# FUNDAMENTALS OF ESTATE PLANNING

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(877) 488-9308

www.webce.com • customerservice@webce.co

# Fundamentals of Estate Planning
## Contents

# Introduction

Life insurance may be used in conjunction with estate planning. But even when it is not, life insurance producers should be familiar with the common estate planning techniques that they may encounter in their clients' estate and financial plans. Your understanding of why, when and how individuals create estate plans will provide many opportunities for you to serve your clients. As you'll learn, life insurance products can be used as a key part of several estate planning tools, often with significant tax benefits.

This course offers a comprehensive overview of estate planning. Upon conclusion, you will be able to:

- associate the application of wills and income in respect of a decedent to estate planning
- describe different types of property ownership
- explain the benefits of making lifetime gifts, and how clients can do so in a tax-favored manner
- demonstrate an understanding of how the federal estate tax can impact an estate, and how to minimize that impact
- apply ways in which a spouse can plan to pass assets to a surviving spouse
- describe how the generation skipping transfer tax works
- interpret the value of irrevocable life insurance trusts and other trusts available as estate planning tools
- explain how to pass assets to children
- demonstrate an understanding of family limited partnerships—how they work and their advantages in estate planning
- devise ways to help clients plan for incapacity and incompetence

# Chapter 1
# What Is a Will?

## Key Points

- Testator's written declaration
- Disposition of assets after death
- Absent unusual conditions, probate court agrees to will
- May not dispose of all property

A **will** is a written document in which an individual (a **testator**) specifies how his or her assets will be managed or distributed after death. If the will was prepared and executed in accordance with legally required formalities, and if the testator was competent and not under duress, the probate court will generally order that the testator's plan be carried out by the executor, also called the personal representative.

A will usually does not exclusively direct the disposition of all of a person's property. The most common examples of property that does not pass by will are jointly held property and life insurance payable to a named beneficiary. While a will is an essential part of almost any estate plan, it should be viewed as only one part of the total picture.

## Purposes of a Will

In addition to providing a plan for the disposition of property, a will allows the testator to:

- minimize or avoid estate costs—taxes, administration expenses and shrinkage of assets
- nominate a guardian for minor dependent children if there is no surviving parent
- make a bequest of specific assets (e.g., family heirlooms) to an appropriate heir
- make a bequest to charity
- nominate an executor or personal representative to carry out the terms of the will during the probate process
- grant the executor specific powers otherwise unavailable under state law (e.g., the power to continue operating the decedent's business)
- make the best use of the unified credit and the unlimited charitable and marital deductions
- provide income for the care of a mentally or physically handicapped child, parent or spouse
- provide for the close-in-time deaths of spouses, which may affect the distribution of assets
- describe how estate settlement costs are to be paid, so they are not charged against particular heirs or bequests

## Testamentary Capacity

### *What It Means*

### Key Points

- Sound of mind
- Later unsoundness does not make will invalid
- Age 18 typically minimum age to make a will
- Testator must not have been under undue influence to make a will in a certain manner

In order for a will to be legally valid, the testator must possess what is called **testamentary capacity**. This simply means that the person must be:

- Of sound mind, and
- Of the minimum legal age to execute a valid will.

**Sound mind:** The testator must be of sound mind at the time the will is executed. If the testator later becomes mentally unsound, that does not affect the validity of the will. If a will is contested, a court may ultimately have to determine whether or not the testator was of sound mind when the will was signed.

**Legal age:** Most states set 18 as the minimum age to make a valid will. This age is often the same as the age of majority, but a few states are exceptions.

**Fraud, duress or undue influence:** Assuming sound mind and legal age, the testator also must not have been under duress or undue influence, or have been the victim of some type of fraud at the time the will was executed. These are the bases for challenging the validity of a will, agreement, contract, or certain other documents. If challengers can prove this sort of inequity in court, the will may not be legally valid.

## Legal Formalities

### *Written Will vs. Oral or Nuncupative Will*

### Key Points

- Printed will preferred
- Two witnesses usually required
- Oral will may be accepted if it meets legal requirements

Wills generally should be printed and signed/authorized in accordance with state law.

State law usually requires two adults to witness the execution of the will. If a will is contested in court, the judge may call upon the witnesses to describe the testator’s state of mind and the actual circumstances surrounding the execution of the will.

An oral will (called a **nuncupative** will), recited by the testator in front of witnesses, may be accepted as valid in some states if it is:

- An accepted form under state law
- Pronounced during the testator's final illness

- Put promptly into writing by the witnesses
- Filed promptly with the probate court

### *Holographic Will*

**Key Points**

- Testator’s handwritten will, no witnesses
- Acceptance depends on state law

A **holographic** will is entirely in the testator’s own handwriting with no attesting witnesses. While it is valid in some states, it is not generally a good idea, as the testator’s handwriting may be illegible, or the testator may express his or her intentions in a confusing or inconsistent manner.

## Revocation of a Will

### *How Revocation Occurs*

**Key Points**

- Physical destruction of the will
- Execution of a new will
- Forced by law to change will in some cases

To revoke a will, the testator can physically destroy the will or simply execute a subsequent will. However, the testator must be of sound mind at the time either of these events occurs to accomplish the revocation.

The law may force a revocation in some cases. For example, the following circumstances automatically revoke a prior will in some states:

- marriage
- divorce
- annulment
- the birth of a child

In some states, divorce may revoke provisions in the will in favor of the ex-spouse without revoking the entire will.

## Codicils: Amendments to a Will

**Key Points**

- Usually for minor changes only
- Requires soundness of mind

To make minor changes, a testator may amend the original will using a legal document called a codicil. Codicils must comply with all the legal formalities of wills, including the "soundness of mind" rule. It's a good idea to review and update a will when the testator:

- moves to a new state
- gets married or divorced
- has a child through birth or adoption
- experiences a major change in financial circumstances or is affected by a change in law
- wishes to change beneficiaries, executors, guardians or trustees

## State Law Restrictions on Disposition

### *Family Protections*

#### Key Points

- Spouse can elect against the will
- Pretermitted children may be entitled to a share

State law imposes some restrictions upon the disposition of the testator's assets. For example, if a husband leaves his wife less than what she would have received if he had died intestate (without a will), she can generally **"elect against the will"** and take the larger intestate share of the estate.

Similarly, in some states, children who are omitted from the will are entitled to a child's intestate share. This is more common in the case of children born after the will was executed.

## Will Contest by Heirs

#### Key Points

- Will contest must be initiated in court
- Variety of grounds may permit contest

Heirs may challenge the validity of a will by initiating a **will contest** in probate court on a variety of grounds:

- The testator was under duress, undue influence or fraud at the time of execution.
- The testator was of unsound mind or below the minimum legal age to write a will.
- The testator's signature was forged.
- The will was not executed in accordance with required legal formalities.
- The testator revoked the will.

# Intestacy

## *Intestate Succession Statutes*

### Key Points

- Dying without a will
- Property distributed by statute
- Decedent's wishes are not considered

A person who died without a valid will is said to have died **intestate.** In this case, the court will distribute the property under the intestate succession statutes of the state, without any consideration for the decedent's unique personal situation. Such a distribution is unlikely to be in total accord with what the decedent would have wished.

The intestacy statutes only take family relationships into consideration, while ignoring all other factors such as taxes, administration costs, or estate shrinkage.

## *The Price of Dying Intestate*

Here are some examples of what can happen when an individual dies intestate.

- **The spouse may not get enough.** Roger and his wife Diane have two minor children. If Roger were to die without a will, he would probably be shocked to learn that, in many states, Diane would receive only one-third of his probate property. The other two-thirds would go to the children under the intestacy laws.
- **No consideration of special needs.** Lydia, a widow, leaves two children—one healthy and one with a physical handicap. A will could recognize the greater needs of the handicapped child, but intestacy laws will treat the children equally.
- **No distribution of specific assets to specific recipients.** Aunt Martha would like a special brooch to go to her favorite niece. She can accomplish this by will, but the intestacy laws would not recognize Aunt Martha's intentions for specific assets.
- **The court will appoint an administrator.** A person who executes a will has the opportunity to nominate an executor. In the absence of a will, the court will appoint an administrator, who may or may not be someone the decedent would have named.
- **The estate may shrink through fees and loss of value.** Intestacy can make estate administration more difficult, and that could translate into higher fees for the administrator of the estate and higher legal fees. The administrator will have the minimum powers granted by law, not the broader powers that could be extended by will. So, the administrator generally has less flexibility in dealing with estate assets, and this may result in loss of value or sale of estate assets at a liquidation price.
- **Without heirs, the state keeps the assets.** If the decedent leaves no heirs (as defined by the intestacy statutes), the decedent's assets, after payment of debts and expenses, pass to the state. The states allow a grace period for heirs to turn up and challenge the escheat. However, by not executing a will, the decedent lost the opportunity to give estate assets to a charity, friend, or other beneficiary of his or her own choosing.

### *Special Rules for Children*

## Key Points

- Adopted child takes full intestate share
- Child born after death takes full intestate share
- Illegitimate children usually take full intestate share from mother

An adopted child will normally take a child's full intestate share from the estates of both the adoptive parents and, in some states, from the estates of the natural (biological) parents.

A child born after the death of a parent will also take a child's full intestate share from the estate of the deceased parent.

Illegitimate children in most states will take a child's full intestate share from the mother's estate, but not the father's estate unless:

- the father has acknowledged the child as his,
- a court has ruled him to be the father, or
- the father married the mother after the child was born.

# What Is Income in Respect of a Decedent (IRD)?

### *Definition and Examples*

## Key Points

- Income earned by decedent
- Income to which decedent had a right
- Not properly includible in gross income before death

**Income in respect of a decedent (IRD)** is income an individual earned or had a right to before death, but which was not properly includible in the individual's gross income prior to death. Examples include such items as:

- Unpaid salary and bonuses
- Deferred compensation benefits
- Accrued interest and rent
- Accounts receivable
- Unpaid fees and commissions
- Uncollected proceeds of a sale made before death
- Uncollected payments on an installment note
- Survivor benefits under a joint-and-survivor annuity

- Gain on deferred annuities
- Death benefits from retirement plans, IRAs, and annuities

### *Includible in Gross Income or Gross Estate*

## Key Points

- Includible in gross estate of decedent and gross income of recipient
- Can pass through probate or outright to recipient
- Taxable at recipient's tax rate
- Gain on sale of asset allows recipient to use decedent's basis

IRD is generally includible in the gross income of the recipient. This may be the decedent's estate or an individual who acquires the right to receive the income directly from the decedent. It does not matter whether the property passes through the probate estate or outright to the recipient. While the income retains the same character it would have had in the decedent's hands, it is taxable at the recipient's income tax rate.

If the income in respect of a decedent represents gain (capital or ordinary) on the sale of an asset, the recipient may utilize the decedent's basis to offset the gain. The basis of appreciated property does not step up to the fair market value at death, even though the income in respect of a decedent is included in the gross estate.

IRD is includible in the decedent's gross estate as a property interest or right that passes at death.

For example, let's say that Robert had a nonqualified deferred compensation plan with his employer. At the time of his death, Robert had received 14 of 20 guaranteed annual payments under the plan. The present value of the six remaining payments is included in his gross estate, and also in the gross income of the beneficiary. However, the beneficiary may be able to deduct federal estate tax attributable to the plan payments.

## Deduction for Estate Tax Paid

### *Offsetting Double Taxation*

## Key Points

- Federal estate tax and federal income tax apply
- Results in large loss of value in higher brackets
- Special income tax deduction permitted

Income in respect of a decedent may be taxed twice—once for federal estate tax purposes and again to the recipient for federal income tax purposes. If the estate was the recipient, and was in a 40% estate tax bracket and a 37% income tax bracket, well over half of the property would be lost to the combined taxes.

To prevent this double taxation, the IRS allows a special income tax deduction for IRD. Remember, the full amount of income is taken into gross income as received, but the recipient is then allowed to deduct the federal estate tax paid by the estate that was attributable to the IRD.

### *Rules for Two or More Items*

## Key Points

- Requires apportionment as determined by law
- Deduction follows each item to recipient

If there are two or more items of income in respect of a decedent in the gross estate, life gets more complicated. The total amount of estate tax attributable to these items must be apportioned among the individual items as follows:

$$\text{Total estate tax attributable to all IRD items} \times \text{Value of each IRD item} \div \text{Value of all IRD items}$$

This deduction then follows each IRD item into the hands of the appropriate recipient.

### *Exception to 2% of AGI Floor*

## Key Points

- Miscellaneous itemized deduction
- Not subject to 2% of AGI floor
- Could reduce IRD deduction

The deduction for estate tax attributable to IRD is a miscellaneous itemized deduction, but it is not subject to the usual 2%-of-adjusted-gross-income (AGI) floor on such deductions.

Note that the deduction for estate tax attributable to IRD is taken by the IRD recipient only as the income is received and in the same proportion. For instance, if $5,000 of estate tax is attributable to an installment promissory note that has five remaining payments of $4,000 each, the IRD recipient must take the deduction in equal proportion, or $1,000 per payment.

# Marital Deduction Planning

## Key Points

- No federal estate tax if part of marital deduction
- Results in no income tax deduction for surviving spouse
- If not used up, IRD assets will be taxed in survivor’s estate

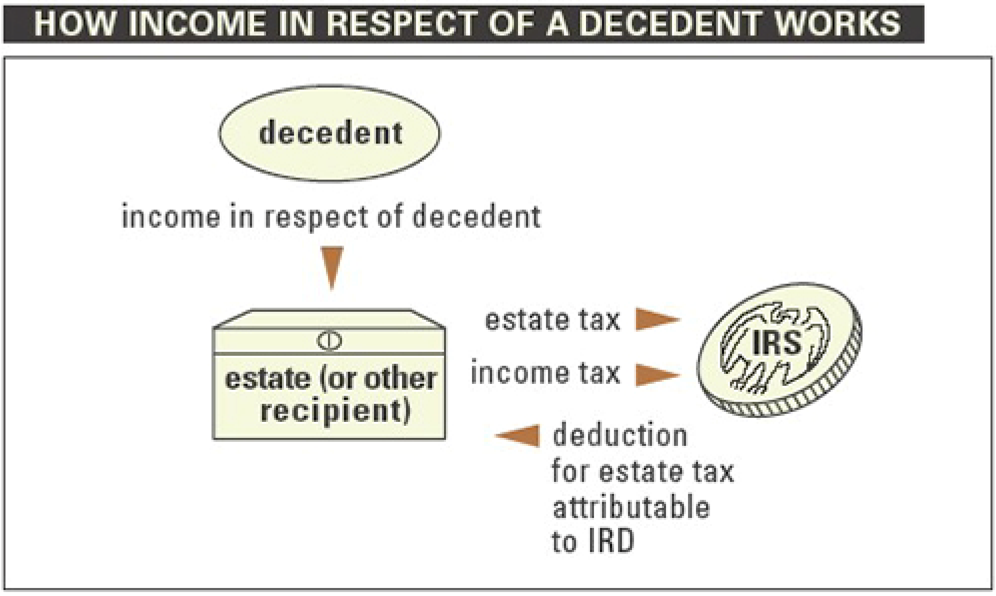
If the income in respect of a decedent passes to the surviving spouse as part of the marital deduction share of the estate, it does not generate any federal estate tax. Thus, there will be no estate tax attributable to the IRD, and no income tax deduction available for the surviving spouse. Leaving IRD to the surviving spouse is therefore preferable to leaving it to other beneficiaries, where it would be depleted by federal estate taxes with only a partial income tax offset.

It is important to note that, to the extent the surviving spouse does not use up the IRD assets, they will be subject to income and estate taxes in the surviving spouse’s estate.

## How Income in Respect of a Decedent Works

### *Graphic*

Here is an illustration that shows how income in respect of a decedent works.



## Chapter 1 Review Questions

1. Elaine is an attorney. She prepares a will for Bob Smith, in which he leaves everything to his son, Sam. His neighbor and close friend, Linda, serves as one of the witnesses to the will. Which one of these people is the testator?

    A. Elaine

    B. Bob

    C. Sam

    D. Linda

2. Is a child inadvertently omitted from a will (for example, a child born after the will was created) entitled to receive a child's intestate share of the estate?

    A. Yes, always

    B. Yes, but only in some states

    C. Yes, but only if there are no other children

    D. No, never

3. Income in respect of a decedent must pass through the probate estate.

    A. True

    B. False

4. Which of the following is *not* an example of income in respect of a decedent?

    A. Interest earned on a savings account

    B. Unpaid salary and bonuses

    C. Death benefits from retirement plans, IRAs and annuities

    D. Unrealized gain on appreciated collectibles

5. What is the name of the document sometimes used to amend a will when changes are minor?

    A. A nuncupative agreement

    B. A codicil

    C. A holographic will

    D. An election against the will

## Answers to Chapter 1 Review Questions

1. B. Bob is the testator-the person writing the will.
2. B. Yes, in some states, a child omitted from a will is entitled to receive a child's intestate share of the estate.
3. B. It doesn't matter whether income in respect of a decedent passes through the probate estate or is paid directly to the recipient.
4. D. Unrealized gain on an investment is not considered IRD.
5. B. A codicil is used to make minor changes to a will.

# Chapter 2
# Property Ownership

## Property Ownership in General

### *Various Forms of Ownership*

In the Unites States, property may be owned in several different ways:

1. Sole, outright ownership, also called "fee simple"
2. Joint tenancy with rights of survivorship
3. Tenancy by the entirety, which also has rights of survivorship
4. Tenancy in common
5. Partial interests such as life estates and remainder interests
6. Community property

Numbers 2 through 6 are forms of co-ownership by two or more people.

### *Importance of Form of Ownership*

## Key Points

- Form important in estate planning
- Determines how and to whom property passes
- Affects amount of gross estate

The form of property ownership is very important in estate planning. It determines how and to whom the property passes at the death of an owner, and the extent to which the value of this property is included in the deceased owner's gross estate for federal estate tax purposes.

For example, while joint ownership is often looked upon favorably—especially by spouses—it can cause some estate planning problems.

## Type of Property Ownership

### *Sole Outright Ownership*

#### Advantages and Disadvantages

**Key Points**

- Sole owner enjoys all rewards and responsibilities of ownership
- Sole owner must bear any expenses alone

A person who is the **sole and outright owner** enjoys the full rewards of property ownership. The sole owner is entitled to any income that the property earns, and is entitled to sell it and reap the entire gain, if any.

However, the sole owner also bears the full responsibility of property ownership. The sole owner must:

- Pay all taxes levied on the property
- Pay all debts against the property
- Pay all expenses related to the property (repair, renovation, maintenance, etc.)
- Bear all losses if the property is sold after it declines in value

### *Joint Tenancy with Rights of Survivorship*

#### Using the Right Words

**Key Points**

- Property owned jointly by two or more people
- May be real estate or other personal property
- Survivorship rights must be included on legal documents
- Tenancy in common is typical default if correct words aren't used

In a **joint tenancy with rights of survivorship**, two or more joint owners hold equal interests in the property. The property may be real estate or any kind of personal property.

The essential words, "with rights of survivorship," must be used on the deed or other evidence of title when the co-ownership is created. For instance: "To Luke Jones, Chloe Jones, Alec Smith and Miranda Smith as joint tenants with rights of survivorship."

What if the deed or other evidence of title does not contain these essential words? State laws vary but, in most states, a tenancy in common is the usual outcome. Lawyers often say that the law does not favor the creation of joint tenancy with rights of survivorship, and if that's what the owners want to establish, they must explicitly demonstrate their intent by using the essential terminology.

### Restrictions on Individual Rights

## Key Points

- Interest may not be disposed of by will
- Property passes automatically to surviving co-owners
- Restrictions can be avoided, but will terminate joint tenancy

Can an owner dispose of an interest in joint-tenancy-with-rights-of-survivorship property by will? No, that would undo the whole idea. The property passes automatically to surviving co-owners at an owner's death, and the decedent's will has no effect upon the transfer.

Can an owner get around the restriction on wills by disposing of the joint interest during life? Generally, yes. In some states, an owner does not even need the consent of the other owners to do so. However, such an action will terminate the joint tenancy, and convert it into a tenancy in common.

## ***Tenancy by the Entirety***

### Similarities to Joint Tenancy

## Key Points

- Only between spouses
- Only in certain states
- Equal interests while both spouses are alive
- Survivorship rights

A **tenancy by the entirety** may only exist between spouses, and only in certain states. It is similar to joint tenancy with rights of survivorship in two major areas:

1. Equal interest in the property. Although women generally have a longer life expectancy than men, the law does not require a complicated actuarial calculation to try to assign more than 50% of the interest to a wife because of her greater statistical likelihood of survivorship.
2. Right of survivorship. When one spouse dies, the other becomes the sole, outright owner of the property.

### Differences from Joint Tenancy

## Key Points

- One spouse may not transfer interest in property without consent of other spouse
- In most states, when spouses take title, law presumes it is tenancy by the entirety
- Documents should still include correct wording

But here the similarities with joint tenancy end. Neither spouse can transfer his or her interest in the property during life without the consent of the other spouse. (Recall that joint tenants with rights of survivorship often do not need the consent of the other owners.)

Also, the law generally does not treat tenancy by the entirety with prejudice, as it often does joint tenancy with rights of survivorship. In most states that recognize tenancy by the entirety, when spouses take title to property, the law presumes they have created a tenancy by the entirety.

To eliminate all doubt, the essential terminology must be present in the deed or other instrument of title. Typical language reads like this: "To Bob and Carol Jones, husband and wife, as tenants by the entirety with rights of survivorship."

### *Tenancy in Common*

#### Differences from Joint Tenancy

**Key Points**

- Two or more co-owners
- No right of survivorship
- Unequal interests permitted

A **tenancy in common** may exist among two or more co-owners, the same as joint tenancy with rights of survivorship. However, a tenancy in common is unlike a joint tenancy in two key respects:

1. There is no right of survivorship when one co-owner dies, and
2. The co-owners may hold unequal interests in the property.

#### Features

**Key Points**

- Ownership percentages do not change
- Deceased owner's interest passes to new party
- Interest may be transferred without consent of other owners

When a tenant in common dies, the ownership percentages do not change for the survivors. Instead, the deceased owner's interest passes under the will to some new party (or under the state intestacy laws if the owner dies without a will). As you might expect, a tenant in common may also freely transfer his or her interest in the property during life without the consent of other owners.

Tenancy in common is the "default setting" in most joint ownership situations. If a joint tenancy with rights of survivorship or a tenancy by the entirety is not created properly, the usual outcome will be a tenancy in common.

### *Partial Interests in Property*

#### Sequencing the Interest

**Key Points**

- Sequencing provides partial interest
- Different methods available

Interests in property may be sequenced in time, providing a **partial interest**. For example, one individual may own a life estate in property, which gives her the right to possess and enjoy the property for as long as she lives.

Another individual may hold a remainder interest in the same property, which gives him the right to possess and enjoy the property after the life estate terminates at the life tenant's death. The life estate is a present interest; the remainder is a future interest.

#### Reversionary Interest

**Key Points**

- Right to take the property back under certain circumstances
- IRS valuation tables used to apportion value among partial interest holders

A **reversionary interest** is a right to get property back upon the occurrence of some contingency. For example, Beth might give her property to her son with the proviso that she will get the property back if her son predeceases her.

The IRS issues valuation tables to apportion the full value of property among the holders of partial interests, based on actuarial factors and an assumed interest rate.

### *Community Property*

#### Nine States

There are nine **community property** states:

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin ("marital property")

While not community property states, Alaska, Tennessee, and South Dakota all have a form of community property trust that allows couples to opt into community property.

### What Is Community Property?

## Key Points

- Only between spouses
- Property acquired during marriage divided 50-50
- Property brought to the marriage separately generally remains that spouse's
- A gift or inheritance belongs to individual spouse
- Deceased spouse's 50% does not automatically pass to surviving spouse
- Some states permit community property with rights of survivorship

The concept of community property exists only between spouses. The term refers to property acquired during marriage in which each spouse is deemed by law to own 50%. It does not matter which spouse actually purchased or earned the property. However, property brought to the marriage by either spouse generally remains the separate property of that spouse. Also, property received by gift or inheritance after marriage is generally separate property.

In a community property state, a deceased spouse's share of 50% of the community property is usually disposed of under the will (or the intestacy laws). It does not pass automatically to the surviving spouse. However, it is possible in some states to have property titled as "community property with right of survivorship."

## How Property Is Transferred

### *Sale or Exchange*

## Key Points

- Cash or other property
- No estate planning consequences for fair market value exchange

Title to property may be transferred by:

- Sale or exchange
- Gift
- Will
- Law
- Contract

In a **sale or exchange**, property is sold for cash or other property. If the seller receives fair market value for the property, this transaction generally has no estate planning consequences. One asset simply takes the place of another in the owner's estate.

