the fact that part of the tax will be charged to the property. Fla. Stat. § 733.817(1)(q) (2015).

721 Fla. Stat. § 733.817(1)(d) (2015).

722 Fla. Stat. § 733.817(3)(a) (2015).

charity and the balance of his estate to his grandchild. Costs of administering T's estate equal $100,000.

1. What is the total amount of federal and state estate taxes payable at T's death?

2. What portion of those taxes are attributable to the QTIP trust?

3. What portion of those taxes are attributable to the charity, T daughter, and T's grandchild?

b) Reduction in taxes from the foreign tax credit

A limited credit for taxes paid to foreign countries is allowable in calculating the federal estate tax[723]. In cases where the credit is available, the Florida apportionment statute first apportions the federal estate that that would have been payable but for the credit. Then, in a separate step, the benefit of the foreign tax credit is apportioned:

- First, in reduction of any federal estate tax otherwise apportioned to the recipients of the foreign interests;[724]
- Then, proportionately to all remaining recipients of interests included in the measure of the federal estate tax.[725]

c) The Florida estate tax

Florida imposes an estate tax equal to the credit allowable against the federal estate tax under IRC § 2011 (referred to as the "tentative Florida tax"),[726] reduced by the estate and inheritance taxes payable to other states.[727] To insure that the benefit of this reduction inures first to the recipients of the property being taxed in the other state:

- With respect to each state, the net Florida tax attributable to the property subject to tax in that state is the excess (if any)[728] of the amount of the tentative Florida tax attributable to the property over the net tax payable to the other state with respect to the property.[729]
- Any remaining Florida tax is attributable to property included in the measure of the Florida tax (exclusive of property subject to tax in other states).[730]

[723] See IRC § 2014.

[724] This reduction occurs whether or not any federal estate tax is attributable to the foreign interests.

[725] Fla. Stat. § 733.817(3)(b) (2015).

[726] Fla. Stat. § 733.817(1)(p) (2015).

[727] Fla. Stat. § 198.02 (2015).

[728] None of the Florida tax is attributable to property taxed in another state if the tax in that state equals or exceeds the tentative Florida tax attributable to the same property. Fla. Stat. § 733.817(3)(c)1 (2015).

[729] Fla. Stat. § 733.817(3)(c)2 (2015). The net federal tax attributable to the property subject to tax in other states is determined as if the property were located in Florida. Fla. Stat. § 733.817(3)(c)4 (2015).

[730] Fla. Stat. § 733.817(3)(c)3 (2015).

COMMENT
In most cases, the complexity of this rule will seldom be encountered, either because there is no property subject to tax in another state or because there is such property, but the tax imposed by the other state equals or exceeds the tentative Florida tax on the same property. • In the former case, the Florida estate tax will be attributable prorata to all interests included in the measure of the Florida tax. • In the latter, the property subject taxation in the other state will be excluded from the calculation as if (in effect) it was not included in the measure of the Florida tax.

d) Taxes attributable to temporary interests

A temporary interest is an interest (whether or not held in trust) in income or in an estate for a specific period of time or for some period controlled by reference to extrinsic events.[731] The tax that is attributable to a temporary interest is attributable to the principal that supports the interest rather than the interest itself.[732]

e) Taxes caused by the elective share

A surviving spouse must bear any additional tax caused by an election to take an elective share.[733] Presumably the additional tax is determined on a marginal basis. The additional tax would be equal to the difference between the tax due without an election and the tax payable with one.

3. Apportioning the burden of the attributed tax

After the tax attributable to each property interest included in the measure of the tax is determined, it is necessary to apportion the burden of the attributed tax among the recipients of the various interests.

For the most part, the burden of an attributed tax will fall prorata on the recipients of the property to which the tax is attributed.

But this is not always the case, particularly with respect to probate transfers and property passing under the terms of a trust.

a) Taxes on interests to which provisions of the IRC apply

The Internal Revenue Code includes several provisions that specify the ultimate burden of federal taxes attributable to various types of property interests.[734]

With respect to these interests, all net taxes (federal, state, etc.) attributable to each category are apportioned among the recipients of all interests of each category in

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731 Fla. Stat. § 733.817(1)(o) (2015).

732 Fla. Stat. § 733.817(5)(d) (2015).

733 Fla. Stat. § 732.215 (2015).

734 These provisions include:

- IRC § 2032A(c)(5) - relating to the recapture tax on special use valuation property.
- IRC § 2033A(i)(3)(F) - relating to the recapture tax on qualified family-owned business interests.
- IRC § 2206 - relating to federal estate taxes attributable to the proceeds of life insurance on the decedent's life.
- IRC § 2207 - relating to federal estate taxes attributable to general powers of appointment.
- IRC § 2207A - relating to federal estate taxes attributable to QTIP property.
- IRC § 2207B - relating to federal estate taxes attributable to property included in the decedent's gross estate under IRC § 2036.
- IRC § 2603(b) - relating to the tax on generation-skipping transfers.

proportion to the value that each interest bears to the value of all interests of that category.[735]

b) Taxes on other property interests

In the absence of an effective contrary provision in the decedent's will or other instrument, the Florida apportionment statute will control the apportionment of taxes on those interests to which the Internal Revenue Code does not speak.

Among others, this includes taxes on property passing by right of survivorship, intestacy, under the decedent's will or under an inter vivos trust (other than a QTIP trust or an IRC § 2036 trust), as well taxes on annuities and revocable, or reversionary interests.

(1) Property passing under decedent's will or inter vivos trust

The Florida statute includes separate but parallel rules covering taxes attributable to property passing under the decedent's will or inter vivos trust. Under these rules:

- Net taxes attributable to nonresiduary devises[736] or trust interests[737] are charged to and are payable from the residuary estate or trust interest whether or not all interests in the residue are included in the measure of the tax. The excess (if any) is apportioned among recipients of nonresiduary devises or trust interests included in the measure of the tax in proportion to the value that each bears to the value of all.[738]
- Net taxes attributable to residuary devises or trust interests are apportioned only among recipients of residuary interests that are included in the measure of the tax in the proportion that each bears to the value of all.[739]
- In the application of the foregoing rules, apportionment among the recipients of the decedent's estate and revocable trust is determined as if all recipients take under a common instrument.[740]

Ex-170: T's will leaves pecuniary bequests of $100,000 and $300,000 to A and B respectively and the residue of the estate (worth $600,000) to C and D equally.

1. Assuming the tax attributable to property passing under T's will is $153,000, how should this tax be apportioned?

2. Change the facts. Suppose the pecuniary bequest to B was $800,000 leaving a residue of only $100,000. How should the $153,000 in taxes be apportioned?

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735 Fla. Stat. § 733.817(4)(a) (2015).

736 A non-residuary devise is any devise that is not a residuary devise. Fla. Stat. § 733.817(1)(g) (2015). For the meaning of residuary devise, see Fla. Stat. § 731.102(30) (2015).

737 A non-residuary interest in a trust is any interest that is not a residuary interest. Fla. Stat. § 733.817(1)(h) (2015). A residuary interest means "an interest in the assets of a trust which remain after provision for any distribution which is to be satisfied by reference to a specific property, or type of property, fund, sum, or statutory amount." Fla. Stat. § 733.817(1)(k) (2015).

738 Fla. Stat. §§ 733.817(5)(a)1 and (b)1 (2015).

739 Fla. Stat. §§ 733.817(5)(a)2 and (b)2 (2015).

740 Fla. Stat. § 733.817(5)(d) (2015).

3. Return to the original facts (i.e., B's bequest is $300,000). Suppose, however, that the taxes attributable to T's estate are only $70,000 because D is T's spouse and the bequest to D qualifies for the estate tax marital deduction?

Ex-171: T (a widower) dies with an estate consisting of undeveloped land worth $250,000, other property worth $100,000, and property held in a revocable trust worth $650,000. T's will leaves the land to his adult son B and the residue of his estate to his revocable trust. The trust provides for a compensating pecuniary gift of $250,000 to T's adult daughter C. The remaining trust property is to be held in continuing trust for T's grandchildren.

1. Assuming the estate taxes at T's death total $153,000, how should the estate taxes be apportioned?

2. Suppose T's will left the residue of his estate (worth $100,000) to C and D equally?

(2) Taxes attributable to an exempt homestead

If a decedent's homestead passes to one or more persons to whom the decedent's exemption from forced sale inures, the homestead is exempt from apportionment[741] and the taxes attributable to it are apportioned instead against the other recipients of the estate or of property passing under a revocable trust in the following order:

- Intestacy property
- Residuary interests
- Other interests

In all cases, apportionment is limited to recipients of interests included in the measure of the federal estate tax.[742]

Ex-172: W dies survived by her child C, by C's child GC , and by a sister S. W's will leaves her homestead (worth $750,000) to her C and the residue of her estate (worth $250,000) to her sister, S. The taxes at W's death amount to $153,000.

1. How are the taxes attributable to the homestead apportioned under the Florida ?

2. Would the answer change if W had left the homestead to GC instead of C?

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[741] Fla. Stat. § 733.817(2) (2015).

[742] See Fla. Stat. § 733.817(5)(c) (2015).

3. Suppose W had left the homestead to C and the residue to Charity?

(3) Other taxes

Taxes on other interests (intestacy, jointly held property, annuities, revocable or reversionary transfers, insurance, etc) are apportioned among the recipients of such interests included in the measure of the tax in proportion to the value that each interest bears to the value of all such remaining interests.[743]

COMMENT
The Florida statute provides that taxes imposed under IRC § 4980A (relating to excess retirement accumulations) are apportioned solely among recipients of interests included in the measure of that tax.[744] This provision is obsolete; the tax on excess retirement accumulations was repealed by the 1997 Taxpayer Relief Act, effective for decedent's dying after 1996.

Ex-173: D's gross estate amounted to $1 million, $900,000 of which resulted from an adjustment under IRC § 2035(b) for gift taxes D paid on a large gift he made two years before his death. Taxes at D's death amounted to $153,000. How should D's taxes be apportioned?

c) Penalties and interest

In general, penalties and interest on taxes are apportioned in the same manner as the tax to which they relate.[745] However, if the court finds that this would produce an inequitable result, the court may assess liability for penalties and interest in the manner it finds equitable.[746]

4. Directing against statutory apportionment

For a variety of reasons, it often is unwise to leave the issue of tax apportionment to the default rules of the federal and state statutes. A well crafted approach to apportionment can facilitate administration and reduce taxes, the latter by avoiding:

- the tax dependent calculation created by the Florida statute, and
- the wasting of GST exemption that occurs when taxes are apportioned to trusts with a zero inclusion ratio.

As the amount of litigation concerning the effectiveness of tax apportionment clauses amply demonstrates, the drafting of such clauses – particularly in those estate plans involving revocable trusts – is not a trivial task. More is needed than a simple provision stating that all taxes are to be paid from the residue. The impact of such a provision can be grossly unfair. And even if it isn't, consideration must be given to what the provision must say and in what instrument (or instruments) it must appear.

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[743] Fla. Stat. § 733.817(5)(f) (2015).

[744] Fla. Stat. § 733.817(5)(e) (2015).

[745] See Fla. Stat. § 733.817(1)(n) (2015) defining tax to include penalties and interest.

[746] Fla. Stat. § 733.817(5)(g) (2015). See also Fla. Stat. § 733.817(8)(c) (2015).

a) Requirements of federal law

Reference has been made previously to the provisions of the Internal Revenue Code that apportion the burden of federal taxes among the recipients of various interests. See "*Taxes on interests to which provisions of the IRC apply*," p. 224.

- Because case law suggests that these provisions preempt state apportionment statutes,[747] a tax apportionment clause that attempts to do more than restate the default rules with respect to areas to which the Code speaks, must comply with the requirements imposed by the Code.
- This applies both to the federal estate tax and to any other taxes imposed with respect to the same property.[748]

(1) Section 2032A and 2033A recapture tax

An additional estate tax is imposed when a qualified heir disposes of property to which the special use valuation rule of IRC § 2032A or the exclusion for qualified family-owned business interests apply.

- In both cases, the Code provides that the qualified heir is personally liable for the additional estate tax.[749]
- Since the Code makes no provision for a contrary provision in any governing instrument, the effectiveness of such a provision is doubtful.

(2) Estate taxes on insurance and general powers

IRC §§ 2206 and 2207 apportion the burden for federal estate taxes[750] on insurance and power of appointment respectively. Under each section, the tax (determined on an average basis) is apportioned to the recipient of the proceeds or property as the case might be.

- Both sections explicitly yield to a contrary provision in the decedent's will.
- Neither section requires that a specific reference to insurance or powers of appointment be made, so a general reference should work.

CAUTION
The Florida statute is somewhat more restrictive on this point. See "*Directions assuming responsibility for taxes attributable to property passing under another instrument*" p. 230.

- But, both sections refer only to the decedent's will. Accordingly, a provision in some other instrument (e.g., the insurance policy or a revocable trust) may not be given effect.

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[747] See Riggs v. Del Drago, 317 U.S. 95 (1942); First Nat'l Bank of Nevada v. Wells, 148 S.E.2d 119 (N.C. 1966); In re Estate of Ogburn, 405 P.2d 655 (Wyo. 1965).

[748] Fla. Stat. § 733.817(4)(a) (2015).

[749] IRC §§ 2032A(c)(5); 2033A(i)(3)(F).

[750] The Florida estate tax is apportioned in the same manner. Fla. Stat. § 733.817(4)(a) (2015).

COMMENT
The Florida apportionment statute contains a unique provision which may make it possible to give effect to a contrary provision in a decedent's revocable trust. See "*Provisions in revocable trust deemed to be part of decedent's will*" p. 230.

(3) The generation-skipping transfer taxes

Except as provided in a provision in a governing instrument that specifically refers to the GST tax, IRC § 2603(b) apportions the burden of the federal GST tax to the property constituting the generation-skipping transfer.[751] In the case of a testamentary direct skip, this would be the property involved in the direct skip.

COMMENT
Since direct skips can occur in a variety of ways (through gifts in a will or trust, or through a beneficiary designation in an insurance or annuity policy), it may be necessary to include apportionment provisions in more than one governing instrument. But see "*Provisions in revocable trust deemed to be part of decedent's will*" p. 230, for a special Florida provision which may make it possible for a provision in a revocable trust to control the burden of GST tax on transfers made in a decedent's will.

(4) QTIP and section 2036 property

IRC § 2207A apportions the burden of federal estate taxes on QTIP property (determined on a marginal basis) to the person receiving the QTIP property at the death of the surviving spouse. IRC § 2207B provides a similar rule for property included in the decedent's gross estate under IRC § 2036. Here, however, the taxes attributable to the property are determined on an average basis.

Both sections provide that the default rules can be waived by specific language in the decedent's will or revocable trust.[752] Thus, to be effective:

- A clause expressing a contrary provision with respect to the taxes attributable to QTIP must specifically refer to QTIP, the QTIP trust, section 2044, or section 2207A.
- A clause expressing a contrary provision with respect to section 2036 property must refer to section 2036 or section 2207B.

b) Requirements of the Florida statute

The Florida statute contains its own set of rules relating to the requirements for an effective tax apportionment provision. These rules will control where the Code is silent. They may also be of some relevance where it is not. Particularly where the Florida statute specifies requirements that are not present in the Code, a conservative draftsperson will want to meet both sets of requirements.

(1) General rule – local effect only

Generally, a provision in a governing instrument directing the payment of tax in a manner different from the statute is effective only to the extent it directs that

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[751] The Florida GST tax is apportioned in the same manner. Fla. Stat. § 733.817(4)(a) (2015).

[752] The rule in the text is applicable only for decedents dying after August 5, 1997. For decedents dying before that date, a provision waiving IRC § 2207A had to be placed in the decedent's will.

the tax be paid from assets which pass pursuant to the governing instrument in which the contrary direction appears.[753]

COMMENT
Under this rule, a provision in a trust that taxes attributable to property passing under it are to be paid from another source is ineffective.

(2) Provisions in revocable trust deemed to be part of decedent's will

If the decedent's will directs that taxes be apportioned according to a provision in the decedent's revocable trust by specific reference to the trust, the provision in the trust is deemed to be a provision in the decedent's will.

Accordingly, the apportionment provision in the trust is effective to control the apportionment of taxes attributable to property passing under both the will and the trust.[754]

COMMENT
In providing that the trust provision deemed to be a provision in the will, the hope is that this will give effect to the provision with respect to taxes covered by Code provisions that require contrary provisions to be in the decedent's will. See "*Estate taxes on insurance and general powers*" p. 228.

(3) Direction in will to pay taxes from revocable trust

In the absence of a contrary provision in the trust, a direction in the will to pay taxes from the decedent's revocable trust is effective.[755]

COMMENT
This provision is effective only for the taxes attributable to property passing under the decedent's will. A different approach is necessary to apportion the burden of taxes on nonprobate property such as joint tenancies and insurance proceeds to the decedent's revocable trust. See "*Directions assuming responsibility for taxes attributable to property passing under another instrument*" below.

(4) Directions assuming responsibility for taxes attributable to property passing under another instrument

A direction in one governing instrument (i.e., "the directing instrument") to pay taxes attributable to property passing under another instrument or instruments from property controlled by the directing instrument is effective only if the directing instrument expressly:

(a) Refers to s. 733.817(5)(h)4; or

(b) Indicates that the property passing under it is to bear the burden of taxation for property not passing under that instrument.[756]

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[753] Fla. Stat. § 733.817(5)(h)1 (2015).

[754] Fla. Stat. § 733.817(5)(h)2 (2015).

[755] Fla. Stat. § 733.817(5)(h)3 (2015).

[756] Fla. Stat. § 733.817(5)(h)4 (2015).

In this regard, a direction in an instrument that all taxes are to be paid from property passing under that instrument whether attributable to that property or otherwise is effective for this purpose.[757]

COMMENT
This provision is intended to reverse Guidry v. Pinellas Central Bank & Trust Co., 310 So. 2d 386 (Fla. 2d DCA 1975) holding that a provision in a revocable trust to pay taxes on property passing outside the trust was ineffective to direct payment of taxes attributable to non-trust assets.

Ex-174: T's revocable trust directs that "all taxes are to be paid from the residue of the trust estate." When T dies, his gross estate includes jointly held property and the proceeds of an insurance policy on his life.

1. Will the provision in the trust will be effective as intended?

2. Suppose the trust expressly stated that the taxes attributable to the joint property and insurance were to be paid from the trust?

Ex-175: T dies survived by a spouse, A and several kids and grandkids. T's estate plan calls for the creation of 3 trusts: a credit shelter (CSx) trust of $600,000 and two QTIP trusts (Q1x and Q2t) containing $400,000 and $1,000,000 respectively. The CSx and Q1x trusts have an inclusion ratio of zero; the Q2t trust has an inclusion ratio of one.

1. In the absence of a contrary provision, how will the estate taxes attributable to the Q1x and Q2t trusts be apportioned?

2. If T wants the taxes attributable to the Q1x trust to be paid from the Q2t trust, where must the provision be placed and what must it say?

c) Conflict resolution

In general, where the apportionment provisions in the decedent's will and another governing instrument conflict, the will controls.[758]

Exceptions:

The governing instrument (rather than the will) controls:

- with respect to taxes remaining unpaid after the will is given effect;[759] or

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757 However, a direction that all taxes are to be paid from the residue without express reference to taxes on property passing outside the will would not suffice. See *e.g.*, Boulis v. Blackburn, 16 So.2d 186 (Fla. 4th DCA 2009)

758 Fla. Stat. § 733.817(5)(h)5 (2015).

759 Fla. Stat. § 733.817(5)(h)5a (2015).

- unless the provision in the decedent's will expressly overrides the provision in the governing instrument, with respect to the payment of taxes attributable to and payable from property passing under the governing instrument.[760]

> ***Ex-176:*** T's revocable trust provides that the trustee is to pay any taxes certified by T's personal representative to be in excess of T's residuary estate. Subsequently, T executes a will that provides that all federal and state taxes on T's gross estate (whether on property passing under the will or not) are to be paid from T's residuary estate. If the taxes at T's death exceed the value of his residuary estate, will the provision in the trust be effective to apportion responsibility for the excess to the trust?

> ***Ex-177:*** T 's will directs that all taxes on any property passing under or outside the will are to be paid from the residuary estate. T's revocable trust, executed before the will, provides that the trust is to bear its equitable share of any taxes. Will the provision in the trust control the apportionment of taxes passing under the trust?

