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Applications In Financial Planning II – 2nd Edition

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Introduction

There are three transfer taxes under federal law: estate tax, gift tax, and generation skipping transfer tax. The federal estate tax is imposed on transfers that occur at death. The transfers subject to tax at death are gratuitous transfers to heirs, and they occur by operation of law or due to a contract effective on a person's death. The estate tax also encompasses some transfers during life that were essentially attempts to evade the estate tax by means of testamentary substitutes.

The gift tax is imposed on lifetime gratuitous transfers of property. If the federal government had only an estate tax, people would likely give all or most of their property away before death. The gift tax makes up for the loss of revenue on the estate tax from lifetime transfers.

The generation skipping transfer tax seeks to replace the revenue that would be lost when property owners transfer substantial wealth to grandchildren or great grandchildren instead of to their children. If the property is not taxed in each generation, the treasury will lose revenue. The generation skipping transfer tax seeks to collect the equivalent amount of tax as though the assets passed to the children instead of skipping to the grandchildren (or beyond).

1-1. The federal estate tax is calculated using the following five main steps:

(1) Value the gross estate;
(2) Calculate the adjusted gross estate;
(3) Determine the taxable estate;
(4) Calculate the tax payable before credits using the estate tax rate schedule; and
(5) Calculate the net estate tax payable.

1-2. Gross Estate

The Internal Revenue Code ("IRC Sec." or "Code") specifies ten categories of property that are included in the gross estate.

IRC Sec. 2033 states that the gross estate will include property owned outright at death. The property owned outright may be real or personal, tangible or intangible. The decedent must have held actual title to the property and cannot have held title as a trustee or "strawman" (third party acting as a mere conduit for another person). Property held in joint tenancy with others or as community property is also treated as property owned outright.

An exception to the outright ownership rule is the ownership of a "lifetime enjoyment." Since the decedent who can enjoy a property for life has no interest after death, there is no property to transfer at death. For example, when a life estate is granted to the decedent by another party, that life estate terminates at the decedent's death, and the decedent has no interest to pass to others because the remainder interest belongs to someone else. Therefore, nothing from a life estate is included in the gross estate.

Income earned prior to death, but which will be payable after death, is still a property right and, is owned outright by the decedent, so it is included in the gross estate. This future income is referred to as *income in respect of a decedent* ("IRD") and includes interest on savings bonds, bonuses or salary not yet paid, future commissions, and royalties earned or to be earned but not yet paid. Because this income is includible in the gross estate and will also be subject to

income tax, the Code limits the double taxation of this property by providing an income tax deduction in Section 691.

IRC Sec. 2035 requires inclusion in the gross estate of only certain property interests transferred within 3 years of death. Generally, transfers made before death, even gifts within 3 years before death, are not includible in the gross estate. While large gifts made before death may be subject to gift tax, they are not included in the gross estate. Under Sec. 2035, there are a few specific gifts made within three years of death that will be included in the gross estate.

First, any gift taxes paid by the decedent within the three years before death will be includible in the gross estate.

Second, a release of a retained interest or power over certain property will cause the value of that property to be included in the gross estate if the release was within 3 years of death. For example, David set up a trust with $1 million of securities and provided in the trust that the income be paid to David during his lifetime and at his death the income would be paid to his daughter. Later, David decided to release his right to the life income. If David died within 3 years after making that release of the life income, then the value of the trust assets at his death will be included in his gross estate. Life insurance presents a special case of the released powers exception. If, within three years of death, the decedent transferred an incident of ownership in a policy insuring the decedent's life, then the proceeds will be included in the decedent's gross estate.

Third, the text describes the special inclusion of assets in the determination of the benefits available under tax code Section 303 (stock redemption), Section 2032A (special use valuation), and Section 6166 (installment payment of estate tax). This inclusion is not in the gross estate. The reason for this type of inclusion is to prevent an estate owner from making lifetime gifts of assets within 3 years of death so his or her estate will qualify for those special tax benefits. Section 2035 will treat such gifts as not having been made. Thus, when a decedent has transferred property by gift within 3 years of death, the property will be brought back into the estate for the limited purpose of determining whether the estate will qualify for the benefits of these code sections 303, 2032A, and 6166.