### *Gift*

## Key Points

- Reduces size of former owner's estate
- Keeping rights to property not permitted
- Adjusted taxable gift possible

When property is transferred by **gift**, there is a reduction in the size of the former owner's estate. This tends to keep the estate in a lower estate tax bracket when the owner dies. However, if an owner tries to keep some kind of string on the gift property, the IRS may consider the property as part of the owner's estate, as though the owner had never made a gift of the property. Some of the prohibited strings are:

- The right to get the property back
- The right to the income from the property
- The right to continued possession or enjoyment of the gift property

Even if the property owner avoided these strings, if the gift exceeded the gift tax annual exclusion, the excess may figure into the estate tax calculation at death as an "adjusted taxable gift." This generally happens only when the property owner made the gift to someone other than a spouse or charity.

### *Will*

## Key Points

- Allows owner to pass assets as desired
- Passed under will = probate estate
- Assets passed outside the will avoid probate

Property that a decedent owned solely and outright at the time of death may pass under the decedent's **will**, if there was one. The will gives a person the opportunity to spell out plans for the distribution of assets after death and allows the testator to make bequests of specific assets—particularly assets that are unique or difficult to divide, such as family heirlooms or digital assets.

Assets passing under the will are often referred to as the probate estate. To the extent assets pass *outside* the will—for example, life insurance proceeds payable to a beneficiary other than the estate—they avoid probate.

### *Laws*

**Key Points**

- Law determines distribution of estate for intestacy
- Property passes by law with certain forms of ownership

If a person dies without a will, the state **intestacy laws** will control the distribution of estate assets. Essentially, state law writes a will for you, in that the distribution of assets occurs without regard for the testator's personal circumstances or wishes. Any individual with specific ideas regarding the distribution of their assets should record those wishes in a will, because their own distribution arrangement will almost certainly be different than what the state law would determine.

Joint tenancy with rights of survivorship and tenancy by the entirety are other cases in which the property avoids probate and passes by **law** to any surviving co-owners.

### *Contractual Arrangement*

**Key Points**

- Life insurance contract, qualified retirement plan, etc.
- Death benefits payable outside of probate

When an individual dies who is covered by an insurance contract or other contractual arrangement where benefits will pass outside of probate (e.g., a qualified retirement plan or deferred compensation arrangement), the insurer or employer has a contractual obligation to pay the death proceeds to the designated beneficiary. Unless the beneficiary is the insured's estate, the proceeds will pass outside the will by **contract**. Proceeds other than insurance benefits are considered "income in respect of a decedent" and are potentially taxable both to the individual's estate and to the beneficiaries.

## Taxation of Jointly Owned Property

### *General Rule*

**Key Points**

- Rights of survivorship: entire value included in gross estate reduced by survivor's contribution to purchase price
- Tenancy in common or community property: only fractional interest included in gross estate

The entire value of joint tenancy with rights of survivorship property is generally included in the gross estate of the first to die. The estate of the first to die must then prove, usually through payment records, that the surviving joint tenant(s) contributed toward all or part of the cost of the property—in other words, prove that their portion wasn't a gift. The gross estate of the first to die can then be reduced by the amount contributed by the surviving joint tenant(s).

For tenancy in common or community property, only the decedent's fractional interest in the property is included in the gross estate.

### *Special Rule for Spouses*

## Key Points

- Usually 50% of value included in gross estate of first to die
- Consideration by each spouse not an issue
- Usually, survivor receives stepped-up basis in only 50%
- May differ in some community property states

Only 50% of the value of property held by spouses as tenants by the entirety or joint tenancy with rights of survivorship is included in the gross estate of the first to die. The consideration provided by each spouse toward the purchase price is not taken into account. However, in nearly all states, the surviving spouse receives a stepped-up basis for income tax purposes in only the 50% of the property included in the deceased spouse's gross estate.

In some community property states, the surviving spouse will receive a stepped-up basis for the entire property even though only one-half was included in the estate of the first spouse to die.

### *Joint Property Planning*

#### Using Alternatives to Avoid Problems

## Key Points

- Some joint ownership forms treated as substitute for a will
- Should be avoided by parties in some circumstances

Joint tenancy with rights of survivorship and tenancy by the entirety can cause a number of problems for the property owners in the estate planning process.

- Some individuals treat joint tenancy with rights of survivorship as a substitute for a will because the property avoids probate.
- The estate may exceed the exclusion amount sheltered from federal estate tax by the applicable credit amount.

#### Issues with Flexibility and Marital Deduction

## Key Points

- Full ownership vests in survivor, desired or not
- Overqualification for estate tax marital deduction
- Bypass trust can help
- Can avoid probate

- Joint tenancy with rights of survivorship and tenancy by the entirety substantially limit estate planning flexibility. Full ownership is vested automatically in the survivor, which may not be advisable, depending on the type of property involved and the survivor's experience, expertise or inclination to manage the property.
- Joint tenancy with rights of survivorship and tenancy by the entirety may also result in overqualification for the estate tax marital deduction. Too much property can pass to the surviving spouse, and may be taxed at his or her later death. Couples can often avoid such overqualification for the estate tax marital deduction by breaking up the joint tenancy with rights of survivorship and using a bypass trust to provide benefits for the survivor without tax consequences at his or her death.

On the positive side of joint tenancy and tenancy by the entirety, state law usually allows the joint interest of a decedent to avoid probate and to pass free of the estate's creditors. Any claims creditors file generally must be paid from other estate assets.

## Property Ownership Summary

Here is a chart that summarizes the primary features of the forms of property ownership we've discussed.

### Property Ownership Summary

| | Outright | Joint Tenancy with Rights of Survivorship | Tenancy by the Entirety | Tenancy in Common | Community Property |
|---|---|---|---|---|---|
| Number of Owners | 1 | unlimited | 2 | unlimited | 2 |
| Equal Interests | n / a | yes | yes | not necessarily | yes |
| Consent to transfer | no | no* | yes | no | yes |
| Right of Survivorship | no | yes | yes | no | (usually) no |
| Passes at Death to: | decedent's estate | surviving co-owners | surviving spouse | decedent's estate | decedent's estate |
| Value Included in Gross Estate | 100% | 100%** (50% for spouses) | 50% | fractional share | 50% |

** Depending on state law*

*** Generally*

## Chapter 2 Review Questions

1. The form of property ownership determines the extent to which the value of the property is included in the deceased owner's gross estate for federal estate tax purposes.
   A. True
   B. False
2. A tenancy by the entirety may exist between:
   A. Spouses only
   B. Spouses, or between parents and adult children
   C. Any members of the same family
   D. Any two individuals
3. A remainder interest in a property is:
   A. A life interest
   B. A future interest
   C. A present interest
   D. The same as sole, outright ownership
4. Mark and Mary live in a community property state and had been married for 15 years when Mary died. Which of the following is *not* one of the ways in which her half of the community property could be distributed?
   A. Her half is distributed under the state's intestacy laws.
   B. Her half is distributed according to her will.
   C. Her half automatically passes to Mark.
   D. Her half automatically passes to Mark, but only because they had community property with rights of survivorship.
5. Which of the following gifts will remove the property from the former owner's estate?
   A. An outright gift
   B. A gift where the former owner has a right to continue to use and enjoy the property.
   C. A gift where the former owner continues to earn income from the property.
   D. A gift where the former owner has the right to get the property back at some point in the future.
6. Four people own a property together. Which of the following forms of property ownership must they use?
   A. Outright
   B. Tenancy by the entirety
   C. Community property
   D. Tenancy in common

## Answers to Chapter 2 Review Questions

1. A. Not only does the form of property ownership determine how and to whom the property passes at the death of an owner, it also determines the extent to which the value of the property is included in the deceased owner's gross estate for federal tax purposes.
2. A. In those states that allow tenancy by the entirety, it may exist only between spouses.
3. B. A remainder interest is a future interest that will come about after the owner of the life interest has passed away.
4. C. Community property does not pass automatically to the spouse, unless the state allows the property to be titled as community property with rights of survivorship.
5. A. Only an outright gift removes the property from the former owner's estate. If the former owner keeps any "strings" on the property, the IRS will likely include the property in the former owner's estate, as though the gift had never been made.
6. D. Tenancy in common is the only one of the choices that allows four owners. Outright ownership is limited to a single owner, and both tenancy by the entirety and community property are between two owners.

# Chapter 3
# Lifetime Gifts

## Why Lifetime Gifts?

### *Estate Planning*

**Key Points**

- Transfer property during life
- Property remains with family
- Donor receives benefits

Just as a will gives an individual the opportunity to transfer property at death, **lifetime gifts** give the individual a similar opportunity during life.

Lifetime gifts to family members are especially good estate planning tools because the property can remain within the family but generate tax and other advantages to the former owner.

### *Advantages to the Donor*

Lifetime gifts have a number of potential advantages. They can:

- significantly reduce the donor's gross estate through use of the gift tax annual exclusion, the gift tax marital deduction and gift-splitting (all discussed later)
- remove the gifted property from the donor's probate estate, usually resulting in a reduction of estate administration costs
- ensure that no appreciation in the value of the property after the time of the gift will be included in the donor's gross estate
- shift the income tax liability for future income from the gift property to other family members who may be in lower tax brackets (if the "kiddie tax" on the unearned income of children under age 18* is avoided)
- relieve the donor of the management responsibilities of the gifted property, which may be an important consideration for elderly donors
- keep the gift relatively private, whereas a will becomes a public document that may be inspected by others

## Note

The effective age of children considered under the "kiddie tax" includes:

a. All children under age 18;
b. Children age 18 who provide less than half of their support with earned income; and
c. Children age 19 to 23 who are full-time students and provide less than half of their support with earned income.

Furthermore, such children do not file a joint return and must have at least one living parent at the end of the tax year.

### *Advantages to the Donee*

## Key Points

- Donee often younger generation
- Provides options

We should not overlook the benefits to the donee, who is often (but not necessarily) a member of a younger generation than the donor.

The gift may enable the donee to attend college or graduate school, start a business, launch a professional practice, buy and furnish a home, or begin an investment portfolio.

## When Is a Transfer a Gift?

### *Characteristics of a Gift*

For a **transfer of property** to be considered a gift, it must be:

- Gratuitous
- Complete, and
- Voluntary

### *A Gratuitous Gift*

## Key Points

- If donor receives fair value, it is a sale, not a gift
- IRS scrutiny likely with sales to family members

There must be a **gratuitous** element to the transfer before it is considered a gift. A "donor" who receives fair value in exchange for the property has made a sale, not a gift. But a donor who sells an antique car worth $50,000 to a family member for $15,000 has made a $35,000 gift.

If the donor and donee are related, the IRS will generally scrutinize any supposed sale to make sure that:

- The price was negotiated at arm's length (this means that a willing buyer and seller are acting independently of each other, each in their own self-interest, which should result in a negotiated price very close to fair market value)
- There was not a "gift element" that was papered over by an apparent sale

### *A Complete Gift*

**Key Points**

- Complete transfer of property
- Donor must have no rights in property

For a gift to occur, the transfer must be **complete**. That is, the donor may not retain any rights in the property. A donor who retains possession of the property itself or retains the power to revoke the gift and get the property back has made an incomplete transfer, which is not considered a gift.

For example, Cal gives common stock in his corporation to his son, Mark, but retains the right to vote these shares. Cal has made an incomplete transfer. When Cal dies, the stock must be included in his gross estate because of the retained interest, as if the transaction with Mark never occurred.

### *A Voluntary Gift*

**Key Points**

- Legal obligations do not count as gifts
- No compulsion may be involved

Finally, the transfer of property must be **voluntary** to qualify as a gift. Let's look at a couple examples.

John is a divorced father. In order to discharge a legal support obligation, he sets up a trust for his minor child. The trust is not considered a gift to the child because the support is legally required.

Mary transfers property to a creditor who has obtained a judgment against her. That transfer is not a gift. Any sort of legal compulsion will raise the issue of whether the transfer is voluntary.

## Federal Gift and Estate Tax System

**Key Points**

- Unified system including estate and gift tax
- Liberal provisions help avoid gift and estate taxes

The federal gift tax and estate tax are parts of a transfer tax system. The federal gift tax has been described as a backstop to the federal estate tax. If there were no taxation of lifetime gifts, people could easily avoid the estate tax through lifetime gifts.

Because of some fairly liberal provisions in the gift tax law, it is still possible to give away significant amounts of property without paying either gift tax or estate tax.

## Exempt Gifts

The federal gift tax reaches most types of gratuitous, complete, voluntary transfers of property. Only a few types of gifts are exempt from the federal gift tax:

- Transfers of property between spouses or ex-spouses pursuant to a separation agreement or divorce decree (exemption is limited if the transferee-spouse is not a U.S. citizen)
- Gifts of tuition payments to an educational institution on behalf of a student
- Gifts of medical expense payments to a service provider on behalf of a patient
- A qualified disclaimer of (refusal to accept) property, which then passes irrevocably to a third party
- The irrevocable assignment of death benefits payable under a qualified retirement plan or IRA
- The exercise of a limited (special) power of appointment
- The exercise or lapse of a "five-and-five" power (a right given to a trust beneficiary to withdraw annually up to $5,000 or 5% of the trust assets, whichever is greater)

## Gift Tax Annual Exclusion

### Key Points

- Exclusion can reduce taxes and keep assets in family
- Must be gift of present interest
- Exception for a minor's trust

Taking advantage of the **gift tax annual exclusion** is a simple and effective way to reduce gift and estate taxes while keeping assets in the family.

Each individual is allowed to give up to $16,000 for 2022 (indexed to inflation annually) to an unlimited number of people without incurring the federal gift tax. For 2022, the annual exclusion for gifts from a donor spouse to a noncitizen spouse is $164,000.

There is a catch, though: To secure the gift tax annual exclusion, the gift must be of a "present interest." This means that the person receiving the gift has the right to enjoy the property immediately. If the donee's enjoyment is delayed until some future time, or by the need to get agreement from one or more people to exercise rights, the gift tax annual exclusion is not available.

An important exception to the present-interest rule is the Section 2503(c) trust for a minor, under which the gift tax annual exclusion is allowed even though the minor technically has a future interest in the trust instead of a present interest.

## Gift-Splitting

### *Sharing in the Same Gift*

#### Key Points

- For married couples only
- Both spouses share for tax purposes regardless of who gave the gift
- Each spouse draws on his or her own credit to reduce tax

**Gift-splitting** is a special tax-saving technique that is available only for married couples. When one spouse makes a gift to a third party (someone besides the other spouse), both spouses can elect to join in the gift for tax purposes, even if the property comes entirely from one spouse. This means that two gift tax annual exclusions can be taken if the gift is of a present interest. The spouses must file a gift tax return to elect gift-splitting.

Further, if the gift exceeds twice the annual exclusion amount, gift-splitting may reduce the tax rate because the gift tax rates go up as the value of the gift increases. In addition, each spouse may draw upon his or her applicable credit amount (also called the unified credit) to reduce or eliminate any federal gift tax otherwise payable.

### *Reducing the Estate's Value*

#### Key Points

- Increases amounts of gift tax exclusions
- Credits used to shelter amounts that exceed annual exclusions

Over a period of time, gifts qualifying for the gift tax annual exclusion can be used to reduce the value of an individual's estate. For example, in 2022, the gift tax annual exclusion amount is $16,000. If a husband and wife have two children, they could give each child $32,000 in 2022 without incurring any gift tax liability, even if the assets come entirely from one spouse or the other.

If each child is married, they could give the spouse of each child the same amount. These gifts could reduce the parents' estate by a total of $128,000 in 2022. Over a five-year period, the parents' estate could be reduced by at least $640,000 (or more if the annual exclusion amount increases in future years).

The estate size is reduced without using the parents' applicable credit amounts. (The applicable credit amount is used only to shelter amounts that exceed the gift tax annual exclusions.)

## Gift Tax Marital Deduction

#### Key Points

- Gift of any amount permitted
- Certain restrictions
- Special expanded annual exclusion available under some conditions

One spouse may make a gift of any amount to the other spouse free of any federal gift tax, provided that:

- The gift is of a property interest that will not terminate at some future time, and
- The spouse receiving the gift is a U.S. citizen.

The **gift tax marital deduction** is not available for marital gifts to spouses who are not U.S. citizens. However, there is an exception for a gift of survivor benefits to a noncitizen spouse under a joint-and-survivor annuity (JSA).

In addition to the JSA exception, the first $164,000 (in 2022) of marital gifts to a noncitizen spouse is eligible for a special, expanded annual exclusion, provided the gift meets the usual requirements for the gift tax marital deduction (e.g., the terminable interest rule).

## Gift Tax Charitable Deduction

### Key Points

- Tax-free lifetime transfers to charity
- Unlimited gift tax charitable deduction

The charitable deduction allows a donor to make tax-free lifetime transfers to a qualified charity.

The amount of the **gift tax charitable deduction** is unlimited, unlike the income tax charitable deduction where annual percentage limitations apply.

## Partial Interest Gift

If a donor makes a gift to charity but retains some power or right over the property, the transfer is considered a **partial interest gift** that does not merit a deduction (income, gift or estate tax deduction).

However, there are some exceptions to the partial interest rule that do entitle the donor to a tax deduction:

- **Charitable Remainder Trust or Pooled Income Fund**—A donor keeps an income interest (or gives an income interest to another person) while transferring the remainder interest to a qualified charitable organization.
- **Charitable Lead Trust**—A donor gives the income interest to the charity and keeps the remainder interest (or gives the remainder interest to someone else).
- **Outright Gift of the Undivided Portion of the Donor's Entire Interest**—A donor may only own a partial interest in that particular property. As long as the donor gives entire partial interest in the property to the charity outright, the donor may deduct the value of the gift.
- **Remainder Interest in a Personal Residence or Farm**—A donor transfers title to the real estate to the charity, but retains a life estate.
- **Qualified Conservation Contribution**—A donor gives the charity an interest in the real estate that meets criteria for preserving the property for conservation purposes.

## Gift Tax Applicable Credit Amount

### *What Is It?*

#### Key Points

- Up to $12.06 million in gifts before gift tax payable
- Law sets credit limits
- Gift tax exclusion amount indexed for inflation

When the value of a gift exceeds the gift tax annual exclusion (or is any amount in the case of a future interest gift), and there is no available deduction (i.e., marital or charitable), the result is a taxable gift. However, a person can give up to $12.06 million (as indexed for 2022) during life in cumulative taxable gifts before any gift tax is actually payable.

Why? Because the **gift tax applicable exclusion amount** shelters cumulative gifts up to that amount.

#### Note

The gift tax applicable exclusion amount is linked to the estate tax applicable exclusion amount as a unified credit. Therefore, to the extent that an individual does not utilize the applicable exclusion amount during life, any remaining portion can be used at death to offset the taxable estate.

### *Significant Increase = Greater Opportunities*

#### Key Points

- Increase in gift tax credit provides greater opportunities
- Inflation-indexed applicable credit amount finally gives people confidence in planning

The significant increase of the gift tax applicable credit amount in recent years has provided even greater opportunities for lifetime giving. The American Taxpayer Relief Act of 2012 set the applicable credit amount at $5 million (adjusted for inflation going forward), allowing people to plan with confidence. More recently, the Tax Cuts and Jobs Act of 2017 doubled the applicable credit amount to $10 million (adjusted annually for inflation)—an amount due to sunset at the end of 2025 and revert back to the $5 million base.

## Computing the Gift Tax

#### Key Points

- Tax is cumulative
- Special calculations required
- Applicable credit offsets gift tax

The gift tax is a cumulative tax, based on the value of all taxable gifts made after 1976. Individuals must make two calculations to compute the tax:

- Tax #1 is computed on all taxable gifts made, including the current gift.
- Tax #2 is computed on all prior gifts only.

The individual must then subtract tax #2 from tax #1 to find the tax due on the current gift. The applicable credit amount may offset the gift tax otherwise due.

## A Note on Prior Law

### Key Points

- Gift and estate tax exemptions decoupled between 2004 and 2009
- These exemptions were reunified in 2011

Under prior law, the gift and estate tax exemptions were decoupled between 2004 and 2009. The gift tax exemption only reached $1 million, while the estate tax exemption grew to $3.5 million. Thus, some donors paid gift taxes between 2004 and 2010 that did not actually provide a sort of "advance payment" on a unified transfer tax bill. In other words, some donors who paid gift taxes ended up not being subject to estate taxes (either because their estates were less than the estate tax exemption at the time or because they died in 2010).

The gift and estate tax exemption amounts were reunified in 2011.

### *Gift Tax Rate*

The top gift tax rates are as follows:

| Year | Top Gift Tax Rate |
|---|---|
| 2011–2012 | 35% |
| 2013–2022 | 40% |

## Gift of Life Insurance

### *Inclusion in the Gross Estate*

### Key Points

- Life insurance can remove value of policy from donor's gross estate
- Donor must not own policy
- Premium payments may also be considered gifts
- Arrange so there is no gift tax on premiums paid by donor

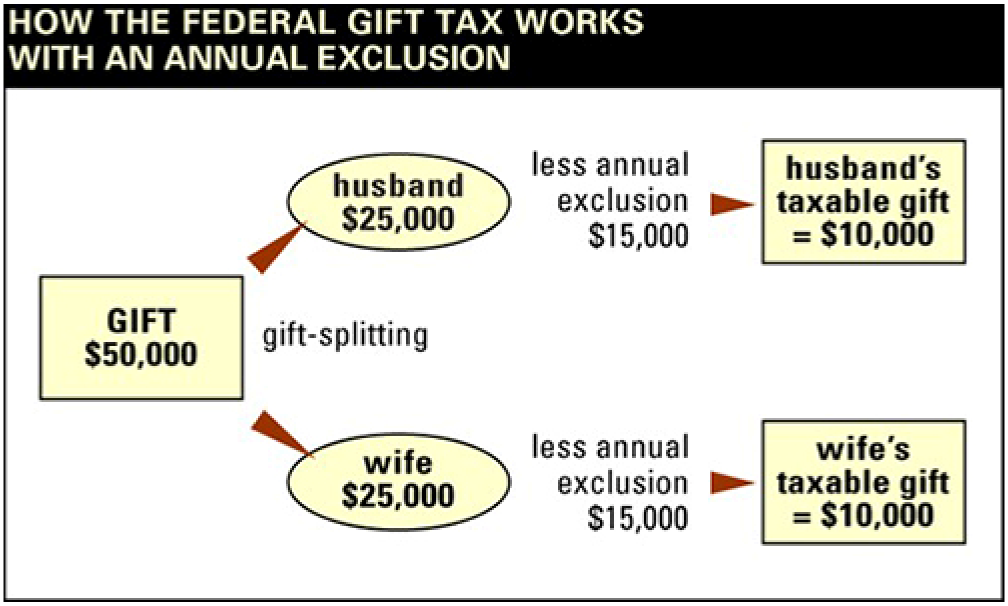
After a donor makes a lifetime gift, any subsequent increase in the value of the gifted property is removed from the donor's gross estate. In the case of a gift of life insurance, the policy's value for gift tax purposes is approximated by the cash value, not the death proceeds. This makes gifts of life insurance policies especially attractive.

If the donor owns a life insurance policy on his or her own life, and still owns the policy at the time of death, the full death proceeds payable will be includible in the donor's gross estate, even if the proceeds avoid probate by being paid directly to a named beneficiary. However, even if the insured donor gifts the policy during life, the proceeds will still be included in the donor's gross estate if the donor dies within three years of the transfer.

If the donor makes premium payments after gifting the policy, these will also be considered individual gifts. But, if the annual premium payments do not exceed the gift tax annual exclusion, and no other gifts are made to the new policyowner, there will usually be no taxable gift (unless the policy was gifted to a trust and was not a gift of a present interest).

## How the Federal Gift Tax Works

Here is an illustration that shows how the federal gift tax works.




Husband and wife would draw upon their respective applicable credit amounts to offset the gift tax otherwise due on their taxable gifts. The gift tax annual exclusion amount, set at $16,000 in 2022, is indexed to inflation.

## State Gift Taxes

### Key Points

- State gift tax laws possible
- No federal tax credit for state gift taxes

We have been discussing federal gift tax laws. You should know that a few states have enacted their own **gift tax laws**.

There is no federal tax credit for state gift taxes paid.