5. Duties, powers and liabilities of fiduciaries

The Florida statute grants, imposes, and in some cases limits the powers, duties, and liabilities of personal representatives and fiduciaries with respect to the collection of apportioned taxes.

- Importantly, these duties, powers and liabilities are not limited to taxes apportioned under the default rules of the statute.
- They extend equally to taxes apportioned pursuant to a governing instrument.

a) Authority to withhold distribution

A personal representative (or fiduciary) is not required to distribute or transfer property to a recipient where:

- The personal representative reasonably anticipates the property may be necessary to pay taxes; or
- There are taxes due from the recipient which remain unpaid.[761]

COMMENT
Where property is transferred or distributed before final apportionment of the tax, the recipient is required to provide a bond or other security for his apportioned liability in the amount and form prescribed by the personal representative or fiduciary.

[760] Fla. Stat. § 733.817(5)(h)5b (2015).

[761] Fla. Stat. § 733.817(6) (2015).

b) Order of apportionment

A personal representative may petition for an order of apportionment at any time.[762]

- The court will then determine all issues concerning apportionment.
- Where the tax to be apportioned has not been finally determined, the court will determine and apportion the probable tax and retain jurisdiction to modify the order from time to time as may be appropriate.[763]

c) Recovery of the tax

(1) Duty of personal representative (or fiduciary) to recover the tax

If the personal representative (or fiduciary) does not have possession of property sufficient to pay the tax apportioned to a recipient, the personal representative (or fiduciary) has a duty to recover the deficiency in the tax.[764]

Recovery is made:

- First from any fiduciary in possession of the property to which the tax has been apportioned;[765]
- Then from the recipient of the property itself.[766]

COMMENT
In any action to recover apportioned tax: • The order of apportionment is prima facie correct.[767] • The court must award taxable costs (including attorney's fees) as in chancery actions and may award penalties and interest on the unpaid tax under equitable principles.[768]

(2) Protection of insurance companies and financial institutions

The recovery rules do not authorize recovery from insurance companies or from financial institutions (banks, trust companies, savings and loan associations, etc.) holding accounts in the name of decedent and others which pass by operation of law.[769]

d) Protection of personal representatives and fiduciaries

(1) Relief from duty to collect apportioned tax

A personal representative (or fiduciary) may be relieved of the duty to collect the apportioned tax by an order of the court finding that:

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762 Where no administration has been commenced, the petition for an order of apportionment may be made by any fiduciary. The petition may be made at any time after 90 days from the decedent's death in the court in which venue would be property for estate administration. Formal notice must be given to all interested persons. In addition, at any time after six months after the decedent's death, any recipient may petition for an order of apportionment. Fla. Stat. § 733.817(7)(a) (2015).

763 Fla. Stat. § 733.817(7)(b) (2015).

764 Fla. Stat. § 733.817(8)(a) (2015).

765 Fla. Stat. § 733.817(8)(a)1 (2015).

766 Fla. Stat. § 733.817(8)(a)2 (2015).

767 Fla. Stat. § 733.817(8)(b) (2015).

768 Fla. Stat. § 733.817(8)(c) (2015).

769 Fla. Stat. § 733.817(8)(d) (2015).

- The estimated costs and attorney fees in collecting the tax will approximate or exceed the amount of the recovery; or
- The person against whom the tax is apportioned is a resident of a foreign country (other than Canada) and refuses to pay the tax on demand; or
- It is impracticable to enforce contribution in view of the improbability of obtaining a judgment, collecting on a judgment or otherwise.[770]

(2) Relief from liability

A personal representative (or fiduciary) who reasonably believes it would be economically impracticable to attempt to enforce collection is not liable for a failure to do so.[771]

(3) Apportionment of uncollected tax

Any apportioned tax that is not collected is reapportioned (under the same rules) as if the property to which the tax was originally apportioned had been exempt from apportionment.[772]

COMMENT
A recipient to whom uncollected taxes are reapportioned under this rule will have paid more than the amount of tax initially apportionable to him or her. In such a case, the recipient has a right of contribution from the person to whom the reapportioned tax was initially apportioned.[773]

e) Taxes levied by a foreign country

Nothing in the apportionment statute requires the personal representative (or fiduciary) to pay any tax levied or assessed by any foreign country, unless specific directions to that effect are contained in the will or other instrument under which the personal representative (or fiduciary) is acting.[774]

B. DISCLAIMERS

For a variety of reasons, it may be desirable to restructure a decedent's distributive scheme after his death.

- If a qualified disclaimer is used for this purpose, the gift, estate and generation-skipping transfer taxes apply as if the property subject to the disclaimer passed directly from the decedent to the person taking the property as a result of the disclaimer.
- Thus, qualified disclaimers may be used to transfer property without the imposition of a gift tax and they may be used to increase or decrease the marital deduction available to the estate of a decedent.

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770 Fla. Stat. § 733.817(9)(a) (2015).

771 Fla. Stat. § 733.817(9)(b) (2015).

772 Fla. Stat. § 733.817(10) (2015).

773 Fla. Stat. § 733.817(11) (2015).

774 Fla. Stat. § 733.817(12) (2015).

1. Requirements of a qualified disclaimer

a) In general

The requirements of a "qualified" disclaimer are a mixture of federal[775] and local law.[776] To qualify

- The disclaimer must be an irrevocable and unqualified refusal to accept the interest.[777]
- It must be made before acceptance and within 9 months of the later of the time the interest was created (usually the decedent's death) or the beneficiary's 21st birthday.[778]

TRA 2010
For decedents dying after 2009 and before December 17, 2010, the time for making a disclaimer of property passing by reason of the death of a decedent is extended to September 17, 2011. [779]

- It must be in a writing, signed, witnessed, and acknowledged like a deed, and it must be filed with the clerk of the court.
- As a result of the disclaimer, the interest must pass, without direction on the part of the disclaimant, either to the spouse of the decedent, or to someone other than the disclaimant.

In the absence of a contrary provision in decedent's will, disclaimed property passes as if the disclaimant had predeceased the decedent.

Ex-178: H and W are U.S. citizens. In 1989, W uses $100,000 of her money to purchase JointAcre taking title with H as tenants by the entirety. In June 1998, W dies. The value of JointAcre at that time is $250,000.

1. Assuming H acts within 9 months of W's death, to what extent may H make a qualified disclaimer with respect to JointAcre?

2. Would the answer differ if H rather than W had furnished the consideration for JointAcre?

3. Would your answer differ if H was not a U.S. citizen?

4. Suppose the asset in question had been stock that H and W had held in a joint brokerage account?

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[775] See §2518.

[776] See Fla. Stat. § 732.801 (2015).

[777] Disclaimers by personal representatives are permissible in Florida. Fla. Stat. § 732.801(2)(b) (2015).

[778] The longer period for contingent interests provided in Fla. Stat. § 732.801 (2015) is not recognized for tax purposes.

[779] See TRA 1020 section 301(d)(1)(C).

COMMENT
If a surviving tenant disclaims, the disclaimed interest will pass to someone else. Thereafter, the disclaimant may wish to continue in possession of the property. As a tenant in common, they have that right as an incident of their continuing interest in the property and the regulations state that this can be done without turning a qualified disclaimer into an unqualified one.[780]

Ex-179: W makes both an election to claim an elective share and a disclaimer of any property passing by reason of her interest in H's estate. Is the disclaimer qualified?

Ex-180: D's will contains a pecuniary bequest to a credit shelter trust and a residuary bequest to a QTIP trust. His will also directs that any portion of the QTIP trust disclaimed by W shall pass instead to the credit shelter trust. W dies two months after D and her personal representative files a disclaimer of 30 percent of W's interest in the QTIP trust. Is the disclaimer qualified?

Ex-181: D dies with a will containing a $100,000 bequest to child, C. After D's death, C makes a qualified disclaimer of her interest in D's estate. Under local law, C is treated as having predeceased D with the result that the $100,000 bequest passes to C's child, GC. Is the transfer from D to GC a direct skip under the GST tax?

Ex-182: D dies with a will which makes cash bequests to a number of legatees. Estate taxes at D’s death would be reduced if the legatees disclaimed and a greater portion of the estate passed to D’s spouse S.

1. If S enters into an enforceable agreement with the legatees under which the legatees disclaim in return for a promise of future lifetime or testamentary gifts from S, will the disclaimer be a qualified one?

2. Would the answer change if S merely implies through unenforceable hints and innuendoes that future compensating gifts or devises will be made?

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[780] See Treas. Regs. § 25.2518-2(c)(5), Example 10.

b) Requirements of a partial disclaimer

A person making a disclaimer need not disclaim all of the property interests left to him or her.

- A disclaimer of a partial interest, including one made in the form of a formula, will be recognized provided the disclaimer consists of a fraction or percentage of each and every substantial interest or right, and it extends over the entire term of the disclaimant's interest.[781]
- Thus, a partial disclaimer by a surviving spouse of his or her interest in a Marital Trust can serve as a useful alternative or adjunct to partial QTIP elections.

CAUTION

It is also possible to disclaim a pecuniary amount.[782] However, to the extent the effect of the disclaimer is to split a trust into two parts or to add property from one trust to another, it is questionable whether the pecuniary disclaimer will result in separate trusts for GST exemption allocation purposes.[783]

- With a disclaimer, both the decision to disclaim, and the decision to disclaim a pecuniary amount -- as opposed to specific property or a fractional amount -- are inherently discretionary.
- However, for a pecuniary split to be recognized under the GST tax, either the split itself or the pecuniary methodology must be required by the governing instrument.

The rules for when a split of a trust will be recognized for GST tax purposes are set out in the form of a graphical decision tree in Appendix A-1, infra p. 279.

2. Drafting in anticipation of qualified disclaimers

A number of postmortem decisions can affect the ultimate tax consequences of a marital plan. Among these is the possibility that the surviving spouse or other beneficiary might make a qualified disclaimer of his or her interest.[784] Proper drafting can extend and facilitate the effective use of disclaimers.

a) Extending the QTIP disclaimer period

One of the requirements for a qualified disclaimer is that it be made no later than nine months after the date on which the transfer creating the interest occurred.[785]

1. For this purpose, interests passing as a result of an exercise, release or lapse of a general testamentary power of appointment are treated as created at the time of the exercise, release or lapse of the power.[786] Hence, the remainder beneficiaries of

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781 Treas. Regs. § 25.2518-3(b).

782 The disclaimer will be recognized provided the assets used to make up the pecuniary amount are segregated from other assets on the basis of their value as of the date of the disclaimer or on a basis that is fairly representative of the changes in value that have occurred between the date of the decedent's death and the date of the disclaimer. Treas. Regs. § 25.2518-3(c).

783 For rulings where the Service has indicated that splits occurring by way of disclaimer will be subject to the requirements for splits under the GST tax, see PLR 9323027; PLR 9236018.

784 The detailed requirements for and the creative use of qualified disclaimers have been discussed at other recent Heckerling Institutes. See Coleman, Disclaimers – New Developments, Opportunities and Unsettled Areas, U. Miami, 33rd Inst. Est. Plan., Ch. 16 (1999); Hart, Advanced Issues in Disclaimer Planning: Sharpening an Old Tool, U. Miami, 28th Inst. Est. Plan., Ch. 14 (1994).

785 Or, in the case of a disclaimant who is under the age of 21, within nine months of his attaining that age, if later. See IRC § 2518(b)(2).

786 See Treas. Regs. § 25.2518-2(c)(3)(i). See also Treas. Regs. § 25.2518-2(c)(5), Ex. (1) and (2).

an IRC § 2056(b)(5) trust can disclaim their interests within nine months of the death of the surviving spouse.

2. The same is not true, however of the remainder beneficiaries of a standard QTIP trust. The nine month period in which they must disclaim runs from the date of the creation of the QTIP trust, not from the date of the surviving spouse's death.[787]

- To remedy this, a spouse of a QTIP trust can be given a general testamentary power to appoint the QTIP property, typically, to creditors of the spouse's estate.
- If desired, the spouse's power can be limited to appointing to the creditors of his or her estate.

COMMENTS
The power should apply only to the portion of the QTIP trust that qualifies for the marital deduction. And, for clients where the GST tax is an issue, the power should be restricted to the nonexempt portion of the QTIP trust.

b) Other disclaimer drafting considerations

Disclaimers involve drafting considerations in two distinct ways.

1. In anticipation of a disclaimer by his or her spouse, the decedent's instrument should state where disclaimed marital property is to go. Possibilities include creating a separate disclaimer trust to hold disclaimed property or adding the disclaimed property to the Family Trust.
   - In either case, if the spouse is to be given a power of appointment over the trust, the power must be limited by an ascertainable standard.
   - Likewise, if the spouse is to serve as trustee, the trustee's discretionary powers to make distributions must be limited by an ascertainable standard.[788]
2. The decedent's instrument should also anticipate the possibility that the spouse will die first and that it will be the decedent who is making the disclaimer. In anticipation of that, the decedent's instrument should:
   - Authorize disclaimers by the decedent's personal representative (and trustees).[789] The authorization should cover disclaimers of powers as well as of interests in property;[790] and
   - Negate any compensating adjustments or claims for reimbursement on the part of beneficiaries whose shares might be reduced or eliminated by the actions of a personal representative or trustee.

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[787] See generally Treas. Regs. § 25.2518-2(c)(3).

[788] The disclaimed property must pass without direction on the part of the disclaimant. Thus, if the disclaimed property passes in trust, the disclaimant may not have a power of appointment (as trustee or otherwise) over the disclaimed property. An exception applies to powers limited by an ascertainable standard. See Treas. Regs. §§ 25.2518-2(e)(1) and (5), Examples 4 - 6.

[789] This suggestion assumes that disclaimers by personal representatives of deceased spouses are permissible under applicable state law. See e.g., U.P.C. § 2-801(a) (1993); Accord Fla. Stat. § 732.801(2)(b) (2015).

[790] A disclaimer by a fiduciary of either a fiduciary power or of property passing to a trust may or may not be recognized for tax purposes, depending on a number of factors one of which is whether fiduciary disclaimers are authorized under applicable state law and/or the terms of the governing instrument. See Coleman, Disclaimers – New Developments, Opportunities and Unsettled Areas, supra note 784 at ¶¶ 1602 – 03.

C. SUBCHAPTER S CORPORATIONS

Stock in a Sub S corporation is a "hot asset" in that improper handling of the stock can result in an inadvertent termination of the corporation's Sub S status. There are two primary areas of concern — that the stock would pass to an ineligible shareholder or that it would pass to an ineligible number of shareholders.

COMMENT
An inadvertent termination of Sub S status may be cured with the consent of the Secretary if within a reasonable time after the discovery of the termination the corporation and its shareholders take appropriate remedial actions.[791]

1. Eligible shareholders

The death of a shareholder does not affect a Subchapter S election previously made. The estate may continue as a shareholder throughout its administration. Ultimately, however, the stock must be distributed to one or more eligible Sub S shareholders.

Small Business Job Protection Act of 1996

Distributions to a trust present special concerns because not all trusts are eligible Sub S shareholders (see below). Fortunately, for any taxable year beginning after 1996, the SBJPA increases the period of time following the grantor's death during which a trust holding Sub S stock must become an eligible S corporation shareholder. The increased period is 2 years, measured from:

- The date the stock is distributed to the trust in the case of a testamentary trust;[792] or
- The date of the grantor's death in the case of other trusts (e.g., a trust created before the grantor's death).[793]

Caution: It would appear that the latter rule applies to a devise of Sub S stock to a grantor's revocable inter vivos trust.

a) Individuals

Individuals are eligible shareholders only if they are a U.S. citizen, a resident alien, or a nonresident alien spouse of a U.S. citizen Sub S shareholder who is treated as a resident alien by virtue of an IRC § 6013(g) election to file a joint income tax return.[794]

b) Certain tax exempt entities

Effective for taxable years beginning after 1996, eligible Sub S shareholders include qualified retirement plans exempt from taxation under IRC § 401(a) and charitable organizations exempt from taxation under IRC § 501(a).[795]

COMMENT
When Sub S stock is held by a tax exempt entity, the entity's share of income or loss, as well as any gain or loss on the sale or other disposition of S corporation stock by the entity, is classified as unrelated business taxable income.[796]

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791 See IRC § 1362(f).

792 IRC § 1361(c)(2)(A)(iii). The period is only 60 days for taxable years beginning before 1997.

793 IRC § 1361(c)(2)(A)(ii). See also Prop. Regs. § 1.1361-1.

794 Treas. Regs. 1.1361-1(f); (g).

795 IRC §§ 1361(b)(1)(B); 1361(c)(7)(A). For the rules on how contributions of Sub S stock to charity are treated under the valuation reduction of IRC § 170(e), see IRC § 170(e)(1).

c) Grantor and controlled trusts

A grantor or controlled trust[797] is an eligible Sub S shareholder if:

1. The trust is a grantor or controlled trust with respect to all of its accounting and corpus income; and
2. The owner of the trust under the grantor trust rules is a citizen or resident of the United States.

> ***Ex-183:*** D creates a discretionary trust with a Crummey withdrawal power for his daughter, M. The trustee of the trust has discretion to distribute trust income or principal to M. Is this trust an eligible S corporation shareholder?

> ***Ex-184:*** D transfers S corporation stock to a wholly owned grantor trust created for the purpose of holding the stock. Subsequently D dies and the grantor trust status of the trust terminates. How long may the trust continue as an eligible S corporation shareholder?

d) Qualified subchapter S trusts

A qualified subchapter S trust (QSST) is an eligible Sub S shareholder. A QSST is a trust that meets the following requirements:

1. During the life of the current income beneficiary, there must be only one[798] U.S. citizen or resident income beneficiary.[799]
2. The beneficiary must be entitled to all trust accounting income currently;[800]

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796 See generally, IRC §§ 512(e)(1)(A) and (B). See also IRC § 512(e)(2) which classifies a portion of the gain on the sale of C corporation stock by a tax exempt entity as unrelated business taxable income if the C corporation had previously been an S corporation.

797 Certain voting trusts created by one or more persons are also eligible S corporation shareholders provided that all beneficial owners of the trust are treated as the owners of their respective share of the trust under the grantor trust rules. See IRC § 1361(c)(2)(A)(iv); Treas. Regs. § 1.1361-1(h)(2)(v).

For recent private rulings holding that grantor trusts may hold Subchapter S stock, see PLR 9543050 (IRC § 674(a) sprinkle power held by nonadverse trustee); PLR 9037011; PLR 9248016 (IRC § 675 power to substitute property of equal value), PLR 9446008 (IRC § 675(2) power to borrow trust property without adequate interest or security); PLR 9035017 (GRIT), PLR 9525032; PLR 9416009; PLR 9415012; PLR 9152034 (GRAT), and PLR 9232013 (IRC § 678 trust with Crummey withdrawal power). But see Rev. Rul. 92-48, 1992-1 C.B. 301 (charitable remainder trusts cannot hold Sub S stock because they are taxable under IRC § 664, not IRC § 678 and Rev. Rul. 92-73, 1992-2 C.B. 224 (an individual retirement account may not be a Sub S shareholder).

798 A married couple is treated as one beneficiary if both are citizens or resident aliens and they file a joint income tax return. Treas. Regs. § 1.1361-1(j)(2)(i).

799 IRC § 1361(d)(3)(A); Treas. Regs. § 1.1361-1(j)(1)(i). Local law or the governing instrument must prohibit distributions to anyone other than the one income beneficiary. Treas. Regs. 1.1361-1(j)(1)(ii); 1.1361-1(j)(1)(iii). In this regard, a distribution of trust income in satisfaction of the grantor's obligation to support the income beneficiary is a distribution to the grantor which will terminate the QSST status of the trust. Treas. Regs. § 1.1361-1(j)(2)(i)(B). See also Treas. Regs. § 1.1361-1(j)(2)(ii)(C).

800 IRC § 1361(d)(3)(B). Absent a contrary provision under local law or the governing instrument, trust income includes distributions from the S corporation but excludes the trust's share of undistributed S corporation income, loss, deduction or credit. Treas. Regs. § 1.1361-1(j)(1)(i). See also PLR 9349009 (proceeds of pro rata redemption of Sub S stock, although a dividend for tax purposes, are corpus for fiduciary accounting purposes and need not be distributed to current income beneficiary of QSST).

