

Estate Practice Problem

Taxpayer "x" is single and makes the following gifts and estate. Compute the gift and estate tax consequences each year. Use Tax tables in Part III for tax rates. Death occurs in 2009.

	2006	2007	2008	Estate 2009	
Gift	512,000	1,012,000	412,000	* 4,000,000	
Exclusion	<u>12,000</u>	<u>12,000</u>	<u>12,000</u>	<u>---</u>	
Taxable Gift	500,000	1,000,000	400,000	4,000,000	Taxable Estate
Prior Yrs Gift	<u>0</u>	<u> </u>	<u> </u>	<u> </u>	
Total	500,000	<u> </u>	<u> </u>	<u> </u>	
Gross Tax	<u> </u>	<u> </u>	<u> (A)</u>	(B) <u> </u>	
Prior Yrs Tax	<u> </u>	<u> </u>	<u> </u>	(C) <u> </u>	
Net Tax	<u> </u>	<u> </u>	<u> </u>	<u> </u>	
Unified Credit	<u> </u>	<u> </u>	<u> </u>	<u> </u>	
Tax Owing	<u> </u>	<u> </u>	<u> </u>	<u> </u>	

A. _____ =

B. _____ =

C. _____ =

* Final estate includes gift taxes paid of \$210,000 and \$180,000.

Taxpayer "x" is single and makes the following gifts and estate:

Death occurs:

	2006	2007	2008	Estate 2009	
	512,000	1,012,000	412,000	* 4,000,000	
Exclusion	<u>12,000</u>	<u>12,000</u>	<u>12,000</u>	---	Taxable Estate
Taxable Gift	500,000	1,000,000	400,000	4,000,000	
Prior Yrs Gift	<u>0</u>	<u>500,000</u>	<u>1,500,000</u>	<u>1,900,000</u>	
Total	500,000	1,500,000	1,900,000	4,900,000	
Gross Tax	<u>155,800</u>	<u>555,800</u>	<u>735,800 (A)</u>	(B) _____	
All Gift Tax Paid	<u>0</u>	<u>0</u>	<u><210,000></u>	(C) <u><390,000></u>	
Net Tax	<u>155,800</u>	<u>555,800</u>	<u>525,800</u>	_____	
Gift/estate Tax Credit	<u><345,800></u>	<u><345,800></u>	<u><345,800></u>	_____	
Tax Owing	<u>0</u>	<u>210,000 (C)</u>	<u>180,000 (C)</u>	_____	

A. _____ =

B. _____ =

* Final estate includes gift taxes paid of \$210,000 and \$180,000.

Crib Sheet Notes

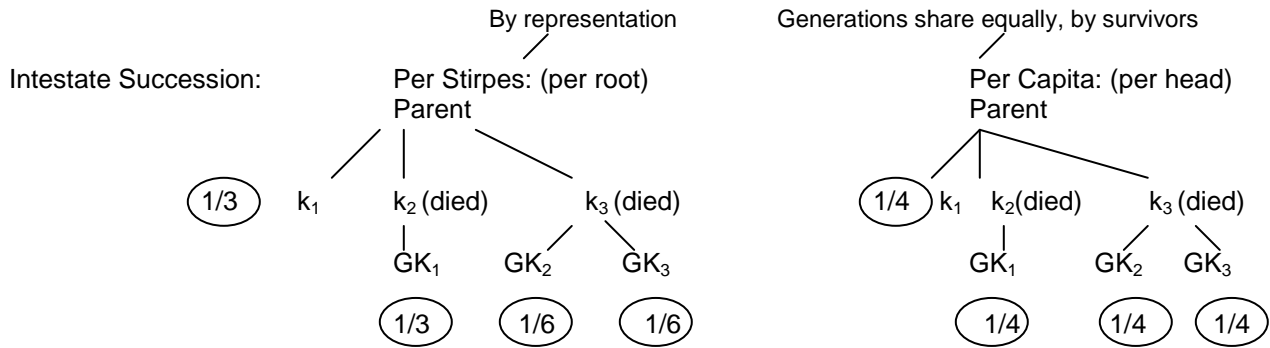
1. Minimum taxable estate?	Minimum gifts?	Forms?	When due?
3,500,000	13,000	E = 706	9 months
		G = 709	April 15th

2. Computation of tax: Estate, Gift and GSTT

3. Transfer credit versus deduction. Tax inclusive versus tax exclusive.
(Estate) (Gift)

4. Gross estate versus probate estate. Tax on income of decedent's assets.

5. Trusts – how taxed? Income versus remainder interest.



6. If you want net \$100,000 to go to heirs (Assume 50% transfer tax rate.):

	ESTATE	TAX	Net to heirs	Cash required
Estate Tax → TAX "INCLUSIVE" (It's more expensive to wait and gift at death.)	200,000	100,000	100,000	\$200,000
Gift Tax → TAX "EXCLUSIVE" (It takes less cash to gift during a lifetime.)	GIFT 100,000	TAX 50,000	100,000	\$150,000