## Chapter 3 Review Questions

1. Which of the following is *not* a reason for Don to make a lifetime gift of a vacation rental property to his son?
   A. Don would be relieved of property management and maintenance for the gifted property.
   B. The gift would reduce the total assets in Don's gross estate.
   C. Future income from the rental property will be taxed at his son's lower tax rate.
   D. Don can continue to enjoy the property even after it is titled to his son.
2. It is possible to give away significant amounts of property without paying either the gift tax or the estate tax.
   A. True
   B. False
3. Which statement about the gift tax annual exclusion is false?
   A. The gift tax annual exclusion is indexed annually for inflation.
   B. Each individual is allowed to give up to the indexed amount to as many people as he or she wishes each year.
   C. It doesn't matter if the gift is of a present interest or a future interest.
   D. Gifts into Section 2503(c) trusts for minors are eligible for the gift tax annual exclusion.
4. The applicable credit amount is used to shelter amounts that qualify for the gift tax annual exclusion.
   A. True
   B. False
5. Which statement about the gift tax marital deduction is false?
   A. One spouse may gift any amount to the other spouse without gift tax as long as the gift is a property interest that will not terminate at some future time.
   B. The gift tax marital deduction is not available to spouses who are not U.S. citizens.
   C. Noncitizen spouses may receive gifts of survivor benefits under a joint-and-survivor annuity.
   D. No annual exclusion is available for gifts to noncitizen spouses.

## *Answers to Chapter 3 Review Questions*

1. D. Don cannot keep any "strings" to the gifted property, including the right to enjoy the property, without pulling the property back into his estate.
2. A. Thanks to some fairly liberal provisions in the gift tax law, this statement is true.
3. C. To secure the gift tax annual exclusion, the gift must be of a present interest. Gifts to Section 2503(c) trusts for minors are an important exception to this rule.
4. B. The applicable credit amount is used only to shelter amounts that *exceed* the gift tax annual exclusion.
5. D. There is a special, expanded annual exclusion available for marital gifts to non-citizen spouses, and the amount of the exclusion is indexed annually for inflation.

# Chapter 4
# Federal Estate Tax

## Nature of the Federal Estate Tax

### Key Points

- Imposed by U.S. government
- Taxes transfer of property at death

The federal government imposes the estate tax on the transfer of property at death. While the estate tax rate is high, the exemption amount is significant, and portability allows a surviving spouse to make use of any unused portion of the deceased spouse's exemption amount. This means that while most people are not affected by the federal estate tax, for people with substantial estates, it can easily be the single largest cause of estate shrinkage.

## Determining the Tax

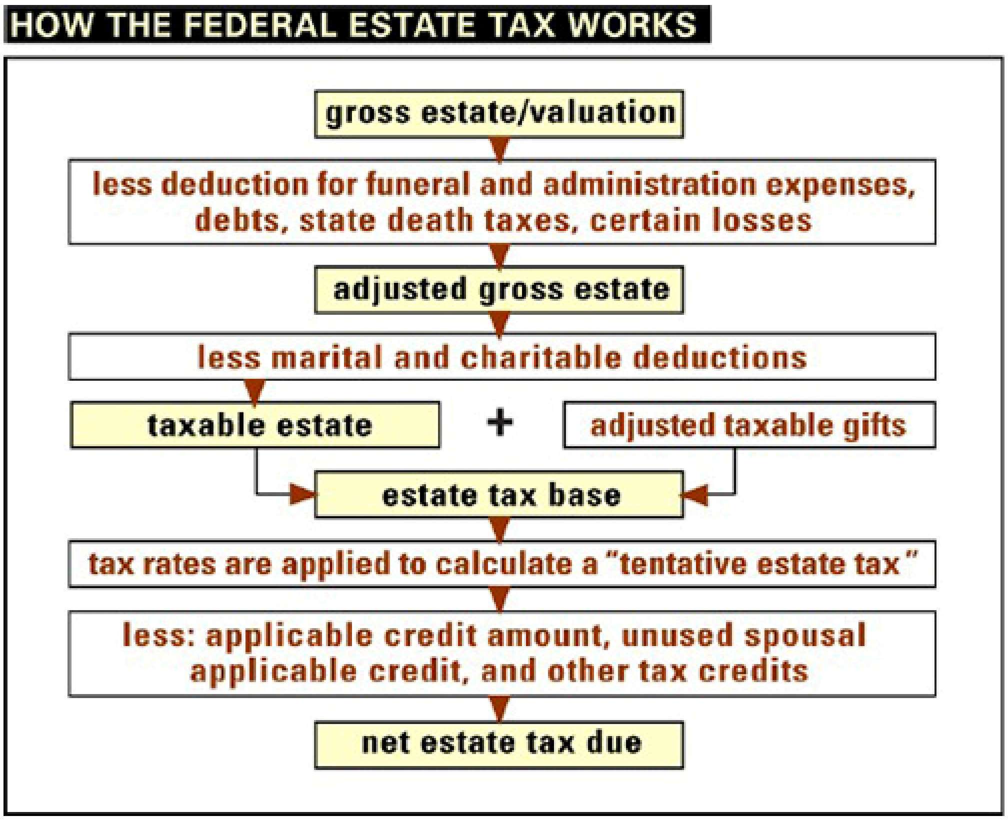
Here are the steps used to calculate the federal estate tax:

1. Determine what property is included in the gross estate.
2. Place a fair market value on each item of includible property.
3. Deduct administration expenses, debts and unpaid taxes of the decedent, funeral expenses, state death taxes actually paid, and certain losses during estate administration to arrive at the adjusted gross estate.
4. Subtract the value of property qualifying for the marital deduction (in the case of a married person's estate) and subtract the value of any bequests to charity to arrive at the taxable estate.
5. Add to the taxable estate any adjusted taxable gifts made during the decedent's lifetime (after 1976 only) to arrive at the total estate tax base.
6. Compute the tentative estate tax by applying the estate tax rate schedule to the estate tax base.
7. Subtract from the tentative estate tax the estate tax applicable credit amount, foreign death tax credit, gift taxes paid on post-1976 taxable gifts, possibly the credit for state death taxes actually paid, and any other credits available to arrive at the estate tax due and payable.

## How the Federal Estate Tax Works

### *Graphic*

Here is an illustration that shows how the federal estate tax works.




## The Gross Estate

### Key Points

- Value of decedent's properties
- Includes certain non-probate properties

The **gross estate** generally includes the value of all property the decedent owned, had an interest in, or controlled at the time of death.

This includes property that avoids probate, such as:

- Property held in joint tenancy with rights of survivorship
- Life insurance death proceeds payable to named beneficiaries
- Retirement plan death benefits

## Life Insurance

### *When Is It Included in the Gross Estate?*

Life insurance on the insured decedent is generally included in the gross estate if:

1. The proceeds are payable to or for the benefit of the estate, or
2. The insured held incidents of ownership in the policy within three years of death.

### *"Payable to or for the Benefit of the Estate"*

**Key Points**

- Estate need not be designated as beneficiary of policy
- Intent of payment of proceeds to trustee governs includability

The policy does not have to designate the estate as beneficiary to be treated as paid to the estate. If the policy proceeds are paid to a trustee who is *required* to pay estate debts and expenses, or to a creditor to pay off the insured's debt, it is just as if the proceeds were paid to the executor who then used them for this purpose.

However, if a trustee is merely *authorized* rather than required to pay estate costs, then the proceeds are only includible in the gross estate to the extent they are actually used to pay estate costs.

### *Avoiding Inclusion in the Estate*

**Key Points**

- Wording of trust document
- Allows cash in for liquidity needs without taxation

Inclusion of the proceeds in the gross estate generally can be avoided if the trust document merely authorizes the trustee to:

- Purchase estate assets at a fair price, or
- Make loans on reasonable terms to the estate.

Either approach can get cash into the estate to meet liquidity needs, without taxation of the proceeds.

### *Incidents of Ownership*

#### Retaining Rights

The term **"incidents of ownership"** includes a variety of rights and powers that an insured decedent may have held over the policy. It takes **only one** of these incidents, held during the three-year period before death, to bring the proceeds into the gross estate. Insureds sometimes create problems in this regard by assigning ownership of a policy during life, but retaining one of these prohibited incidents:

- Right to change the beneficiary
- Right to surrender the policy for cash
- Right to borrow against the policy or pledge it for a loan

- Right to assign the policy
- Right to elect or revoke a settlement option
- Right to get the policy back after a transfer (reversionary interest)
- Right to convert group coverage to an individual contract
- Right to exercise any other important right or power under the policy

### Inclusion in the Estate

**Key Points**

- Rights need not be exercised
- Right can be held directly or indirectly
- Community property policy included for half of proceeds

Simply retaining one or more of these rights is enough to pull the proceeds into the insured's gross estate. It doesn't matter whether the insured ever actually exercised these rights, and it doesn't matter whether the insured holds the rights directly or indirectly.

In the case of a policy owned as community property, only one-half of the proceeds are included in the estate. This is an exception to the usual rule, which holds that even when rights are only exercisable in combination with another person, the entire proceeds are still includible in the gross estate.

#### *Policy on Another's Life*

**Key Points**

- Fair market value included in gross estate
- Amount depends on type of policy

If a decedent owned a life insurance policy on the life of another, the fair market value of the policy is included in the gross estate.

For a paid-up policy, this will be the replacement cost of a comparable policy. For any other type of policy, the value is the "interpolated terminal reserve value," which is approximated by (but not identical to) the cash value, plus a prorated portion of any unearned premium.

## Annuities

### *When Are They Included in Estate?*

#### Key Points

- Straight-life annuity avoids estate
- Remaining payments cause all or part to be included in estate
- Survivor payments subject to federal income tax
- Deduction for estate tax available

If the decedent was receiving payments under a straight-life annuity, with no survivor benefit or refund feature, nothing is included in the gross estate. Why? There is no remaining value in the annuity that passes to anyone else. It simply terminates.

But if there are remaining guaranteed payments, the cost of a comparable contract that would provide such benefits is included in the gross estate if the decedent paid all of the premiums. If the decedent paid only part of the premiums, then the cost of a comparable contract is included in the gross estate only in proportion to the consideration furnished by the decedent.

The survivor payments will be subject to federal income tax as income in respect of a decedent, with a deduction for the federal estate tax attributable to the remaining value of the annuity contract at the decedent's death.

### *Exception to Premium-Payment Test*

#### Key Points

- Value includible if annuity payable to estate
- Also applicable to qualified retirement plans and other types of annuities

There's an important exception to the premium-payment test for inclusion of annuities in the gross estate. If the annuity payments are payable to the decedent's estate, then 100% of the value is includible even if the decedent paid less than 100% of the premiums.

The annuity rules also apply to employer-sponsored retirement plans, tax-sheltered annuities and IRAs, as well as commercial annuities.

## Transfers within Three Years of Death

### *General Rule and Life Insurance Exception*

**Key Points**

- Property given within three years of death not included in gross estate
- Life insurance exception: death proceeds included if policy transferred within three years of death

In general, property given away within three years of death is not included in the gross estate. However, life insurance is an exception to the rule. If an insured makes an absolute assignment of all rights in the policy *more than three years* before death, the death proceeds should escape inclusion in the insured's gross estate. However, if an insured transfers a life insurance policy *within three years* of death, the death proceeds (and not just the value of the policy at the time of the gift) are included in the gross estate.

### *Other Applications of Three-Year Rule*

#### Partial Transfer

**Key Points**

- Maintaining a right pulls proceeds into estate
- Gift tax exclusion does not shelter proceeds from inclusion in estate

A transfer that is not considered an absolute assignment will fall under the three-year rule. Consider this situation:

Several years ago, Sean gave a policy covering his life to his daughter, Tori. He retained the right to borrow against the policy. Later, Sean realized that this was an incident of ownership, so he assigned the right to borrow to Tori. Sean died two years later. In this situation, the three-year rule requires the entire proceeds to be included in Sean's gross estate.

Controlling shareholders of closely held corporations must take particular care that the corporate incidents of ownership in policies on their lives are not imputed to them, causing such policies to be taxed in their estates at their deaths, even though policy benefits may go elsewhere.

Other situations in which the three-year rule applies involve a past transfer of property, before the three-year period preceding death, with retention of either a life estate, a power to revoke, or a reversionary interest that is later released during the three-year period. The fact that a transferred policy was a lifetime gift sheltered by the gift tax annual exclusion will not avoid the three-year pullback of the death proceeds into the gross estate.

### Sale for Full Consideration

## Key Points

- An exception to three-year rule
- But part of proceeds may be includible in beneficiary's income

Sale for a full and adequate consideration is an exception to the three-year rule.

Recall, however, that the sale of a life insurance contract is a transfer for a valuable consideration for federal income tax purposes, which will make part of the death proceeds includible in the beneficiary's gross income unless an exception applies.

# Lifetime Gifts with Retained Powers or Interests

## Key Points

- Gifted property can be included in the estate if certain powers and interests are retained
- Decedent need not actually exercise powers

If a decedent gifted property during life but **retained powers and interests,** the decedent will still be treated as the property owner for federal estate tax purposes. These powers and interests include:

- The right to income from the property
- The right to possess or control the enjoyment of the property
- The right to get the property back in the event the donee predeceases him or her, if the actuarial expectancy of this happening exceeds 5%
- The right to amend, revoke or terminate the earlier transfer

The decedent need not actually exercise any of these powers; the mere possession of them at death will pull the transferred property back into the gross estate.

# General Powers of Appointment

## Key Points

- General power = included in gross estate
- Limited power = not included in gross estate

**General Power:** Property over which the decedent had a general power of appointment is included in the gross estate. This is usually property held in trust that the decedent could have required the trustee to distribute to the decedent himself, his estate, his creditors or his estate's creditors.

**Limited or Special Power:** If the decedent held only a limited (or special) power of appointment, under which the property could only be appointed to people other than the decedent, his creditors, and his estate or its creditors, then the property subject to the power is not included in the gross estate.

## Jointly Owned Property

### Key Points

- Inclusion depends on contribution to purchase price
- Certain types of ownership excepted from full inclusion

The general rule is that property owned in joint tenancy with rights of survivorship is fully includible in the gross estate of the first co-owner to die, unless the executor can prove that the surviving co-owner contributed to the purchase price. If the executor can prove that the decedent paid for only 40% of the property, only 40% of its value will be included in the gross estate.

An exception is provided for spouses who own property in joint tenancy with rights of survivorship or as tenants by the entirety. Here, only 50% of the property's value is generally included in the gross estate of the first spouse to die.

## Valuation of the Gross Estate

### Key Points

- Fair market value on date of death
- Fair market value six months after death if alternate valuation date is elected

The general rule is that estate assets are valued at their fair market value as of the date of death, or the alternate valuation date (six months after death), if elected.

Let's take a look now at how the estate is valued.

## Deductions from the Gross Estate

### *Expenses and Debts*

After a value has been placed on the gross estate, certain deductions are permitted before calculating the "adjusted gross estate." They include:

- Funeral expenses
- Estate administration costs
- Claims against the estate, such as debts owed to creditors
- Unpaid mortgages and indebtedness against property whose full value was included in the gross estate
- Certain property losses incurred during estate administration

### *Other Deductions*

**Estate Tax Marital Deduction:** The decedent is allowed an unlimited marital deduction for property left to a surviving spouse at death.

**Estate Tax Charitable Deduction:** The decedent is allowed an unlimited deduction for bequests to charity at death.

**State Estate Tax Deduction:** Federal estate tax law allows a deduction for state death taxes "actually paid."

## Estate Tax Computation

### Key Points

- Taxable estate is one part of estate tax base
- Adjusted taxable gifts is another part

When the marital and charitable deductions, funeral expenses, debts of the decedent, and estate administration costs and losses are subtracted from the gross estate, the result is the **"taxable estate."** This is one component of the estate tax base.

The other is **"adjusted taxable gifts."** This is the sum of all lifetime taxable gifts that the decedent made after 1976, except those gifts which are included in the gross estate (e.g., a gift of a life insurance policy in which the decedent retained an incident of ownership). The date-of-death value of these adjusted taxable gifts is not considered, only the amount of the taxable gift at the time the gift was made. So, any appreciation in the gift property after the gift was made is ignored.

## Estate Tax Rates

### *Tentative Estate Tax*

The **estate tax rates** are applied to the estate tax base to arrive at the **"tentative estate tax."**

| Year | Top Estate Tax Rate |
|---|---|
| 2011–2012 | 35% |
| 2013–2022 | 40% |

## Estate Tax Credits

### *Offset Credits*

After a tentative estate tax has been computed, the last step is to offset this tax by any of these **estate tax credits**:

- Federal gift taxes paid on post-1976 taxable gifts (which is only fair since we had to add back the adjusted taxable gifts)
- The foreign death tax credit, for certain taxes paid at death to foreign governments
- The credit for tax on prior transfers, where estate property was subject to another estate tax within 10 years before or two years after the current decedent's death
- The estate tax credit, which changed according to the following schedule:

| Year of Death | Credit Amount | Equivalent Exemption |
|---|---|---|
| 2017 | $2,141,800 | $5,490,000 |
| 2018 | $4,417,800 | $11,180,000 |
| 2019 | $4,505,800 | $11,400,000 |
| 2020 | $4,577,800 | $11,580,000 |
| 2021 | $4,625,800 | $11,700,000 |
| 2022 | $4,769,800 | $12,060,000 |

## Portability of Deceased Spouse's Unused Applicable Exclusion Amount

### Key Points

- Any applicable exclusion amount unused by the decedent may be used by the surviving spouse
- The executor must elect portability

When one spouse dies, the decedent's estate may use some, all or none of the applicable exclusion amount. If the decedent's estate only uses some or none, the surviving spouse has the benefit of adding the unused amount to his or her own estate at death. This is called portability. It was introduced as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and made permanent by the American Tax Relief Act of 2012.

Portability is not automatic. The executor must file Form 706 along with a federal estate tax return to successfully elect portability and transfer the deceased spouse's unused exclusion amount to the surviving spouse. This is true even if the estate is not otherwise required to file an estate tax return—and with the exclusion set at $10 million (indexed to $12.06 million in 2022), many estates would not otherwise have to file. However, failure to file and make this election could expose the surviving spouse to unnecessary payment of estate tax on amounts in excess of the spouse's exclusion amount.

Individuals who fail to make the election with the estate tax return may file Form 706 separately up to two years after the spouse's death.

## Chapter 4 Review Questions

1. The gross estate generally includes property that avoids probate, such as life insurance proceeds payable to named beneficiaries.

   A. True

   B. False

2. Which of the following incidents of ownership, held during the three-year period before death, will bring the life insurance proceeds into the gross estate?

   A. The right to change the beneficiary

   B. The right to borrow against the policy

   C. The right to convert group coverage to an individual contract

   D. Any incident of ownership would be enough to bring the proceeds into the gross estate

3. When Jackson died, he held a power of appointment over a piece of property under which he could only appoint the property to someone other than himself, his creditors, his estate or its creditors. What type of power is this?

   A. A general power

   B. A special power

   C. A power of property appointment

   D. A half-and-half power

4. The alternate valuation date is ___ month(s) after death.

   A. One

   B. Three

   C. Six

   D. Twelve

5. Which of the following is *not* a legitimate deduction from the gross estate?

   A. Estate tax marital deduction

   B. Estate tax charitable deduction

   C. Estate tax dependent deduction

   D. State death tax deduction

## *Answers to Chapter 4 Review Questions*

1. A. All property that the decedent owned, controlled, or had an interest in at the time of death is included in the gross estate.
2. D. Any incident of ownership will bring the proceeds into the gross estate.
3. B. This type of power is called a special power or a limited power. A general power allows appointment to anyone.
4. C. The alternate valuation date is usually six months after death.
5. C. There is no estate tax dependent deduction.

# Chapter 5
# Estate Valuation

## Estate Valuation in General

### *Fair Market Value*

**Key Points**

- Assets valued at fair market value
- Assessed value has no meaning for this purpose
- Personal property value refers to retail, not wholesale, price

For federal estate tax purposes, all of the property an individual owned or had an interest in is included in his or her gross estate. Most assets are valued at their **fair market value** on the date of death—the value at which a willing buyer would buy, and a willing seller would sell, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the pertinent facts.

The "assessed value" of real estate and some personal property is not relevant in determining fair market value. The "wholesale price" of personal property (e.g., jewelry, autos, etc.) is also irrelevant. Fair market value always refers to the retail price.

Proper asset valuation provides the basis for the federal estate tax, so it is important to understand how various assets are valued and how certain planning options can affect the total estate tax due.

### *Alternate Valuation Date*

**Key Points**

- Alternate valuation date is six months after death
- May be used only to produce a decrease in estate value
- If elected, must be used for all property
- Cannot be rescinded
- Election applies to all property in the estate
- Can affect the use of other estate planning strategies

One important decision that faces the executor is when to value the assets in the gross estate. While it is typical to use the value at the date of death, the executor may instead choose to value the gross estate at the **"alternate valuation date,"** which is six months after the date of death. If the executor transfers any property during that six-month period, the value on the date of transfer is the pertinent figure.

The executor can only elect to use the alternate valuation date if it will result in a decrease in the value of the gross estate and in the federal estate tax due. The executor cannot elect the alternate valuation date simply to obtain a higher stepped-up basis for income tax purposes, which the executor might want to do if the estate—even at an inflated value—was not subject to estate tax.

The executor's election to use the alternate valuation date is irrevocable and applies to all property included in the estate. The executor cannot value some estate assets as of the date of death and others as of the alternate valuation date. When the heirs plan to sell their inherited property, the executor may forgo the lower valuation in order to reduce the later taxable gain for heirs.

Selection of the valuation date can have other planning repercussions. To take advantage of special-use valuation, a Section 303 redemption, or Section 6166 installment payments, the value of the business interest must exceed a specified percentage of the value of the estate. If property in the estate changes in value between the date of death and the alternate valuation date, election of the alternate valuation date may permit a borderline estate to take advantage of these special provisions where it would not be possible with a date-of-death valuation.

No matter which valuation date the executor selects, different assets require different approaches to determine the correct value. Let's take a look at some specifics.

## Valuation of Life Insurance

### Key Points

- Death proceeds from policy on decedent's life might be included in gross estate
- Decedent-owned policy on another included in gross estate

The proceeds payable at death from a **life insurance policy on the decedent's life** are includible in the decedent's gross estate if:

- They are payable to the estate, or
- The decedent held any incidents of ownership in the policy within three years of death.

If a decedent owned a **life insurance policy on the life of another**, the fair market value of the policy is included in the gross estate. For a paid-up policy, this will be the replacement cost of a comparable policy. For any other type of life policy, the value is the "interpolated terminal reserve value," which is approximated by (but not identical to) the cash value, plus a prorated portion of any unearned premium.

## Valuation of Annuities

### Key Points

- If payments cease at death, no value to include in gross estate
- If payments continue, present value of future payments included

If a decedent owned an **annuity** and payments from the annuity cease at death, there is no value to be included in the decedent's gross estate. On the other hand, if payments continue to be paid to a beneficiary, the present value of the future payments must be included in the gross estate.

This rule also applies to annuities paid from IRAs, tax-sheltered annuities and qualified retirement plans.

## Valuation of Traded Securities

### Key Points

- Valued at fair market value
- Depends on value on date traded

**Securities** regularly traded on an exchange or over the counter are valued at their fair market value on the valuation date. The fair market value of a security is defined as the arithmetic mean between the highest and lowest selling prices on the specified date. For listed securities, this information will be readily available in the financial section of the newspaper.

If no sales of the security took place on the valuation date, then the executor must find the mean average, on the nearest dates before and after the valuation date when sales actually occurred. The difference between these two averages is then prorated to the valuation date.

## Valuation of Closely Held Stock

### *A Subjective Process*

### Key Points

- Subjective valuation
- Uses factors from IRS

The valuation of **closely held stock** (and other business interests) is a subjective process that must take into account these factors identified by the IRS:

- The type of business and its earning history
- The economic outlook—for the country, for the industry, for the company
- The book value of the stock
- The profitability of the company
- Any goodwill the company may have
- The size of the block of stock to be valued relative to all shares outstanding
- The price of comparable stock that is publicly traded
- The ability of the company to pay dividends
- Any previous sales of the stock

An expert appraiser will consider all of these factors and arrive at a value for the business.

### *Effect of Buy-Sell Agreement*

## Key Points

- Ensures buy-out of decedent’s stock at a stipulated price
- Price must approximate fair market value

The owners may choose to execute a buy-sell agreement to ensure that their stock is convertible into cash when an owner dies. Either the corporation or the shareholders are obligated under the agreement to purchase the stock of a deceased owner at a price fixed in the agreement.

For this price to be accepted by the IRS as the estate tax value, it must approximate the fair market value of the stock at the time the agreement is made.

### *Buy-Sell Agreement: IRS Requirements*

## Key Points

- Internal Revenue Code governs valuation
- Certain requirements before agreement is valid for IRS purposes

A purchase agreement may be disregarded in valuing a closely held business unless the agreement is:

1. A bona fide business arrangement,
2. Not a device to transfer property to family members for less than full and adequate consideration, and
3. Comparable in its terms to an arm’s-length transaction (in other words, a willing buyer and seller acting independently of each other, each in their own self-interest, which should result in a negotiated price very close to fair market value).