3. The trust must preclude corpus distributions to persons other than the beneficiary;[801]
4. The current beneficiary's income interest must terminate on the earlier of the beneficiary's death or the termination of the trust;[802]
5. Upon termination during the life of the current income beneficiary, all trust assets must be distributed to that beneficiary;[803] and
6. An election pursuant to IRC § 1361(d)(2) must be made.[804]

COMMENT
A QSST may be either an inter vivos or a testamentary trust. In either case, the beneficiary of the QSST is an owner for purposes of IRC § 678(a) of that portion of the trust consisting of Subchapter S stock.[805] Accordingly, the beneficiary is taxable on the income whether or not it is distributed.

Ex-185: D transfers S corporation stock to a QSST trust. Subsequently the trust sells the stock at a gain. Is the gain taxable to D or the trust?

e) Electing Small Business Trust

Under the SBJPA of 1996, an electing small business trust (ESBT) may now be an eligible Sub S shareholder.[806]

(1) ESBT requirements

An ESBT is any trust (other than a QSST or a tax exempt trust)[807] that meets the following requirements:

- All trust beneficiaries must be individuals, estates or certain charitable organizations;[808]
- No trust interest may be acquired by purchase;[809] and
- The trust must affirmatively elect to be treated as an ESBT.[810]

A QSST may provide for the accumulation of income in the event it ceases to hold Sub S stock. Rev. Rul. 92-20, 1992-1 C.B. 301. Stub income at the death of the life tenant may be paid either to the beneficiary's estate or to the remainderman. Rev. Rul. 92-64, 1992-2 C.B. 94.

801 IRC § 1361(d)(3)(A)(ii).

802 IRC § 1361(d)(3)(A)(iii).

803 IRC § 1361(d)(3)(A)(iv).

804 IRC § 1361(d)(3). The QSST election is made by the income beneficiary of the trust. In general, the election must be made within a period of 2 months and 16 days after the earlier of the date the stock is transferred to the trust or the corporation's Sub S election. See generally, Treas. Regs. § 1.1361-1(j)(6). An inadvertent failure to make a timely QSST election may be remedied for two years by following the method detailed in Rev. Rul. 94-23, 1994-1 C.B. 609.

805 IRC § 1361(d)(1)(B).

806 IRC § 1361(c)(2)(A)(v). The Service has issued final regulations covering the taxation of ESBTs. See Treas. Regs. §§ 1.444-4; 1.641(c)-1; 1.1361-1(j)(12)1.1361-1(m), 67 Fed. Reg. 34388 (May 14, 2002).

807 See IRC §§ 1361(e)(1)(B)(i) and (ii).

808 IRC § 1361(e)(1)(A)(i). Eligible charitable organizations are those described in IRC §§ 170(c)(2) - (5). Until January 1, 1988, eligible charitable organizations may only have contingent interests in an ESBT.

809 IRC § 1361(e)(1)(A)(ii). This does not preclude the trust itself from purchasing Sub S stock.

(2) Taxation of ESBTs

The portion of an ESBT that consists of Sub S stock is treated as a separate share for income tax purposes.[811]

(a) The income from that share (the trust's allocable share of S corporation income, gain, etc) is taxed at the highest individual rate (currently 39.6% for ordinary income and 28% for capital gains).[812]

(b) Income, losses, deductions and credits of the Sub S portion of the trust are limited to:[813]

- The trust's allocable share of Sub S income, gain, loss and deduction;[814]
- Gains and losses from the sale of Sub S stock; and
- To the extent provided in regulations, state or local income taxes and administration expenses property allocable to the Sub S stock.

(c) Excess deductions and loss carryovers at the termination of all or any portion of the ESBT are taken into account by the entire trust in according to the usual rules of IRC § 642(h).

Ex-186: D's will leaves S corporation stock to a QTIP trust for the benefit of D's U.S. citizen spouse.

1. If D's spouse makes a QSST election, will the trust qualify as a QSST?

2. Would the answer change if the trust D created was an inter vivos trust?

2. Maximum number of shareholders

A Sub S corporation may have no more than 100 shareholders.[815] For this purpose:

- A husband and wife are treated as one shareholder if both are citizens or resident aliens.[816] So too are all members of a shareholder's family.[817]
- Stock owned by a grantor or IRC § 678 trust, including an electing qualified Subchapter S trust, is treated as being owned by the owner of the trust for income tax purposes.[818]

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810 The election, which may not be revoked without the consent of the of the Secretary of the Treasury or his delegate, is effective for the taxable year in which it is made and for all years thereafter. IRC § 1361(e)(3).

811 IRC §§ 641(d)(1)(A) and (B).

812 IRC § 641(d)(2)(A).

813 In determining the alternative minimum tax, the usual $22,500 exemption applicable to trusts is not available with respect to the Sub S portion of an ESBT. IRC § 55(d)(1)(C).

814 IRC § 641(d)(2)(C)(i).

815 IRC § 1361(b)(1)(A). For taxable years prior to 1997, the limit is 35.

816 IRC § 1361(c)(1). This rule extends to the estates of either or both spouses provided the estates are not foreign estates. Treas. Regs. § 1.1361-1(e)(2). See also Treas. Regs. § 1.1361-1(g), Example 2 indicating that a nonresident alien spouse may qualify as a Sub S shareholder if an election is made under IRC § 6013(g) to file a joint return with a U.S. citizen spouse.

817 IRC § 1361(c)(1)(A)(ii).

- Stock owned by an electing small business trust is deemed owned by all persons who are entitled to, or who could in the discretion of any person receive, current distributions of principal or income.[819]

Comment
In general, all Sub S shareholders must consent to an election to be treated as a Sub S corporation. However, even though all potential current beneficiaries of an ESBT count against the 100 shareholder limit, Notice 97-12[820] indicates that only the trustee need consent to the Sub S election itself.

D. PLANNING FOR CLOSELY HELD BUSINESS INTERESTS

The Code contains several special provisions for estates consisting in significant part of an interest in a closely held business. IRC § 2032A permitting special use valuation for business interests is discussed in "*Special use valuation*" on page 74. Here we consider two additional provisions:

- one which extends favorable tax treatment to redemptions of stock to pay taxes and expenses and
- a second which permits deferral and installment payment of taxes attributable to interests in closely held businesses.

1. Section 303 redemptions

Under IRC § 303 a redemption of stock included in a decedent's gross estate[821] is a sale or exchange to the extent that the amount received on redemption does not exceed death taxes (federal or state), including the deferred estate tax on QDOT property, GST taxes for transfers occurring as a result of death, and deductible funeral and administration expenses, provided:

a) value of the stock included in decedent's gross estate[822] (or in the case the QDOT tax, in the surviving spouse's gross estate) exceeds 35 percent of his adjusted gross estate;[823]

b) the person whose stock is redeemed is liable for the death taxes, funeral expenses or costs of administration;

c) if the redemption occurs more than 4 years after decedent's death, the amount received on the distribution is actually used to pay taxes, funeral expenses, or costs.

818 See Treas. Regs. 1.1361-1(h)(1)(i); 1.1361-1(h)(1)(iii)

819 An ESBT that can not make current distributions to anyone has no current beneficiaries. In that event, the trust itself is counted as a shareholder of the Sub S corporation. IRC § 1361(e)(2).

820 1997-3 I.R.B. 11

821 In PLR 9110052 the Service allowed IRC § 303 to be used to redeem stock received in a tax-free stock dividend after the death of the decedent.

822 In Rev. Rul. 87-132, 1987-2 C.B. 82 (1987), the Service ruled that IRC § 303 applied to the redemption of nonvoting common stock that had been distributed to the estate after the decedent's death in the form of a pro-rata stock dividend.

823 For purposes of this test, a decedent's gross estate is considered to include the value of any property the decedent transferred by gift within three years of death.

If decedent (or decedent and his spouse, jointly) own at least 20 percent of the value of two or more corporations, decedent's interest in those corporations may be aggregated for purposes of the 35-percent test.

2. Deferral and installment payment of taxes

Under IRC § 6166, payment of certain taxes attributable to a closely held business may be deferred for up to five years, paid in ten annual installments, or both.

Eligible taxes: Eligible taxes include estate taxes, QDOT taxes occurring at the death of the surviving spouse,[824] and GST taxes resulting from a direct skip of the business interest occurring at the same time as and as a result of the decedent's death.[825]

Qualification: To qualify, the value of the closely held business[826] included in decedent's gross estate (or in the case of the QDOT tax, in the surviving spouse's gross estate) must exceed 35 percent of his adjusted gross estate.[827]

COMMENT
IRC § 7479, created by the 1997 TRA, gives the Tax Court authority to provide declaratory relief on matters relating to the initial or continuing eligibility for deferral under IRC § 6166.

Interest: For decedents dying after 1997, interest at 2 percent is payable on the 2-percent portion of the extended taxes; interest at 45 percent of the rate applicable to tax underpayments in general is payable on the balance of the deferred tax. In either case, interest on taxes deferred under IRC § 6166 is no longer deductible for income or estate tax purposes. The 2-percent portion for decedents dying in 2015 is $1,470,000.

Acceleration: Acceleration occurs if one-half or more in value of decedent's interest is redeemed, sold, exchanged or otherwise disposed of, or if withdrawals of money and other property from the business equal or exceed one-half of its value. However, corporate reorganizations and tax free exchanges are not considered dispositions. And redemptions qualifying under IRC § 303 are not withdrawals provided an amount equal to the redemption distribution is paid on the balance of the estate tax within a year of the redemption.[828]

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[824] See IRC § 2056A(b)(10)(A) and (B).

[825] See IRC § 6166(i).

[826] A closely held business is a sole proprietorship, or a partnership if the gross estate includes 20 percent of the total capital interest of the partnership or there are fewer than 46 partners, or a corporation if the gross estate includes 20 percent of the value of the voting stock or there are fewer than 46 shareholders. The term also encompasses actively managed real estate enterprises. See Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (June 26, 2006). See also Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-367, 1975-2 C.B. 472.; See also PLR 9602017; PLR 9634006; TAM 9635004.

[827] For purposes of this test, a decedent's gross estate is considered to include the value of any property the decedent transferred by gift within three years of death.

If decedent (or decedent and his spouse, jointly) own at least 20 percent of the value of two or more corporations, decedent's interest in those corporations may be aggregated for purposes of the 35-percent test.

[828] On this, see Rev. Rul. 86-54, 1986-1 C.B. 356 (1986).

Ex-187: D's estate includes an interest in a closely held business for which an IRC § 6166 election is made to defer taxes. Under D's estate plan, the residue of her estate is left half to her husband H and half to Charity. If local law provides that interest paid on the taxes deferred under IRC § 6166 is to be paid from the residue of the estate, must the estate reduce the value of the residue for purposes of determining the marital and charitable deductions available to D?

E. PLANNING FOR DISTRIBUTIONS FROM IRAS

Typically an IRA is a trust or custodial account created by an individual at a bank or other eligible financial institution and into which the individual makes contributions which are then invested on behalf of the contributor.[829] With the exception of "rollover contributions," all contributions must be made in cash[830] and must be made with respect to[831] a year prior to the year in which the IRA owner turns 70½.

In general, except for certain tax-free rollovers, the taxable component[832] of a distribution from an IRA is taxable as ordinary income. And this is true whether the distribution is made to the participant during life or it is made to some other beneficiary after the participant's death.

CAUTION
During the participant's life, if a participant has more than one IRA, these principles are applied in the aggregate. Accordingly, the existence of nondeductible contributions in one IRA will affect the taxation of distributions from all of the taxpayer's IRAs.

In the period between when a participant turns 59½ and the time the participant turns 70½, distributions from an IRA may be made in any amount and the only tax consequences will be the tax on the taxable component discussed above. However, the Code imposes an additional excise tax on most distributions that occur before the participant turns 59½.[833]

Exceptions:

The additional tax does not apply to:

- Distributions after the death or disability of the participant;[834]
- A periodic distribution.[835]
- Distributions to pay qualified higher education expenses.[836]

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[829] Within limits, contributions to a traditional IRA are deductible by the contributor. Thereafter, the contributions accumulate tax free as long as they remain in the IRA.

[830] See IRC § 219(e)1). See also Treas. Regs. § 1.219-1(a); Prop. Regs. § 1.219(a)-2(a).

[831] A contribution for a particular year may be made after the close of the year if it is labeled as being made on account of the prior year and it is made before the due date (excluding extensions) of the IRA owner's income tax return for the year for which the contribution is to be made. IRC § 219(f)(3).

[832] Usually, the taxable component will equal the full amount of the distribution. However, if the IRA owner has made nondeductible contributions, the distribution will be taxed under the rules applicable to annuities with the owner's nondeductible contributions being treated as an investment in the annuity contract. Accordingly, a portion of each distribution will be characterized as a nontaxable return of basis.

[833] IRC § 72(t)(1). The tax is imposed on the taxable component of the distribution. Accordingly it does not apply to any portion is that is a nontaxable return of nondeductible contributions.

[834] IRC §§ 72(t)(2)(A)(ii) and (iii).

[835] A periodic distribution is a distribution that is part of a series of substantially equal periodic (annually or more frequently) payments for the life (or life expectancy) of the participant or for the joint lives (or joint life expectancy) of the participant and the participant's designated beneficiary. IRC § 72(t)(2)(A)(iv).

- Qualified first-time homebuyer distributions.[837]

In addition, once a participant reaches his or her required beginning date (see below), the Code requires that a minimum annual distribution be made from an IRA. An additional excise tax is imposed for any year in which the actual distributions do not equal or exceed the required minimum. The tax is punitive. It is equal to 50 percent of the excess of the minimum over the amounts actually distributed.

1. Key concepts

Beginning in 1987, the MRD rules were set out in a set of proposed regulations (hereinafter the 1987 regulations).[838] These regulations which were never finalized were notorious for their complexity. On January 11, 2001, the IRS promulgated a new set of proposed regulations (hereinafter the proposed regulations) dealing with the subject.[839] The effect of the proposed regulations was to greatly simplify, and in many cases liberalize, the minimum distribution rules. Finally, on April 16, 2002, the IRS issued final minimum distribution regulations (hereinafter the final regulations or the new regulations). The final regulations are effective January 1, 2003.[840]

a) Required beginning date

To avoid imposition of a penalty tax, a minimum distribution from an owner's IRA must be made each year, beginning with the year in which the owner attains age 70½. However, the distribution for that first year need not be made until April 1 of the following year. Thereafter, the required minimum distribution must be made by the end of the calendar year for which the distribution is required. Accordingly, the true date at which distributions must commence – referred to as the "required beginning date" (RBD) – is April 1 of the year following the year in which the owner turns 70½.[841]

COMMENT
As will be seen, the amount of the MRD will be a function in part of the owner's age on his or her birthday for the distribution year. Note, that this can be either 70 or 71 for the first year. That is, if the owner's birthday occurs in the first half of the calendar year, the owner will attain 70½ in the same calendar year in which he attains age 70. If, however, the owner's birthday occurs in the second half of the calendar year, he will not attain 70½ until the year in which he attains age 71.

836 Generally, qualified higher education expenses include tuition, room, board, fees, books, supplies, and equipment for the enrollment or attendance of the IRA owner, his spouse or the children and grandchildren of either at an institution of higher learning. See IRC § 72(t)(2)(E).

837 Essentially, distributions up to $10,000 over the lifetime of the IRA owner to pay the costs of acquiring, constructing, or reconstructing a personal residence for an IRA owner who qualifies as a “first-time homebuyer.” See IRC § 72(t)(2)(F).

838 See 52 Fed. Reg. 28075 *et seq.* (1987).

839 See Prop. Regs. §§ 1.401(a)(9)-0 through 1.401(a)(9)-8; 1.403(b)-2; 1.408-8; 54.4974-2. Subsequently issued corrections to these proposed regulations were published in 66 Fed. Reg. 10981 (Feb. 21, 2001).

840 MRDs are determined under the new final regulations for all years after 2002 even if the IRA owner died prior to 2003. Treas. Regs. § 1.401(a)(9)-1, A-2(b)(1). MRDs from IRAs for the 2001 calendar year may be calculated using either the 1987 regulations or the proposed regulations. MRDs from IRAs for 2002 may be calculated using either the proposed regulations or the new final regulations.

841 See IRC § 401(a)(9)(A) and (C).

2006 PENSION PROTECTION ACT
For taxable years beginning in 2006 or 2007, an IRA participant who has actually attained age 70½ may distribute up to $100,000 annually from a regular or Roth IRA directly to a public charity without having to take the distribution into taxable income. In the case of a regular IRA, the distribution counts as part of the participant's required minimum distribution.

b) Beneficiaries: "designated" and otherwise

After an IRA owner dies, the remaining account balance will be distributed in one or more installments to one or more beneficiaries as selected by the owner or as a consequence of a failure to select. In either case, the recipient beneficiary or beneficiaries could include an individual such as the owner's spouse or other family member, a charity, a trust, or even the estate of the owner.

(1) "Designated beneficiary"

Beneficiary as used in the preceding paragraph is to be contrasted with the concept of a "designated beneficiary." A designated beneficiary is a term of art which is used to refer to the person, if any, whose life expectancy is used to calculate the MRDs for an IRA. Because the designated beneficiary must have a life expectancy, only individuals can qualify. Thus, if the owner names a charity or his or her estate as the beneficiary, there will be no "designated beneficiary" for the IRA.[842]

COMMENT
The same can also be the case when a trust is the named beneficiary of an IRA. With a trust, however, it may be possible to ignore the trust itself and to treat the trust beneficiaries as the designated beneficiaries of the IRA. This possibility is explored more fully in "*The look-through rule"*, supra p. 258.

(2) Multiple beneficiaries

An IRA owner is not restricted to naming a single beneficiary; multiple beneficiaries — including those designated by class description — are permissible.[843] Where multiple beneficiaries (by class or otherwise) are named:

- One bad apple spoils the entire barrel. That is, all of the beneficiaries must be individuals; otherwise the distribution rules apply as if there is no designated beneficiary.
- Assuming that all of the named beneficiaries are individuals – the beneficiary with the shortest life expectancy is used to determine minimum distributions.

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842 Treas. Regs. § 1.401(a)(9)-4, A-3.

843 See Treas. Regs. § 1.401(a)(9)-4, A-1. It must be possible to identify the class member with the shortest life expectancy as of the date on which the designated beneficiaries are to be determined. For more on when that date is, see "*When are designated beneficiaries determined*", infra p. 261.

COMMENT
There is an exception for separate accounts. If separate accounts are established, each account will be judged separately.[844] That is, a separate account for which an individual is the named beneficiary will have a designated beneficiary even though other separate accounts do not.

(3) When are designated beneficiaries determined

To be a designated beneficiary, an individual must be a beneficiary as of the date of the owner's death. In addition, the individual must remain a beneficiary and be identifiable as such[845] on September 30 of the calendar year following the calendar year of the owner's death. It is that date (hereinafter the DB determination date) at which the designated beneficiary or beneficiaries are finally determined from the class of eligible persons (i.e., those who were beneficiaries as of the owner's death). Thus, a person is not taken into account in determining the owner's designated beneficiary or beneficiaries if, although the person was a beneficiary at the date of the owner's death, the person is no longer a beneficiary – for example, because of a qualified disclaimer – as of the DB determination date.[846]

c) Life expectancy methodologies

As will be illustrated shortly, to calculate the MRD for any given year you must divide the balance in the IRA account as of the end of the preceding year[847] by the "applicable distribution period."[848] In those cases where the is a designated beneficiary, the applicable distribution period will be based on a life expectancy factor derived from one of three tables. The process for determining the appropriate life expectancy can take either of two forms.

(1) Fixed term methodology

Where a life expectancy is to be determined on a fixed-term basis, Table V of Reg. § 1.72-9 (see Appendix D, infra p. 286) is used to determine an initial life expectancy factor; thereafter the factor is reduced by 1 for each year after the year of the initial determination.

COMMENT
In general, the fixed-term methodology is used to calculate required minimum distributions after the owner's death when the owner's spouse is not the sole designated beneficiary. It is an unavoidable consequence of using this method that distributions from an IRA will cease before the beneficiary's death if the beneficiary survives his or her actuarial life expectancy.

(2) Recalculation methodology

The process of determining a recalculated life expectancy begins the same way. That is, an initial life expectancy factor is determined from a table. However, that

844 See generally, Treas. Regs. § 1.401(a)(9)-8, A-2 and A-3.

845 Where beneficiaries are described as a class, this requirement is satisfied if it is possible, as of the DB determination date, to identify the class member with the shortest life expectancy. Treas. Regs. § 1.401(a)(9)-4, A-1.