Tenancy With Right Of Survivorship (JTWROS) form of ownership

Slide 10

Taxpayers "X" and "Y" owned their personal residence as JTWROS. Their cost was \$80,000 of which \$60,000 can be documented as being contributed by Taxpayer "X." Assume that Taxpayer "Y" dies and the FMV of the house is \$200,000. Compute the amount includible in "Y"'s gross estate under the following assumptions:

Part A: Taxpayer "X" and "Y" were spouses.

Answers:

$$\frac{1}{2} (200,000) = \underline{\$100,000}$$

Part B: Taxpayers "X" and "Y" were brother and sister.

Answers:

$$X = 60,000 / 80,000 = 75\%$$

$$Y = 20,000 / 80,000 = 25\% \quad \text{i.e., } (1/4) \$200,000 = \underline{\$50,000}$$

Community Property versus Joint Tenancy
Slide 10

	<u>Community Property</u>	<u>Joint Tenancy WROS</u>
Federal Estate Tax Consequences	½ is includible in the gross estate of decedent; qualifies for marital deduction if left to a spouse	½ includible in the gross estate of decedent; automatically qualifies for marital deduction
Federal Gift Tax Consequences	No liability if gift is to spouse, ½ of gift to third party is given by each spouse	No liability if gift is to spouse, ½ of gift to third party is given by each spouse, if elected
Federal Income Tax Consequences	Step-up in basis for entire property if ½ included in decedent spouse's estate	Step-up basis only for the ½ of property included in decedent spouse's estate
State Probate Consequences	½ subject to probate	None subject to probate
Heirs Who Can Inherit	Can be left by will to children, spouse, or other heirs	Passes only to surviving spouse by operation of law

Types of Trusts
Slide 25

- | | |
|----------------------------|------------------------------|
| 1. Asset Protection | 4. Spousal Remainder |
| 2. Clifford | 5. Standby |
| 3. Dynasty | 6. Wealth Replacement |

- a. 2 After a minimum period of ten years and one day the assets would revert to grantor
- b. 4 At the termination of the trust the assets would transfer to grantor's spouse
- c. 3 Used to increase the value of the GSTT exemption by delaying distributions
- d. 1 An irrevocable trust formed in a foreign country that is used to protect assets from the grantor's U.S. creditors
- e. 6 Life insurance trust with a Crummey power
- f. 5 Designed to become operational if grantor becomes disabled

Shifting property ownership to a minor child

Slide 30

If the child is **18** or older any income will be taxed at the child's lower tax rate. Also, both the property and its future appreciation are removed from the donor's **ESTATE**. The most common ways of shifting ownership to minors include: UGMA, UTMA, 2503(c) trust, and a Crummey trust.

A. UGMA account

A UGMA account is when property is transferred by gift to an adult custodian but the minor obtains both legal and equitable **TITLE**. The custodianship must end when the child reaches the age of **MAJORITY**. Property is restricted to cash, securities, life insurance, or annuities and the custodian only has limited investment powers. Income earned by the account is taxed to the

MINOR.

B. UTMA account

In most states the UTMA has replaced the UGMA account because of its additional

FLEXIBILITY. For example, the UTMA account gives the custodian unlimited investment power. For both UGMA's and UTMA's the custodial assets will be included in the parents' or grandparents estate if they die while serving as **CUSTODIAN**.

C. 2503(c) trust (Hint: aCCumulation trust)

This is an irrevocable trust that places no restrictions on the type of its investment and income distribution is at the discretion of the trustee. Accumulated income is taxed to the trust whereas distributed income to the beneficiary. There is only **ONE** beneficiary and at age 21 they must be given the right to an immediate distribution of both principal and accumulated income. If the beneficiary elects not to receive the property it becomes a **GRANTOR** trust.

D. Crummey trusts

These are irrevocable trusts established for minors and drafted to include a **"CRUMMEY" power** which makes them a **PRESENT INTEREST** subject to the gift tax annual exclusion. The amount of the withdrawal is generally made subject to a **5** and **5** power which limits their estate tax inclusion and avoids gift tax treatment to the other beneficiaries if the power is allowed to lapse. The grantor is given an annual exclusion for each beneficiary who is given a withdrawal right.