### *Buy-Sell Agreement: Accumulated Case Law*

## Key Points

- Accumulated case law creates additional rules
- Estate must be obligated to sell at a fair and adequate fixed price (set amount or formula)
- Individual prohibited from selling interest during life without first offering interest to business or other owners

The accumulated case law has created certain additional rules:

1. The estate must be obligated to sell at an owner’s death, either under a mandatory agreement or under an option held by the business or the surviving owners;
2. The sale price must be fixed by the agreement, either as a dollar amount or by some formula for determining the price;
3. The agreement must prohibit an individual owner from selling his or her interest during life without first offering it to the business or to the other owners at the price specified in the agreement; and

4. The price set in the agreement must have been fair and adequate at the time the agreement was made.

### *Buy-Sell Agreement: Understated Value*

#### Key Points

- Fair market value applies
- Cannot use a different price to avoid estate taxes

If the price or value appears to be understated, or reflects some kind of discount, it should not automatically be used for estate valuation purposes. The value of the business interest for federal estate tax purposes is the fair market value at death (or the alternate valuation date).

The price set in a buy-sell agreement will not necessarily fix the fair market value for estate tax purposes if the agreement is between closely related people and is merely a scheme for avoiding estate taxes.

You may have access to calculation software that will calculate the projected value of a particular business based on its net worth, earnings history, and other input information.

## Valuation of Tangible Personal Property

#### Key Points

- Fair market value established by professional appraisal
- Sale price may be accepted as fair market value

**Tangible personal property** such as antiques, autos, artwork and jewelry are valued at fair market value in accordance with the general rule. Any single property valued over $3,000 or any group of properties that exceeds $10,000 must be appraised by an expert.

Such property is frequently sold following death, either at an estate auction or through private dealers. If the sale occurs relatively close in time to the valuation date, the sale price will normally be accepted as the fair market value.

In one case, the IRS ruled that a collection of silver coins—still usable as legal tender—was worth twice the face value of the coins. When coins have a fair market value on the open market higher than their nominal value, the higher fair market value will be the figure to report on the estate tax return.

## Valuation of Partial Interests

### *IRS Valuation Tables*

#### Key Points

- Applies to variety of interests
- Ownership split between two or more
- Use IRS valuation tables

**Partial interest** refers to life estates, remainder interests, reversionary interests and annuity interests in property. The common characteristic here is that the beneficial ownership of property is split between two or more people. The valuation task is to assign a value to each interest that will add up to the value of the whole. The relevant considerations are:

- The period an income interest or annuity will last, or that a remainder or reversionary interest will be delayed, both based on average life expectancies or a specified term of years
- The interest rate assumed for discounting and compounding
- The amount of the periodic payment or the value of the whole

### *Revisions to the IRS Tables*

#### Key Points

- At least every 10 years
- Recent revisions reflect improving mortality

The IRS is required by law to revise the tables for valuing partial interests at least once every 10 years to reflect more recent mortality data. To calculate the value of a partial interest at that particular time, an individual must insert the prevailing rate into the applicable valuation tables and apply that factor to the amount of the periodic payment or the value of the whole.

## Valuation of Real Estate Generally

#### Key Points

- Fair market value rule generally applies
- Mortgaged property provides deduction when computing estate tax
- Several factors considered by appraisers

The fair-market-value rule on the selected valuation date also holds for most **real estate**. Do not rely on the assessed value for property tax purposes.

If the property is encumbered by a mortgage, the full fair market value of the property is still included in the gross estate. However, the mortgage may be deducted as a debt when computing the estate tax.

An appraiser will usually consider these factors in valuing real estate:

- Sales of comparable property near the valuation date
- Location of the property
- Any rental income produced by the property
- The value accepted by the probate court in the estate inventory
- Any other appropriate measure included in professional appraisal standards

## Special Use Valuation of Farm and Business Real Estate

### *Highest and Best Use Standard*

#### Key Points

- Results in higher valuation
- Congress provided some relief for farming and small businesses

One of the factors used in determining fair market value for property has been the standard of "highest and best use." For example, if property was worth $500 per acre as used by the decedent, but $4,000 per acre to a real estate developer, the property historically was included in the deceased's gross estate at the higher valuation. This resulted in substantially higher estate taxes, and often the decedent's heirs had to sell the land in order to pay the estate taxes.

Congress, wanting to encourage the continued use of real property for farming and/or small business purposes, enacted IRC Section 2032A to provide some relief by allowing special-use valuation in situations involving real property used in closely held businesses and in farming.

### *Current Use vs. Highest and Best Use*

#### Key Points

- Property must comply with certain conditions
- Provides significant reduction in value; maximum indexed annually
- Eases estate tax burden and liquidity needs

**Special use valuation** provides that, if certain conditions are met, the executor may elect to value real property in the decedent's estate that is devoted to farming or closely held business use on the basis of the property's "current use" rather than its "highest and best use."

The maximum reduction in value under this provision is $1,230,000 for 2022 (as indexed). Special use valuation eases both the estate tax burden and liquidity needs of the estate, often allowing property to remain in the family or family business.

### *Qualifying for Special Use Valuation*

To qualify for this special use valuation, these conditions must be met:

- The value of the farm or closely held business assets (reduced by debts attributable to such assets) in the decedent's gross estate, including both real and personal property, must be at least 50% of the adjusted value of the gross estate. For purposes of this calculation, the property is valued on its "highest and best use" basis.
- "Adjusted value of the gross estate" for purposes of this provision means the gross estate less unpaid mortgages or indebtedness against property included in the gross estate.
- At least 25% of the adjusted value of the gross estate must consist of qualified farm or closely held business real property.
- The real property qualifying for special use valuation must pass to a qualified heir—the decedent's spouse, ancestor (parent, grandparent, etc.), lineal descendant (biological or adopted child, stepchild, grandchild, etc.), or the spouse, widow, or widower of any lineal descendant.
- Such real property must have been owned by the decedent or a member of his or her family and used or held for use as a farm or closely held business for at least five of the last eight years prior to decedent's death.

### *Determining the Value*

If these tests are met, the value is determined as follows:

- Excess of average annual gross cash or crop share rental for comparable land use
- Minus the average state and local real estate taxes for such comparable land
- Divided by the average annual effective interest rate for all new federal land bank loans

This formula cannot reduce the value by more than $1,230,000 (indexed amount for 2022).

### *The Recapture Tax*

## Key Points

- Recapture of tax benefits possible with change in ownership or use
- Full or partial recapture possible within 10 years

The beneficiaries of an estate that employed special use valuation could reap a windfall by turning around and selling the property at its highest-and-best-use value. To prevent this, the IRS can **recapture** the tax benefits in full within 10 years if the heirs sell the property outside the family or cease using the property for farming or business purposes. A partial disposition results in **partial recapture**.

## What Is Section 6166?

### Key Points

- Addresses closely held business included in gross estate
- Allows estate tax to be spread over 14 years for qualifying estates

In most cases, the federal estate tax is due at the filing of the estate tax return nine months after an individual's death. However, when a closely held business (including a farm) is included in the gross estate, it may produce such a large tax liability that the executor cannot pay the tax at the regular time without forcing a sale of all or part of the business—particularly in cases where the business owner did not do sufficient succession planning.

That's where Section 6166 comes in. This provision of the Internal Revenue Code allows qualifying estates to spread out payment of the estate tax over 14 years to prevent the forced sale of a farm or business.

## Qualifying for Section 6166

### Key Points

- Available if business value meets legal requirements
- Two or more businesses may be joined in value for qualifying purposes
- Executor must elect Section 6166 treatment on estate tax return

Section 6166 is available only if the gross estate includes an interest in a closely held business with a value exceeding 35% of the adjusted gross estate (gross estate minus debts of decedent, expenses, and certain losses during estate administration).

The decedent's interest in two or more businesses may be lumped together to meet the 35% test provided the decedent owned at least 20% of each business at death.

To qualify for Section 6166, the executor must elect it on the decedent's federal estate tax return.

## Maximum Tax Payable under Section 6166

### Key Points

- Installments subject to maximum
- Formula provided in law

The maximum amount of tax that may be paid in installments under Section 6166 is the tax attributable to the interest in the farm or closely held business, determined like this:

$$\begin{matrix}\text{Maximum} \\ \text{amount}\end{matrix} = \begin{matrix}\text{Net estate tax} \\ \text{(after credits)}\end{matrix} \times \begin{matrix}\text{Value of} \\ \text{business interest}\end{matrix} \div \begin{matrix}\text{Adjusted} \\ \text{gross estate}\end{matrix}$$

## Eligible Business Interests

Business interests eligible for Section 6166 include:

- A sole proprietorship
- An interest in a partnership with 45 or fewer partners
- An interest in a partnership if 20% or more of the total partnership interest is included in the gross estate
- Stock in a corporation having 45 or fewer shareholders
- Stock in a corporation if 20% or more of the voting stock is included in the gross estate

## Attribution Rules

A variety of attribution rules apply to help the estate meet the 20%/45-owners tests. For example, stock actually owned by other family members is treated as if owned by the decedent (for the 20%/45-owners test only, not for purposes of calculating the federal estate tax). Here is a summary of the various means of attribution:

- Stock owned individually by the decedent's spouse, lineal descendants, ancestors and siblings is attributed to the decedent.
- Stock or partnership interests owned by spouses jointly in any form—including community property and tenancy in common—may be treated as owned by one spouse.
- Property owned by a corporation or partnership is attributed to shareholders or partners in proportion to their interests.
- Property owned by another estate or a trust is attributed to its beneficiaries in proportion to their interests. However, there is no attribution unless the trust beneficiary has a present interest in the trust.

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### Note

The attribution rules may be used only to meet the 20%/45-owners tests, not the 35%-of-adjusted-gross-estate rule.

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## Benefits of Section 6166

### *Installment Payments*

**Key Points**

- Estate tax deferred for five years
- Interest on tax paid during five-year period
- Tax usually paid in up to 10 equal annual installments
- Installments begin on fifth anniversary of tax return due date

After electing Section 6166, the executor of a qualifying estate is permitted to defer paying the estate tax attributable to the business interest for five years, though it must pay interest on the tax during this period.

Beginning on the fifth anniversary of the due date for filing the federal estate tax return, the executor must pay the tax itself in 10 equal annual installments. (The executor may actually choose to pay in any number of equal installments up to ten, but most executors utilize the maximum allowable installment period.) Because the first tax payment coincides with the last interest-only payment, the spread-out comes to 14 years.

### *Special Interest Rate*

**Key Points**

- Special rate applies
- Limit on amount eligible for special rate inflation-indexed
- Interest rate on excess is 45% of usual rate for underpayments

A special 2% interest rate applies to the deferred federal estate tax attributable to the first $1 million in excess of the value sheltered by the estate tax credit amount. The dollar limit on the amount eligible for the special 2% interest rate is inflation-indexed:

| | |
|---|---|
| 2019 | $1,550,000 |
| 2020 | $1,570,000 |
| 2021 | $1,590,000 |
| 2022 | $1,640,000 |

In 2022, the estate tax exemption equals $12.06 million and the 2% rate is available for the amount of estate tax attributable to the next $1,640,000 in value of the business (i.e., the value from $12,060,000 to $13,700,000). The interest on deferred estate tax attributable to the value of the closely held business in excess of that amount is only 45% of the usual rate for tax underpayments.

## Acceleration of Tax

### *Disposition of Business Interest*

**Key Points**

- IRS can accelerate due date under some transfers
- Transfers to certain family members by reason of death not included

If one-half or more of the business interest is sold, or if money or property is withdrawn from the business that exceeds 50% of its value, then the IRS can accelerate the due date of the tax. Transfers to members of the transferor's family by reason of death do not trigger acceleration. The "approved" family members are the spouse, lineal descendants, ancestors and siblings.

**Example**

Sheila owned a flower shop when she passed away. Her executor elected Section 6166 for her business, which passed to her daughter, Anna, under Sheila's will. During the installment period, Anna dies, passing the flower shop to her daughter (Sheila's granddaughter). In this case, Sheila's remaining estate tax is not accelerated because her granddaughter is a lineal descendant.

### *Failure to Pay an Installment*

**Key Points**

- Can accelerate unpaid tax
- Six-month grace period allowed plus interest and penalty
- Special interest rate lost if payment is late

Failure to pay an installment when due may also accelerate all unpaid tax. However, the estate has a six-month grace period in which to catch up on the overdue installment, plus interest and a 5%-per-month penalty, before acceleration occurs.

The special interest rate on the initial amount is also lost if a payment is late. Further, the IRS may impose standard penalties for nonpayment unless the failure was due to reasonable cause.

### *Deduction of Section 6166 Interest; Section 6166 Lien*

**Key Points**

- Interest on installments not deductible
- Tax lien imposed until final installment paid

The interest paid on federal estate tax installments may not be deducted. This applies for both federal income tax and federal estate tax purposes.

If the executor elects Section 6166 treatment, the IRS imposes a tax lien on the underlying property until the final installment is paid.

## Review of Section 6166 Advantages

There are several advantages to electing Section 6166. It:

- Defers payment of the estate tax liability attributable to the closely held business for five years.
- Allows the estate tax attributable to the closely held business to be paid in installments over as many as 10 years, with the first installment due at the end of the deferral period.
- Makes use of a special low interest rate for payments on the estate tax liability attributable to the business, up to an inflation-adjusted maximum.

Section 6166 also has its disadvantages. It:

- Forces the estate to remain open until the last installment is paid, increasing estate administration costs.
- Requires the payment of interest on the unpaid estate tax balance. If the qualifying property exceeds the amount currently eligible for the special 2% interest rate, this interest may be substantial.
- Imposes penalties and lien for failure to pay, which can be very onerous if something goes wrong during the 14-year period.

## Life Insurance vs. Section 6166

### Key Points

- Life insurance may provide more liquidity than Section 6166
- Avoids restrictions on transfer of ownership
- Eliminates interest payments on installments
- Consider requirements for providing life insurance

Because of the disadvantages of Section 6166, a more viable liquidity tool is often life insurance on the business owner's life in an amount sufficient to pay the entire estate tax liability.

By using life insurance to help provide adequate liquidity, business owners can avoid restrictions on the subsequent transfer of ownership outside the family. Paying the tax when due also totally eliminates interest payments and allows the estate to close in a timely fashion.

However, in order to use life insurance for this purpose, the business must be able to make ongoing premium payments, and the business owner must be insurable. In addition, the business owner cannot own the life insurance or the benefit will be subject to federal estate taxes.

## Chapter 5 Review Questions

1. An executor elects to use the alternate valuation date. Which of the following statements is false?
    A. This election is irrevocable.
    B. This election applies to ALL property included in the estate.
    C. The executor can make this election in order to decrease the value of the gross estate.
    D. The executor can make this election in order to obtain a higher stepped-up basis for income tax purposes.
2. At the time of her death, Jill owned an annuity in which payments will continue to a beneficiary. What will be included in Jill's gross estate?
    A. Nothing-there is no value left for Jill from the annuity
    B. The present value of future payments
    C. The full initial value of the annuity
    D. It depends on whether the annuity is paid from an IRA, tax-sheltered annuity or qualified retirement plan
3. For the IRS to accept the price set in a buy-sell agreement as the estate tax value for closely held stock, the price must approximate the fair market value at the time of the owner's death.
    A. True
    B. False
4. Partial interest refers to any of the following EXCEPT:
    A. An outright gift
    B. A life estate
    C. A remainder interest
    D. A reversionary interest
5. Which of the following would *not* be eligible for Section 6166?
    A. A sole proprietorship
    B. An interest in a partnership with 45 or fewer partners
    C. Stock in any corporation, whether or not voting rights are included
    D. Stock in a corporation with 45 or fewer shareholders
6. Section 6166 attribution rules may be used to meet both the 20%/45-owners tests and the 35%-of-adjusted-gross-estate test.
    A. True
    B. False

7. Failure to make an installment payment under Section 6166 may result in any of the following *except* which one?

   A. Acceleration of all unpaid tax

   B. Loss of the special interest rate

   C. Standard penalties for nonpayment (unless there was reasonable cause)

   D. A 10-day grace period in which to catch up on the overdue payment

## *Answers to Chapter 5 Review Questions*

1. D. The executor cannot elect the alternate valuation date for the purpose of obtaining a higher stepped-up basis.
2. B. The present value of future payments will be included in Jill's estate.
3. B. It must approximate the fair market value at the time the agreement is made.
4. A. A partial interest refers to any beneficial ownership of property that is split between two or more people. An outright gift provides the donee with full ownership, not a partial interest.
5. C. Stock in a corporation may be eligible if 20% or more of the voting stock is included in the gross estate.
6. B. The attribution rules may be used only to meet the 20%/45-owners tests, not the 35%-of-adjusted-gross-estate rule.
7. D. There is a grace period, but it lasts six months, not 10 days.

# Chapter 6
# Spousal Planning

## The Marital Deduction in General

### *Gift Tax and Estate Tax Deductions*

**Key Points**

- Shelters property transferred between spouses
- Transfer may be during life or after death
- Includes both gift and estate taxes

The **marital deduction** is really two deductions that serve a common purpose: To shelter property transferred from one spouse to another from both gift and estate taxes, regardless of whether the transfer occurs during life or at death.

**Gift Tax Marital Deduction:** When a person gives away cash or property in excess of the annual gift tax exemption amount, that gift is usually subject to the federal gift tax. However, when the gift is from one spouse to the other, the unlimited gift tax marital deduction eliminates any gift tax on the transfer, assuming the donee-spouse is a U.S. citizen.

**Estate Tax Marital Deduction:** One spouse may leave an unlimited amount of property to the other at death without triggering the federal estate tax.

## Qualifying for the Marital Deduction

### *Who May Use the Deduction*

**Key Points**

- Only transfers of property between spouses
- At death, applies only to property in gross estate
- Available for federal estate tax purposes
- Available to specified individuals

The marital deduction only applies to transfers of property between spouses. State law determines whether a couple is married or not. For example, "common law" marriages, where cohabitation has lasted a certain number of years, are recognized in some states but not others.

For transfers at death, the marital deduction only applies to property included in the gross estate for federal estate tax purposes. This makes sense since only that property is potentially subject to tax at the decedent's death.

The marital deduction is generally available for federal estate tax purposes to estates of U.S. citizens, resident aliens, and nonresident aliens, where the surviving spouse is a U.S. citizen. Where the surviving spouse is not a U.S. citizen, a special exclusion is available in lieu of the marital deduction.

### *Ways to Pass Property to Spouse*

Only property that passes from the deceased spouse to the surviving spouse is eligible for the marital deduction. Property may pass in a variety of ways to meet this requirement:

- Under the deceased spouse's will
- As life insurance death proceeds
- By right of survivorship in the case of property held by the spouses as tenants by the entirety or as joint tenants with rights of survivorship (but not as tenants in common)
- Under a general power of appointment
- Under state intestacy laws
- Under the surviving spouse's election against the will (where the will leaves less than the state law minimum)
- Under a dower or curtesy interest*
- As a lifetime gift to the spouse that is pulled back into the deceased spouse's gross estate at death
- Under an estate trust
- Under a qualified terminable interest property (QTIP) election by the executor

** Dower and curtesy interests were, under common law, the rights of a wife and a husband, respectively, in the property of the other spouse. Most states have adopted statutory substitutes for the old common law interests, and have made the rights of spouses identical.*

### *Terminable Interest*

## Key Points

- An interest that could be terminated
- Results in disqualified terminable interest

To qualify for the marital deduction, the property that passes to the surviving spouse (or the donee-spouse in the case of a lifetime gift) must not be a **terminable interest.** That is, the spouse's interest in the property must not be subject to:

- Expiration due to the passage of time,
- The occurrence of some future event, or
- The failure of some future event to occur.

If any of these things can happen, then the spouse has a *disqualified* terminable interest.

## Example of Terminable Interest Rule

Lindsey leaves her Twin Forks vacation home to her husband, Jason, but only until her son from her first marriage reaches age 30, at which time this son will take title to the home. If the son should die before reaching age 30, Jason gets to keep the property. Jason has a terminable interest in the home. The vacation home would not qualify for the marital deduction in Lindsey's estate. Note that we do not wait to see if the son lives until age 30. The mere fact that Jason's interest *could* have terminated is enough to disqualify the interest.

## Survival Clauses

### *Exception to Terminable Interest Rule*

#### Key Points

- Spouse often must outlive decedent by certain period to inherit
- Represents a terminable interest, but exception applies

There is an exception to the terminable interest rule. Let's look at an example.

John and Sarah are in a terrible car accident. John dies. His will includes a survival clause, which provides that Sarah must outlive him by six months (the maximum amount of time allowed) in order to inherit property under his will. Technically, Sarah has a terminable interest because she would not inherit under the will if she died during the six-month period.

But Sarah is lucky. She survives the six-month period and receives the property. In this case, the marital deduction is allowed under a special exception to the terminable interest rule.

### *Simultaneous Death and Common Disaster Clauses*

#### Key Points

- Variants of survival clauses
- Six-month clause common to deal with various situations

Variations of survival clauses are simultaneous death and common disaster clauses, but these clauses may muddle the issue more than resolve it. A six-month survival clause is often recommended because it will deal with these contingencies:

- The spouses do in fact die simultaneously
- The deaths are not simultaneous, but do result from the same accident or disaster
- The deaths are unrelated as to cause, but occur within six months of one another

### *Avoiding the Large Estate Valuation*

## Key Points

- Don't put all property into one estate
- Spouses may want to choose which heirs will inherit assets

The spouses often want to avoid piling all of the property into one spouse's estate where it will be taxed in a higher estate tax bracket than if it were split between the two estates. Also, the spouses may want their respective assets to pass to their own blood relations rather than to in-laws if they should die close in time to one another.

The six-month survival clause accomplishes these objectives without the complications of determining whether death was simultaneous or resulted from a common cause.

## Life Estate with Power of Appointment

### *Marital Deduction Trusts*

## Key Points

- Spouse receives life estate
- Spouse has power to appoint property
- Equivalent to outright ownership
- Marital deduction or "A" trust utilizes this exception

There is another option—let's look at how it works for Mike and Jennifer.

When Mike dies, he gives Jennifer a life estate in property, coupled with a general power to appoint the property to herself, her creditors, her estate or her estate's creditors. Jennifer also received a lifetime income from the trust. This is deemed equivalent to outright ownership of the property, and qualifies the transfer for the marital deduction.

**Marital deduction trusts** often utilize this exception to the terminable interest rule.

## Life Insurance Settlement Options

### *Qualifying for the Marital Deduction*

Similar rules apply to life insurance proceeds held under a **settlement option**. The proceeds can qualify for the marital deduction if these conditions are met:

- They are paid in installments or under the interest-only option to the spouse (but no one else) for life;
- The periodic payments are made annually or at more frequent intervals;
- The spouse has an unrestricted general power of appointment over the proceeds; and
- No one else has a power of appointment over the proceeds.

# Estate Trusts

### *Trust Ownership, Management and Beneficial Title*

## Key Points

- Legal entity created by grantor with legal title to trustee
- Trustee manages property for beneficiaries
- Beneficiaries hold beneficial title to trust property
- Trustee must act in best interests of trust beneficiaries

- A **trust** is a legal entity created by a grantor.
- The **grantor** is an individual who wishes to have the trust manage property on behalf of the trust beneficiaries.
- The **trustee** takes legal title to whatever property the grantor transfers to the trust.
- The beneficiaries hold the equitable or **beneficial title** to the trust property. That means they are generally entitled to the income and/or principal of the trust.

The trustee, as legal titleholder, can exercise most of the usual rights over trust assets. For example, he or she can usually invest or sell the assets. But trustees cannot act in their own interest; they must act in accordance with the trust terms and their fiduciary responsibilities to the trust beneficiaries.

### *Written Trust Agreement*

## Key Points

- Drafted and put in writing by attorney
- Based on grantor's objectives

The trust agreement should always be in writing, and should be prepared only by an attorney who specializes in estate planning. Once the attorney understands the grantor's objectives, the attorney will draft a trust that addresses the following key issues:

- Who (if anyone) is to receive the trust income, and how long do these income payouts (or accumulations of income) last?
- Who is to receive distributions of trust principal and at what times?
- When will the trust terminate?

### *Estate Trust*

## Key Points

- Special trust where income may be accumulated, not paid out
- Qualifies for marital deduction
- May be paid only to spouse and to spouse's estate at death

The **estate trust** is a special kind of trust that qualifies for the marital deduction. Here, the trust income may be accumulated, rather than paid out annually to the surviving spouse as is the case with the life estate/power of appointment and QTIP trusts.

However, any accumulated income cannot be paid out to anyone other than the surviving spouse. And the trust corpus, including accumulated income, must be paid to the spouse's estate at his or her death, where it will be distributed under the terms of that spouse's will.

## Advantages of the Marital Deduction

Here are the primary **advantages** of the marital deduction.