846 Treas. Regs. § 1.401(a)(9)-4, A-4(a).

847 See Treas. Regs. § 1.401(a)(9)-5, A-3.

848 See Treas. Regs. § 1.401(a)(9)-5, A-1.

factor is not reduced by 1 each year. Rather, in subsequent years the life expectancy of the reference person or persons (now a year older) is recalculated by once again looking it up in the appropriate table.

> **COMMENT**
>
> In general, the recalculation methodology is used to calculate required minimum distributions during the owner's life as well as after the owner's death when the sole designated beneficiary is the owner's spouse. The methodology, when available, is advantageous because it insures that distributions will continue no matter how long the owner (or the owner's spouse) lives.[849]

2. Distributions during the owner's life

Minimum distributions from an IRA must begin once the owner reaches his or her required beginning date. The required distribution for any particular year is equal to the balance in the IRA at the close of the preceding year divided by a life expectancy factor referred to as the divisor.

a) The new uniform distribution table

With one exception noted below, during the owner's lifetime, the existence and/or identity of a designated beneficiary is irrelevant to the calculation of minimum required distributions. Instead, the divisor is determined by looking up the factor in the Uniform Lifetime Table (hereinafter sometimes the "ULT") shown below.[850] The factor used is the one that corresponds to the IRA owner's attained age as of his or her birthday in the year for which the MRD is being determined.

[849] Under the 1987 regulations, the recalculation methodology was elective. Under the new regulations, it is automatic. Indeed, the new regulations do not speak of "recalculation" per se. Instead, when the effect of a recalculated methodology is allowed, the regulations speak of a life expectancy based on the "attained age" of the owner, the owner's spouse, or both together.

[850] See Treas. Regs. § 1.401(a)(9)-5, A-4. See also Treas. Regs. § 1.401(a)(9)-9, A-2. The Uniform Lifetime Table is also reproduced in Appendix A, p. 298.

Uniform Lifetime Table

Age	Divisor	Percentage	Age	Divisor	Percentage
70	27.4	3.65%	93	9.6	10.42%
71	26.5	3.77%	94	9.1	10.99%
72	25.6	3.91%	95	8.6	11.63%
73	24.7	4.05%	96	8.1	12.35%
74	23.8	4.20%	97	7.6	13.16%
75	22.9	4.37%	98	7.1	14.08%
76	22.0	4.55%	99	6.7	14.93%
77	21.2	4.72%	100	6.3	15.87%
78	20.3	4.93%	101	5.9	16.95%
79	19.5	5.13%	102	5.5	18.18%
80	18.7	5.35%	103	5.2	19.23%
81	17.9	5.59%	104	4.9	20.41%
82	17.1	5.85%	105	4.5	22.22%
83	16.3	6.13%	106	4.2	23.81%
84	15.5	6.45%	107	3.9	25.64%
85	14.8	6.76%	108	3.7	27.03%
86	14.1	7.09%	109	3.4	29.41%
87	13.4	7.46%	110	3.1	32.26%
88	12.7	7.87%	111	2.9	34.48%
89	12.0	8.33%	112	2.6	38.46%
90	11.4	8.77%	113	2.4	41.67%
91	10.8	9.26%	114	2.1	47.62%
92	10.2	9.80%	115+	1.9	52.63%

COMMENT

The factors set out in the Uniform Lifetime Table are based on the recalculated joint and survivor life expectancy of a person the owner's age and another hypothetical beneficiary who is 10 years younger.

Ex-188: T turned 70½ in August of 2001. As of December 31, 2002, T's balance in his IRA is $1,000,000.

1. Under the new regulations, what is T's MRD for 2003?

2. What is the divisor that will be used to calculate the MRD for year 2004?

3. Would the answer to the preceding two questions change if T turned 70½ in February of 2002 instead of August?

b) Exception for much younger spouse

The noted exception occurs when T's sole designated beneficiary is his spouse and the spouse is more than 10 years younger than T. In that case, in lieu of the divisor under the Uniform Lifetime Table, T may calculate the MRD using the joint life expectancy of his and his spouse's attained ages for the distribution year.[851]

[851] Treas. Regs. § 1.401(a)(9)-5, A-4(b)(1).

- The joint life expectancy is obtained from the Joint and Last Survivor Table in Treas. Regs. § 1.401(a)(9)-9, A-3 (see Appendix E, infra p. 287) using the attained ages of T and his spouse on their respective birthdays for the year the MRD is being calculated.
- T's spouse is the "sole designated beneficiary" if she is the sole beneficiary of T's entire interest at all times during the distribution year.[852] This determination is made on a year-by-year basis. Thus, eligibility to use this methodology will cease if the much younger spouse dies or if the couple divorce. This happens, however, only for calendar years following the year of the divorce or the spouse's death.

COMMENT
On the applicability of this rule when IRA distributions are made to a trust for the benefit of the owner's spouse, see "*Conduit trusts*" infra. p. 265.

Ex-189: T who turns 70½ in January of 2003 is married to S who turns 59 in February of the same year.

1. What is the divisor that should be used to calculate the MRD for 2003?

2. Assuming that S is the sole designated beneficiary of T's entire IRA account at all times during 2004, what is the divisor for that year?

3. Suppose in the second question that S began the year 2004 as T's sole designated beneficiary but she died (or T and S were divorced) prior to the end of the year. May T still use the Joint and Last Survivor Table to determine the divisor for 2004?

4. Would it matter in the third question that T designated his child as beneficiary of his IRA shortly after S death (or the divorce) and prior to the end of 2004?

3. Distributions after the owner's death

Under the 1987 regulations, an owner's designated beneficiary was written in stone at the earlier of the owner's RBD or the owner's death. Under the new regulations, however, an owner's beneficiary or beneficiaries are not finalized until the DB determination date. As has been mentioned previously, this is September 30th of the calendar year following the year in which the owner dies.[853] In the material that follows, however, the assumption is

852 Treas. Regs. § 1.401(a)(9)-5, A-4(b).

853 See Treas. Regs. § 1.401(a)(9)-4, A-4(a).

made that the DB determination date has been reached and the designated beneficiary or beneficiaries, if any, have been determined.[854]

COMMENT
If the owner's death occurs after his RBD, the minimum distribution for the year of the owner's death is determined using the same approach that the owner was using prior to death (e.g., normally by resort to the Uniform Lifetime Table).[855]

a) If there is no designated beneficiary

If there is no designated beneficiary as of the DB determination date, the applicable rule for determining the MRD from that point forward will depend on whether the owner died before or after his required beginning date.

(1) Owner dies before the RBD

Where the owner's death occurs before the RBD (that is, before April 1 of the year following the year in which the owner turns 70½), the entire balance in the owner's IRA account must be distributed by the end of the fifth calendar year following the year of the owner's death.[856]

COMMENT
Note that this rule (hereinafter the 5-year rule) does not require ratable or even periodic distributions. The rule is met if the entire account is distributed in a single distribution on December 31st of the fifth calendar year.

(2) Owner dies on or after the RBD

If the owner dies on or after his or her RBD with no designated beneficiary as of the DB determination date, the owner's account must be distributed over a fixed-term life expectancy determined on the basis of the owner's age on his or her birthday for the year of death. The life expectancy is determined by using the Single Life Table found in Treas. Regs. § 1.401(a)(9)-9, A-1. (See Appendix D, infra p. 286.)[857]

Ex-190: T, whose birthday is in December, dies in June of 2003, at the age of 72.

1. Assuming the balance in T's IRA at the end of 2002 was $1,000,000, what is the MRD for the year of T's death.

2. Assuming T had no designated beneficiary, what is the divisor for determining the MRD for 2004?

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[854] The new final regulations apply in the determination of MRDs after January 1, 2002 even if the owner died prior to that date. Treas. Regs. § 1.401(a)(9)-1, A-2(b)(2). The planning significance of having a DB determination date that occurs after the owner's death is discussed in "*Post-mortem considerations*", infra p. 278.

[855] Treas. Regs. § 1.401(a)(9)-5, A-4(a).

[856] Treas. Regs. §§ 1.401(a)(9)-3, A-1 and A-2. See also Treas. Regs. § 1.401(a)(9)-3, A-4. Compare IRC § 401(a)(9)(B)(ii) stating that the owner's entire interest must be distributed within 5 years after the death of the owner.

[857] Treas. Regs. §§ 1.401(a)(9)-4, A-3(b); 1.401(a)(9)-5, A-5(a)(2).

3. What is the divisor for 2005?

b) Designated beneficiary other than owner's spouse

(1) Distributions during the designated beneficiary's life

Where there is a designated beneficiary other than the owner's spouse as of the DB determination date, the beneficiary must take required distributions beginning in the year after the owner's death over a period measured by the longer of:

- the beneficiary's fixed-term life expectancy based on the beneficiary's age on his or her birthday for the calendar year following the year of the owner's death; or
- the remaining fixed term life expectancy of the owner determined on the basis of the owner's age on his or her birthday for the year of death.

In both cases, the fixed term life expectancy is determined initially under the Single Life Table found in Treas. Regs. § 1.401(a)(9)-9, A-1 (See Appendix D, infra. p. 286.) and is then reduced by 1 for each year that has elapsed since the year for which the initial determination was made.[858]

(2) Distributions after the death of the designated beneficiary

What happens when the designated beneficiary dies? In the typical case where the IRA was being distributed over the beneficiary's fixed-term life expectancy, if the designated beneficiary survives that life expectancy, all of the owner's account will have already been distributed. Otherwise, there will be a remaining account balance at that time. Likewise, there could be a remaining account balance at the death of the designated beneficiary if distributions were being made over the owner's remaining fixed-term life expectancy. In both cases, however, this will not affect the distribution period. The remaining account balance must be distributed over the remaining term of the original designated beneficiary's (or owner's) fixed-term life expectancy.[859]

COMMENT
In the situations discussed above, may the designated beneficiary name a successor beneficiary to receive distributions in the event the designated beneficiary dies before the entire account has been distributed? The proposed regulations, specifically indicated the answer was yes.[860] But this statement was not included in the final regulations. Nevertheless, it seems likely that the answer remains the same.

Ex-191: T, a widower, dies in early 2003. T's child, C, is the sole designated beneficiary as of September 30, 2004. C was 45 as of his birthday in 2003.

1. What is the divisor for determining the MRD for the year of T's death?

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858 Treas. Regs. §§ 1.401(a)(9)-3, A-3(a); 1.401(a)(9)-5, A-5(a)(1); 1.401(a)(9)-5, A-5(c)(1). In lieu of this rule, if the owner died prior to his RBD, an IRA may either require use of the 5-year rule discussed in "*Owner dies before the RBD*", supra p. 265, even when there is a designated beneficiary, or the IRA could allow the beneficiary to elect to comply with the 5-year rule . See Treas. Regs. § 1.401(a)(9)-3, A-4 for additional details relating to these options.

859 Treas. Regs. §§ 1.401(a)(9)-5, A-7(c)(2).

860 See Prop. Regs. § 1.401(a)(9)-5, A-7(d), Example 1..

2. What is the divisor for determining the MRD for 2004?

3. What is the divisor for determining the MRD for the 2006?

4. If C dies in 2006, before the minimum distribution for the year is made, what will be the divisor for the MRD for 2006?

5. How about for 2007?

Ex-192: Suppose in the preceding example that T had named his mother M as the sole designated beneficiary. Suppose further that T and M turned age 60 and 81 respectively in early 2003. How do these additional facts affect your answers?

c) Sole designated beneficiary is owner's spouse

(1) Distributions during the spouse's life

Where the owner's spouse is the sole designated beneficiary as of the DB determination date, the remaining account balance must[861] be distributed over the spouse's remaining life expectancy.

The divisor is determined under the Single Life Table found in Treas. Regs. § 1.401(a)(9)-9, A-1 (Appendix B, infra p. 286) based on the spouse's attained age for the year in question. That is, the spouse's life expectancy is recalculated.[862]

Distributions must begin by the later of:

- The end of the calendar year after the year in which the owner died; or
- The end of the calendar year in which the deceased owner would have reach reached 70½.[863]

COMMENT
In practice, the opportunity to defer the beginning of distributions offered by the second option exists only if the owner dies before the end of the year in which he would have reached 69½. The first option will yield a later beginning date if the owner dies after that point.

[861] Here again, if the owner died prior to the RBD, distribution may be made using the 5-year rule instead of the rule described in the text associated with this note.

[862] See Treas. Regs. § 1.401(a)(9)-5, A-5(c)(2).

[863] Treas. Regs. §§ 1.401(a)(9)-3, A-3(b); 1.401(a)(9)-5, A-5(c)(2).

Ex-193: T dies on his 79th birthday in late 2003. His 73-year-old spouse S (whose birthday is the same day) is his sole designated beneficiary.

1. What is the divisor for determining the MRD for the year of T's death.

2. When must distributions to S begin and what is the divisor for determining the first distribution?

3. What is the divisor for determining the MRD for the following year?

4. How would the answers to questions 1 and 2 change if T and S were 69 and 63, respectively in 2003?

(2) Distributions after the death of the surviving spouse

In general, after the spouse's death (and beginning in the calendar year following the spouse's death), the remaining benefits in the owner's IRA must be distributed over the spouse's fixed-term life expectancy based on the spouse's age on the birthday that occurred in the calendar year of the spouse's death reduced by 1 for each year that has elapsed since that year.[864]

COMMENT

An exception applies if the owner dies before his RBD and the surviving spouse dies before distributions to her must begin.[865] In that event, the spouse becomes the new IRA owner.[866] Accordingly:

- If the spouse has a designated beneficiary as of the DB determination date with respect to her death, distributions will be determined using the beneficiary's fixed-term life expectancy as described in "*Designated beneficiary other than owner's spouse*", supra. p. 253. [867]
- Otherwise, the entire IRA account must be distributed in compliance with the 5-year rule. See "*Owner dies before the RBD*", supra p. 252.

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864 Treas. Regs. § 1.401(a)(9)-5, A-5(c)(2).

865 That is, the spouse dies before the later of the end of the calendar year following the year of the owner's death or the end of the year in which the owner would have turned 70½.

866 Treas. Regs. § 1.401(a)(9)-4, A-4(b).

867 See Treas. Regs. § 1.401(a)(9)-4, A-1 and A-2. This is true even if the surviving spouse remarries and designates her new husband as beneficiary. Treas. Regs. § 1.401(a)(9)-3, A-5 (final sentence).

Ex-194: T dies on his 79th birthday in late 2003. His 73-year-old spouse S (whose birthday is the same day as T's) is his sole designated beneficiary. If S dies six years after T (in 2009):

1. What is the divisor for determining the MRD for the year of S's death.

2. What is the divisor for determining the MRD for 2010?

3. What is the divisor for determining the MRD for 2011?

d) Spousal rollovers

Whether or not the owner dies before his or her required beginning date, if the owner's spouse is the sole designated beneficiary, the spouse may obtain a smaller MRD (that is a larger divisor) by rolling over the owner's IRA into her own IRA[868] or by treating the owner's IRA as her own.[869] This results in the following advantages:

- Distributions to the spouse need not begin until the spouse's RBD.
- At that point, distributions will be determined using the Uniform Lifetime Table instead of the spouse's recalculated life expectancy under the Single Life Table.
- The spouse can name a designated beneficiary so that distributions after the spouse's death will be made over the designated beneficiary's fixed-term life expectancy under the Single Life Table.[870]

(1) What may be rolled over

With some exceptions, a spouse may roll over (or treat as her own) any portion of the owner's IRA balance for which the owner's spouse is the designated beneficiary. For IRAs, the only major exceptions are:

(a) Rollover treatment is not available if a trust is the named beneficiary of an IRA unless the spouse has either the right to revoke the trust or to withdraw the entire IRA account balance. (See "*Loss of rollover option*", infra p. 263.)

(b) No portion of an IRA that is required to be distributed under the minimum distribution rules is eligible for rollover treatment. [871]

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868 See IRC § 408(d)(3).

869 See Treas. Regs. § 1.408-8, A-5(a). The election is made by the spouse making a contribution to the IRA or by failing to take a required distribution as IRA beneficiary, or by redesignating the IRA account as her own. Treas. Regs. § 1.408-8, A-5(b).

870 If there is no designated beneficiary as of the spouse's DB determination date, the spouse's IRA account must be distributed within 5 years of her death if the she died before her RBD or over her remaining fixed term life expectancy if she died after that date. See "*If there is no designated beneficiary*", supra p. 265.

871 Normally, the required minimum distribution for the year in which the rollover occurs and for all subsequent years is determined under IRC § 401(a)(9)(A) with the spouse as IRA owner. However, if the election is made in the year of the owner's death, the spouse takes any required distribution for that year as a designated beneficiary under IRC § 401(a)(9)(B). Of course, no such distribution would be required if the distribution for the year had already been taken by the owner prior to his death. See Treas. Regs. § 1.408-8, A-5(a).

(2) When to roll over

There is no time limit in which a spouse must make a decision to roll over (or to treat as her own) an owner's IRA balance. This may be done at any time after the owner's death.[872] The timing of the rollover decision, however, can be important. Generally, it is advisable to execute the rollover as soon as possible because the death of the surviving spouse before the rollover occurs will eliminate the option.

COMMENT
It is not necessary to wait until the DB determination date to do a rollover or to elect to treat the owner's IRA as that of the surviving spouse. If the spouse is the sole beneficiary as of the owner's death, the rollover or election may be done as soon as the required distribution for the year of the owner's death, if any, is made.

4. Naming a trust as IRA beneficiary

Other factors aside, it is usually preferable to name an individual as the beneficiary of an IRA. In some cases, however, other planning objectives dictate that a trust be named as beneficiary. For example, if IRA benefits constitute a large portion of an estate, it may be necessary to name a family trust as beneficiary to avoid wasting the owner's unified credit. Then too, in second marriage situations an owner may want to retain as much control over the IRA benefits as possible by naming a QTIP trust as beneficiary.

Naming any trust as an IRA beneficiary raises issues under the MRD rules. And naming a QTIP trust raises marital deduction issues as well as issues relating to the potential loss of distribution options that would otherwise be available with an outright designation of the spouse as beneficiary. These issues are examined in this section of the outline where the assumption is that it will be a QTIP trust that is the named beneficiary. Some of the same issues are present when a nonmarital trust is named as beneficiary.

a) Obtaining the marital deduction

Where a QTIP trust is named beneficiary of an IRA, special precautions are necessary to insure that the IRA benefits qualify for the marital deduction. To insure qualification:

1. The spouse must have the right each year to compel the QTIP trustee to withdraw all accounting income from the IRA and distribute it to him or her.[873]
2. A QTIP election must be made with respect to both the trust and the IRA itself.[874]

COMMENT
For additional factors that must be considered in states having the Prudent Investor Act and the Uniform Principal and Income Act with a power to adjust or a unitrust conversion authority, see Rev. Rul. 2006-26.[875]

[872] See Treas. Regs. § 1.408-8, A-5(a).

[873] Rev. Rul. 2000-2, 3 I.R.B. 305.

[874] That is, the IRA should be listed separately on schedule M.

[875] 2006-22 I.R.B. 939 (May 20, 2006)

b) Trusts and the minimum distribution rules

(1) The look-through rule

A trust cannot be a designated beneficiary; only individuals can.[876] Nevertheless, under the so called "look-through rule," when a trust is named as a beneficiary of an owner's IRA, it is possible to ignore the trust and to treat the trust beneficiaries as the designated beneficiaries.[877]

The look-through rule applies if:

(a) The trust is valid under state law (or would be but for the fact that there is no corpus);

(b) The trust is or will by its terms become irrevocable upon the death of the owner; [878]

(c) The trust beneficiaries who are beneficiaries with respect to the trust's interest in the IRA are identifiable from the trust instrument.

(d) Certain documentation requirements detailed in the regulations are complied with.[879]

If the look-through rule is not available, there is no designated beneficiary and the IRA account must be distributed within 5 years of the owner's death if the owner died before his RBD or over the owner's remaining fixed term life expectancy if he died after that date.

If the look-through rule is available, read on.