Reverse Gift
Gifts Causa Mortis
Slide 68

a/k/a Death Bed Gift

A reverse gift is a gift of highly appreciated property to an individual with a **SHORT** life expectancy. The expectation is to inherit the gift back when the donee dies, thus getting a stepped-up basis. Section 1014(e) requires the basis substitution rules unless the donee lives at least **ONE** year. (Death-bed gifts)

Marital and Non-Marital Trusts

Slide 96

	"A" Trust-Power of Appointment Trust	"B" Trust-Bypass Trust, Credit Shelter Trust	"C" Trust-QTIP Trust
Does trust qualify for marital deduction?	Yes	No	Yes-if executor elects
How is income distributed?	At least annually to surviving spouse	In any way specified in trust, can be to spouse	At least annually to surviving spouse
Can surviving spouse invade corpus?	Yes, but the power can be limited to testamentary use	Noncumulative right to invade \$5,000 or 5% of corpus can be granted, but not required	Noncumulative right to invade \$5,000 or 5% of corpus can be granted, but not required
Does surviving spouse have power over disposition of property at death?	Yes	No	No
What assets are placed in the trust?	Usually, assets left after nonmarital trust is funded are placed in trust	Usually, assets equal to exemption equivalent are placed in trust	Usually, assets left after nonmarital trust is funded are placed in trust

Valuing life estates, remainders, and reversions
Slide 100

The value of computing life estate, remainders, and reversions is based on computing their **PRESENT VALUE** using IRS Table **S**. A reversion interest is merely a remainder interest retained by the **GRANTOR**. There are different tables for fixed-term annuities, life annuities, and annuities paid over joint-life expectancies.

Example:

An individual establishes a \$100,000 trust paying income to her husband for his life with the remainder going to their only child. Her husband is seventy years old and the appropriate discount rate is 8.6%. Using the attached Table S, compute the value of the following:

Life Estate

Remainder interest: **\$40,162** Income Interest: **\$59,838** Total Interest: **\$100,000**

**Single Life, 8.6 Percent, Based on Life Table 80CNSMT
Present Worth of an Annuity, of a Life Estate,
and of a Remainder Interest**

<u>Age</u> <u>(1)</u>	<u>Annuity</u> <u>(2)</u>	<u>Life Estate</u> <u>(3)</u>	<u>Remainder</u> <u>(4)</u>
55	9.2057	.79169	.20831
56	9.0839	.78121	.21879
57	8.9575	.77035	.22965
58	8.8268	.75910	.24090
59	8.6916	.74748	.25252
60	8.5526	.73552	.26448
61	8.4100	.72326	.27674
62	8.2641	.71071	.28929
63	8.1150	.69789	.30211
64	7.9625	.68478	.31522
65	7.8060	.67132	.32868
66	7.6450	.65747	.34253
67	7.4793	.64322	.35678
68	7.3091	.62858	.37142
69	7.1351	.61362	.38638
70	6.9579	.59838	.40162
71	6.7785	.58295	.41705
72	6.5966	.56731	.43269
73	6.4123	.55146	.44854
74	6.2248	.53534	.46466

Chapter 14 rules

Slide 130

Estate Freezes

Chapter 14 provides the rules for valuing interests in corporations and partnerships which are transferred between **FAMILY** members. It requires that in transfers between family members, retained interests are valued at **ZERO**, unless certain requirements are met. The zero valuation will not be used if a **FIXED** payment right is retained by the donor.

Example:

Taxpayer "X" give his daughter 100 percent of the non-voting common stock in his solely owned corporation. The FMV of the corporation is \$1 million dollars and he retains non-cumulative voting preferred stock with a liquidation value of \$400,000. Identify the value of the gift before and after Chapter 14, before the \$13,000 exclusion.

Before:	\$600,000	After:	\$1,000,000
Chapter 14		Chapter 14	

Exotic Questions:

1. T F Chapter 14 applies to both cumulative and noncumulative preferred stock.
2. I F Chapter 14 does not apply when the retained interest is of the same class as the transferred interest.
3. I F Chapter 14 does not apply to personal residences or publicly traded stock.
4. I F Chapter 14 has effectively eliminated GRIT's as an estate planning tool.
5. I F The fixed payment requirement (for dividends) of Chapter 14 refers to both time and amount.

Personal holding company (PHC)

Slide 147

A PHC is a corporation typically organized to receive highly appreciated **ASSETS** in exchange for its stock. The stock received is generally **NONVOTING** common that is used for gifting to remove future appreciation from the owner's estate while retaining voting control.

A. Explain the two tests to qualify as a personal holding company.

1. Stock ownership: Requires that **50** percent or more of outstanding stock be owned by **5** or fewer shareholders the last half of the year.
2. Income test: At least **60** percent of the income must be PHC income such as dividends, interest, and amounts received for certain personal services.

B. Identify the two primary reasons for creating a PHC.

1. Its stock provides a simple and effective way of **GIFTING**.
2. Valuation **DISCOUNTS** similar to a limited partnership when valuing stock.
3. Disadvantage – Additional corporate tax of 15% on undistributed personal holding company income.