- Property qualifying for the marital deduction at the first spouse's death does not incur estate tax liability.
- The surviving spouse receives a stepped-up basis for income tax purposes on property qualifying for the marital deduction. Thus, if the surviving spouse subsequently sells the property, there will be less taxable gain.
- When spouses properly coordinate the marital deduction with other estate planning tools, they can minimize the combined estate tax liability in both of their estates. Even though couples with smaller estates who have not adequately planned could avoid the estate tax simply by utilizing the unused exclusion amount left by the first spouse to die, there are many reasons the couple should do more than sign basic wills.

## Disadvantages of the Marital Deduction

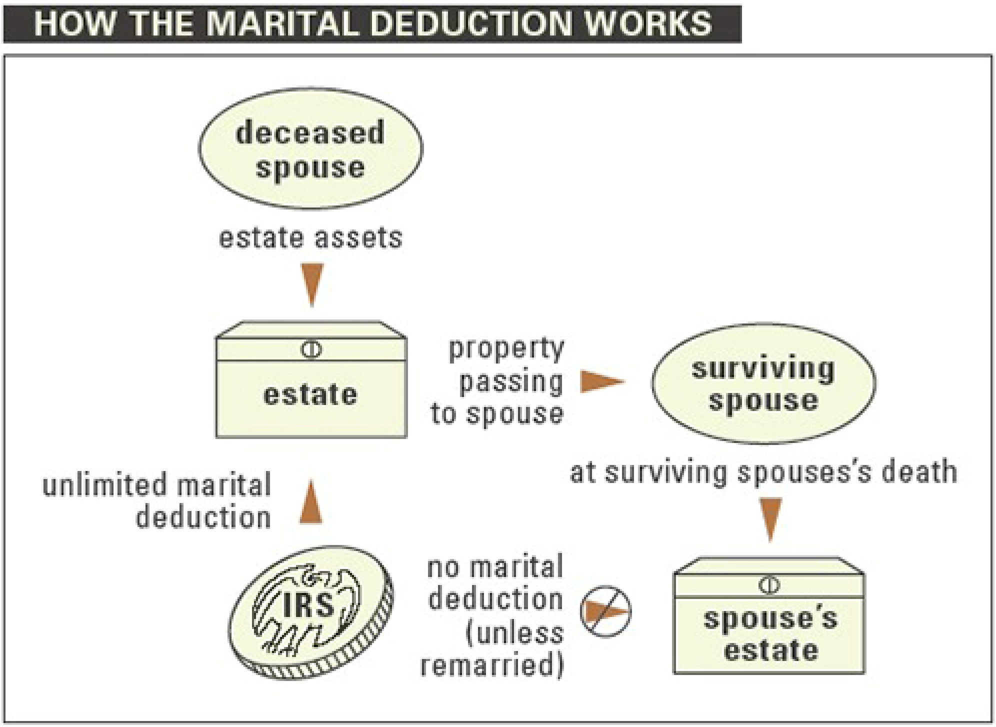
The main disadvantage is the temptation for the first spouse to die to "overutilize" the marital deduction. If the first spouse to die takes full advantage of the marital deduction, all property remaining in the surviving spouse's estate at his or her subsequent death may be subject to the federal estate tax. If the surviving spouse's estate exceeds the applicable exclusion amount, even if it does include the deceased spouse's unused exclusion amount, this can result in a substantial estate tax liability at the second death.

Everyone has an applicable exclusion amount from the federal estate tax. So, instead of leaving this applicable exclusion amount outright to the spouse, where it will be taxed at the second death, a spouse could choose to put it in a trust that will provide an income to the surviving spouse but bypass the second estate at death. Then the survivor can use his or her own applicable exclusion amount to shelter other assets from tax at the second death. This is accomplished through the use of a bypass trust.

## How the Marital Deduction Works

### *Graphic*

Here is an illustration that shows how the marital deduction works.




## What Is Qualified Terminable Interest Property (QTIP)?

### Key Points

- Restricted property that can still qualify for estate tax marital deduction
- Includes property given during life that qualified for gift tax marital deduction

**Qualified terminable interest property (QTIP)** is property in a decedent's estate that, even though it is subject to certain restrictions, can still qualify for the estate tax marital deduction.

The term also includes property given to a spouse during life that qualifies for the gift tax marital deduction, even though it is subject to similar restrictions.

## Brief Review of Marital Deduction

### Key Points

- Transfer of property in life or at death may be subject to taxes
- Transfer to spouse is an exception
- Both spouses must be U.S. citizens

When people leave property to others at death—or give property away during life that exceeds or does not qualify for the gift tax annual exclusion—that property is generally subject to a federal estate tax (death transfer) or a federal gift tax (lifetime transfer) if the total transfer exceeds the applicable exclusion amount sheltered from federal estate tax by the applicable credit amount.

The unlimited marital deduction allows spouses to transfer any amount of property between themselves, during life or at death, without triggering either the federal estate tax or the federal gift tax, assuming both spouses are U.S. citizens.

## Terminable Interest

### Key Points

- Terminable interests do not qualify for marital deduction
- An interest that can expire or terminate

Terminable interest is an interest in property that can expire due to the passage of time or terminate due to the occurrence or non-occurrence of some future event. Property left (or given) to the spouse cannot be a **terminable interest** if it is to qualify for the marital deduction.

**Example #1**: Geraldo leaves his wife, Alicia, a life income interest in a trust. At her later death, the trust corpus will be held for Geraldo's invalid brother. Alicia has no power, by will or otherwise, to change the use of the trust corpus. She has a terminable interest in the trust, and her interest will not qualify for the marital deduction in Geraldo's estate.

**Example #2**: Caroline leaves Shady Acres Ranch to her husband, Brady, but only for as long as he remains unmarried following her death. If Brady remarries, Shady Acres will pass to Caroline's niece. Brady has a terminable interest in Shady Acres, and it will not qualify for the marital deduction in Caroline's estate.

In the second example, it is not necessary to wait and see whether Brady remarries. The mere fact that he could lose Shady Acres by virtue of remarriage is enough to cause forfeiture of the marital deduction.

## "Qualified" Terminable Interest

While terminable interests generally do not secure the marital deduction, the law does allow certain types of terminable interests to qualify for the deduction when they meet certain legal criteria. The executor of the deceased spouse's estate (or the donor-spouse, in the case of a lifetime gift) must then elect to take the marital deduction for the qualified terminable interest.

## Qualification Requirements for QTIPs

### Key Points

- Two types can become QTIPs
- Will qualify if certain requirements are met
- Specific rules for community property states

Two kinds of terminable interests can be qualified:

1. Lifetime income interests, and
2. Income interests in charitable remainder trusts.

In both cases, the surviving spouse's interest in property can terminate at death, but the law will still allow the marital deduction if certain requirements are met.

In community property states, a spouse's interest in the participant-spouse's qualified retirement plan, IRA, or SEP, arising from community property laws, may qualify for QTIP treatment if the participant-spouse dies before the nonparticipating spouse.

## Lifetime Income Interest

### Key Points

- Also called qualifying income interest for life
- Must meet certain requirements

A **lifetime income interest** is also called the **qualifying income interest for life**. Often, the surviving spouse has an income interest in property held in trust, but the trust is not a necessity. In all cases, the qualifying income interest for life must meet the following requirements:

- The spouse must have the right to all income from the property for life, payable annually or at more frequent intervals;
- No one, not even the surviving spouse, may have a power to appoint the property to anyone other than the surviving spouse; and
- The deceased spouse's executor (or the donor-spouse) must irrevocably elect to take the marital deduction for the property on the federal estate or gift tax return.

## Income Interest in Charitable Remainder Trust

### Key Points

- Charity receives full interest when spouse dies
- Trust qualifies if spouse and charity are only beneficiaries

Suppose the spouse is the income beneficiary of a **charitable remainder annuity trust** or unitrust. The spouse's income interest will eventually terminate. At that time, the charity will succeed to the full interest in the trust property. The spouse has no power to dispose of the trust property by will. However, if the spouse and the charity are the only trust beneficiaries, the trust can qualify for the marital deduction.

In this case, the spouse does not have to have a lifetime income interest. The income interest could expire after a period of years (say, 20), at which point the charity would take over.

## Tax Consequences of QTIPs

### Key Points

- QTIP provides marital deduction to avoid estate tax at first death
- Property is taxed at second death

When regular property qualifies for the marital deduction at the first spouse's death, it avoids estate tax at that time. However, any amount that remains at the second death is taxed in the surviving spouse's estate. That's usually because the spouse either received it outright or had a general power of appointment over it. So, the IRS essentially says, "No tax is due at the first death, but we're going to even things up at the second death."

The QTIP allows use of the marital deduction at the first death under an exception to the terminable interest rule. When the surviving spouse dies, there is nothing to tax in the estate—the interest in the property terminated at death, so there's nothing to pass on to anyone else.

Does that mean a QTIP allows a couple to avoid the estate tax at both deaths? No. The tax code wants the taxes due at the second death. While the tax law allows a violation of the terminable interest rule at the first death, it evens the score by taxing property that technically does not pass through the second spouse's estate to the eventual heirs.

The net effect of all these legal fictions is that the tax is delayed until the second death, even though the first spouse to die actually controls how the property is ultimately distributed.

## Why Use QTIPs?

There are several reasons why QTIPs make sense, and why they are commonly used:

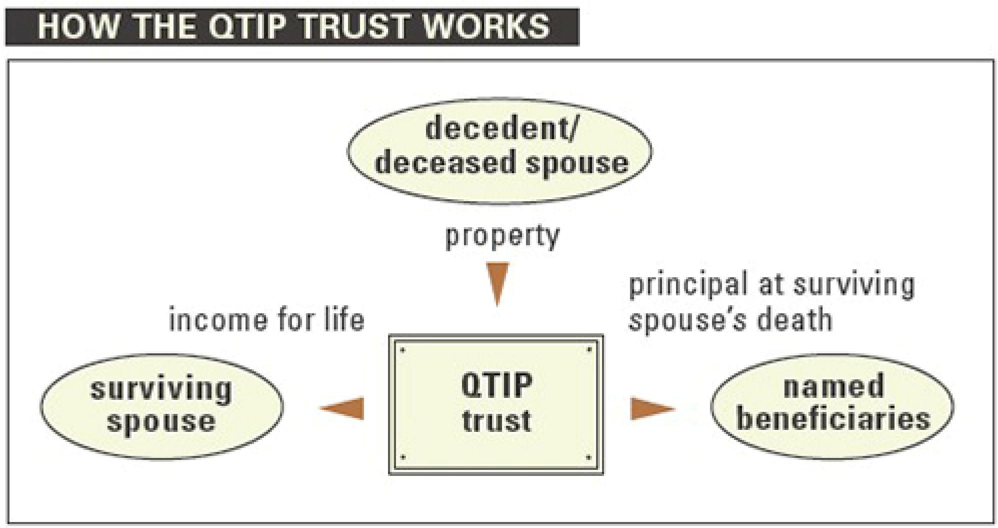
- **Flexibility.** A QTIP trust adds flexibility to the estate plan of the first spouse to die. Since the final decision regarding whether to qualify the QTIP property for the marital deduction is delayed until after the estate owner's death, the current circumstances of the surviving spouse and other beneficiaries can be taken into account.
- **Income.** The surviving spouse can be assured of receiving all of the income from the QTIP property for his or her entire lifetime.
- **Control.** The estate owner can restrict the ultimate disposition of the QTIP property without sacrificing the marital deduction.
- **Relieving a potential burden on a spouse.** Sometimes it is inappropriate to leave property outright to a surviving spouse—perhaps because the spouse is aged, infirm or not sophisticated in financial affairs or property management. The QTIP trust allows property to be managed for the spouse's benefit without these burdens.

- **Addressing second marriage situations.** The QTIP trust is especially useful in second marriage situations. The first spouse to die can be assured that the property will pass eventually to his or her children or other heirs, rather than to the surviving spouse's children from a prior marriage, while still providing lifetime financial security to the surviving spouse.
- **Addressing remarriage fears.** The QTIP also addresses the "remarriage fear" that many estate owners have. If property is left outright to a surviving spouse who later remarries, the property could wind up in the hands of the new spouse. The QTIP trust provides for a surviving spouse, but retains control over the ultimate disposition of the property.

## How the QTIP Trust Works

### *Graphic*

Here is an illustration that shows how the QTIP Trust works.




## What Is a Bypass Trust?

### *The Basics*

## Key Points

- Minimizes combined estate taxes to be paid by spouses
- Under will, estate divided into two parts when first spouse dies

A **bypass trust** (also known as a **credit shelter trust**) is an estate planning device used to minimize the combined estate taxes payable by spouses. Of course, with the applicable exclusion amount set so high, this is only useful for very large estates. Here's how it works:

At the death of the first spouse, the will divides the estate into two parts.

1. One part, equal to the applicable exclusion amount sheltered from tax by the applicable credit amount, is placed in a trust. The trust may provide liberal benefits to the surviving spouse, but will bypass the surviving spouse's estate at death.
2. The other part either passes outright to the surviving spouse, or is placed in a marital deduction trust for the spouse's benefit.

### *Primary Purpose*

## Key Points

- Fully use applicable credit amount at each death
- No marital deduction for trust property at first death, but no estate tax due
- No estate tax liability for property that does pass via marital deduction
- At second death, surviving spouse's applicable credit shelters assets

The general idea of the bypass trust is to make full use of the applicable credit amount at each death. If everything passed outright to the surviving spouse at the first death, it could all be subject to estate tax at the second death. But by using the applicable credit amount to shelter assets at the first death, this amount (and more, if the property has gone up in value) can avoid estate taxation at the second death.

The property placed in the bypass trust does not qualify for the marital deduction at the first death. Nevertheless, no estate tax is due on the assets put into the bypass trust because the applicable credit amount sheltered these assets from federal estate taxation. Further, no estate tax liability will be incurred on the property passing via the marital deduction to the surviving spouse. So, there are no federal estate taxes at all at the first death.

Then, at the second death, the surviving spouse can use his or her own applicable credit amount (plus any available deceased spousal unused exclusion amount) to shelter additional assets.

### Example

For example, suppose Brad has $14 million in assets and his wife, Anna, has $8 million. If Brad dies in 2022, only $1.94 million will pass to Anna under the will. The other $12.06 million will go into the bypass trust, where it is sheltered from the estate tax by the applicable credit amount. The assets in the bypass trust can provide income to Anna for the rest of her life.

## Bypass Trusts vs. Simple Wills

### *Is a Bypass Trust Still Necessary?*

The **American Taxpayer Relief Act (ATRA**) of 2012 set a $5 million federal estate tax exemption amount, which rose to $5.49 million in 2017. ATRA also made spousal portability permanent, allowing spouses to utilize their combined lifetime exemption amounts. The Tax Cuts and Jobs Act of 2017 then doubled the base exemption amount to $10 million ($12.06 million in 2022, as indexed for inflation).

Considering the high exemption amount, some couples may want to think about whether a simple will coupled with the use of portability would be more appropriate than a bypass trust or other sophisticated trust vehicle. Spouses should evaluate several factors when deciding which option is appropriate for them:

- Will estate assets exceed the combined lifetime exemption amount?
- Are they subject to a state inheritance tax?
- Will their beneficiaries be best served by receiving a large lump sum of cash?
- Does the generation skipping transfer tax (GST tax) apply to them? (Married couples may not rely fully on portability and also utilize GST exemptions.)
- Are their assets likely to need protection from creditors?

### *The Capital Gains Factor*

Capital gains taxes also factor into this equation. Assets that appreciate in value and are included in the estate of the second spouse to die have an advantage—they are entitled to a step up in basis. Portability helps shelter such assets from estate taxes.

A beneficiary of a bypass trust asset will not receive a stepped-up basis at the death of the second-to-die spouse. Instead, that asset will be valued as of the date it was purchased by the trust or transferred into the trust.

Since the beneficiary receiving assets from the family trust or bypass trust is more likely to incur income or capital gains tax repercussions, a simple will coupled with portability may be the wiser choice.

## General Design of a Bypass Trust

### *Spouse's Lifetime Income and Other Rights*

#### Key Points

- Typically, surviving spouse receives all income
- Property passes to children when survivor dies
- Surviving spouse typically has liberal rights in trust

The bypass trust usually provides that the surviving spouse will receive all the income from the trust for life, with the property then passing to the children at the surviving spouse's death. The surviving spouse usually has very liberal rights in the bypass trust. In addition to all the income, the surviving spouse can have:

- Distributions of principal for purposes of health, education, support and maintenance
- A limited power of appointment over the trust principal, which means the spouse (let's say the wife) can appoint the principal to anyone except herself, her estate, her creditors or the creditors of her estate
- The right to withdraw the greater of $5,000 or 5% of the trust principal annually

### *Amount Bypassing Surviving Spouse*

## Key Points

- Bypass trust not included in second estate
- Trust controls final disposition, not surviving spouse
- Amount going into bypass trust can be capped if desired

The bypass trust will not be included in the second estate, even if the spouse does have these powers and privileges. However, assets subject to a 5 and 5 power (the greater of $5,000 or 5% of trust principal) will be included in the surviving spouse's gross estate.

The one thing the surviving spouse *cannot* do is control the final disposition of the trust, except within the constraints of any limited power of appointment that the surviving spouse may have. Instead, the trust terms established by the first-to-die spouse control the final disposition.

Most bypass trusts are designed so that the amount that bypasses the surviving spouse and goes into the trust is linked to the amount of the estate tax exemption. Consider that the exemption amount is currently high. Would the client want to remove that much from the marital deduction share going directly to the spouse? Some clients may want to cap the amount going into the bypass trust at a sum that is less than the full exemption amount for the year of death.

### *Deceased Spousal Unused Exclusion Amount*

## Key Points

- Bypass trust less appealing due to portability of deceased spousal unused exclusion amount
- Executor of first-to-die spouse must elect portability on estate tax return

Clients may be less inclined to use the bypass trust now because the deceased spousal unused exclusion (DSUE) amount is eventually available to the surviving spouse in addition to that spouse's individual exclusion amount. The ability of the surviving spouse to make use of the DSUE amount is known as "portability." In order for the surviving spouse to take advantage of portability, the executor of the first-to-die spouse's estate must make an election on a timely filed estate tax return, or file Form 706 separately from the estate tax return (allowable for up to two years after the spouse's death).

Despite the portability provision, a bypass trust may still be useful for several reasons:

- The DSUE amount transferred at the time of the first spouse's death may not suffice to protect estate assets that continue to grow.
- The portability of the DSUE amount may not apply to state estate taxes. Many states have effectively de-coupled their own estate tax from the current federal estate tax law.
- A bypass trust provides protection from creditors of the surviving spouse.
- The assets in a bypass trust will eventually benefit family members or loved ones upon the death of the surviving spouse—not the spouse of a second marriage and his or her extended family.
- The unused exclusion amount does not apply to the generation skipping transfer tax.

## Income Accumulation

### Key Points

- Trustee might have discretion to pay out or accumulate income
- Standards provided by trust
- Accumulation results in trust as separate taxpayer paying income under special rates

Some first-to-die spouses are reluctant to have all trust income paid out to the surviving spouse. Instead, the trustee is given discretion to pay out or to accumulate income. The trust usually provides some standard for the trustee to go by in exercising such discretion, related to the spouse's income needs.

If income is accumulated in the trust, the trust becomes a separate taxpayer and pays income tax under the special rate schedule for trusts and estates.

## Sprinkling Trust

### Key Points

- Trustee might have power to spread income among beneficiaries
- Surviving spouse also could have sprinkling power
- Estate tax benefits of second-to-die spouse safe if spouse cannot sprinkle income to self or for own benefit
- Retains flexibility of income distribution

In the sprinkling trust, the trustee is given the power to "sprinkle" income—and maybe principal also—among several beneficiaries (for example, the spouse and children). If the spouse is already in a relatively high income tax bracket, this can substantially reduce the family tax burden while still keeping all the trust income within the family unit. Sometimes it is the surviving spouse who holds the sprinkling power rather than the trustee.

For example, let's say the husband is the surviving spouse. He can safely hold the sprinkling power without undoing the estate tax benefits at his death as long as he cannot exercise his powers to sprinkle income to himself or in any way for his own benefit. For example, if he has an obligation to support children who are still minors, he should not be able to exercise his sprinkling power to discharge his own support obligation.

Giving the trustee or surviving spouse a sprinkling power enables the first-to-die spouse to avoid carving in stone the distribution of trust income and principal before all the facts are in. Some of the children will undoubtedly have greater financial needs than others, and the sprinkling provision allows the surviving spouse to take this into account.

## The Five-and-Five Power

### Key Points

- Beneficiaries given power to withdraw specified portion of trust principal
- Possibility of undoing tax benefits
- Trust might give spouse right to borrow only, not withdraw principal

The spouse and other trust beneficiaries can be given a power to withdraw annually from the trust the greater of $5,000 or 5% of the trust principal.

Of course, if the surviving spouse makes withdrawals under the five-and-five power, he or she may be undoing, in part, the tax benefits of the bypass trust. The property removed from the trust will be included in the gross estate at death unless consumed. If left in the trust, the property would escape the estate tax at the second death.

Furthermore, in the year the surviving spouse dies, the amount he or she could have withdrawn in that year is included in the gross estate even if the surviving spouse did not in fact withdraw it. Consider 5% of a $15 million trust—that would mean an extra $750,000 in the gross estate.

Because of these potential tax problems, some trusts just give the spouse a right to borrow from the principal of the trust instead of the withdrawal power. Thus, the spouse has access to the principal without potentially adverse tax consequences.

## Beneficiaries Other Than the Spouse

### Key Points

- Spouse need not be major beneficiary of bypass trust
- Estate tax benefits hold if beneficiary does not have general power of appointment over trust assets

While the surviving spouse is usually the major income beneficiary of the bypass trust, this is not a requirement. If the spouse is already wealthy, then the first-to-die spouse may want to name children, grandchildren or an aging parent as the beneficiary.

The same estate tax result will hold; that is, the trust will generally not be includible in the gross estate of any beneficiary who dies while the trust is in existence, if it does not give the beneficiary a general power of appointment over the assets of the trust.

## Review of Bypass Trust Advantages

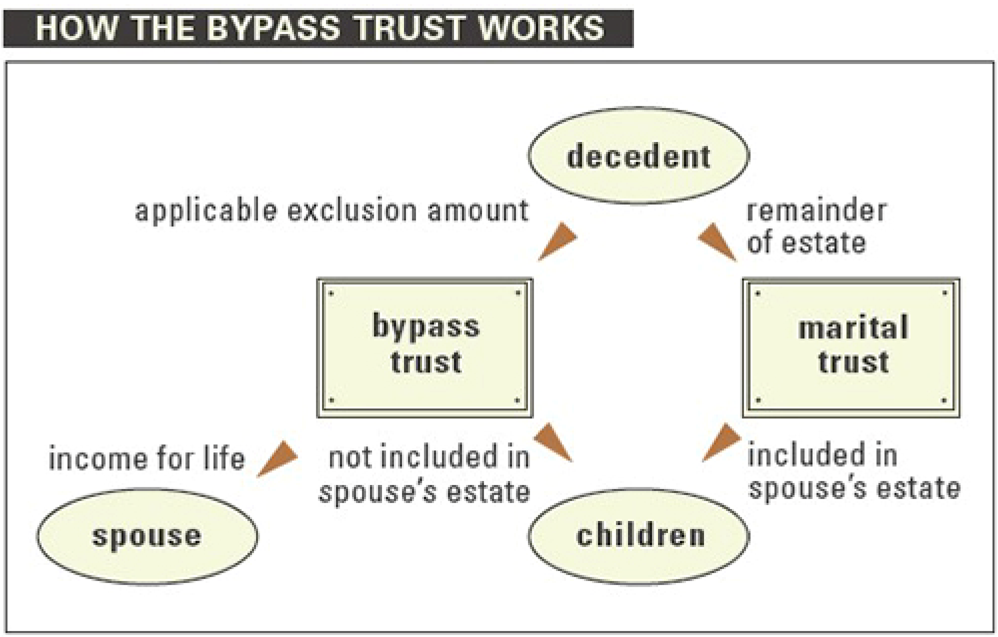
Here again are the primary advantages of using a bypass trust.

- The property placed in the bypass trust will be included in the gross estate of the first to die. However, there should be no estate tax liability because the estate tax on those assets will be offset by the applicable credit amount.
- The property placed in the bypass trust will usually pass outright to (or be retained in trust for) the children at the death of the second to die. The value of the trust will not be included in the gross estate at the second death.
- The spouses will make maximum use of their respective applicable credit amounts at each death.
- The surviving spouse can receive the income from the bypass trust for life, and also have fairly liberal rights to withdraw principal. Alternatively, the income may be accumulated, or distributed to the spouse and other beneficiaries at the discretion of the trustee.
- The first spouse to die is assured that the property placed in the trust will ultimately pass to specified heirs.

## How the Bypass Trust Works

### *Graphic*

Here is an illustration that shows how the bypass trust works.