(2) Applying the look-through rule

If the look-through rule applies, the beneficiaries of the trust as of the DB determination date will be treated as designated beneficiaries of the IRA. In the usual case where there is more than one trust beneficiary, the beneficiary with the shortest life expectancy is used to determine required distributions.[880] This rule must be read, however, in conjunction with the more broadly applicable principal that in the absence of separate accounts, if any one or more of the beneficiaries as of the DB determination date is not an individual, distributions are determined as if there was no designated beneficiary.[881]

> ***Ex-195:*** D dies after his RBD. D's testamentary QTIP trust is the named beneficiary of D's IRA. The trust provides that all trust property is to be distributed outright at S's death in equal shares to D's three children, all of whom are younger than S. No other person has a beneficial interest in the trust. Under state law and the governing instrument, the portion of any required distribution that constitutes income is distributable annually to S; the portion that constitutes principal is retained in the trust. S has the power each year to compel the trustee to withdraw an amount equal to the income earned in the IRA

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876 Treas. Regs. § 1.401(a)(9)-4, A-5(a).

877 Treas. Regs. § 1.401(a)(9)-4, A-5(a).

878 A testamentary trust meets this requirement. See Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Examples 1 and 2.

879 Treas. Regs. § 1.401(a)(9)-4, A-5(b). For additional detail on the documentation requirements, see Treas. Regs. § 1.401(a)(9)-4, A-6.

880 See Treas. Regs. §§ 1.401(a)(9)-4, A-5(c); 1.401(a)(9)-5, A-7(a)(1).

881 Treas. Regs. § 1.401(a)(9)-4, A-3.

and to distribute the income to S. Assuming the documentation requirements of the look-through rule are met, how does the rule apply to these facts?

COMMENT
S's life expectancy is this example is determined using the Single Life Table. However, unlike the situation where the benefits are paid outright to S, S's life expectancy will be determined on a fixed-term (rather than a recalculated) basis. This restriction can be avoided by modifying the QTIP trust to qualify as a conduit trust. See ***Ex-196*** below and infra p. 265.

(3) The successor beneficiary exception

In general, in applying the look-through rule, all trust beneficiaries who could potentially share in the benefits of an IRA, whether their rights are vested or contingent, are treated as designated beneficiaries.[882] There is no de minimis rule. Nevertheless, a trust beneficiary is disregarded if the beneficiary can take a portion of the IRA benefits only as a successor in interest of another beneficiary after that beneficiary's death.[883] For convenience, we will refer to this as the "Successor Beneficiary" exception. Its application is illustrated in the following example which appears in the final regulations.

Ex-196: Same facts as the preceding example except that the trust provides that all amounts distributed from D's IRA during S's life are to be paid directly to S. D is survived by S and by the three children. Assuming the documentation requirements of the look-through rule are met, how does the rule apply to these facts?

(a) Conduit trusts

As a convenience, a trust with the characteristics of that in ***Ex-196*** may be referred to as a "conduit trust" since it serves as a mere conduit in the distribution of any IRA benefits received by the trust to the beneficiaries of the trust. As the example illustrates, with a conduit trust it is possible to make a surviving spouse the sole designated beneficiary of a decedent's IRA even though the trust itself is the nominal IRA beneficiary.

COMMENT
Since the issuance of the final regulations, there has been considerable discussion on estate planning list serves about the exact meaning and requirements of the successor beneficiary exception. Many practitioners have concluded that the exception is incoherent and logically inconsistent. Here is part of the reason why.

882 Treas. Regs. § 1.401(a)(9)-5, A-7(b).

883 Treas. Regs. § 1.401(a)(9)-5, A-7(c)

We know from the fact that the regulations state that S is the sole beneficiary of a trust like that in ***Ex-196*** that S's children have been excluded as beneficiaries under the successor beneficiary exception. Yet there remains in ***Ex-196*** a possibility that the children will ultimately receive IRA benefits. This would occur, for example, if S died shortly after D and before the expiration of her fixed-term life expectancy under the tables. In that event there would be benefits left in the IRA for distribution to the children.

What then is the operative principal that controls when a beneficiary can be ignored under the successor beneficiary exception? The most likely formulation is that a successor beneficiary can be disregarded if the beneficiary can take a portion of the IRA benefits only if another trust beneficiary dies before receiving distribution of the entire benefit to which he or she would otherwise have been entitled — that is, before the beneficiary attains his or her tabled life expectancy. Support for this formulation of the exception can be found in the interpretation estate planning professionals had given for the similar exception contained in the revised proposed regulations[884] as well as in the statement in the preamble to the final regulations to the effect that the final regulations "retain" (as opposed to "alter") the prior rule.[885]

An advantage of this interpretation is that it adequately explains the difference between ***Ex-195*** and ***Ex-196.*** In the former, the children will receive the IRA benefits allocated to corpus even if S lives her entire life expectancy.[886] In the latter they will not.

(b) Other trusts

The application of the successor beneficiary rule to trusts other than conduit trusts is more uncertain. The uncertainty comes from the following statement in the final regulations:

> However, the [successor beneficiary exception] does not apply to a person who has any right (including a contingent right) to the employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death.

The Preamble indicates that this statement is intended to clarify that the successor beneficiary exception "only applies to a person who could be entitled to a portion of the employee's benefit by becoming the successor to the interest of one of the employee's beneficiaries after that beneficiary's

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884 The predecessor to the successor beneficiary exception in the final regulations is found in Prop. Regs. § 1.401(a)(9)-5, A-7(c) which provides:

> (c) Death contingency. (1) If a beneficiary (subsequent beneficiary) is entitled to any portion of an employee's benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed by the plan, the subsequent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy … or whether a beneficiary who is not an individual is a beneficiary.

On the proper construction of this language, see Covey, Practical Drafting, 6474 (July 2001).

885 The Preamble states: "[t]he regulations also retain the exception to this rule under which, if a beneficiary (subsequent beneficiary) is entitled to any portion of an employee's benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed by the plan, the subsequent beneficiary will not be considered a beneficiary."

886 More specifically, S is not the sole designated beneficiary in ***Ex-195*** because IRA proceeds that constitute principal as a matter of fiduciary accounting law are held in that trust for ultimate distribution to the children. That means the children have an interest in the IRA proceeds other than as a mere successor to S's interest. Consequently, they must be counted as designated beneficiaries of the IRA.

death." A similar limitation, at least in the view of the Service, applied under the revised proposed regulations.[887]

> ***Ex-197:*** Same facts as ***Ex-195*** except the remainder at S's death passes per stirpes to D's descendants. D is survived by S, by the three children, and by one or more grandchildren. Assuming the documentation requirements of the look-through rule are met, how does the rule apply to these facts?

c) Drafting concerns

The ability to look through a trust and have the beneficiaries be treated as designated beneficiaries so that benefits can be paid over the life expectancy of the oldest is helpful. But, if the planning objective is to craft a trust that qualifies for this treatment, additional drafting considerations arise. Remember, this is an area where one bad apple (i.e., ineligible beneficiary) will spoil the entire barrel.

(1) Charitable beneficiaries

A charity cannot be a designated beneficiary. Accordingly, the existence of a charitable gift in a trust will mean that distributions will be determined under the rules applicable when there is no designated beneficiary.[888]

(2) Costs, expenses and taxes

Care must also be exercised with respect to the source of money used to pay for costs, expenses and taxes. The trust instrument should preclude the use of IRA assets for all such purposes when other assets are available and the trust should be funded with sufficient other assets to insure that the need to use IRA assets will not arise.

(3) End limitations

An end limitation is an ultimate gift in a trust (typically either to some designated person's heirs or to charity) contingent on the failure of any other named beneficiary to survive to the point at which the distribution occurs. The gift is included to avoid the existence of an implied reversion in the settlor or the settlor's estate.

Whether or not end limitations can raise a concern under the look-through rule is an unsettled question. Neither the examples in the regulations or PLR 200228025 tell us the terms of any applicable end limitation.[889] Given the conclusion in PLR 200228025 that contingent beneficiaries must be considered, however, there is at least some concern that end limitations can present a problem as well.

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[887] See PLR 200228025.

[888] Well, not exactly. Not all charitable gifts are problematic. For example, in Ex. 197, a gift to charity in the event that all of D's descendants predeceased S would not be a problem; the charity would not be treated as a trust beneficiary for the same reason that the grandchildren aren't.

[889] Treasury "punted" the issue in Example 1 of Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3) upon which ***Ex-195*** is based, because the regulation states somewhat disingenuously that the children are the sole remainder beneficiaries of the trust.

(a) The problem

One might reasonably ask why we care in ***Ex-197*** whether D's grandchildren and more remote descendants are excluded from the group of trust beneficiaries under the Successor Beneficiary After all, by definition the grandchildren and their descendants would be younger than S. So even counting them as designated beneficiaries would not alter the result in the example; benefits could still be paid over S's life expectancy.

The answer, of course, is that we don't care if we can ignore the grandchildren and more remote descendants. Instead, we care whether we can ignore the interest of the charity or the reference person's heirs that is found in the trust's end limitation (or in the absence of an end limitation, the implied reversion in D's estate).[890] If we can't, we will have an ineligible designated beneficiary. The reason for this in the case of an end limitation to charity or the implied reversion to D's estate is obvious. Neither is an individual. The concern with the end limitation in favor of someone's heirs is that the ultimate heir under the Florida intestacy statute is the State of Florida.

(b) The drafting lesson

What then is the drafting lesson? It is that end limitations must be crafted to eliminate all possibility of an ineligible beneficiary sharing in the IRA proceeds. Virginia Colemen[891] has suggested the following:

- A trust the provides for the spouse for life, then to spouse’s descendants provided that if at any time during the spouse’s life there are not descendants, then outright to the spouse.
- Long-term dynasty trust for decedent’s descendants provided that if at any time there is only once such descendant, then outright to that descendant.

Alternatively, of course, the trust could be drafted to qualify as a conduit trust.

(4) Powers of appointment

(a) Eliminating ineligible and older appointees

Powers of appointment present two issues with respect to the minimum distribution rules. First, and most obviously, there is the question of whether the instrument must be drafted to preclude appointment to ineligible or older persons so that such potential appointees do not undermine the advantages of the look-through rule. The question is unsettled at this point. So caution would suggest that powers be drafted to preclude appointment to:

- charities or other ineligible beneficiaries

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890 It has been suggested that a literal reading Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 1 would suggest that only beneficiaries named in the trust instrument by name or class description need be considered in applying the look-through rule. See Virginia F. Coleman, Preserving the Designated Beneficiary of a Qualified Retirement Plan or IRA If a Trust is Named as Beneficiary: Practical Advice for Planning After the Final Section 401(a)(9) Regulations, 38 Philip E. Heckerling Institute on Estate Planning, Special Session II-D, p. 2. On that assumption, the implied reversion in D’s estate that would exist if the trust were drafter without an express end limitation would not create a problem.

891 See Virginia F. Coleman, Preserving the Designated Beneficiary of a Qualified Retirement Plan or IRA If a Trust is Named as Beneficiary: Practical Advice for Planning After the Final Section 401(a)(9) Regulations, 38 Philip E. Heckerling Institute on Estate Planning, Special Session II-D, pp. 7 - 8.

- any individual who is older than the spouse.

Ex-198: At D's death, his IRA benefits are payable to a QTIP trust that gives D's spouse S a testamentary power to appoint the principal of a QTIP trust to and among D's descendants and their spouses. Assuming the documentation requirements of the look-through rule are met, how does the rule apply to these facts?

(b) Dealing with accumulated IRA benefits

A second issue relating to powers existed under the revised proposed regulations and may or may not exist under the final regulations. In effect, Prop. Regs. § 1.401(a)(9)-5, A-7(d) provided that an IRA owner would be treated as not having a designated beneficiary if any person or persons could change the beneficiaries of the IRA after the DB determination date. This statement created a potential issue for powers of appointment because of the possibility that a power could be exercised to change the ultimate recipient of accumulated IRA benefits (i.e., those that are treated as principal under applicable state law).[892]

The final regulations do not contain the statement found in Prop. Regs. § 1.401(a)(9)-5, A-7(d). Whether this was meant to change the rule or not, however, is unclear. In any case, the concern can be eliminated either by providing that powers cannot be exercised over accumulated IRA benefits or by drafting the trust to qualify as a conduit trust. (On this latter, see "Conduit trusts", infra p. 265.)

(5) Discretionary distribution powers

A similar concern arises if the trustee of a QTIP or other trust has discretion to distribute trust principal. Of course, in the case of a QTIP trust, that discretion would have to be exercisable only for the benefit of the surviving spouse. In other trusts, it could be a power to spray principal among a group of beneficiaries. Either way, if the power is exercisable over accumulated IRA benefits, it could be seen as an impermissible discretion to change the beneficiary of a portion of the IRA after the DB determination date.

d) Impact on favorable distribution options

Naming a QTIP trust as IRA beneficiary will restrict and in some cases eliminate the favorable distribution options that would otherwise be available were the spouse named as an outright beneficiary of an IRA.

(1) Loss of rollover option

Naming a QTIP trust as IRA beneficiary usually involves an important tradeoff. The surviving spouse will not be able to roll over the IRA (or elect to treat it as her own) unless the spouse has the right to receive an immediate outright

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892 See Covey, Practical Drafting, 6476 (July 2001).

distribution of the IRA account balance.[893] Even then, a rollover is permitted only if the spouse does in fact take outright ownership of the IRA.

> ***Ex-199:*** D dies with a gross estate worth $1,325,000 consisting of $325,000 of marketable securities held in a revocable living trust and an IRA with a balance of $1,000,000 for which the revocable trust is the named beneficiary. At his death, D's spouse, S becomes trustee. And as trustee S is required to divide the revocable trust into two shares. One share worth $625,000 is to be held in continuing trust for S and her descendants. The remaining share worth $700,000 is to be distributed to S outright.
>
> 1. If S takes a distribution of the entire IRA and allocates $300,000 of it to the credit shelter trust and the balance to the outright distribution to S, to what extent may S rollover the distribution to a spousal IRA?
>
> 2. Would your answer change if the marital share was to be held in a QTIP trust?

(2) Potential loss of other favorable distribution options

(a) The options involved

Elsewhere in this outline reference has been made to three special distribution options that are available when IRA benefits are payable outright to a surviving spouse as the sole designated beneficiary. These are:

- The ability to defer the commencement of required distributions (and in some cases have the spouse become the owner) when the owner dies before his RBD (See "*Sole designated beneficiary is owner's spouse*" and "*Distributions after the death of the surviving spouse*", supra p. 254 and 255 respectively);
- The calculation of lifetime distributions under the Joint and Last Survivor Table in Treas. Regs. § 1.401(a)(9)-9, A-3 instead of the Uniform Distribution Table when the spouse is more than 10 years younger than the owner (See "*Exception for much younger spouse*", supra p. 250); and
- The ability to use a recalculated life expectancy during the spouse's overlife followed by a changed to a fixed-term life expectancy when the spouse dies. (See "*Sole designated beneficiary is owner's spouse*", supra p. 254)

Importantly, however, each of these distribution options is available only if the spouse is the sole designated beneficiary. As was illustrated in the discussion of the look-through rule and the successor beneficiary exception,

[893] See Treas. Regs. § 1.408-8, A-5(a). In a series of private letter rulings, the IRS has permitted a spousal rollover where: 1) the decedent's estate is the named beneficiary and the spouse is the only beneficiary of the estate; 2) the spouse is entitled to an outright distribution from an estate or trust that is the named beneficiary and the spouse as sole personal representative or trustee has discretion to distribute the IRA to herself; 3) a trust is the named IRA beneficiary and the spouse has the power to withdraw the IRA balance.

this will not be the case with a traditional QTIP trust; the first tier remainder beneficiaries and perhaps others as well will also be designated beneficiaries.[894] Hence, without more, use of the QTIP (or other income only trust) for the spouse will preclude use of these distribution options.

(b) Conduit trusts

A partial solution is to modify the trust to qualify it as a conduit trust. This is done by including a provision that requires that all amounts distributed to the trust from the IRA during the spouse's overlife be distributed directly to the spouse by the trustee. If the trust is to qualify for the marital deduction, the trust must also require the trustee to distribute all income currently to the spouse.

- The new regulations contain an example of a trust with such a clause. The example states that the clause results in the spouse being the sole beneficiary of the IRA for purposes of the first of the distribution options listed above.[895]
- Although not specifically mentioned in the example, the conduit trust approach should qualify the trust for the second and third distribution options as well.

COMMENT
There is a conceptual issue that arises with the use of a conduit trust to qualify a QTIP trust for the distribution option that permits the spouse's life expectancy to be recalculated. If that is the case, all IRA benefits will not be distributed from the IRA if the spouse lives to her table life expectancy. This is implicitly recognized in the regulations in that the remaining account balance at the death of the spouse is payable over the spouse's remaining fixed-term life expectancy. It is hard, therefore, to reconcile the conclusion in the new regulations that the spouse is the sole beneficiary of the IRA.

5. Post-mortem considerations

Because an IRA owner's designated beneficiary or beneficiaries do not become finalized until the DB determination date (September 30th of the calendar year following the year of the owner's death), certain post-mortem planning techniques can be utilized to restructure an IRA distribution plan to achieve a better tax result. Note that these techniques do not include the naming of new beneficiaries. IRA beneficiaries must be named by the IRA owner in accordance with the terms of the IRA documentation.

a) Disclaimers

If the IRA owner has named successive beneficiaries, a disclaimer can be used to change the identity of the designated beneficiary from the primary to a secondary beneficiary.

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[894] See Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 1 discussed in "*Other trusts*", supra p. 273.

[895] See Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

Ex-200: Prior to his death, T names his child C as the beneficiary of his IRA. T also names his grandchild GC as an alternate beneficiary in the event the C does not survive T. Subsequently, T dies survived by C and GC.

1. If C makes a qualified disclaimer of his interest in T's IRA, will GC become the designated beneficiary for purposes of determining required distributions after T's death?

2. Would the answer be the same if T had named his descendants per stirpes as the beneficiaries of his IRA?

b) Early distributions

It is possible to use early distributions as a post mortem planning mechanism. Any IRA beneficiary whose benefit is "cashed out" prior to the DB determination date need not be taken into account in applying the designated beneficiary rules.[896] Thus, if the IRA benefits are payable to a charity and an individual as of the owner's death, a distribution of the charity's full share of the IRA before the DB determination date would allow the remaining benefits to in individual to be distributed over the individual's life expectancy.

COMMENT
On the other hand, an individual who is a beneficiary as of the IRA owner's death and who dies prior to the DB determination date without disclaiming, continues to be treated as a beneficiary for purposes of determining the distribution period for required distributions. This applies both to persons designated as a beneficiary by the IRA owner as well as persons designated by the spouse of an IRA owner in those cases where the owner dies before his or her required beginning date and the spouse dies prior to the time at which distributions to the spouse have begun.[897]

c) Separate accounts

Another and potentially more useful way to deal with the situation described in the preceding section would be to establish separate accounts for the charity and the individual so that the designated beneficiary rules could be applied separately for each. With respect to separate accounts:

- Separate accounts are not recognized during the IRA owners life.[898]
- The interests of the various beneficiaries must be expressed as a fraction or a percentage share; a pecuniary interest in an IRA account will not qualify;[899]
- Separate accounts established before December 31 of the calendar year following the year of the IRA owner's death will be recognized for all purposes, including the determination of the applicable distribution period;[900]

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[896] See Treas. Regs. § 1.401(a)(9)-4, A-4(a).

[897] Treas. Regs. § 1.401(a)(9)-4, A-4(c). This latter situation is discussed further at "*Distributions after the death of the surviving spouse*", supra p. 268.

[898] See Treas. Regs. § 1.401(a)(9)-8, A-2(a)(2) (separate accounts are recognized "for years subsequent to the calendar year containing the date on which the separate accounts were established, or date of death if later…".

[899] See Treas. Regs. § 1.401(a)(9)-8, A-3. Separate shares must share ratably in all post-death investment gains and losses, contributions, and forfeitures, for the period prior to their establishment. Id.

- Separate accounts established after that date will be recognized for the purpose of determining account balances but not for the purpose of determining the applicable distribution period.[901]

Ex-201: Prior to his death, D names Charity as the beneficiary of $25,000 of his $500,000 IRA with his child C and his grandchild GC as equal beneficiaries of his the balance.

1. How do the separate account rules apply to these facts.

2. What could be done to produce a better result on these facts?

Ex-202: Suppose in ***Ex-201*** that D had named a testamentary trust as sole beneficiary of his IRA and the trust provided that C and GC were to share equally in all IRA benefits distributed to the trust. How do the separate account rules apply to these facts?