Bargain sale
Slide 159

A bargain sale occurs when a donor sells appreciated property to a charity for an amount **LESS** than its FMV. The transaction is divided into a sale and a donation component. The sale component gets a pro rata allocation of basis and a **GAIN** is recognized based on the difference between this amount and the actual sale proceeds. The remainder of the FMV is claimed as a charitable contribution.

Example:

Taxpayer "X" sells property with a FMV of \$100,000 to her church for \$60,000. Compute her recognized gain and donation if her basis in the property was \$80,000.

Step # 1:

$$\frac{60,000}{100,000} \text{ Sales Price} = 60\% \times 80,000 \text{ Basis} = 48,000 \quad \underline{\% \text{ of Basis that was sold}}$$

Step # 2:

	Sales Price	60,000
Less:	<u>% of Basis</u>	<u>(48,000)</u>
Equals	<u>Taxable Gain</u>	<u>12,000</u>

Step # 3:

	FMV of Property Given	100,000
Less:	<u>Sales Price</u>	<u>(60,000)</u>
Equals	<u>Charitable Donation</u>	<u>40,000</u>

Generation-Skipping Transfer Tax (GSTT)

Slide 163

The GSTT is a flat tax of **45** percent on both gifts during lifetime or transfers at death to persons who are at least **TWO** generations younger than the donor. It is in **ADDITION** to any gift or estate tax that would otherwise be due on the transfer.

A. Identify the GSTT exemption.

Each individual gets one lifetime exemption of **\$3,500,000** for generation skipping transfers. The use of the exemption is not **MANDATORY** and can be allocated between transfers in whatever dollar amount the transferor chooses. However, automatically applies to **DIRECT** skips unless the donor files an election that it does not apply.

B. Explain how the annual exclusion for gifts affects the GSTT.

Gifts that qualify as a direct skip will generally get the **SAME** exclusions as for the regular gift tax. Thus, the **\$13,000** annual exclusion, the exclusion for educational and medical expenses, and gift splitting will apply to both the GSTT and the “regular” gift tax.

C. Describe the procedure for determining two generations younger.

If **RELATED** the normal lines of descent are used. Thus, grandchildren, grandnephews, and grandnieces would all be considered **TWO** generations. If unrelated **37½** years younger is considered two generations. A **SPOUSE** is always assigned the same generation regardless of age.

D. Distinguish between “direct” and “indirect” skips.

1. Direct skips

Direct skips are gifts or bequests made directly to someone two or more generations younger or to a **TRUST** where all interests are held by **SKIP** persons. The GSTT on such transfers must be reported and **PAID** at the time of the **TRANSFER** in addition to the related gift or estate tax.

2. Indirect skips

Indirect skips are gifts or bequests are made to a **TRUSTS** that includes both **SKIP AND NON-SKIP** persons. The GSTT is not assessed until the “skip” person **RECEIVES** property either from a **taxable distribution** or a **taxable termination**.

1. Explain the ramifications of the GSTT on the two types of “indirect” skips.

A. Taxable Distributions

The **GIFT AND ESTATE TAXES** are paid when the **TRUST** is formed but the **GSTT** is not imposed until funds are actually **DISTRIBUTED** to the “skip” person. The **SKIP** person is responsible for paying the tax when the distribution occurs and filing a Form 706GS/D.

B. Taxable Termination

The **GSTT** is also imposed when a non-skip person’s interest is terminated resulting in only **SKIP** persons remaining as beneficiaries. The GSTT is imposed regardless if the assets are actually distributed and the **TRUSTEE** is responsible for both the filing of Form 706GS/T and paying the tax.

2. Describe a generation-skipping trust.

This is a trust whose income beneficiary is a child and remainder beneficiary is a **GRANDCHILD**. GSTT has eliminated the “skipping” of a generation but currently is used to take advantage of the **\$3,500,000** exemption as **APPRECIATION ON TRUST ASSETS IS ALSO EXEMPT**.

A. Identify what is meant by a reverse QTIP election.

This is an election that allows a QTIP trust to use the GSTT **EXEMPTION** of a predeceased spouse for generation skipping transfers. Thus, the QTIP assets are subject to **GSTT** in the deceased spouse’s estate and regular estate tax in the surviving spouse’s estate.

1. **T** **F** If a couple splits gifts for gift tax purposes it is automatically treated as split for GSTT purposes.
2. **T** **F** If all beneficiaries of a trust are skip persons GSTT is due at the time of transfer.
3. **T** **F** An individual’s grandchild whose parents have died is not considered a skip person.
4. **T** **F** Both federal estate and state death taxes are deducted in determining the amount subject to GSTT.