## Chapter 6 Review Questions

1. The marital deduction is:
    A. Limited to $10,000 per year of marriage
    B. Limited to $1 million (as indexed for inflation)
    C. Unlimited
    D. Unlimited except for gifts
2. Only property that passes from the deceased spouse to the surviving spouse is eligible for the marital deduction. Which of the following does *not* qualify for the estate tax marital deduction?
    A. A terminable interest in property
    B. Property passed under state intestacy laws
    C. Life insurance proceeds
    D. Property passed by will
3. Which of the following is *not* a favorable tax consequence of the marital deduction?
    A. No estate tax at the first spouse's death
    B. The surviving spouse receives a stepped up basis on property qualifying for this deduction
    C. With proper planning, it provides a way to minimize estate tax liability for both spouses
    D. If the first spouse to die took full advantage of the marital deduction, all property in the surviving spouse's estate at his or her death is subject to the federal estate tax
4. The following are all reasons to use a qualified terminal interest property (QTIP) trust EXCEPT:
    A. A QTIP trust adds flexibility to the estate plan for the first spouse to die, since the surviving spouse can decide if the property placed in the trust is necessary to his or her situation, or whether that property could be used by other beneficiaries.
    B. A QTIP election makes the estate tax marital deduction available in every situation.
    C. The estate owner can restrict the final disposition of the QTIP property without forgoing the marital deduction.
    D. The surviving spouse can be assured of receiving all the income from the QTIP property for life.
5. What are the two kinds of qualified terminable interest property?
    A. Community property and jointly held property
    B. Lifetime income interest and income interests in a charitable remainder trust
    C. Contingent interest and remainder interest
    D. Remainder interest and income interests in a charitable remainder trust

6. A bypass trust is also known as a:
    A. Credit shelter trust
    B. Marital trust
    C. Charitable remainder trust
    D. QTIP trust

## *Answers to Chapter 6 Review Questions*

1. C. The marital deduction is unlimited.
2. A. A terminable interest in property is not eligible for the estate tax marital deduction (with the exception of certain survival clauses).
3. D. Having all property subject to estate tax in the surviving spouse's estate is not an advantage, especially if that estate then exceeds the applicable exclusion amount, possibly resulting in a substantial estate tax liability.
4. B. A QTIP election makes the estate tax marital deduction available only for certain types of terminable interests and only if all requirements are met.
5. B. The two kinds of qualified terminable interest property are lifetime income interest and income interests in a charitable remainder trust.
6. A. A bypass trust is also known as a credit shelter trust.

# Chapter 7
# Passing Property to Grandchildren

## What Is the Generation Skipping Transfer (GST) Tax?

### *Life Income in Trust*

**Key Points**

- Life income interest in trust for child reduces estate taxes
- At death, trust continues for additional descendants

Estate owners often seek to arrange the disposition of their assets so that transfer taxes are not levied on each generation.

Parents give children a life income interest in a trust, with fairly liberal invasion privileges. At the child's death, the trust continues for grandchildren and perhaps subsequent lineal descendants. By properly arranging the child's interest, they can avoid the federal estate tax when the child dies and the remainder passes to grandchildren.

### *Reducing Loss of Estate Tax Revenue*

**Key Points**

- GST tax prevents skipping of transfer tax with multigenerational trusts
- Law has been revised frequently and may continue to be revised

In order to reduce the loss of estate tax revenue, Congress first enacted a **generation skipping transfer (GST) tax** in 1976 as a sort of "backstop" to the federal estate and gift taxes. After exemptions were applied, the GST tax was intended to prevent the skipping of transfer tax on a generation of heirs through the use of multigenerational trusts where the interests were not sufficiently "robust" to trigger a tax on each passing generation. The original GST tax law went through several alterations, and was eventually replaced by a new GST tax law in 1986.

## Taxable Events

### *Three Types of Tax-Triggering Events*

Under GST tax law, the IRS singles out three types of generation-skipping transfers as tax-triggering events:

**Taxable Terminations:** The transferor (e.g., grandparent) typically places assets in a trust that pays income to a child for life and then, after the child dies, passes the remainder to grandchildren and perhaps later descendants. When a child of the grantor dies, that child's interest in the trust terminates, and a proportionate interest in the trust usually passes to descendants. The GST tax law treats the termination of the child's interest in the trust as a taxable termination. This termination may result not only by reason of the child's death, but also due to the lapse of time or the child's release of a general power of appointment.

**Taxable Distributions:** A taxable distribution is any distribution from a trust to a skip person when the distribution is neither a direct skip nor a taxable termination.

**Direct Skips:** The transferor may also bypass the children completely and give the asset either outright to the grandchildren or to a trust for their benefit. This type of taxable event is called a direct skip.

## Exemption

### *Lifetime Transfers and Transfers at Death*

#### Key Points

- Specified exemption for each transferor
- Irrevocable allocations
- Married couples may split GST tax

Each transferor has a $12.06 million **exemption** (in 2022) which can be used for both lifetime transfers and transfers at death. Allocations to particular transfers are irrevocable.

The exemption is not transferable to another, but married couples may elect to split a generation-skipping transfer and treat it as if made 50% by each spouse, even though the transferred property actually came from only one of the spouses.

### *Allocation Rules*

#### Key Points

- Complex rules govern allocation of exemption
- Some allocations are automatic
- Some discretion permitted

There are complex rules regarding the allocation of the exemption to particular generation skipping transfers. Certain allocations are automatic:

- Lifetime direct skips (unless elected otherwise on a timely filed gift tax return) and
- Indirect skips to a generation-skipping trust (unless elected otherwise)

Individual transferors or their executors have some discretion over the allocation of the exemption. Retroactive allocations are permissible under certain circumstances.

***Planning Pointer***

### Key Points

- Transfers must qualify for annual exclusion
- Part of exemption allocated to transfers that do not qualify for exclusion

In order to keep the assets of an irrevocable life insurance trust from being subject to the GST tax, transfers to the trust must qualify for the annual exclusion, and the insured must allocate part of the exemption to transfers that do not qualify for, or that exceed, the annual exclusion. This is done by the timely filing of a gift tax return.

## The GST Tax Inclusion Ratio

The taxable amount of a generation skipping transfer is the value of the transfer times the **inclusion ratio**, which is:

1 -the "applicable fraction"

Thus, if the applicable fraction is zero, the inclusion ratio is 1.

In turn, the applicable fraction is:

GST tax exemption allocated to trust or property ÷ A - (B + C)

Where:

| | | |
|---|---|---|
| A | = | Value of transferred property |
| B | = | State and federal estate taxes actually recovered from the trust that are attributable to such property |
| C | = | Federal gift tax and estate tax charitable deductions allowed with respectto such property |

### Note

For a direct skip that is a nontaxable gift, the inclusion ratio is zero.

## Valuation of Transferred Property

### Key Points

- Usually valued at fair market value on transfer date
- Consideration paid by transferee reduces value
- Alternate valuation date could be available

The transferred property is generally valued at its fair market value as of the transfer date, reduced by any consideration paid by the transferee.

Under certain limited circumstances, an alternate valuation date is available.

## Generation Assignment

### *Making the Assignment*

**Key Points**

- Assignment by conventional family lines
- Transferor and spouse always same generation
- Special rule when younger person predeceases skip person

As a general rule, a person is **assigned to a generation** along conventional family lines whenever possible. A transferor and spouse are always assigned to the same generation, regardless of any actual difference in ages. A relationship by adoption or half-blood is treated the same as a whole-blood relationship.

There is a special rule applicable when a person at, say, the child level has predeceased the skip person, say, the grandchild. Here the skip person moves up into the generation bracket of the person who has predeceased.

### *Extension of Predeceased Parent Exception*

**Key Points**

- Exception extended to other situations
- Non-family transfers have specific rules by number of years

The **predeceased-parent exception** extends to taxable terminations and taxable distributions as well as direct skips, and also to certain collateral heirs, provided the transferor had no lineal descendants still living when the transfer occurred.

For non-family situations, a person belongs to the same generation as the transferor if born within 12½ years of the transferor. Generations then follow in 25-year increments (i.e., 12½ to 37½, 37½ to 62½, etc.).

## Flat Rate of Tax

The generation-skipping transfer tax is levied at a **flat rate**, and in addition to the federal estate and gift tax. It is imposed at the time of a taxable distribution, taxable termination, or direct skip.

The GST flat tax rate is matched to the top federal estate tax rate of 40% in 2022.

| Year | GST Flat Tax Rate |
|---|---|
| 2010 | 0% |
| 2011–2012 | 35% |
| 2013–2022 | 40% |

## Reverse QTIP Election

### Key Points

- Used to qualify property under GST tax
- Donor or decedent deemed transferor
- For separate trusts, likely both QTIP and reverse QTIP elections permitted

An executor may make a QTIP election to qualify property for the marital deduction under the federal estate and gift tax rules. The executor may also make a **reverse QTIP election** for this same property under the GST tax, allowing the donor or decedent to be deemed the transferor for GST tax purposes.

If the executor specifies on the estate tax return that separate trusts are going to be created, the executor can make both the QTIP and reverse QTIP elections for differing amounts transferred in trust, thereby reducing both the estate and GST taxes.

Under current law, a trust can be "severed" into separate trusts so that a QTIP election can be made for one trust and a reverse QTIP election made for the other trust.

## Dynasty Trust Planning

### *Multi-Generational Trust*

### Key Points

- Multi-generational trust
- Typically used in states with no rule against perpetuities
- Substantial tax minimization
- Many states revised or repealed the rule against perpetuities

A **dynasty trust** is a multi-generational trust established in a state that has revised or repealed the rule against perpetuities. When properly established and administered, a dynasty trust can conserve family wealth through successive generations by minimizing the effect of federal transfer taxes.

Property rights are established under state law, not federal law. In keeping with this general principle, property held in trust is subject to applicable state law with respect to the creation, administration, duration and termination of trusts.

The rule against perpetuities limits the duration of a trust to the period of lives in being at the time of the trust's creation, plus 21 years following the last survivor's death. This means that any future interest that does not vest within this time period would be void. Practically speaking, the rule against perpetuities limits the length of a trust to about 70 to 100 years.

Many states have revised or repealed their laws regarding the rule against perpetuities, thus relaxing or eliminating the limitations on trust duration. Differences between these states exist concerning how long of a trust term is permitted. Some states exempt trusts from the rule against perpetuities altogether so that a trust can, in effect, be perpetual. State legislatures continue to revise laws concerning trust duration.

### *Features*

The purpose of a dynasty trust is to make family wealth available to successive generations. The terms of the trust are designed to preserve trust assets. All terms must conform to state laws concerning trust formation. Here are some important features of a typical dynasty trust:

**Irrevocable.** A dynasty trust is an irrevocable trust. Neither the grantor nor any subsequent beneficiary may alter its terms.

**Funding**. The grantor can use any asset to fund the trust, though an asset that has the potential to increase in value is preferable. Any appreciation in the asset after its transfer to the trust will not be subject to gift or GST tax. Another option is for the trustee to purchase life insurance with gifts made by the grantor to an irrevocable life insurance trust (ILIT). This provides a way to leverage the gift tax exclusion and GST tax exclusion because only the annual gifts to the trust used to pay the life insurance premiums would be subject to tax, not the death benefit itself.

**Spendthrift Provision**. Beneficiaries are not allowed to access the trust assets, nor can they sell their beneficiary interest in the trust.

**Beneficiary Class**. The trust defines beneficiaries by identifying existent beneficiaries (presumably family members) and specifying lineal descendants as future beneficiaries.

**Trustee Selection.** State law generally dictates that at least one trustee be located in the trust situs (in other words, the state whose courts have primary jurisdiction over the trust). Corporate trustees are generally preferable because the trustee will "outlive" the grantor and beneficiaries. Furthermore, the trustee must be independent to properly execute the role (e.g., exercise a sprinkling power).

**Investment Choices**. The trustee can be limited to relatively conservative investment options within the fiduciary duty to balance the needs of present and future beneficiaries.

**Limited Payout**. The trustee can be instructed to only make discretionary distributions of income or income/principal to the beneficiaries based on a sprinkling power.

**Domestic Asset Protection**. States that allow dynasty trusts may also provide statutory protection to the trust from the grantor's creditors, as well as creditors of the beneficiaries.

**Termination**. The terms of the trust define the end point for the trust—whether the trust will be perpetual (lasting as long as the class of beneficiaries) or will end by a certain date.

### *Utilizing Transfer Tax Exemptions—Gift and Estate Taxes*

## Key Points

- Funded with gift tax annual exclusion
- Can be doubled through gift-splitting
- Grantor should not reserve any rights or powers over assets

### Gift Tax

The grantor can fund the dynasty trust over time using the gift tax annual exclusion qualified by Crummey powers (subject to the five-and-five limitation). Husband and wife grantors can agree to split a gift, effectively doubling the amount of an annual gift excluded for gift tax purposes. Any amount above the annual exclusion will be considered a taxable gift, to which the grantor can apply an exemption equal to the unified credit ($12.06 million in 2022).

### Estate Tax

If the grantor creates the irrevocable trust during life, the assets within the trust will not be subject to the estate tax as long as the grantor has not reserved any rights in or powers over the trust and its assets. Also, because the beneficiaries only have an income interest, the trust assets will not be included in any beneficiary's estate, and the trust assets will avoid subsequent estate tax.

## *Utilizing Transfer Tax Exemptions—GST Tax*

### Key Points

- GST tax prevents avoidance of estate taxes by transferring property to younger generations
- Part of GST exemption must be allocated to transfers to dynasty trust

The IRS imposes a generation skipping transfer (GST) tax to prevent estate owners from avoiding estate taxes on successive generations by transferring property to someone two or more generations younger (usually grandchildren).

Because the GST exemption must be allocated for trusts designed to extend across several generations, part of the GST exemption must be allocated for each transfer to such a trust. The transferor(s) can fund the dynasty trust over time using:

- The gift tax annual exclusion qualified by Crummey powers (subject to the five-and-five limitation), and
- Allocation of the GST tax lifetime exemption.

Both funding methods may be doubled through gift-splitting. A married couple with three children and seven grandchildren could use the annual exclusion ($16,000 in 2022) and gift-splitting to shelter a $320,000 annual addition to the trust—plus subsequent appreciation—from transfer taxes.

Where the GST exemption has been allocated to all taxable generation-skipping transfers, any future appreciation in (or accumulated income from) the transferred property is not subject to the GST tax.

## *Advantages*

### Key Points

- Pass wealth to future generations
- Avoid transfer taxes to promote growth of assets
- Avoid uncertainty of changes in transfer tax laws
- Asset appreciation not taxed

While the obvious advantage to a dynasty trust is the ability to pass significant wealth to future generations, another key advantage is the avoidance of transfer taxes. Without the impact of federal estate taxes on each generational transfer, the assets within the trust can continue to grow over the years, though it is important to note that the trust will pay a tax on any income it generates.

A dynasty trust avoids the uncertainty posed by potential future changes to the federal transfer tax laws. The idea is to set up a dynasty trust at a time when the federal transfer tax exemption amounts are higher and the GST tax rates are lower than at any time in recent history.

A final advantage lies in the appreciation potential of assets placed within the dynasty trust over the years (or decades, or even centuries). An asset is valued for transfer taxes at the time of transfer, and as a result an asset that appreciates goes in at a lower value and then grows free of further transfer tax liability. The amount of wealth transferred from generation to generation can be tremendous in a properly drafted trust.

### *Potential Objections*

## Key Points

- Trust may work too well in providing for future generations
- Future generations may lose their need and/or desire to strive to make their own way in the world

Some wealthy individuals are reluctant to create a trust that benefits successive generations. They want future family members to strive to be productive members of society, and not just to rely on the trust distributions.

## Chapter 7 Review Questions

1. Under GST tax law, the IRS singles out all of the following types of generation-skipping transfers as tax-triggering events EXCEPT:
    A. Taxable terminations
    B. Taxable distributions
    C. Direct skips
    D. Double skips
2. Retroactive allocations of the exemption to particular generation-skipping transfers are permissible under certain circumstances.
    A. True
    B. False
3. The rule against perpetuities limits a trust to approximately:
    A. 20 – 50 years
    B. 70 – 100 years
    C. 150 – 200 years
    D. 1000 years
4. When establishing a dynasty trust, the grantor must do all of the following EXCEPT:
    A. Fund the dynasty trust with one large initial gift
    B. Choose at least one trustee from the state in which the trust is situated
    C. Direct the trustee to balance the needs of present and future beneficiaries
    D. Conform to state law in all trust terms
5. A dynasty trust does all of the following EXCEPT:
    A. Avoids transfer taxes
    B. Avoids paying tax on any income it generates
    C. Avoids the uncertainty of future tax law changes
    D. Allows tax-free appreciation of trust assets

## *Answers to Chapter 7 Review Questions*

1. D. Double skips are not singled out by the IRS as a type of taxable generation skipping transfer.
2. A. Under certain circumstances, retroactive allocations of the exemption are permissible.
3. B. Practically speaking, the rule against perpetuities limits a trust term to somewhere between 70 and 100 years.
4. A. The trust may be funded with one large gift, or the grantor may make continuing gifts over time.
5. B. A dynasty trust does pay tax on any income it generates; however, appreciation of assets is tax-free because the assets are valued for transfer taxes at the time they are transferred into the trust.

# Chapter 8
# Irrevocable Life Insurance Trusts

## What Is an Irrevocable Life Insurance Trust?

### *Basic Features*

**Key Points**

- Grantor gives up all rights in trust property and trust
- Name applies to trust holding life insurance policies
- May be called a Crummey trust

An **irrevocable trust** is one in which the grantor completely gives up all rights in the property transferred to the trust, and retains no rights to revoke, terminate or modify the trust in any material way. When such a trust holds a life insurance policy, usually on the grantor's life, it is an irrevocable life insurance trust.

If Crummey powers are granted to the beneficiaries, it may also be referred to as a "Crummey trust" after a famous court case of the same name.

### *Primary Objectives*

Typically, people use irrevocable life insurance trusts in their estate planning to accomplish four primary objectives:

1. To help meet the liquidity needs of the grantor's estate
2. To avoid the estate taxation of the death proceeds
3. To help provide for the income needs of survivors after liquidity costs have been satisfied
4. To shelter property from creditors at death

## Funding Alternatives

### *Funded or Unfunded*

#### Key Points

- Policy and other property transferred to funded trust
- Trust income may be taxed in a funded trust
- Only life insurance policy in unfunded trust
- Grantor makes annual cash gifts to unfunded trust
- Unfunded trusts more common

An irrevocable life insurance trust may be either "funded" or "unfunded."

In a **funded** life insurance trust, the grantor not only transfers the life insurance policy to the trust, but also transfers other property to the trust from which the premium payments may be made. The property may be in the form of cash, securities or some other asset.

The major drawback of the funded life insurance trust is that the trust income may be taxed to the grantor if it can be used to pay premiums on a policy on the life of the grantor or the grantor's spouse.

In an **unfunded** life insurance trust, the trustee has no other property in the trust with which to pay premiums, and is dependent on annual cash gifts from the grantor. The "unfunded" trust is more commonly used.

## Features of the Irrevocable Life Insurance Trust

### *Setting up the Trust*

#### Key Points

- Created during grantor's life, often for family members
- Policy may be existing or new
- Trustee usually pays premiums
- May be a grantor trust, which is ignored for income tax purposes

The irrevocable life insurance trust is created during the grantor's life and is funded with a life insurance policy on the grantor. This may be an existing policy that the grantor gifts to the trust, or it may be a new policy that the trustee acquires with cash the grantor transfers to the trust.

The beneficiaries of the trust are often family members of the grantor—spouse, children, grandchildren, spouses of children and grandchildren.

The grantor usually gives the trustee the discretion to pay premiums. If the trustee can pay premiums from trust income, then the trust generally is considered to be a grantor trust. The grantor is allowed to ignore a grantor trust for income tax purposes, which ensures that growth to future generations will not be diminished by income taxes.

Usually, however, the grantor makes annual transfers of cash to the trust so that the trustee can pay the premiums. Of course, these annual transfers are treated as gifts.

### *Maintaining the Trust*

## Key Points

- Grantor gifts cash to trust to pay premiums
- Qualifies for gift tax annual exclusion if proceeds payable at death
- Gifts of future interests if proceeds held in trust at death

Where the trust beneficiaries cannot begin to "enjoy" the policy until the grantor-insured dies, the gifts/transfers would ordinarily be future interests. That means no gift tax annual exclusion would be available to shelter the annual cash transfers from the federal gift tax.

However, in Revenue Ruling 76-490, the IRS ruled that an employer's payment of monthly premiums for group term life insurance held in an employee's irrevocable trust qualified for the gift tax annual exclusion. The IRS considered the premiums a present interest because, under the terms of both the group insurance policy and the trust, death proceeds were payable to the trust beneficiary immediately upon the death of the insured.

When the trust and policy terms provide that the death proceeds are to be held in trust upon the insured's death rather than be paid immediately to the beneficiary, the annual premium transfers are considered gifts of future interests unless one or more Crummey powers are used to convert them to present interests.

## The Crummey Power

### *Purpose*

## Key Points

- Secures gift tax exclusion for gifts to pay life insurance premiums
- Beneficiaries may temporarily withdraw cash transfers, making cash a present interest gift qualifying for the exclusion
- No withdrawals anticipated in order to maintain value in trust

The gift tax annual exclusion applies only to gifts of a present interest, whereas annual gifts to the trust that enable the trustee to pay premiums are gifts of a future interest. The **Crummey power** turns them into gifts of a present interest by giving the trust beneficiaries the power, exercisable annually for a limited period of time, to immediately withdraw the cash transfers to the trust. The trustee must notify the beneficiaries when a transfer is made to the trust that is subject to their Crummey powers.

Naturally, the grantor hopes the beneficiaries won't exercise their powers, but the mere fact that they could is sufficient to convert what might otherwise be future-interest gifts into present interests that qualify for the gift tax annual exclusion ($16,000 per donee in 2022). So, if there are four beneficiaries with Crummey powers, the grantor could shelter up to $64,000 ($16,000 each × 4) of cash transfers from the gift tax in 2022, or up to $128,000 with gift-splitting. These withdrawal powers may or may not accumulate if unexercised (they generally lapse after the specified period expires).

### *Limits on Amount*

## Key Points

- Crummey power has its own limits
- Maximum that is not a taxable gift to trust beneficiaries

Notwithstanding the gift tax annual exclusion amount, the Crummey power for each holder is often limited to the greater of:

- $5,000, or
- 5% of principal

This is called the "five-and-five" limit, and represents the maximum amount that will not be considered a taxable gift to the other trust beneficiaries if the holder of the power allows it to lapse unexercised each year.

### *When Withdrawal Amounts Are Not Exceeded*

## Key Points

- If withdrawal limits are not exceeded, some amounts are excludable
- Amount that could be withdrawn in year of death must be included
- Exceptions apply

If the beneficiary's annual right of withdrawal does not exceed the five-and-five limits ($5,000 or 5% of principal), the amounts the beneficiary could have withdrawn but did not are excludable from the beneficiary's gross estate—except for the amount that could have been withdrawn in the year of death, which generally must be included.

However, if a withdrawal right is limited to a certain period during the year of the beneficiary's death, and the withdrawal right lapsed before death, the amount that could have been withdrawn in that year need not be included in the beneficiary's gross estate.

### *When Withdrawal Amounts Are Exceeded*

## Key Points

- If withdrawal limits are exceeded, some amounts are includable
- Lapse of withdrawal power is gift to other beneficiaries
- Certain conditions can still shelter the lapse from gift tax

If the beneficiary's right of withdrawal exceeds the five-and-five limits, the aggregate excess amounts which could have been withdrawn will be includable in the beneficiary's gross estate up to a maximum of the full amount of the proceeds.

However, the IRS considers the lapse of the withdrawal power as a gift to other trust beneficiaries under IRC Section 2514, to the extent that the lapsing right exceeds the greater of $5,000 or 5% of the trust assets subject to the power. If the Crummey power extends over the entire trust, and is not limited to the annual addition to the trust, there is a greater likelihood that the 5% criterion will shelter the lapse from the gift tax.

For example:

| Where trust assets are: | Greater of $5,000 or 5% is: |
|---|---|
| $50,000 | $5,000 |
| $75,000 | $5,000 |
| $100,000 | $5,000 |
| $300,000 | $15,000 |
| $500,000 | $25,000 |

### *Applicable Credit Amounts*

## Key Points

- Lapses exceed $5,000/5%
- Methods available to avoid problems
- Alternative strategies may be required

If lapses exceed the $5,000/5% safe harbor, the holders of the Crummey power will have to draw upon their **applicable exemption amounts** to shelter the resulting taxable gifts from the gift tax.