6. Roth IRAs

a) Overview

Roth IRA is the name given to a special form of IRA first permitted by the 1997 TRA. In general, Roth IRAs are subject to the same rules as traditional IRAs except that:

- Contributions to a Roth IRA are not deductible;
- Distributions from a Roth IRA are not taxable; and
- The required minimum distribution rules do not apply until after the IRA owner dies.

b) Contribution limits

Contributions to a Roth IRA are subject to the same basic limitations for traditional IRAs. That is, for 2011, contributions are typically limited to $5,000 per year.[902] However, with a Roth IRA:

1. Contributions may be made by the IRA owner after his or her required beginning date;
2. The amount that may be contributed to a Roth IRA is reduced by any contributions the IRA owner makes to a traditional IRA;
3. The maximum contribution is phased out based on the participant's modified adjusted gross income[903] for the year. The following table shows the income

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900 See Treas. Regs. § 1.401(a)(9)-8, A-2(a)(2).

901 Id.

902 This number is increased to $6,000 for taxpayers who are over age 50 and who have not made full contributions in prior years.

903 This is the taxpayer's adjusted gross income (determined without regard to any income generated by a rollover of a traditional IRA to a Roth IRA for the year) increased by any exclusions for foreign earned income, foreign housing, adoption assistance and interest on U.S. savings bonds used to pay expenses of higher education.

level at which a full contribution is available as well as the income level at which no contribution is permitted. Again, the numbers shown are for 2011.

Filing Status	Full Contribution	No Contribution
Single[904]	$107,000 or less	$122,000 or more
Married – Joint	$169,000 or less	$179,000 or more
Married – Separate	-0-	$10,000 or more

c) Rollovers from traditional IRAs

(1) Eligibility

A traditional IRA may be rolled over or converted into a Roth IRA provided, if the taxpayer is married, the taxpayer and his or her spouse file a joint return for the year.

The taxable portion of any amount rolled over into a Roth IRA must be included in the IRA owner's gross income. The amount included in income as a result of a rollover into a Roth IRA counts as income for purposes of determining the deductibility of contributions to a standard IRA but not for purposes of determining the eligibility for contributions to the Roth IRA itself.

d) Taxation of distributions

(1) Overview

The taxation of a distribution from a Roth IRA turns on whether the distribution is a qualified or nonqualified distribution.

(a) If the distribution is a qualified distribution, the entire distribution is tax free.

(b) If the distribution is not a qualified distribution:

- All earnings included in the distribution are includible in taxable income.
- Moreover, the earnings are subject to a ten percent premature withdrawal penalty if the distribution occurs before the IRA participant turns 59½ and the distribution would not otherwise satisfy one of the exceptions for premature distributions from a traditional IRA.[905]
- However, distributions are treated as first being comprised of contributions. Therefore, a distribution will result in taxable income only after all contributions to the Roth IRA have been distributed.

(2) Qualified distributions

A qualified distribution from a Roth IRA is not includible in taxable income. A distribution is a qualified distribution if it occurs more than five years after the contribution to the Roth IRA, and:

(a) It occurs after the IRA owner is 59½;

(b) It occurs after the IRA owner's death;

[904] Or head of household.

[905] The 1998 Technical Corrections Act would extend the ten percent penalty tax on premature distributions to distributions of the contributions itself if the distribution occurred within 5 years of the contribution to the Roth IRA.

(c) It is attributable to the IRA owner’s total and permanent disability; or

(d) It constitutes a qualified first-time homebuyer distribution.

ANSWERS—SPECIAL ESTATE PLANNING TOPICS

Ex-169. **First question –** The answer is $475,500 of which $393,900 is federal estate tax (FET) and $81,600 is the Florida estate tax. The amounts are determined as follows:

Gross estate	$ 2,100,000
2053 deduction	(100,000)
Adj. GE	**2,000,000**
2055 deduction	(250,000)
Tax. Estate	**1,750,000**
2001 tax	668,300
Unified credit	(192,800)
Gross tax	**475,500**
2011 credit	(81,600)
FET	**$ 393,900**

Second question – The Florida and federal estate taxes that would have been payable had T's estate not included the $1 million QTIP trust are $35,100 and $20,400, respectively. These numbers are derived as follows:

Gross estate	$ 1,100,000
2053 deduction	(100,000)
Adj. GE	**1,000,000**
2055 deduction	(250,000)
Tax. Estate	**750,000**
2001 tax	248,300
Unified credit	(192,800)
Gross tax	**55,500**
2011 credit	(20,400)
FET	**$ 35,100**

Accordingly, the FET estate tax attributable to the QTIP property is $358,800 ($393,900 - $35,100). The Florida estate tax attributable to the QTIP property is $61,200 ($81,600 - $20,400).

Third question – After accounting for the federal and Florida estate taxes attributable to the QTIP property, there remains an unattributed tax of $55,500. This balance will be attributed to T's daughter and grandchild using an average apportionment methodology. Since the daughter's interest ($500,000 of insurance proceeds) is twice as large as the $250,000 residuary passing to grandchild, two-thirds of the $55,500 balance ($37,000) is attributable to daughter and one-third ($18,500) is to grandchild.

Comment: None of the tax was attributed to the gift to charity because that gift was not included in the measure of the estate tax.

Ex-170. **First question –** On these facts, 10 percent of the tax is attributable to the property passing to A, 30 percent is attributable to the property passing to B and the balance of 60 percent is attributable to the residue. The tax attributable to the property passing to A and B is charged to the residue. So too is the tax attributable to the residue itself.

Second question – Here the tax attributable to preresiduary gifts is $137,700 (90 percent of $153,000) or $137,700) and the tax attributable to the residue is 10 percent or $15,300. The former is charged first to the residue with the excess of $37,700 being apportioned ratably between preresiduary beneficiaries A and B. Fla. Stat. § 733.817(5)(a)1 (1999). The treatment of the taxes attributable to the residuary estate is less clear. The statute states only that the taxes attributable to the residue are to be apportioned to the residuary beneficiaries. Fla. Stat. § 733.817(5)(a)2 (1999). The statute is silent about the possibility that the residue will already have been exhausted by the

taxes attributable to preresiduary gifts. The correct result would appear to be that the $15,300 should likewise be apportioned ratably between A and B.

Third question – The answer here is much more convoluted. First, in making the initial attribution of the tax among the various interests, only interests included in the measure of the tax are considered. Since the portion of the residue passing to D will qualify for the marital deduction, it is ignored. Thus the total value of all interests included in the tax is $700,000 of which A gets one-seventh and B and the residue take three-sevenths each.

Nominally, the portion of the tax attributable to the residue (3/7ths) is charged only to C. However, the portion of the tax attributable to the pre-residuary gifts is charged and paid from the entire residue. Since the residue is left equally to C and D, the preresiduary tax is charged in the same manner. This in turn creates a tax dependent calculation because the marital deduction allowable for D's interest must be reduced by the amount of tax chargeable to that interest. IRC § 2056(b)(4)(A).

Comment: A similar result would occur if D were a charity instead of T's spouse.

Ex-171. **First question –** T 's will and revocable trust will be read together as if all gifts were made in a common instrument. Fla. Stat. § 733.817(5)(d) (1999). That common instrument would contain two preresiduary gifts -- a specific devise worth $250,000 to B, a pecuniary bequest in the same amount to C. The instrument would also contain a residuary gift worth $500,000 to the trust for the grandchildren.

All taxes attributable to the two preresiduary gifts will be charged to and paid from the residue. So will the taxes attributable to the residue itself. Accordingly, all $153,000 of taxes will be apportioned to the trust for the grandchildren.

Second question – Again, the will and trust will be treated as a common instrument. Accordingly, there is a combined residue of $500,000, ten percent of which passes to C, an equal percent to D, and the balance of eighty percent to the trust for the grandchildren. A corresponding percentage of the $153,000 of taxes will be apportioned among C, D, and the trust.

Ex-172. **First question –** Under the facts, the homestead is exempt from apportionment. Accordingly, the taxes attributable to it will be apportioned to the residue of W's estate. See Fla. Stat. §§ 733.817(2) (1999) and 733.817(5)(a)1 (1999).

Second question – No. Under these facts, the homestead remains exempt from forced sale. Snyder v. Davis, 699 So.2d 999 (Fla. 1997). Accordingly, the homestead is exempt from apportionment and all taxes are apportioned to the residue under Fla. Stat. § 733.817(5)(c) (1999).

Third question – The answer here is unclear. Supposedly the taxes attributable to the homestead should be apportioned to the residuary estate because the homestead is exempt from apportionment. However, the residuary gift to charity is initially deductible from the gross estate so it is not included in the measure of the estate tax. It seems clear that the Florida apportionment statute can not exempt the homestead from the federal estate tax. Whether it suffices for purposes of the Florida estate tax is an unresolved issue.

Ex-173. **Answer –** The answer is unknown and unknowable. The one thing that seems clear is that the apparent answer given in the Florida statute can't be the correct one. According to the Florida statute the answer should be prorata among the recipients of the interests included in the measure of the tax. But 90 percent of D's estate is property that the United States collected in gift tax from D. Does this mean that 90 percent of D's estate tax bill will be apportioned to the U.S.? Fat chance of that!

Comment: A similar issue is presented with respect to the adjustment for cumulative but unpaid distributions under IRC § 2701(d).

Ex-174. **First question –** No because the trust does not expressly indicate that the residue is to bear the burden of the taxes attributable to the nonprobate property.

Second question – Well, this will clearly do the trick with respect to the joint property. But IRC § 2206 comes into play with respect to the insurance. That section requires that a contrary provision

be placed in the "governing instrument." If this is read as referring to the insurance policy itself, it is doubtful that the trust provision will work.

Comment: The same issue presents itself with respect to taxes attributable to property subject to a general power of appointment. See IRC § 2207

Ex-175. **First question –** First, the aggregate tax attributable to both QTIP trusts will be determined on a marginal basis. Thus, the aggregate tax will equal the excess of the tax with the QTIP trusts over the tax without them. This aggregate tax will then be apportioned among the two QTIP trusts in proportion to their value. Thus 4/14ths will be apportioned to the Q1x trust and 10/14ths to the Q2t trust.

Second question – To be effective, the provision must be placed in the Q2t instrument and it must either expressly refer to section 733.817(5)(h)4 (awkward) or it must expressly indicate that the property in the Q2t trust is to bear the burden of the taxes attributable to the Q1x trust.

Ex-176. **Answer –** The answer is yes. The provision in the revocable trust is effective with respect to taxes remaining unpaid after the application of the provision in the will. Fla. Stat. § 733.817(5)(h)5a (1999).

Comment: These facts are similar to those of Yoakley v. Raese, 448 So. 2d 632 (Fla. 4th DCA 1984) which arose under the former statute. There the court held that the will and not the trust controlled; accordingly the excess taxes were not effectively apportioned to the revocable trust. As mentioned, the result is different under the new statute.

Ex-177. **Answer –** Yes because the contrary provision in the will does not expressly override the provision in the trust. Fla. Stat. § 733.817(5)(h)5b (1999).

Comment: Compare the contrary result reached under the former statute in In re Estate of Strohm, 241 So. 2d 167 (Fla. 4th DCA 1970).

Ex-178. **First question –** H may only disclaim the half of Jointacre he succeeds to at W's death by right of survivorship. The half of Jointacre he received from W by gift in 1989 had to be disclaimed within 9 months of the acquisition of Jointacre. See Treas. Regs. §§ 25.2518-2(c)(4)(i); 25.2518-2(c)(5), Examples 7 and 8.

Second question – No. The Service initially took the position that H could not disclaim any portion of JointAcre that was attributable to consideration furnished by him. This position was rejected by the Tax Court in McDonald v. Comm. T.C.M. 1989-140 and the newly issued regulations now agree. Treas. Regs. § 25.2518-2(c)(4)(i); 25.2518-2(c)(5), Example 7.

Third question – Yes, the answer differs. On these facts, the creation of the tenancy was not a gift. IRC § 2523(i)(3). And all of the tenancy would be includible in W's gross estate. IRC § 2040(a). Accordingly, H may disclaim all of Jointacre; not just W's half. See Treas. Regs. § 25.2518-2(c)(5), Example 9.

Fourth question – The answer depends on the nature of the tenancy. In many states, the creation of a joint brokerage account or joint bank account is an incomplete gift because the depositor may unilaterally withdraw his or her own contributions. Where that is the case, the surviving joint tenant may disclaim any portion of the account except that attributable to his or her own contributions. Treas. Regs. §§ 25.2518-2(c)(4)(iv); 25.2518-2(c)(5), Examples (12) – (14).

For a discussion of joint bank accounts under Florida law, see Rodriguez, Joint Ownership of Bank Accounts in Florida by Husband and Wife, 71 Fla. Bar J. 24 (Jan. 1997).

Ex-179. **Answer –** Yes provided both elections are made within the 9 month period. Rev. Rul. 90-45, 1990-1 C.B. 175 (1990).

Ex-180. **Answer –** Maybe. This is a qualified disclaimer only if W has no power of appointment over the credit shelter trust and is either not the trustee of that trust or, if she is trustee, her powers are limited by an ascertainable standard. See Treas. Regs. § 25.2518-2(e)(1) and (5), Examples 11 and 12.

Florida note: But see Fla. Stat. § 736.0814(2) (2015) discussed in the answer to the third question of ***Ex-44*** supra p. 59.

Ex-181. **Answer –** Yes. A local law presumption of death (other than that contained in the Simultaneous Death Act) is not given effect for purposes of the IRC § 2612(c)(2) predeceased child rule. See "*Exception for predeceased ancestor*" on p. 126.

Ex-182. **First question –** No. A disclaimer is not a qualified disclaimer if the disclaimant accepts any consideration for making the disclaimer. Treas. Regs. § 25.2518-2(d)(4), Example (2).

Second question – Yes, according to the 5th Circuit at least. See Monroe v. Comm., 124 F.3d 699 (5th Cir. 1997), rev'g Estate of Louise S. Monroe, 104 T.C. 352 (1995), in which the 5th Circuit held that the requirement that a disclaimer by "unqualified" was related to the idea that the disclaimant could not accept benefits from the disclaimed property, that consideration for the disclaimer is such a benefit, but that a mere "expectation" or "implied promise" is not sufficient to render a disclaimer unqualified.

Ex-183. **Answer –** According to the Service the answer is yes because the lapse of the Crummey withdrawal power after each contribution is a release of a general power which makes M the owner of the trust under IRC §§ 678(a)(2) and 677(a). See PLR 9535047.

Ex-184. **Answer –** It depends. If the grantor dies after 1997, the answer is two years from the date of the grantor's death. If the grantor died before 1998, the two year period applies only if the entire trust is includible in D's gross estate. Otherwise the period is only 60 days. Treas. Regs. § 1.1361-1(h)(2)(ii).

Comment: For purposes of the above rule, if the S stock is community property, the entire trust is deemed includible in the decedent's gross estate if the decedent's entire community interest is so includible.

Ex-185. **Answer –** The gain is taxable to the trust. See Treas. Regs. § 1.1361-1(j)(8) reversing a contrary conclusion in Rev. Rul. 92-48, 1992-1 C.B. 216. Accord PLR 199905011.

Ex-186. **First question –** Yes assuming the QTIP trust otherwise meets the requirements of a QSST trust. Treas. Regs. § 1.1361-1(j)(4).

Second question – It depends. An inter vivos QTIP cannot qualify as a QSST because the grantor and not the current beneficiary will be treated as owner of the income portion of the trust under IRC § 677. Treas. Regs. § 1.1361-1(j)(4)..If the trustee of the QTIP trust has discretion to distribute principal to the grantor's spouse, the QTIP trust will be a wholly grantor trust. See IRC §§ 672(e); 677(a). As such, it is an eligible S corporation shareholder. However, in the absence of such a power, or some other trust provision making the trust a grantor trust as to principal income, an inter vivos QTIP trust would be an eligible Sub S shareholder only if it qualified as an ESBT.

Caution: A QTIP trust that qualifies as a S corporation shareholder because it is a wholly owned grantor trust will loose that status upon the divorce of the grantor and the spouse. In that event, the spouse must make a QSST election within two months and 15 days of the date of the divorce. Treas. Regs. § 1.1361-1(k)(1), Example 10(ii).

Ex-187. **Answer –** No. Although the position of the Service on this question used to be yes, the Service has changed its position in light of recent case decisions to the contrary. The current position of the Service is that the obligation to pay interest arising from a deferral of taxes under IRC § 6166 is not taken into account in valuing property for purpose of the marital deduction, the charitable deduction, or the credit for prior transfers. Rev. Rul. 93-48, 1993-2 C.B. 270.

Comment: The new position of the Service is more lenient than the prior cases would appear to require. See Estate of Whittle v. Comm., 994 F.2d 379 (7th Cir. 1993); Estate of Street v. Comm., 974 F.2d 723 (6th Cir. 1992); Estate of Walter E. Richardson, Jr., 89 T.C. 1193 (1987).

Ex-188. **First question –** T will be 72 in 2003 so his MRD is $39,063 ($1,000,000 divided by 25.6).

Comment: Note that even though T reached his RBD before the new regulations became operative, he may still determine his MRD using the new approach. Note also, that the answer is the same whether or not T had previously designated a beneficiary and whether or not he had previously

elected to recalculate his life expectancy. Nor, except as noted below, does it matter who his designated beneficiary, if any, is. Spouse, charity, trust, estate, it is all the same.

Second question – T will be 73 in 2004 so the divisor is 24.7.

Third question – Yes. If T attained 70½ in February, he would be 71 on his birthday that occurs in 2001. Accordingly, he would be 73 in 2003 and 74 in 2004. Thus, the divisor for 2003 would be 24.7 (instead of 25.6) and the divisor for 2004 would be 23.8 (instead of 24.7).

Ex-189. **First question –** It depends. If S is the sole designated beneficiary of T's entire IRA account at all times during 2003, T can use a divisor of 27.9. This is the joint and survivor life expectancy of a 71 and 59 year old. (See the Joint and Last Survivor Table in Treas. Regs. § 1.401(a)(9)-9, A-3 excerpted in Appendix E, infra p. 300). Otherwise, T must use the shorter 26.5 divisor specified in the Uniform Lifetime Table.

Second question – The answer is 27.0. This is the joint and survivor life expectancy of T and S as of their attained ages (72 and 60, respectively) in 2004. (See the Joint and Last Survivor Table in Treas. Regs. § 1.401(a)(9)-9, A-3 excerpted in Appendix E, infra p. 300).

Third question – Yes. But T will have to use the Uniform Lifetime Table for 2005 and after. Treas. Regs. § 1.401(a)(9)-5, A-4(b)(2).

Fourth question – It depends. It clearly does not matter where S has died. The regulations expressly state as much. See Treas. Regs. § 1.401(a)(9)-5, A-4(b)(2). The regulation, however, does not cover the case of divorce. So the answer in the case of divorce is that T would have to use a divisor of 25.6 (the factor for a 72-year-old under the ULT).

Ex-190. **First question –** The answer is $40,486. This is $1,000,000 divided 24.7, the factor for a 73-year-old in the Uniform Lifetime Table. (See Appendix C, infra p. 298.)

Second question – The divisor is 13.8. This is the 14.8 year life expectancy factor for a 73-year-old under the Single Life Table found in Treas. Regs. § 1.401(a)(9)-9, A-1, the relevant portion of which is excerpted below, reduced by 1 for the year that has elapsed from the year of T's death.

Single Life Table – Excerpted.	
Age	Life Expectancy
68	18.6
69	17.8
70	17
71	16.3
72	15.5
73	**14.8**
74	14.1

Third question – The divisor is 12.8 (the 14.81 determined above reduced by 2 for the two years that have elapsed since T's death).

Ex-191. **First question –** It depends. If T died before the RBD, there is no MRD for the year of his death. Otherwise, the divisor will be determined under the Uniform Lifetime Table based on the age T was or would have become on his birthday for calendar year 2003.

Second question – The answer is 37.9. This is the fixed-term single life expectancy of a 46-year-old. (See the Single Life Table found in Treas. Regs. § 1.401(a)(9)-9, A-1 (See Appendix B, infra. p. 299.)

Third question – The answer is 36.9.

Fourth question – The answer is 35.9.

Fifth question – The answer is 34.9.

Ex-192. **Answer –** With M as the designated beneficiary, T's remaining fixed-term life expectancy would be greater than M's. So the divisor for the year following T's death will be 24.2. This is the 25.2 life expectancy of a 60-year-old under the Single Life Table reduced by 1 for the year that elapsed between T's year of death (2003) and the year (2004) which distributions begin. Note that no distribution is required for 2003 since T died before his required beginning date.