IRC Sec. 2036 requires that property be included in the gross estate if the owner transferred it by means of a lifetime gift but retained a right for life to use or enjoy the property or to specify who could use or enjoy the property. For example, Darlene transfers $1 million in trust and retains the right to specify which of her children will receive the income annually from the trust. The property in the trust will be included in Darlene's gross estate when she dies because she has retained the right to specify who could enjoy the property. The key here is that the entire value of the property on the date of death is included, not just the retained interest. If the donor retained a right to receive the income for life or for a period only ascertainable by the date of death, then the property is included by IRC Sec. 2036. The examples of this type of transfer include retained life estates, the retained possession or "enjoyment" of the right to income, or the right to determine who will have the possession/enjoyment of income. In addition, you will recall that under Sec. 2035, if within three years of death the decedent releases the power that would result in inclusion by Sec. 2036, the full value is still included.

IRC Sec. 2037 requires inclusion in the gross estate of any lifetime gift conditioned on the recipient surviving the decedent. For example, Denise places $1 million in a trust for her brother Fred, who is given a right to the income for life. If Fred dies, the trust assets will return to Denise. If Denise dies first, however, the trust assets will go to Denise's children. Denise has a *reversionary interest (reversion)* because the trust assets can return to her. If *the reversionary interest is* actuarially worth 5% or more of the property's total value and if Denise must be alive at Fred's death to receive the property, then the trust assets are included in Denise's gross estate. If this two part test is met, the full value of the property will be included in the decedent's gross estate.

IRC Sec. 2038 requires lifetime transfers be included in the gross estate where the decedent kept a power to alter, amend, revoke, or terminate the gift. Even the mere ability to affect the timing of the gift results in inclusion. If the donor is also merely a trustee or custodian and in that capacity retains a forbidden power, then the value of the property is includible, even if the donor cannot benefit in any way from the power. Exercise is not required; the *mere possession* of the power results in the inclusion in the gross estate.

IRC Sec. 2039 requires that the present value of a survivor's income right under an annuity (or similar arrangement) be included in the decedent's gross estate. For example, Adam purchased an annuity that will pay him $10,000 annually for life and after Adam's death will pay $5,000 annually for life to his wife. Adam's gross estate will include the present value of the $5,000 annual payments that will be made to Adam's wife after his death. Note that if the payments ended at Adam's death, there would be no amount of the annuity included in his gross estate. Also, if Adam's wife had helped to purchase the annuity and had contributed one-quarter of the premium, then only ¾ of the present value of her income interest would be included in Adam's gross estate.

IRC Sec. 2040 provides that when the decedent owned property jointly with right of survivorship (or as tenants by the entirety) with a spouse, one-half of the value of the property will be included in the decedent's gross estate, regardless of the amount of the decedent's contribution. This rule is referred to as the 50-50 rule and applies to both real and personal property.

A different rule applies when the property is owned in joint tenancy with right of survivorship by persons who are not spouses. For non-spouses, the general rule is that the entire value of the property is includible in the decedent's estate; however, there is an exception known as the consideration furnished rule. To the extent that the estate can prove consideration furnished by the survivor, the value of the property will not be included in the gross estate. The amount that will not be included will be in the same proportion as the consideration furnished by the survivor. Thus, if Peter and Paul are not spouses and bought a car in joint tenancy with right of survivorship and Paul can prove that he contributed 25% of the original purchase price, then when Peter dies, 25% of the value of the car will not be included and 75% will be included in Peter's gross estate.

IRC Sec. 2041 requires the gross estate to include property over which the decedent held a general power of appointment that could be exercised during life or at death. A general power gives the holder such control over property that it essentially confers ownership. A power of appointment is the ability to direct who will receive property (usually in trust).

IRC Sec. 2042 requires the death benefit from a life insurance policy on the decedent's life to be included in the decedent's gross estate if the decedent possessed any incidents of ownership in the policy at the time of death. Incidents of ownership are rights to benefits under the policy or rights to control the policy benefits. Policy benefits include items like the right to name or change a beneficiary, the right to borrow against the policy, the right to use the cash value, or the right to cancel the policy. Note that even if the decedent held no incidents of ownership in a policy at death, if the policy proceeds are payable to the executor or to the decedent's estate, the proceeds will be included in the decedent's gross estate.

Corporate-owned life insurance will be includible in the decedent's gross estate if the decedent controlled the corporation (owned more than 50% of the stock) and if the proceeds are payable to a person other than the corporation or its creditors.