To avoid this result, individuals sometimes draft Crummey trusts to limit the withdrawal right to the lesser of:

- The Crummey beneficiary's proportionate share of additions to the trust, or
- The amount of the gift tax annual exclusion (with gift-splitting, if available), or
- The greater of $5,000 or 5% of the trust corpus.

If the $5,000/5% criterion turns out to be the lowest of these amounts, the grantor will not get the full benefit of the gift tax annual exclusion. That unfortunate result led to the creation of four alternative strategies: the hanging power, the power of appointment trust, the separate trust, and a large initial gift to seed the trust.

## Hanging Power

### Key Points

- Crummey beneficiary's rights limited
- Withdrawal right suspends or hangs until lapse can occur within the 5-and-5 limits
- Expected result: no gift tax
- Payment of death proceeds into trust allows hanging power to be exercised by distribution of excesses
- Trust could remain in effect until lapse

The trust may limit the Crummey beneficiary's withdrawal rights to the lesser of:

- The beneficiary's proportionate share of the addition, or
- The amount of the gift tax annual exclusion.

The trust may also provide that any excess portion of the annual withdrawal right does not lapse. This will prevent any lapse in excess of $5,000/5% from becoming a taxable gift. Instead of lapsing, the excess portion is "suspended" or "hangs" (thus, **hanging power**) until such time as the lapse can occur within the five-and-five rule limitations.

Then, the theory goes, since the $5,000/5% safe harbor is not being used to offset taxable gifts to other beneficiaries, it is available to reduce the accumulated excesses. The expected result is that the accumulated excesses will lapse each year, within the $5,000/5% limit, without gift tax consequences.

When the insurance death proceeds are paid into the trust, the trustee may exercise the hanging power by distributing the accumulated excesses. Alternatively, the trust could remain in effect until the accumulated excesses lapse without resulting in taxable gifts.

The IRS, however, has ruled one hanging power invalid. The IRS said that where the withdrawal right would not lapse if such a lapse would result in a taxable gift, the power to withdraw beyond the $5,000/5% limit would not be respected.

## Power of Appointment

### Key Points

- Trust beneficiaries designate in wills who will receive excess amounts
- Result: no taxable gift
- IRC addresses certain situations where amounts are included in gross estate

Another alternative is to give the trust beneficiaries a testamentary **power of appointment** over the accumulated excesses. In their wills, the beneficiaries designate who will receive the excess amounts not withdrawn under Crummey powers. Since there is no lapse of the accumulated excesses, the beneficiaries do not make any taxable gifts.

But under IRC Section 2041(a)(2), the estate of a beneficiary who died before trust termination would include any portion of the trust over which the beneficiary held a general power of appointment. Thus, the amount that could have been withdrawn in the year of death will be included in the gross estate.

Further, IRC Section 2041(a)(2) treats each lapse as a transfer subject to the estate tax lifetime transfer rules. Therefore, for every prior year in which the beneficiary had rights in excess of the $5,000/5% limit, a portion of the trust principal may come into the beneficiary's gross estate.

## Separate Trust

### Key Points

- Separate trusts established for each beneficiary
- Each beneficiary may receive distributions
- At beneficiary's death, estate receives remaining trust property
- Lapse of right does not cause taxable gift
- Value of trust included in each beneficiary's gross estate

A third option involves creating a **separate trust** for each beneficiary. The beneficiary of each trust would be entitled to receive distributions from the trust, and the beneficiary's estate would be entitled to receive any remaining trust property upon the beneficiary's death.

The lapse of the withdrawal right in this case does not result in a taxable gift because all the property subject to the power goes either to the beneficiary or to the beneficiary's estate, and not to other trust beneficiaries. The value of each trust at the beneficiary's death (or the alternate valuation date) is includible in the beneficiary's gross estate.

## Large Initial Gift

### Key Points

- Gift seeds the trust
- 5% safe harbor shelters lapses
- Taxable gift could occur with initial gift

The final option is to **"seed"** the trust with a **large initial gift**. Here, no taxable gifts should arise with respect to lapses of Crummey powers exercisable over subsequent gifts because the 5% safe harbor will apply to a sufficiently high trust corpus to shelter the lapses.

Of course, the initial gift may very well be taxable.

## IRS Vigilance

### *Tax Court Ruling*

**Key Points**

- IRS monitors artificial creation of beneficiaries who have Crummey powers only
- Tax Court has ruled against IRS

When the premium payment is substantial, there may not be enough beneficiaries to shelter the annual cash transfers to the trust under the gift tax annual exclusion. Grantors have tried to get around this by "creating" beneficiaries who have no rights in the trust except Crummey powers.

The IRS has attacked this practice in letter rulings, but received something of a setback in the *Cristofani* case in 1991. The Tax Court ruled that the unexercised rights of withdrawal by several beneficiaries allowed additions to the trust to qualify for the gift tax annual exclusion. The IRS later acquiesced in the result in *Cristofani*, but has indicated that it will continue to press the issue outside the Ninth Circuit.

Two 1996 IRS releases indicate that the IRS will seek to deny exclusions for Crummey powers when (1) the power holders have no other interests in the trust; (2) there is a prearranged understanding that the powers will not be exercised; or (3) the withdrawal rights are not in substance what they purport to be in form. At a minimum, the beneficiaries should have some other interest in the trust besides Crummey powers.

### *Time to Exercise Powers*

**Key Points**

- Beneficiaries must have reasonable time period to exercise powers
- Trustee must notify beneficiaries when trust receives cash transfer subject to their withdrawal powers

The trust should give the beneficiaries a reasonable period of time in which to exercise their powers (e.g., 30 days). If the trust says they have until December 31 to exercise their powers, and the grantor makes the cash transfer on December 30, the IRS would almost certainly view this as a sham. The gift tax annual exclusion (multiplied by the number of beneficiaries with present interests) would be lost.

Also, the trustee must give the beneficiaries formal notice that the trust has received a cash transfer subject to their Crummey withdrawal powers.

### *Ruling on Irrevocable Life Insurance Trust*

**Key Points**

- Right of beneficiary to withdraw more than 5-and-5 limit and lapse of power unexercised = gift to other beneficiaries
- Applies even with remainder interest only for other beneficiaries

The IRS has ruled that where a beneficiary of an irrevocable life insurance trust (ILIT) could withdraw up to 10% of the principal each year (i.e., more than the five-and-five limit), the lapse of the power unexercised would be a gift to the other trust beneficiaries to the extent that it exceeds 5% or $5,000, whichever is greater.

The IRS applied this result even though the other trust beneficiaries had only a remainder interest and the trustee could theoretically exhaust the entire principal by making distributions during the income beneficiary's life.

## Intentionally Defective ILIT

### *Characteristics*

An **intentionally defective ILIT** is an irrevocable life insurance trust in which the grantor keeps a certain power over the assets inside the trust, causing the trust's income to be taxed to the grantor rather than to the trust itself. Despite the grantor's retention of the power, the assets inside the trust remain outside of the grantor's estate for federal estate tax purposes.

The intentional defect is actually a planning choice by the grantor to pay income tax on the trust while keeping the trust assets outside of the grantor's estate.

The purpose of an intentionally defective ILIT is to lock in the transfer tax value of the assets placed in the trust while allowing the value of assets inside the trust to increase free of income tax. Since the grantor pays the tax on the transfer, as well as the income tax the trust would normally pay, the assets grow unabated, and the beneficiaries can receive them without paying income tax.

### *Powers Retained by the Grantor*

The grantor trust powers are those powers retained by the grantor that cause the inclusion of trust income in the grantor's gross income. Note that the grantor is treated as holding any power or interest of a spouse.

- Grantor has a reversionary interest in the trust assets and/or income if the value of such interest exceeds 5%.
- Grantor has beneficial enjoyment of the trust assets and/or income subject to a power of disposition by the grantor or a non-adverse party without the approval or consent of an adverse party.
- Grantor retains certain administrative powers or the power to control beneficial enjoyment of trust principal or income.
- Grantor or trustee can revoke the trust without the beneficiary's consent.
- Grantor or a non-adverse party could direct that trust income be (1) distributed to the grantor or the grantor's spouse; (2) accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to pay premiums on insurance on the life of the grantor or the grantor's spouse.
- Income is or may be used for the support of the grantor's spouse or is actually used for the support of a person whom the grantor is legally obligated to support, or is or may be applied in discharge of any other obligation of the grantor.

Retaining one of these powers does not necessarily cause the inclusion of the trust and its assets in the grantor's estate for estate tax purposes. For example, the power to substitute assets in a trust is a retained power that *does not* include the trust in the grantor's estate.

### *Tax Implications*

## Key Points

- Crummey powers make completed gifts of a present interest
- Assets excluded from grantor's estate
- Income is taxed to the grantor

#### Federal Gift Tax

Assets transferred to an intentionally defective ILIT are completed gifts for federal gift tax purposes. If the trust beneficiaries are given a Crummey power (the ability to withdraw the grantor's contribution), the gift is actually a present interest and the transfer qualifies for the annual gift tax exclusion.

#### Federal Estate Tax

Assets the grantor transfers to the intentionally defective ILIT are excluded from the grantor's estate for federal estate tax purposes.

#### Federal Income Tax

Because the grantor keeps a certain power or right over the trust assets, the income generated by the trust is taxed to the grantor. However, if the trust requires that the trust repay the grantor for payment of the income tax attributable to the intentionally defective ILIT, all assets within the trust would be included in the grantor's estate.

### *Income Tax Payment Is Not a Gift*

## Key Points

- Grantor who pays income tax on trust income does not make a gift to the beneficiaries
- Trust includable in grantor's estate if trustee is required to repay the grantor

The grantor's payment of any income tax on trust income arguably confers an economic benefit on the trust beneficiaries, since they are relieved of any income tax burden during the grantor's life. So has the grantor made a taxable gift to the beneficiaries?

An IRS revenue ruling has concluded that the grantor of a defective ILIT does not make a gift to the beneficiaries by virtue of paying the income tax on trust income. If the trustee is required by the trust instrument or state law to reimburse the grantor for any income taxes paid, the trust is includable in the grantor's gross estate as a retained interest. However, the trust will not be includable merely because the trustee has discretion to reimburse the grantor under the terms of the trust or under state law, unless there is evidence of a prior understanding between the grantor and trustee or other extrinsic facts that would fetter the trustee's discretion.

### *Installment Sales*

One approach is the use of an installment sale between the intentionally defective grantor trust (IDGT) and the grantor:

1. The grantor funds the IDGT with money and liquid assets (at least 10% of the value of the asset that will be the subject of the installment agreement).
2. The grantor and the IDGT trustee enter into an installment sale agreement whereby the grantor accepts a promissory note with a principal balloon payment at the end of the term in exchange for the transfer of assets expected to appreciate to the IDGT.

The grantor does not realize any taxable gain on the sale of the appreciating assets to the trust since the grantor and trust are the same for income tax purposes. And, there is no gift tax imposed on the transfer of the appreciating assets to the trust because the grantor receives commensurate value in the form of the installment note.

The interest rate of the note is determined by the applicable federal rate (AFR) and the length of the term of the note—it is necessary for the interest rate to be reasonable in order to properly claim the transaction is a sale rather than a gift. The assets within the IDGT need to appreciate at a rate greater than the applicable federal rate in order to gain an advantage for the trust and its beneficiaries. The cash and liquid assets originally contributed are used to pay the interest on the note. At the end of the term, the trust pays the principal.

The use of the installment note is a way to remove the assets from the grantor's estate while retaining an income stream from the assets.

### *Advantages and Drawbacks*

## Key Points

- Removes assets from grantor's estate
- Freezes the value of assets
- Places income tax burden on grantor instead of on trust
- Preserves potential losses from depreciated assets
- Allows substitution of assets
- Grantor pays tax on income he or she never receives

The intentionally defective ILIT removes assets from the grantor's estate for estate tax purposes and freezes their value so that any appreciation will go to the beneficiaries without transfer tax costs. The distinct advantage is that it places the income tax burden on the grantor rather than the trust.

Retaining the power to substitute assets offers the grantor the opportunity to preserve potential losses from depreciated assets, which would otherwise disappear upon death. Because the intentionally defective ILIT takes a carryover basis in the assets transferred, the grantor can substitute the appreciated assets inside the trust for liquid assets with limited or no appreciation at a later time. Thus, when the substituted assets are eventually included in the grantor's gross estate, the heirs will receive a stepped-up basis in those assets for income tax purposes.

One clear drawback, of course, is that the grantor will pay income tax on income he or she never actually receives, and the obligation is permanent because the trust and its terms are irrevocable.

## Liquidity Planning

### *Using Life Insurance Proceeds from the Trust*

**Key Points**

- Trust document authorizes trustee to make funds available to executor
- Can authorize purchase of illiquid assets
- Can authorize loans to estate

Suppose the grantor-insured dies and the policy proceeds are paid into the trust. How can the proceeds be made available to the executor for liquidity?

The trust document must authorize the trustee to make the proceeds available to the executor. This is usually done in one of two ways:

- By authorizing the purchase of illiquid assets from the estate, or
- By authorizing loans to the estate.

Either way, cash flows into the estate at the time it is needed to pay funeral costs, expenses of the decedent's last illness, death taxes, probate expenses, and the claims of creditors.

### *Power of Trustee*

**Key Points**

- Power must be discretionary to exclude proceeds from gross estate
- Estate must not be a direct or indirect beneficiary of proceeds

It is critical that the trust document merely authorizes the trustee to make the proceeds available to the executor. If the trustee is *required* to do so, the policy proceeds would likely be includible in the grantor-insured's gross estate. This would undo a chief advantage of using the irrevocable life insurance trust.

As long as the trustee has discretionary power only, and the estate is not a direct or indirect beneficiary of the proceeds, the proceeds will not be includible in the gross estate unless and to the extent actually used to pay estate obligations (i.e., without any bona fide loan or asset purchase taking place).

### *Making a Loan*

**Key Points**

- Loan terms may not be more favorable than commercial terms
- Incorrect usage could jeopardize estate tax exclusion

The danger doesn't end there. If the trustee arranges a "sweetheart deal" on the purchase or loan to pump additional cash into the estate, the IRS could consider it a use of the life insurance proceeds to benefit the estate, which would jeopardize the estate tax exclusion for the proceeds.

In order to avoid a taxable distribution of trust income, the purchase of an asset from the estate should be for a fair price, and any loan should:

- Bear a reasonable rate of interest
- Provide a repayment schedule, and
- Be secured by estate assets as collateral.

## Tax Aspects of Irrevocable Life Insurance Trusts

### *Conditions for Excluding Trust Corpus from Gross Estate*

The trust corpus, including the life insurance, generally avoids being included in the grantor-insured's gross estate for estate tax purposes if:

- The trust is irrevocable;
- The grantor is not the trustee;
- The grantor has no incidents of ownership over the insurance policy;
- The insurance proceeds are only used to purchase estate assets or to make loans to the estate in reasonable, arm's-length transactions, not to pay estate costs in a direct manner; and
- The insured lives for at least three years after transferring the policy to the trust.

The IRS has ruled that a grantor's power to remove a trustee and appoint an individual or corporate successor trustee that is not related to or subordinate to the grantor is not a reservation of the trustee's power by the grantor. Thus, such a reserved power will not cause the trust property to be included in the grantor's gross estate.

### *Other Tax Issues*

**Key Points**

- Grantor trust income taxable
- Gift tax avoidable with Crummey powers
- After expenses, trust assets may be held for beneficiaries
- Generation skipping tax might be an issue for large trusts

If the trust is a grantor trust as defined in tax law, any income produced by the trust will be taxed to the grantor. The trustee's ability to use trust income to pay premiums on a policy on the life of the grantor or the grantor's spouse is one of the factors that would make the ILIT a grantor trust.

The grantor can avoid paying gift tax on annual cash transfers to the trust by giving the beneficiaries properly drafted Crummey powers.

After estate settlement costs have been provided for, the remaining trust assets can be held for the benefit of trust beneficiaries.

When several generations are covered by the trust, the generation-skipping tax becomes a planning consideration. There is an exemption from this tax, so it will only be a factor in rather large trusts.

## Non-Tax Advantages of Irrevocable Life Insurance Trusts

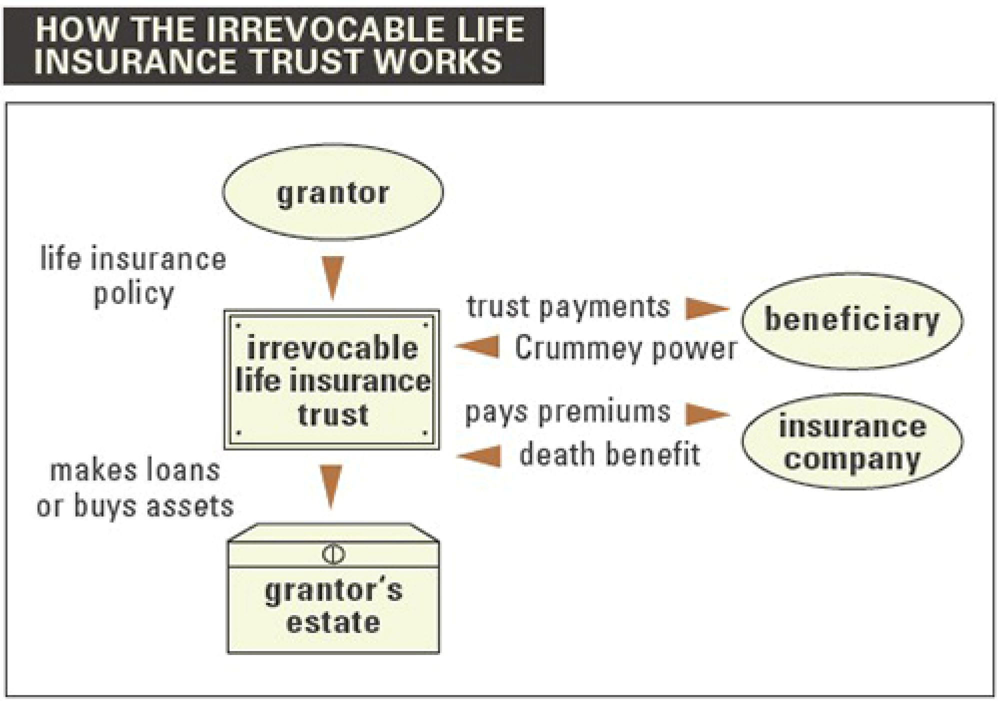
In addition to tax avoidance, an irrevocable life insurance trust can:

- Make cash available to help pay estate settlement costs.
- Help to provide financial security for the grantor's survivors.
- Avoid probate costs on the life insurance proceeds and any other assets passing via the trust.
- Keep the trust provisions private and confidential, not a matter of public record as in the case of a will.
- Avoid the claims of creditors against assets in the trust at the grantor's death.

## How the Irrevocable Life Insurance Trust Works

### *Graphic*

Here is an illustration that shows how the irrevocable life insurance trust works.



## Chapter 8 Review Questions

1. Typically, irrevocable life insurance trusts are used in estate planning to accomplish all of the following EXCEPT:
    A. To provide liquidity to the grantor's estate
    B. To avoid the generation-skipping transfer tax
    C. To provide income for survivors (after liquidity needs have been met)
    D. To shelter property from creditors at death
2. Are annual transfers to an ILIT to pay premiums subject to the gift tax? Select the answer that is FALSE.
    A. Where trust beneficiaries cannot "enjoy" the policy until the grantor dies, the transfers for premiums would generally be considered gifts of a future interest, meaning they would be subject to the gift tax.
    B. The IRS ruled that in the case of transfers to pay premiums, if the beneficiaries get the death proceeds immediately upon the death of the insured, the annual transfers can be considered gifts of a present interest, not subject to gift tax.
    C. If the death proceeds will be held in trust after the death of the insured, the annual transfers are considered gifts of a present interest, and are not taxable.
    D. If the death proceeds will be held in trust after the death of the insured, but the beneficiaries have Crummey powers to withdraw those annual transfers, they are considered gifts of a present interest, and not taxable.
3. Notwithstanding the gift tax exclusion, Crummey powers are limited in the following way in order for it not to be considered a taxable gift to the other trust beneficiaries if the holder of the power allows it to lapse unused:
    A. 5% of the trust assets
    B. $5,000
    C. $5,000 PLUS 5% of the principal
    D. $5,000 OR 5% of the principal
4. An intentionally defective ILIT does all of the following EXCEPT:
    A. Removes assets from the grantor's estate
    B. Freezes the value of the assets placed in the trust so that any appreciation goes to the beneficiaries tax free
    C. Places the income tax burden on the grantor
    D. Allows the grantor to make changes to the trust if his or her situation changes

5. Norma is the grantor-insured for an ILIT. When she dies, her estate needs cash to pay for funeral costs, final medical expenses, death taxes, probate expenses, etc. How can the proceeds of the life insurance policy in the ILIT be made available to the executor?

    A. The trust terms may authorize the purchase of illiquid assets from the estate, or authorize loans to the estate.

    B. The trust terms may only authorize the purchase of illiquid assets from the estate.

    C. The trust terms may only authorize loans to the estate.

    D. The trust terms may authorize that all proceeds be paid into the estate.

## *Answers to Chapter 8 Review Questions*

1. B. An ILIT helps avoid the estate taxation of the death proceeds.
2. C. If the death proceeds will be held in trust after the death of the insured, the annual transfers are considered gifts of a future interest, and are therefore subject to the gift tax.
3. D. The maximum is the greater of $5,000 or 5% of the principal.
4. D. The grantor cannot make any changes; the terms of the ILIT are irrevocable.
5. A. While the proceeds may not go directly into the estate, the trust terms have either of these two options for making cash available to the executor. However, the trust must not require the trustee to make the cash available, or else the trust assets will end up being included in the grantor's estate.

# Chapter 9
# Other Trusts

## What Is a Revocable Living Trust?

### *Definition*

**Key Points**

- Created during grantor's life
- Grantor can change or revoke
- Usually ends or becomes irrevocable at grantor's death
- Different from irrevocable trust and testamentary trust

A **revocable living trust** is a trust created during the grantor's lifetime that the grantor may alter, amend or revoke. After the grantor's death, the trust either becomes irrevocable or terminates.

The revocable living trust may be contrasted with both an irrevocable trust (also a trust created during life but which can't be changed) and a testamentary trust (a trust established by the decedent's will to take effect after death, in which assets must pass through probate before entering the trust).

## Purposes of a Revocable Living Trust

Because of the revocability feature, the revocable living trust does not provide any tax advantages during the grantor's lifetime or at the grantor's death. Revocable living trusts:

- Avoid probate on any assets the grantor transfers into the trust during life (these assets, however, do not avoid estate taxes)
- Receive life insurance proceeds made payable to the trust at the grantor-insured's death
- Receive probate assets pouring over into the trust under the deceased grantor's will (assuming the trust did not terminate at the grantor's death)
- Control the disposition of trust assets through the terms of the trust, much as the grantor's will would have done if the assets were part of the probate estate
- Keep the decedent's directions for asset distribution private (unlike wills, which are admitted to probate and subject to public inspection)
- Provide management of the trust assets by a trustee other than the grantor, if the grantor becomes incapacitated
- Allow flexibility—the grantor may have an attorney prepare a written amendment to the trust at any time without tax or other penalty
- Provide security for the grantor and the grantor's family through the right to revoke the trust and reclaim outright ownership of the trust property if an emergency arises

## Typical Features of a Revocable Living Trust

### *Two-Part Trust*

#### Key Points

- First part directs management during grantor's life
- Second part manages and disposes of trust after death

Typically, the first part of the trust instrument directs how the trust is to be managed during life. The second part deals with the management and disposition of trust properties after death.

The first part of the trust agreement provides that, during life, the grantor:

- Will receive all trust income,
- May add property to the trust or remove property from the trust at any time, and
- May change any of the trust provisions—or cancel the whole arrangement—for any reason and at any time.

### *The Trustee*

#### Key Points

- Can be grantor or other entity or person
- Second part of trust document can be changed only during life

The grantor can choose to serve as the sole trustee of the trust. However, to avoid day-to-day investment responsibility, the grantor could instead name a bank or some other person as trustee.

The second part of the trust instrument will direct exactly how the trustee is to use the trust properties during the grantor's life and dispose of them after the grantor's death. In this sense, the revocable living trust is like a will. The grantor can change it at any time during life, but those terms become unchangeable at death.

## Avoiding Probate Costs and Delays

#### Key Points

- Trust property not subject to probate
- Avoids typical long delays of probate

Properties the grantor transfers to the revocable living trust during life are not subject to probate at the grantor's death. Therefore, assets in the trust avoid the delays and costs of settling or probating an estate. Probate costs may be substantial or modest, depending on the state.