Ex-193. **First question –** The divisor of 19.5 is determined using the Uniform Lifetime Table. (See Appendix A, infra p. 298.)

Second question – Distributions must begin by the end of 2004 – the calendar year following the year of T's death. S will be 74 as of her birthday in 2004, so the divisor is 14.1. (See the Single Life Table in Appendix B, infra p. 299.)

Third question – The answer is 13.4. This is the life expectancy of a 75-year-old under the Single Life Table in Appendix B, infra p. 299.)

Fourth question – First, no distribution would be required for the year of T's death. Additionally, distribution to S need not begin until 2005. This is the year following the year in which T would have turned 70½. S will be 65 in 2005, so the divisor for the first required distribution is 21. The divisor for the following year is 20.2. (See the Single Life Table in Appendix B, infra p. 299.)

Ex-194. **First question –** The divisor is determined using the Single Life Table. (See Appendix B, infra p. 299.) S would be 79 as of her birthday in 2009, so the divisor is 10.8.

Second question – The divisor for determining the distribution for the year following S's death is the spouse's life expectancy as of the year of the spouse's death reduced by 1 for the year that has elapsed since that year. Accordingly, the divisor for 2010 is also 9.8. (See the Single Life Table in Appendix B, infra p. 299.)

Third question – After the spouse's death, life expectancies are determined on a fixed-term basis. So, the answer is 8.8.

Ex-195. **Answer –** Under the look-through rule, S and D's three children are all designated beneficiaries of D's IRA. See Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 1. Since there is more than one designated beneficiary, the beneficiary with the shortest life expectancy – in this case S – is used to determine minimum distributions.

Ex-196. **Answer –** Because of the Successor Beneficiary exception, S is the sole designated beneficiary of D IRA. The children are not counted because their only interest in the IRA proceeds are as a successor in interest to S's interest in the trust. See Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

Ex-197. **Answer –** The answer is not all that certain. One possibility is that the grandchildren too are now beneficiaries of the trust for purposes of the look-through rule. Support for this conclusion is found in PLR 200228025. Although this ruling dealt with facts controlled by the revised proposed regulations, the ruling was issued after the final regulations and the reasoning of the ruling is equally applicable to those regulations.

In PLR 200228025, IRA benefits were payable to an irrevocable trust for the benefit of the settlor's two minor grandchildren. Distributions from the trust could be made in the discretion of the trustee for the grandchildren's support health and maintenance until age thirty, at which time each grandchild could withdraw his entire share. If either grandchild died under age 30, the entire amount was distributable to the other grandchild. If both grandchildren died under the age of 30, the trust was payable to various contingent beneficiaries, the oldest of which was 67 years old.

On these facts, the Service ruled that minimum required distributions must be based on the life expectancy of the oldest beneficiary *including the contingent beneficiaries*. With respect to the necessity of considering the contingent beneficiaries, the ruling states:

> Section 1.401(a)(9)-1, Qs&As, of the Proposed Regulations E-5(b) and E- 5(e)(1), provide rules governing contingent beneficiaries. Pursuant to these sections of the regulations, beneficiaries whose entitlement to the employee's benefit is contingent on any event other than the death of a "prior" beneficiary must be considered for purposes of determining which beneficiary has the shortest life expectancy and, as such,

> who is the designated beneficiary for purposes of section 401(a)(9) of the Code. In this case, the discretion the trustee of Trust X has with respect to the payment of trust amounts to the Grandchildren, who are the primary beneficiaries, is a contingency over and above the death of a prior beneficiary. The Trust X language does not require that the payments from the IRA Accounts be paid to the Grandchildren on an annual basis and therefore Trust X language does not preclude there being an accumulation of distributions from the IRA Accounts. Under such circumstances, the Contingent Beneficiaries must be considered in determining the beneficiary with the shortest life expectancy.

One possible distinction between PLR 200228025 and the facts in this example is that distributions in the former were discretionary (albeit, subject to an ascertainable standard) while distributions in the example are not. Nevertheless, the trust in the example is not a conduit trust. There exists the possibility that IRA benefits will become payable to the grandchildren. Hence, it appears that the grandchildren must be considered trust beneficiaries for purposes of the look-through rule for the same reason that the children are considered beneficiaries.

Ex-198. **Answer –** The answer is unclear. The concern is that because a descendant of D could always marry someone who is older than the decedent's surviving spouse, it is not possible to identify the oldest beneficiary for purposes of the look-through rule so that the IRA benefits must be distributed as if there is no beneficiary. A similar problem would arise if the power would be exercised in favor of an ineligible beneficiary such as a charity.

From a pure property law standpoint, however, the objects of a power of appointment should be ignored for purposes of the look-through rule. The potential objects of a power of a appointment do not have an interest in property; they have a mere expectancy, much the same as the expectancy a potential heir has in the estate of a living person. See e.g, Simes, Law of Future Interests § 58 (West 1966). No one would suggest that the potential heirs of a trust beneficiary are beneficiaries for purposes of the look-through rule. Indeed such a suggestion would be inconsistent with the result reached in Treas. Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 1. Nevertheless, there is a very real concern that the Service (or a court) could hold otherwise, particularly where the objects are identified with precision in a trust instrument.

Ex-199. **First question –** Under these facts, the $700,000 distributed to S outright is eligible for a spousal rollover. See PLR 9808043.

Comment: It is important that S was the sole trustee of the revocable trust. If she is a co-trustee or if someone else is the trustee, the result is different. In that event, the IRS has applied a presumption that the marital share will be funded first from assets other than the IRA. With a marital share of $700,000 and other property worth $325,000, that would mean that only $375,000 of the marital share qualifies for a spousal rollover. See PLR 9750063.

Second question – Yes, the answer changes. No spousal rollover is possible unless S has the right to and actually does withdraw the IRA from the QTIP trust.

Ex-200. **First question –** Yes. See Treas. Regs. § 1.401(a)(9)-4, A-4(a). See also the Preamble to the new final regulations.

Second question – Yes, the answer is the same.

Ex-201. **First question –** The don't. Separate accounts must consist of a fraction or percentile share. Without more, the $25,000 pecuniary amount going to Charity will mean that separate accounts cannot be established for C and GC.

Second question – The solution is to distribute Charity's full share before September 30 of the year following D's death so that the Charity will not be treated as a beneficiary as of that date. Then separate accounts can be established for C and GC. If this too is done before the DB determination date, the shares will be honored for purposes of determining the applicable distribution period. That is, C's account will be distributed over his fixed-term life expectancy and GC's account will be distributed over his (longer) fixed-term life expectancy. If the separate accounts are not established until after September 30 of the year following D's death, the account balances of the two accounts will be determined separately, but the benefits of both accounts will have to be distributed of C's fixed-term life expectancy.

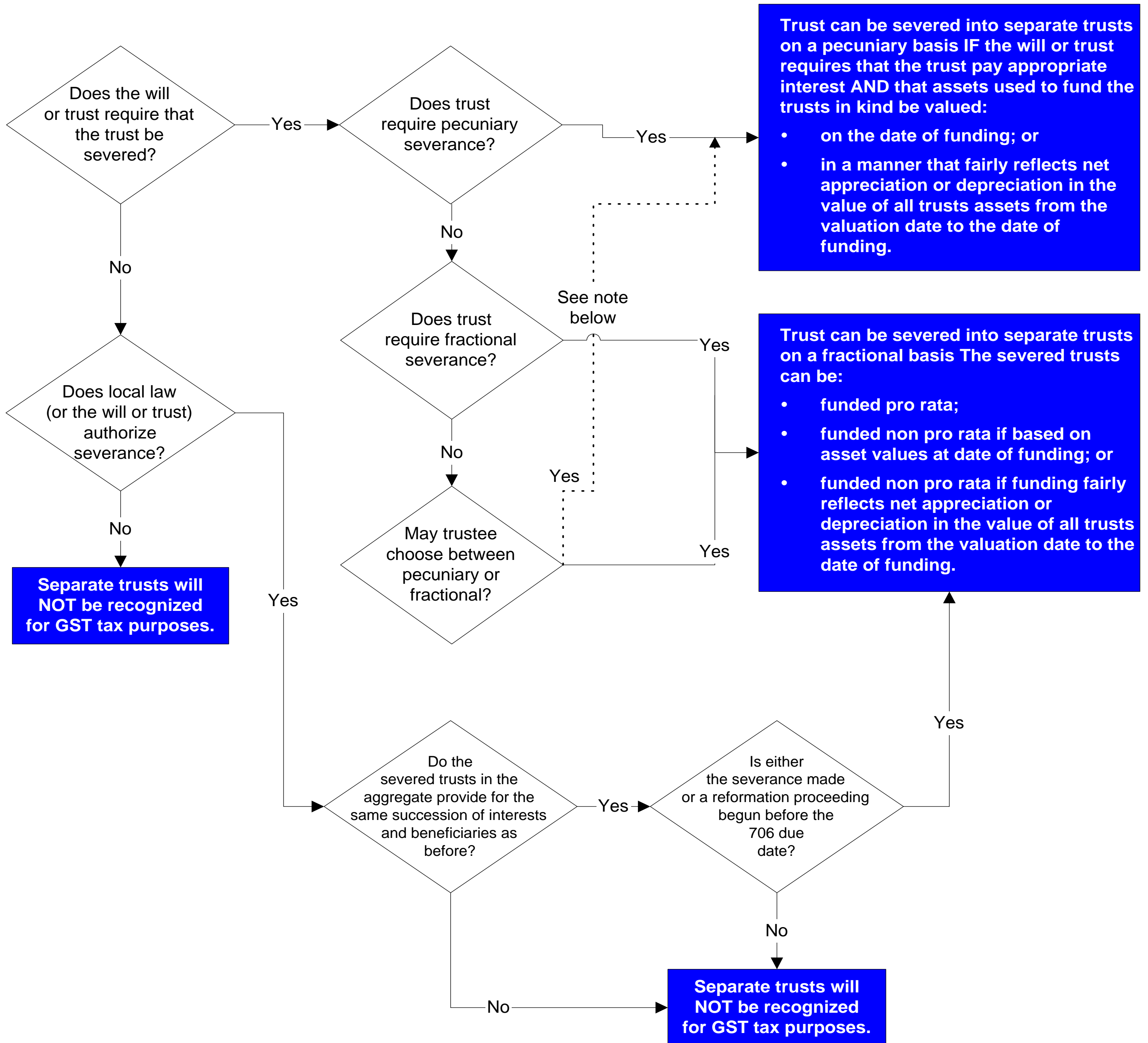
Ex-202. **Answer –** They don't. The separate account rules apply at the plan level, not at the trust level. The plan benefit is not divided into separate accounts when the benefits are payable to a trust even if the beneficial interests in the trust constitute separate shares for trust accounting purposes. See Treas. Regs. § 1.401(a)(9)-4, A-5(c).

APPENDIX A: GRAPHICAL DECISION TREES

This appendix contains a series of graphical decision trees that make application of some of the more difficult GST rules more comprehensible. These were developed in conjunction with Bruce Stone of Holland & Knight LLP. For each tree, start at the upper left and proceed according to the appropriate answer. The decision trees cover the following areas:

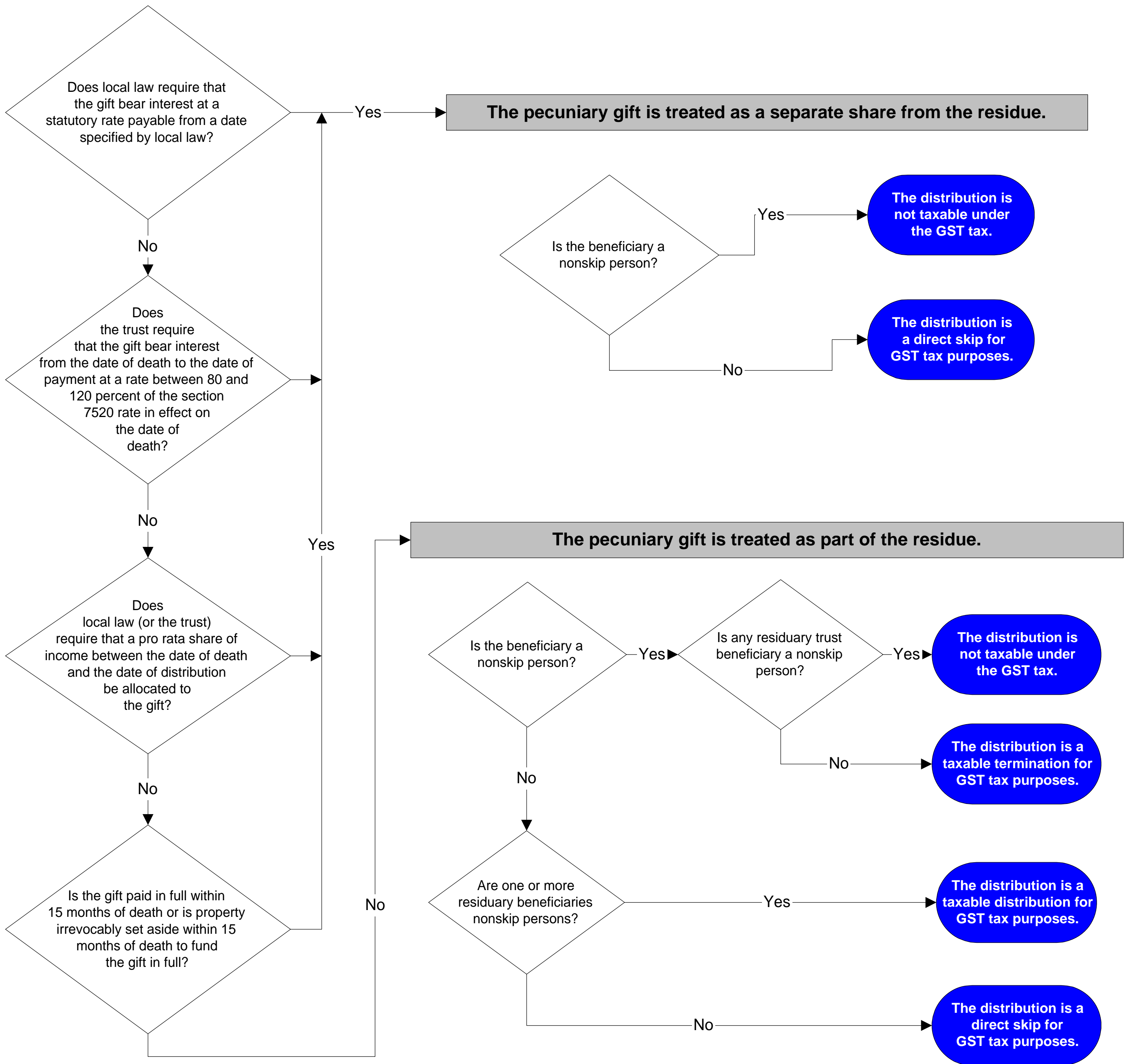
Appendix	Description
A-1	**Severing Trusts Included in the Gross Estate** This decision tree simplifies the complex rules in the GST regulations covering when a trust that is included in the gross estate of a transferor can be split into more than one trust and be treated as separate trusts for GST tax purposes. These rules can apply to the basic split that occurs through a marital formula contained in a revocable trust as well as other splits, including one done in anticipation of a reverse QTIP election.
A-2	**Distribution of Pecuniary Gift From Inter Vivos Trust Included in Gross Estate** This decision tree covers the characterization of distributions in satisfaction of pecuniary gifts from a revocable inter vivos trust. For GST tax purposes, pecuniary gifts under a will or revocable inter vivos trust are either treated as separate from other gifts or not. For gifts in a will, the issue is one of valuation. For gifts in a revocable trust, the issue is more important; it involves the characterization of the distribution for GST tax purposes. This decision tree covers the characterization of distributions in satisfaction of pecuniary gifts from a revocable inter vivos trust.
A-3	**Severing Trusts Not Included in the Gross Estate** This decision tree is a companion one to that in A-1. This tree covers the severance of a trust other than at the time the trust is included in the gross estate of the transferor.
A-4	**Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death** Assuming a pecuniary gift under a will or trust is treated as separate from other gifts in the instrument (See A-2), this decision tree can be used ascertain how the denominator for that applicable fraction with respect to the gift is to be valued. This, of course, will be necessary only if the beneficiary of the pecuniary gift is a skip person.
A-5	**Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death** Use this decision tree to determine the value of the denominator of the applicable fraction for residuary gifts which follow one or more separate pecuniary gifts.

Appendix A-1
Severing Trusts Included in the Gross Estate

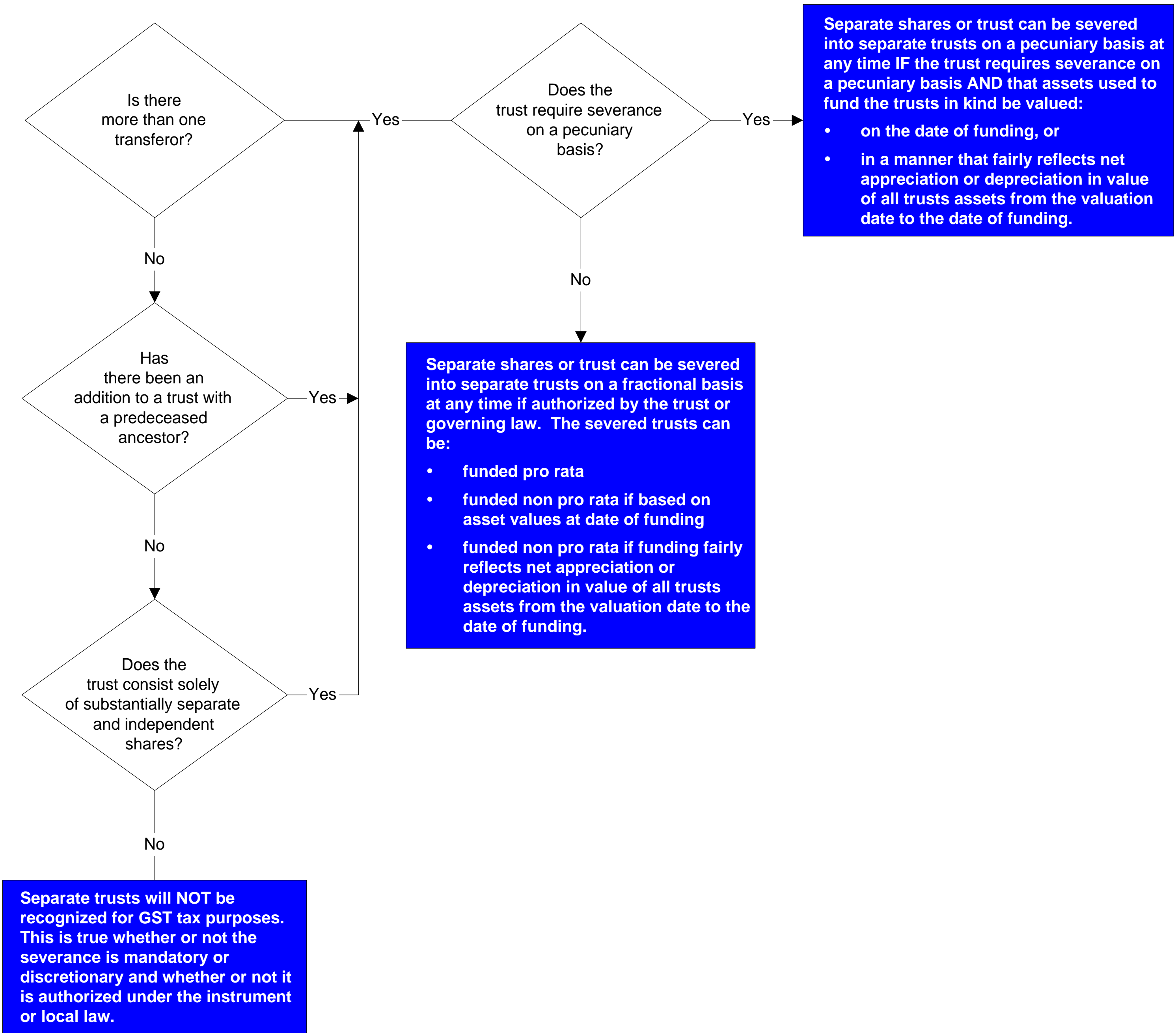


Note: Treas. Reg. § 26.2654-1(b) appears to authorize a pecuniary split if the instrument directs either that the trust be split or that it be split on a pecuniary basis. If so, the choice between a fractional or a pecuniary split may be left to the discretion of the trustee as long as the split itself is required.