IRC Sec. 2044 requires inclusion of property in a decedent's gross estate when a marital deduction was taken on a prior estate tax

return for QTIP (Qualified Terminable Interest Property). For example, Roberta's estate received a QTIP deduction for assets left in a QTIP trust for her husband Sam. The value of the property in the QTIP trust at Sam's death must be included in his estate.

Valuation. When property is included in the gross estate, it must be valued. Generally, the assets includible in the gross estate are valued at the fair market value as of the date of death. However, in order to avoid hardship to an estate that sustains losses after the decedent's death, a second date may be used that is six months after the date of death. This date is referred to as the alternate valuation date. While the alternate valuation date allows for use of the fair market value on the date six (6) months from the date of death, any asset sold prior to the 6 months will be included in the gross estate at the sale value.

Alternate valuation may be used if, and only if, the gross estate is reduced *and* the estate tax will be reduced. Items that decline in value by the mere passage of time, such as annuities or royalties must use the date of death value.

Chapter 1

Overview of Federal Estate and GST Taxation

1. What is the proper order of the major steps to computing the federal estate tax?

(Text 1.3)

(A) Gross estate, taxable estate, adjusted gross estate, marital deduction, net estate tax payable.

(B) Gross estate, tentative tax base, estate tax payable before credits, net estate tax payable.

(C) Gross estate, adjusted gross estate, taxable estate, tentative tax base, estate tax before credits, net estate tax payable.

(D) Adjusted gross estate, marital and charitable deductions, estate tax before credits, credits, net estate tax payable.

2. In all of the following situations, the property interests will be included in the decedent's gross estate, EXCEPT:

(Text 1.4, 1.7-1.10, 1.13)

(A) The decedent transferred a yacht to his girlfriend 2 years before his death.

(B) Decedent was the beneficiary of a QTIP trust for which her spouse's estate received a marital deduction.

(C) Decedent retained a life estate in a home and granted the remainder to his girlfriend.

(D) The decedent purchased a house and made her son a joint tenant with right of survivorship.

3. Decedent holds a mortgage payable to her for realty she sold 10 years ago. Her gross estate includes:

(Text 1.5)

(A) There is no asset to include because the mortgage is intangible.
(B) The real property value at the date of death.
(C) The real property less the outstanding mortgage balance.
(D) The date of death value of the mortgage.

4. Bill Owner granted his son, Harold a life estate in a home. The remainder interest was retained by Bill Owner. If Harold dies, his gross estate will include which of the following values:

(Text 1.6)

(A) The value of the life estate.
(B) The value of the remainder interest.
(C) The full value of the real property.
(D) No amount.

5. What is IRD?

(Text 1.6)

(A) Income earned but not paid to the decedent prior to death, includible in the gross estate.
(B) Income received by beneficiaries on estate assets, deductible from the gross estate
(C) Income earned by the fiduciary for administration, deductible on the estate tax return.
(D) Income distributed by the estate, deductible on the estate tax return

Chapter 1

Overview of Federal Estate and GST Taxation

1. C is the answer. The gross estate is the starting point for the calculation. The adjusted gross estate is then determined by subtracting debts, funeral expenses, and administration expenses. The taxable estate is determined by subtracting the marital, charitable, and state death tax deductions. The tentative tax base includes any gifts required to be reported. The estate tax before credits is determined using the estate tax rate schedule. Finally, the net estate tax is found by reducing the tax before credits by applicable credits. Gross estate, adjusted gross estate, taxable estate, tentative tax base, estate tax before credits, net estate tax payable.

2. A is the answer. A gift of a yacht will not be brought back into the decedent's gross estate. Most gratuitous transfers will not be brought back into the decedent's estate but certain gifts will. A gift of life insurance within three years of death will be brought back into the gross estate. A QTIP trust will be included in the surviving spouse's estate in order because it earlier qualified for the marital deduction in the spouse's estate. Property held jointly with anyone is includable in the gross estate. A retained life estate or retained income interest will be included under Section 2036.

3. D is the answer. The mortgage is intangible, but intangible assets are included in the gross estate. The mortgage can be valued and is an asset individually owned by the decedent (IRC 2033).

4. D is the answer. Harold owned only a life estate in the property at the time of his death. His interest did not allow him to pass anything at his death. No value of the property will be included in Harold's gross estate.

5. A is the answer. IRD is income in respect of a decedent and is income the decedent earned but had not received before death.

Future income rights possessed at the time of death are owned outright under Section 2033. This may also result in an income tax deduction under Section 691 ("estate tax deduction").