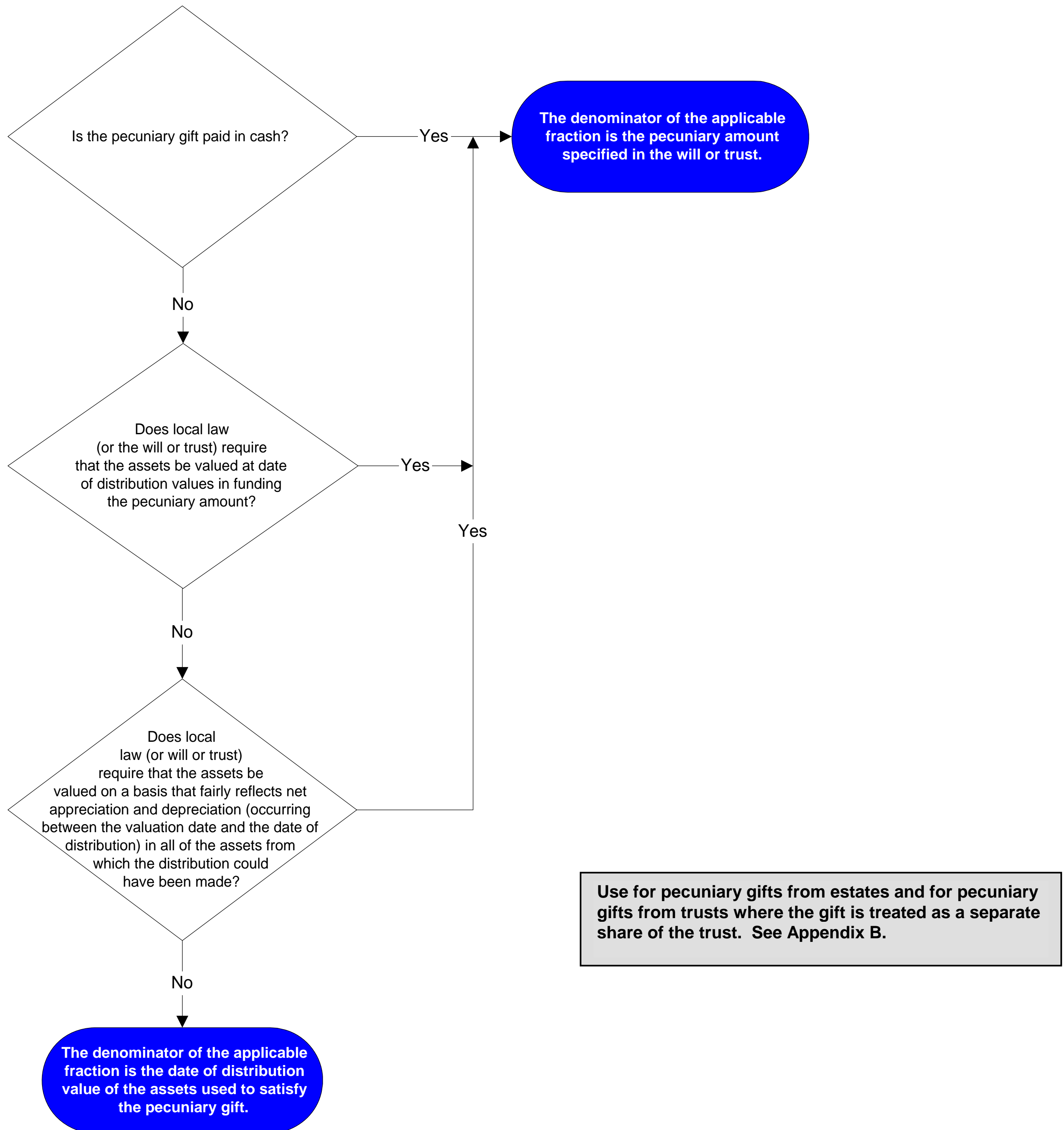
Appendix A-2
Distribution of Pecuniary Gift From Inter Vivos Trust Included in Gross Estate



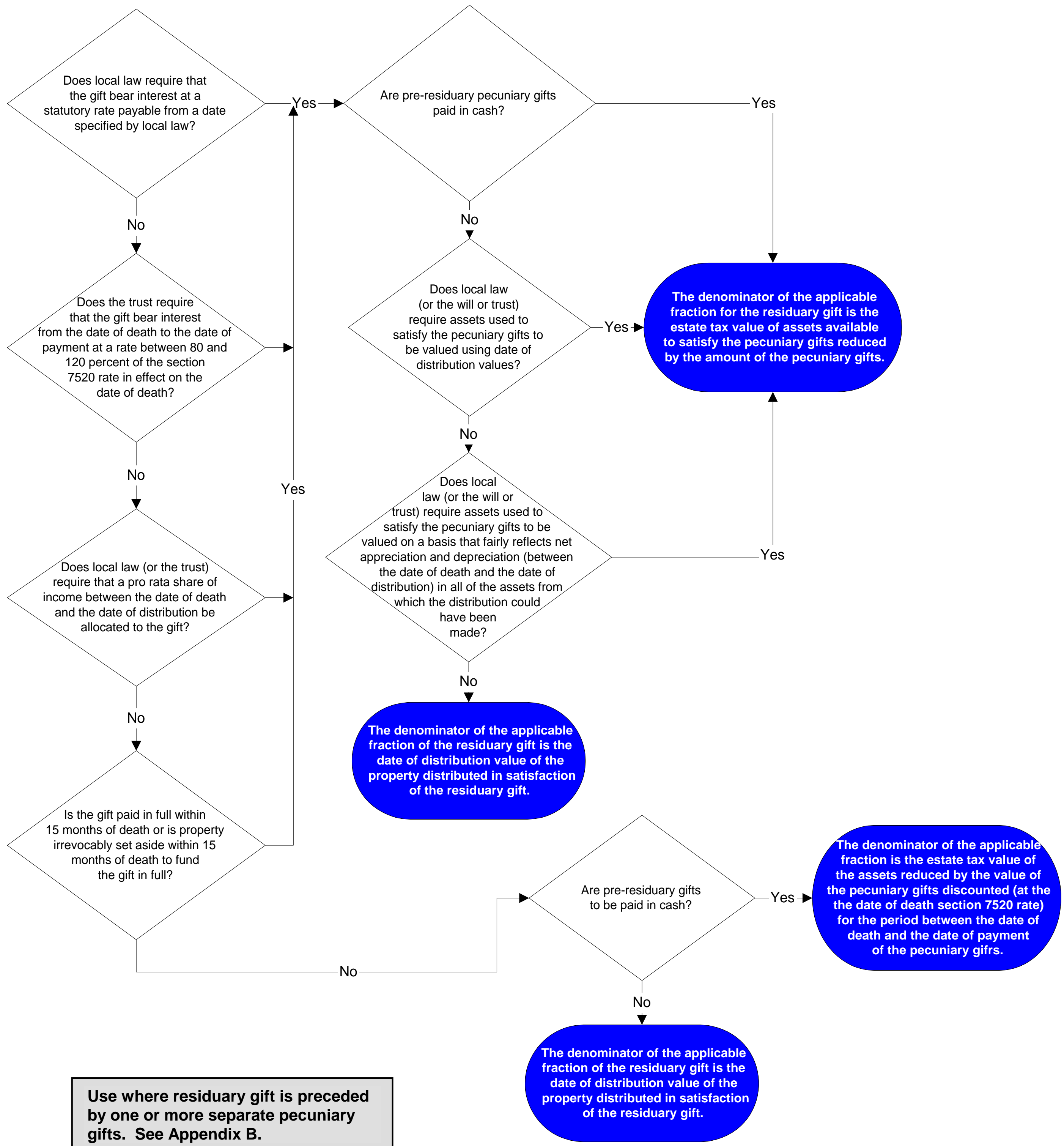
Appendix A-3
Severing Trusts Not Included in the Gross Estate



Appendix A-4
Determining the Denominator of the Applicable Fraction for Pecuniary GST Gifts at Death



Appendix A-5
Determining the Denominator of the Applicable Fraction for Residuary GST Gifts at Death



APPENDIX B:
TABLE OF REV. PROC. 64-19
INFLUENCED RULES

	Pecuniary			**Fractional**		
	Allowed with date of distribution, division, etc. funding?	Allowed with minimum worth funding?	Allowed with fairly representative funding	Pro rata at date of distribution, division, etc. allowed?	Non pro rata at date of distribution, division, etc. allowed?	Non pro rata with fairly representative funding allowed?
Basic marital deduction formula gifts	Yes	Yes	Yes	Yes	Yes	Yes
Partial disclaimers	Yes	No	Yes	Yes	No	No
Partial QTIP / QDOT	No	No	No	Yes	Yes	No
Reverse QTIP	Yes	No	Yes	Yes	Yes	Yes
Division of living trust	Yes	No	Yes	Yes	Yes	Yes
Other GST severances	Yes	No	Yes	Yes	Yes	Yes
Pecuniary transfers to QDOT by surviving spouse	Yes	Yes	Yes	Yes	No	No
Outright pecuniary distribution from living trust or testamentary trust (Requirements for separate share treatment)	Yes	No	Yes	Not applicable		

APPENDIX C:
UNIFORM LIFETIME TABLE

Age	Divisor	Percentage
70	27.4	3.65%
71	26.5	3.77%
72	25.6	3.91%
73	24.7	4.05%
74	23.8	4.20%
75	22.9	4.37%
76	22.0	4.55%
77	21.2	4.72%
78	20.3	4.93%
79	19.5	5.13%
80	18.7	5.35%
81	17.9	5.59%
82	17.1	5.85%
83	16.3	6.13%
84	15.5	6.45%
85	14.8	6.76%
86	14.1	7.09%
87	13.4	7.46%
88	12.7	7.87%
89	12.0	8.33%
90	11.4	8.77%
91	10.8	9.26%
92	10.2	9.80%

Age	Divisor	Percentage
93	9.6	10.42%
94	9.1	10.99%
95	8.6	11.63%
96	8.1	12.35%
97	7.6	13.16%
98	7.1	14.08%
99	6.7	14.93%
100	6.3	15.87%
101	5.9	16.95%
102	5.5	18.18%
103	5.2	19.23%
104	4.9	20.41%
105	4.5	22.22%
106	4.2	23.81%
107	3.9	25.64%
108	3.7	27.03%
109	3.4	29.41%
110	3.1	32.26%
111	2.9	34.48%
112	2.6	38.46%
113	2.4	41.67%
114	2.1	47.62%
115+	1.9	52.63%

APPENDIX D:
SINGLE LIFE TABLE

Age	Life expectancy	Age	Life expectancy	Age	Life expectancy
0	82.4	38	45.6	75	13.4
1	81.6	39	44.6	76	12.7
2	80.6	40	43.6	77	12.1
3	79.7	41	42.7	78	11.4
4	78.7	42	41.7	79	10.8
5	77.7	43	40.7	80	10.2
6	76.7	44	39.8	81	. 9.7
7	75.8	45	38.8	82	. 9.1
8	74.8	46	37.9	83	. 8.6
9	73.8	47	37.0	84	. 8.1
10	72.8	48	36.0	85	. 7.6
11	71.8	49	35.1	86	. 7.1
12	70.8	50	34.2	87	. 6.7
13	69.9	51	33.3	88	. 6.3
14	68.9	52	32.3	89	. 5.9
15	67.9	53	31.4	90	. 5.5
16	66.9	54	30.5	91	. 5.2
17	66.0	55	29.6	92	. 4.9
18	65.0	56	28.7	93	. 4.6
19	64.0	57	27.9	94	. 4.3
20	63.0	58	27.0	95	. 4.1
21	62.1	59	26.1	96	. 3.8
22	61.1	60	25.2	97	. 3.6
23	60.1	61	24.4	98	. 3.4
24	59.1	62	23.5	99	. 3.1
25	58.2	63	22.7	100	2.9
26	57.2	64	21.8	101	2.7
27	56.2	65	21.0	102	2.5
28	55.3	66	20.2	103	2.3
29	54.3	67	19.4	104	2.1
30	53.3	68	18.6	105	1.9
31	52.4	69	17.8	106	1.7
32	51.4	70	17.0	107	1.5
33	50.4	71	16.3	108	1.4
34	49.4	72	15.5	109	1.2
35	48.5	73	14.8	110	1.1
36	47.5	74	14.1	111+	1.0
37	46.5				

APPENDIX E:
JOINT AND SURVIVOR TABLE (EXCERPT)

Ages	56	57	58	59	60	61	62	63	64	65	66	67	68	69	70	71	72	73	74	75	76
70	30.3	29.5	28.8	28.1	27.4	26.7	26.1	25.4	24.8	24.3	23.7	23.2	22.7	22.2	21.8	21.3	20.9	20.6	20.2	19.9	19.6
71	30.1	29.4	28.6	27.9	27.2	26.5	25.8	25.2	24.5	23.9	23.4	22.8	22.3	21.8	21.3	20.9	20.5	20.1	19.7	19.4	19.1
72	30.0	29.2	28.4	27.7	27.0	26.3	25.6	24.9	24.3	23.7	23.1	22.5	22.0	21.4	20.9	20.5	20.0	19.6	19.3	18.9	18.6
73	29.8	29.1	28.3	27.5	26.8	26.1	25.4	24.7	24.0	23.4	22.8	22.2	21.6	21.1	20.6	20.1	19.6	19.2	18.8	18.4	18.1
74	29.7	28.9	28.1	27.4	26.6	25.9	25.2	24.5	23.8	23.1	22.5	21.9	21.3	20.8	20.2	19.7	19.3	18.8	18.4	18.0	17.6
75	29.6	28.8	28.0	27.2	26.5	25.7	25.0	24.3	23.6	22.9	22.3	21.6	21.0	20.5	19.9	19.4	18.9	18.4	18.0	17.6	17.2
76	29.5	28.7	27.9	27.1	26.3	25.6	24.8	24.1	23.4	22.7	22.0	21.4	20.8	20.2	19.6	19.1	18.6	18.1	17.6	17.2	16.8
77	29.4	28.6	27.8	27.0	26.2	25.4	24.7	23.9	23.2	22.5	21.8	21.2	20.6	19.9	19.4	18.8	18.3	17.8	17.3	16.8	16.4
78	29.3	28.5	27.7	26.9	26.1	25.3	24.6	23.8	23.1	22.4	21.7	21.0	20.3	19.7	19.1	18.5	18.0	17.5	17.0	16.5	16.0
79	29.3	28.4	27.6	26.8	26.0	25.2	24.4	23.7	22.9	22.2	21.5	20.8	20.1	19.5	18.9	18.3	17.7	17.2	16.7	16.2	15.7
80	29.2	28.4	27.5	26.7	25.9	25.1	24.3	23.6	22.8	22.1	21.3	20.6	20.0	19.3	18.7	18.1	17.5	16.9	16.4	15.9	15.4
81	29.2	28.3	27.5	26.6	25.8	25.0	24.2	23.4	22.7	21.9	21.2	20.5	19.8	19.1	18.5	17.9	17.3	16.7	16.2	15.6	15.1
82	29.1	28.3	27.4	26.6	25.8	24.9	24.1	23.4	22.6	21.8	21.1	20.4	19.7	19.0	18.3	17.7	17.1	16.5	15.9	15.4	14.9
83	29.1	28.2	27.4	26.5	25.7	24.9	24.1	23.3	22.5	21.7	21.0	20.2	19.5	18.8	18.2	17.5	16.9	16.3	15.7	15.2	14.7
84	29.0	28.2	27.3	26.5	25.6	24.8	24.0	23.2	22.4	21.6	20.9	20.1	19.4	18.7	18.0	17.4	16.7	16.1	15.5	15.0	14.4
85	29.0	28.1	27.3	26.4	25.6	24.8	23.9	23.1	22.3	21.6	20.8	20.1	19.3	18.6	17.9	17.3	16.6	16.0	15.4	14.8	14.3
86	29.0	28.1	27.2	26.4	25.5	24.7	23.9	23.1	22.3	21.5	20.7	20.0	19.2	18.5	17.8	17.1	16.5	15.8	15.2	14.6	14.1
87	28.9	28.1	27.2	26.4	25.5	24.7	23.8	23.0	22.2	21.4	20.7	19.9	19.2	18.4	17.7	17.0	16.4	15.7	15.1	14.5	13.9
88	28.9	28.0	27.2	26.3	25.5	24.6	23.8	23.0	22.2	21.4	20.6	19.8	19.1	18.3	17.6	16.9	16.3	15.6	15.0	14.4	13.8
89	28.9	28.0	27.2	26.3	25.4	24.6	23.8	22.9	22.1	21.3	20.5	19.8	19.0	18.3	17.6	16.9	16.2	15.5	14.9	14.3	13.7
90	28.9	28.0	27.1	26.3	25.4	24.6	23.7	22.9	22.1	21.3	20.5	19.7	19.0	18.2	17.5	16.8	16.1	15.4	14.8	14.2	13.6
91	28.9	28.0	27.1	26.3	25.4	24.5	23.7	22.9	22.1	21.3	20.5	19.7	18.9	18.2	17.4	16.7	16.0	15.4	14.7	14.1	13.5
92	28.8	28.0	27.1	26.2	25.4	24.5	23.7	22.9	22.0	21.2	20.4	19.6	18.9	18.1	17.4	16.7	16.0	15.3	14.6	14.0	13.4
93	28.8	28.0	27.1	26.2	25.4	24.5	23.7	22.8	22.0	21.2	20.4	19.6	18.8	18.1	17.3	16.6	15.9	15.2	14.6	13.9	13.3
94	28.8	27.9	27.1	26.2	25.3	24.5	23.6	22.8	22.0	21.2	20.4	19.6	18.8	18.0	17.3	16.6	15.9	15.2	14.5	13.9	13.2
95	28.8	27.9	27.1	26.2	25.3	24.5	23.6	22.8	22.0	21.1	20.3	19.6	18.8	18.0	17.3	16.5	15.8	15.1	14.5	13.8	13.2
96	28.8	27.9	27.0	26.2	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.8	18.0	17.2	16.5	15.8	15.1	14.4	13.8	13.1
97	28.8	27.9	27.0	26.2	25.3	24.5	23.6	22.8	21.9	21.1	20.3	19.5	18.7	18.0	17.2	16.5	15.8	15.1	14.4	13.7	13.1
98	28.8	27.9	27.0	26.2	25.3	24.4	23.6	22.8	21.9	21.1	20.3	19.5	18.7	17.9	17.2	16.4	15.7	15.0	14.3	13.7	13.0
99	28.8	27.9	27.0	26.2	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9	17.2	16.4	15.7	15.0	14.3	13.6	13.0
100	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	21.1	20.3	19.5	18.7	17.9	17.1	16.4	15.7	15.0	14.3	13.6	12.9
101	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.7	17.9	17.1	16.4	15.6	14.9	14.2	13.6	12.9
102	28.8	27.9	27.0	26.1	25.3	24.4	23.6	22.7	21.9	21.1	20.2	19.4	18.6	17.9	17.1	16.4	15.6	14.9	14.2	13.5	12.9
103	28.8	27.9	27	26.1	25.3	24.4	23.6	22.7	21.9	21	20.2	19.4	18.6	17.9	17.1	16.3	15.6	14.9	14.2	13.5	12.9
104	28.8	27.9	27	26.1	25.3	24.4	23.5	22.7	21.9	21	20.2	19.4	18.6	17.8	17.1	16.3	15.6	14.9	14.2	13.5	12.8
105	28.8	27.9	27	26.1	25.3	24.4	23.5	22.7	21.9	21	20.2	19.4	18.6	17.8	17.1	16.3	15.6	14.9	14.2	13.5	12.8
106	28.8	27.9	27	26.1	25.3	24.4	23.5	22.7	21.9	21	20.2	19.4	18.6	17.8	17.1	16.3	15.6	14.8	14.1	13.5	12.8
107	28.8	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.6	14.8	14.1	13.4	12.8
108	28.8	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.8
109	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.8
110	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7
111	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7
112	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7
113	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7
114	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7
115+	28.7	27.9	27	26.1	25.2	24.4	23.5	22.7	21.8	21	20.2	19.4	18.6	17.8	17	16.3	15.5	14.8	14.1	13.4	12.7

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