Settling the estate of a decedent always ties up the decedent's property—at least to some degree. Typically, the local probate court will appoint an executor or an administrator who will collect all the properties of the estate, hold these properties until creditors' claims are satisfied and other formalities are complied with, and then distribute the remaining properties as directed in the decedent's will. (If there is no valid will, property will be distributed according to state intestacy laws.) During this time, which usually ranges from six months to a year or more, the properties may be poorly invested and income or principal may not be readily available to the beneficiaries or heirs.

The revocable living trust can be especially important if the grantor owns real property in states other than the grantor's state of residence. The grantor can avoid multiple probate proceedings in several states (called ancillary probate) by placing the property in the trust during life.

## Pourover Receptacle

### Key Points

- Revocable trust is inactive during life
- Does not terminate when grantor dies
- May receive assets passing by will after probate and insurance proceeds
- Life insurance proceeds have more flexible payouts than standard settlement options
- Becomes irrevocable at grantor's death

The revocable living trust can be a "shell" during the grantor's lifetime—in other words, inactive. If the trust does not terminate at the grantor's death, the trust may receive assets passing under the will (after probate) and from life insurance policies. This is often called a **pourover trust**. Remember, at the grantor's death the trust becomes irrevocable, and the grantor's comprehensive plan for the disposition of assets will be carried out via the trust terms.

With respect to life insurance proceeds, the trust can provide more flexibility in the payout to beneficiaries than is possible with the standard settlement options offered by the insurer. Also, where there are a number of different policies, the proceeds can be consolidated in the trust and administered under a single comprehensive plan of disposition.

## Asset Management

### Key Points

- Frees grantor of investment responsibilities
- Professionally managed by trustee
- Income paid to grantor

The revocable living trust can be more than a mere shell during the grantor's lifetime. If the grantor wants to be free of investment responsibilities, or fears future mental incapacity or absence from the property, the grantor may choose to transfer assets into the trust during life, where the trustee will professionally manage them.

Typically, the grantor will receive any income earned by these assets.

## Tax Consequences of the Revocable Living Trust

### *No Tax Benefits for Grantor*

**Key Points**

- No federal income or estate tax benefits
- Could be subject to gift tax if income paid to someone other than grantor
- Can provide liberal benefits to beneficiaries
- Can still escape estate tax when beneficiary dies

The grantor generally does not enjoy any federal income tax or estate tax benefits from the trust. If the trust generates income, the grantor is taxed on it. In fact, if this income is paid to someone other than the grantor, it would be a gift potentially subject to the gift tax.

The trust can be designed to provide fairly liberal benefits to the beneficiaries—all the income and even some rights to withdraw principal—and the trust can still escape the federal estate tax when a beneficiary dies.

### *Qualified Revocable Trust*

**Key Points**

- May be treated as part of decedent's estate for federal income tax purposes
- Both executor and trustee must agree trust will not be treated as a separate trust
- Permits additional income tax advantages to apply to trust

The IRS issued regulations that allow a **qualified revocable trust** to be treated as part of the decedent's estate for federal income tax purposes. For that to happen, both the executor and the trustee must elect to treat the revocable trust as part of the estate instead of as a separate trust.

The election would allow certain income tax advantages that apply only to estates to apply to qualifying revocable trusts as well. The election may be made on Form 1041, the federal income tax return for trusts and estates.

## Disadvantages of the Revocable Living Trust

Besides the lack of tax savings for the grantor, other disadvantages of a revocable living trust include the following:

- Initial expense—It may be more expensive to establish than a will, and the grantor can expect to pay an additional legal fee for the attorney to prepare this extra document.
- Ongoing expense—If the grantor funds the trust with assets during life, a trustee other than the grantor or a family member may assess an annual fee for managing the trust assets.
- Limited asset protection—Assets in the trust at death may not escape the claims of creditors of the estate, just as if the grantor still owned these assets outright.

## Funding the Revocable Living Trust

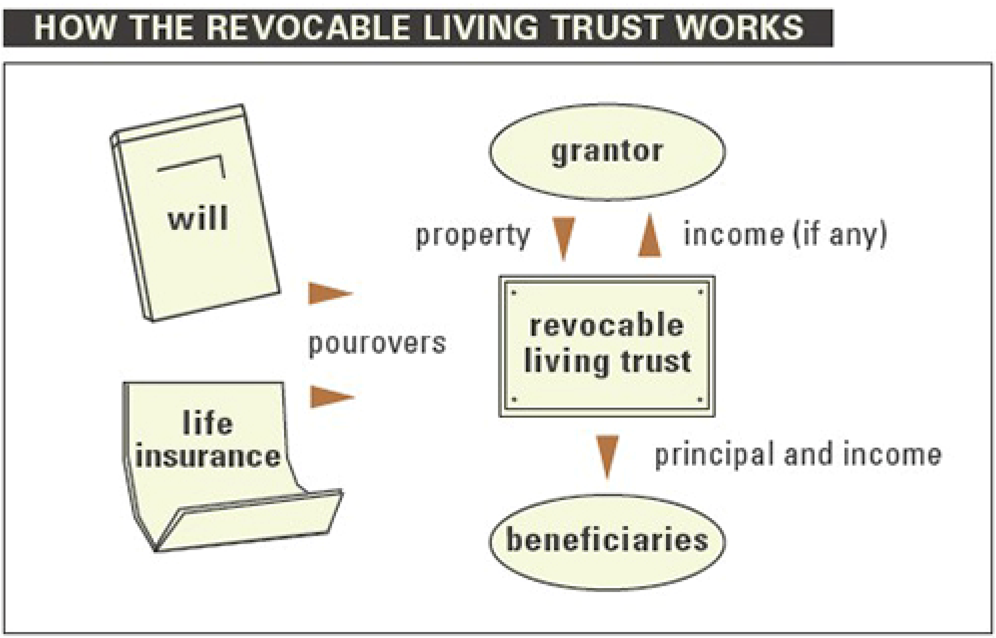
We have already discussed some of the possibilities in passing, but here is a list of all the funding options. The grantor can:

- Immediately transfer the ownership of certain properties to the trust.
- Arrange to transfer properties to the trust at a later time—typically when there seems to be a high risk of death, disability or incapacity.
- Name the trust as the beneficiary of life insurance proceeds.
- In the will, name the trust as the beneficiary of certain properties, or even of the entire net probate estate.

## How the Revocable Living Trust Works

### *Graphic*

Here is an illustration that shows how the revocable living trust works.




## What Are QPRTs, GRATs, and GRUTs?

### *The Importance of IRC Section 2702*

### Key Points

- Special rules for valuing gifts in trust when there is a retained interest
- Retained qualified interest allows reduced value

We are going to look at three forms of grantor retained interest trusts: **Qualified Personal Residence Trusts (QPRTs)**, **Grantor Retained Annuity Trusts (GRATs)**, and **Grantor Retained Unitrusts (GRUTs)**. But what is a retained interest trust?

The tax code provides special rules for valuing gifts in trust when the donor (or, in some cases, a family member) retains an interest in the trust for the benefit of the donor's family.

- If the retained interest is not qualified under IRC Section 2702, the interest is valued at zero and the entire value of what is transferred to the trust is considered a gift.
- If the retained interest is a qualified interest under IRC Section 2702, the value of what is considered a gift is reduced by the value of the qualified interest.

### *Qualified Interest*

Under IRC Section 2702(b), a qualified interest is either:

- **A qualified annuity interest** (fixed payments at least annually);
- **A qualified unitrust interest** (payments, at least annually, that are a fixed percentage of the net fair market value of the trust as revalued annually); or
- **A qualified remainder interest** (a non-contingent remainder interest if all other interests in the trust are either qualified annuity interests or qualified unitrust interests).

## Qualified Personal Residence Trust (QPRT)

### *What It Is*

**Key Points**

- Irrevocable trust consists of personally owned home
- Grantor retains income right or use of property
- Rights exist for a fixed period, then pass to beneficiary

A **Qualified Personal Residence Trust (QPRT)** is an irrevocable trust into which the grantor places a personally owned home while retaining an income right or the use of the property for a fixed period of years. At the end of the specified period of years, the home will pass to beneficiaries, such as a child or grandchild of the grantor.

Generally, the grantor is making a gift of the future right to trust assets to family members (known, in this case, as remaindermen).

### *Requirements to Establish a QPRT*

There are certain IRC Section 2702 requirements that a QPRT must meet in order to be a qualified interest trust:

1. The grantor must establish an irrevocable trust.
2. The trust must provide that the grantor **retains the right to enjoy trust income or possess trust property** for a specified number of years. The longer the specified term of the trust, the greater the value of the retained income interest, and therefore, the lower the taxable gift the grantor is making to the ultimate remainder beneficiaries.
3. The grantor must **transfer a principal residence and/or one other residence** to the trust. Under the Internal Revenue Code rental-use rules, if the grantor uses the residence for the greater of (1) 10% of the number of days during which the house is rented at a fair rental, or (2) two weeks, and rents the property for the balance of the year, it will qualify.

### *Additional Considerations*

Here are additional considerations when establishing a QPRT.

- One or more qualified appraisers should **value the property** shortly before it is placed into trust.
- If the grantor resides in the home at the expiration of the trust term, the grantor should **enter into a written lease** requiring payment of a fair market rental to the remaindermen (family members). The IRS has taken the position that the home may not be transferred out of the trust (as, for example, by sale to the grantor) during the term of the trust.
- The trustee should be someone other than the grantor or the grantor's spouse.

### *Advantages*

## Key Points

- Freezes property value
- Removes property from grantor's estate
- Provides limited protection from creditors

Some of the advantages to creating a QPRT include the following:

- The transfer of the personal residence to a QPRT effectively freezes the property's value for gift tax purposes.
- The personal residence is removed from the grantor's estate for estate tax purposes if the grantor outlives the term of the trust (otherwise, the value of the property will be included in the estate).
- The transfer of property to the QPRT provides limited asset protection. Though the trust is a self-settled trust and likely lacks sufficient protection under state law, the grantor's reduced interest in the property (something that lasts only for a term of years) will not be as attractive to creditors as other property.

### *Potential Drawbacks*

- **The grantor's life expectancy may be too short**. If the grantor does not survive the term of the QPRT, the property will be part of the grantor's estate.
- **The basis may be too low**. The beneficiaries' tax basis in their interest in the residence will be the same as the trust's tax basis, which is the same as the grantor's tax basis, which is possibly low. For instance, let's say a grantor owns a vacation home worth $2 million that was originally purchased for $300,000. In a QPRT, the grantor's basis in the property carries over to the trust and on to the beneficiaries. If the grantor had simply left the property to the beneficiaries, the property would have a stepped-up basis of $2 million.
- **The family dynamics may be too complex**. When there are multiple beneficiaries, those beneficiaries will eventually own the property together. Will this group of individuals get along well enough to effectively manage and/or utilize the property? How do they plan to equally (or unequally) cover the costs of ownership? Or will family dynamics undermine the successful ownership of the property?

## Grantor Retained Annuity Trust (GRAT)

### *What It Is*

## Key Points

- Used to transfer assets to younger generations
- Grantor retains right to income for a period of years
- Remaining assets pass to beneficiaries

A **Grantor Retained Annuity Trust (GRAT)** is an irrevocable trust into which the grantor places one or more assets expected to appreciate in value while retaining a right to income from the trust for a fixed period of years.

At the end of the trust term, the remaining assets in the trust pass to the beneficiaries, such as a child or grandchild of the grantor. Generally, the grantor is making a gift of the future right to trust assets to the remaindermen (family members).

### *Requirements*

There are certain IRC Section 2702 requirements which a GRAT must meet in order to be a qualified interest trust:

- The grantor must establish an irrevocable trust.
- The trust must provide the grantor an interest to an annual income from the trust for a specified number of years. The longer the specified term of the trust, the greater the value of the retained income interest, and therefore the lower the taxable gift the grantor is making to the ultimate remainder beneficiaries.
- In valuing the remainder interest for beneficiaries for gift tax purposes, the IRC Section 7520 rate should be used according to the length of the trust term.
- The grantor's gift to the beneficiaries must be a gift of a future interest, so there is no available gift tax annual exclusion.
- The annuity must be a set dollar amount, or a set percentage of the initial value of the trust. Income in excess of the set dollar amount can be distributed to the grantor, but is not considered when valuing the retained interest at the outset. As a result, the annuity payout does not need to be the same for each year, but the annuity paid one year cannot exceed 120% of the annuity in the previous year.
- The trustee should be someone other than the grantor or the grantor's spouse.

### *Advantages*

## Key Points

- Provides savings on federal gift taxation
- Removes assets from the grantor's estate

A GRAT provides **savings on federal gift taxation**. The grantor's gift to the beneficiaries is equal to the remainder interest of the GRAT as determined at the time the trust is created. The remainder is determined using a formula that considers the number of years for the trust and the applicable federal rate under IRC Section 7520. This discount rate effectively freezes the value of the asset(s) placed in the GRAT for federal gift tax purposes. If the value of assets in the GRAT subsequently increases, that appreciation will not be subject to the federal gift tax.

A GRAT also **removes the asset(s) from the grantor's estate**. If the grantor survives the term of the trust, the asset(s) are no longer part of the grantor's estate because the grantor no longer holds any right or interest in the asset(s). However, if the grantor dies during the trust term, the assets within the trust are included in the grantor's estate. Of course, given the choice of achieving some federal transfer tax savings with the prospect of outliving the term of the trust, the grantor may decide it is worth the risk of establishing the GRAT. One option is to arrange term life insurance on the life of the grantor in order to pay estate costs associated with the inclusion of GRAT assets in the estate.

### *"Zeroed Out" GRAT*

## Key Points

- Value of retained annuity interest = value of remainder interest for beneficiaries
- No taxable gift

A **"zeroed out" GRAT** is a GRAT for which the value of the retained annuity interest equals the remainder interest for family members.

This means there is no taxable gift based on the calculation of the number of years for the trust, the prevailing applicable federal rate under IRC Section 7520, and the amount of the annuity payout.

### *Rolling GRAT*

## Key Points

- Series of short-term GRATs
- Lower risk that grantor will die during trust term
- Greater flexibility to choose funding assets in relation to current financial markets

A **rolling GRAT** is not a single GRAT, but rather a series of GRATs that have very short terms (e.g., a series of two-year GRATs).

The advantages gained by creating a series of short-term GRATs rather than one longer-term GRAT are:

- the lower risk that the grantor will die during the term of the GRAT, and
- the greater degree of planning flexibility in terms of how to react to financial markets and tax changes when funding the GRAT (the greater the appreciation during the term of the GRAT above the applicable federal rate, the greater the effect of wealth transfer to the beneficiaries).

### *Potential Drawbacks*

#### Key Points

- Mortality risk
- Irrevocable trust = no option to amend or revoke if circumstances change

As noted, perhaps the biggest drawback of a GRAT is that if the grantor dies during the term of the trust, the trust property is included in the grantor's estate.

The GRAT is an irrevocable trust, so its terms cannot be amended or the trust revoked if the grantor's situation changes, or if federal law changes might afford a better use of the grantor's unified credit.

## Grantor Retained Unitrust (GRUT)

### *What It Is*

#### Key Points

- Irrevocable trust similar to a GRAT
- Difference lies in income interest—fixed percentage of annually revalued trust assets (vs. set dollar amount for GRAT)

Like a GRAT, a **Grantor Retained Unitrust (GRUT)** is an irrevocable trust into which the grantor places assets while retaining a right to income for a fixed period of years. The basic difference between a GRAT and a GRUT is that the GRUT income interest is a fixed percentage of the trust assets as valued every year, rather than a set dollar amount or percentage of the value of assets originally transferred into the trust.

For example, if the payout rate is 6%, the trustee will pay the grantor 6% of the value of the trust assets as revalued each year. If the trust assets earn more than 6%, the excess earnings will be added to principal and there will be a higher dollar payment the following year.

### *Effectiveness vs. GRAT*

## Key Points

- Effectiveness depends on desired result
- Not as good at passing on asset appreciation
- Can provide income as hedge against inflation

Because of the potential for an increasing payout from year to year, the GRUT is not as effective as the GRAT in shifting asset appreciation to younger generations. However, the GRUT can be useful for estate owners who wish to transfer assets to children while retaining a potentially increasing annual return of income (a hedge against inflation).

## What Is a Qualified Domestic Trust (QDOT)?

## Key Points

- Ensures that at death of survivor noncitizen spouse, assets in trust are subject to estate taxes
- Tax imposed as if property had been in first spouse's estate
- Regular estate tax marital deduction available if surviving spouse becomes a citizen under specific circumstances

The estate tax marital deduction is not available when the surviving spouse is not a United States citizen.* However, there is a special exception for property placed in a **qualified domestic trust**. The purpose of a qualified domestic trust is to ensure that, although the assets in the trust avoid federal estate taxation at the first death, the tax will be imposed at the death of the surviving noncitizen spouse.

** The regular estate tax marital deduction is available if the surviving spouse becomes a U.S. citizen before the estate tax return is filed. However, the spouse must have been residing in the U.S. at the time of the decedent's death and continuously thereafter until becoming a U.S. citizen.*

## Requirements for a Qualified Domestic Trust

The requirements for a qualified domestic trust include the following:

- The trustee (or at least one trustee if there are co-trustees) must be either a U.S. citizen or a domestic corporation.
- The trustee must have the right to withhold any federal gift or estate taxes due on the trust property before a distribution of trust assets is made (there is no impediment to a distribution of income).
- The qualified domestic trust must meet the usual requirements for a marital deduction trust—a life estate/power of appointment trust, a QTIP trust, or an estate trust. The withholding of estate tax described above will not violate the income payout requirements of the power of appointment or QTIP trusts.
- The executor of the decedent's estate must make an irrevocable election on the federal estate tax return and must file it within one year of the due date, including any extensions.

- Gift tax is due on any distribution from the trust to a third party while the surviving noncitizen spouse is still alive.
- Estate tax is due on property remaining in the trust at the death of the surviving noncitizen spouse, or at such earlier time as the trust ceases to qualify as a QDOT.

If the assets passing to a QDOT exceed $2 million, the IRS imposes certain additional requirements.

## Distributions from a Qualified Domestic Trust

### *Rules for Distributions to Noncitizens*

#### Key Points

- Distributions of principal from trust to noncitizen triggers estate tax
- Income-only distributions to noncitizen do not trigger tax
- At second death assets remaining in trust subject to estate tax
- Tax also levied if trust fails requirements

Any distribution of principal from the trust to the surviving noncitizen spouse during life will result in the immediate imposition of estate taxes on the amount of principal distributed, unless the distribution is made because of hardship. Income-only distributions to the surviving noncitizen spouse do not trigger the tax.

At the surviving spouse's death, the value of the assets remaining in the qualified domestic trust at that time will become subject to estate tax. The tax is also levied if the trust fails at any time to meet the qualified domestic trust requirements described previously.

A special Form 706-QDT, "U.S. Estate Tax Return for Qualified Domestic Trusts," is used to report any estate tax payable by reason of the distributions described above. The return is due by April 15 of the year following the year in which the distribution occurs.

## Gift Tax Rules for Noncitizen Spouses

### *Marital Deduction Annuity Exception*

#### Key Points

- Gift tax marital deduction not available for gifts to noncitizens
- Exception for survivor benefits gift payable under a joint-and-survivor annuity
- Qualifies for deduction only if QDOT requirements met

There are also some special rules relating to noncitizen spouses under the federal gift tax.

The gift tax marital deduction is not available for gifts to noncitizen spouses. However, there is an exception for a gift of survivor benefits payable to a noncitizen spouse under a joint-and-survivor annuity. But at death, the annuity will qualify for the estate tax marital deduction only if the qualified domestic trust requirements are met.

### *Expanded Exclusion for Gifts to Noncitizens*

## Key Points

- Specified gift amount exempt from gift tax if the gift meets citizen requirements and qualifies for exclusion
- Expanded annual exclusion amount for marital gifts to noncitizen spouses
- Marital gift must still meet usual requirements to qualify

In addition to the annuity exception, the first $164,000 (indexed amount for 2022) to a noncitizen spouse is exempt from the gift tax if the gift meets the usual marital deduction requirements for U.S. citizens and qualifies for the gift tax annual exclusion.

In place of the gift tax marital deduction, federal gift tax law allows an expanded annual exclusion for marital gifts to noncitizen spouses. The amount of the expanded annual exclusion is indexed to inflation:

<table>
<tr><th>Year of Gift</th><th>Exclusion Amount</th><td rowspan="6">Even though the gift tax marital deduction is not available, a marital gift to a noncitizen spouse generally must meet the usual requirements (e.g., the terminable interest rule) to qualify for the expanded annual exclusion.</td></tr>
<tr><td>2018</td><td>$152,000</td></tr>
<tr><td>2019</td><td>$155,000</td></tr>
<tr><td>2020</td><td>$157,000</td></tr>
<tr><td>2021</td><td>$159,000</td></tr>
<tr><td>2022</td><td>$164,000</td></tr>
</table>

## Qualified Domestic Trust Planning Considerations

### *Executor’s Responsibilities*

## Key Points

- Property passed to noncitizen spouse survivor outside of QDOT does not qualify for estate tax marital deduction
- Result = increase in estate tax liability
- Executor decides whether to use QDOT
- Executor balances desires of decedent and needs concerning taxation

If property passing to a surviving noncitizen spouse is not placed in a qualified domestic trust, the property will fail to qualify for the estate tax marital deduction. This can result in a substantial increase in the federal estate tax liability.

Since the executor of the estate must make an election on the estate tax return, this provides some flexibility in planning. The executor can take into account the precise situation existing at death in determining whether to make such an election.

The executor must balance the elimination of appreciation from the estate tax base at the second death (i.e., no election) against the opportunity to defer estate tax until the second death (i.e., make the election).

Of course, the executor must also respect the decedent's wishes with respect to the security of the surviving spouse, even if there is a financial price to pay.

### *Property Passing by Right of Survivorship*

## Key Points

- Does not qualify for estate tax marital deduction
- Property could be held in tenancy in common and deceased person's interest passes to QDOT
- Direct passing of life insurance does not qualify
- Life insurance could pass to the QDOT instead of spouse
- Best solution: spouse could own the policy

Jointly held property that passes outright to the surviving spouse by the right of survivorship will not qualify for the estate tax marital deduction. For this reason, the spouses might want to consider placing the property in tenancy in common, with the deceased's interest passing to the qualified domestic trust.

Likewise, life insurance proceeds passing directly to the spouse will not qualify. The life insurance could be arranged so that the qualified domestic trust is the beneficiary in order to qualify. Better yet, the spouse could own the life insurance policy so that the proceeds avoid the estate tax and are still available for spousal and family needs.

### *Noncitizen Spouse Creates the Trust*

## Key Points

- Property passes directly to surviving noncitizen spouse
- Noncitizen spouse irrevocably transfers property to QDOT before filing of estate tax return
- IRS has approved such a case

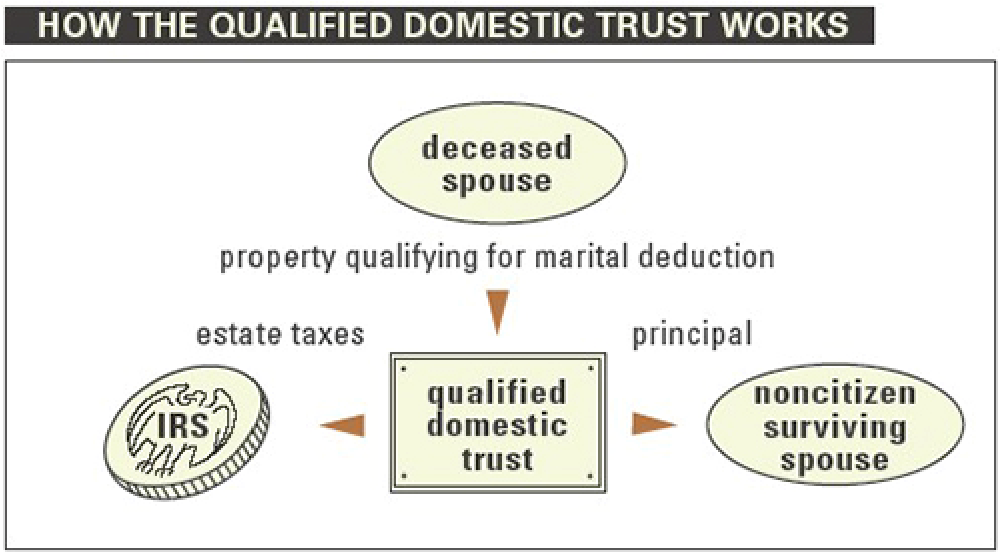
The special exception has been allowed where property passed directly to the surviving noncitizen spouse instead of into a qualified domestic trust, but the noncitizen spouse irrevocably transferred such property to a qualified domestic trust before filing the estate tax return. Thus, the surviving spouse can create the trust.

The IRS approved such a case where the surviving noncitizen spouse—the designated beneficiary of the decedent's IRAs—set up a qualified domestic trust before the estate tax return was filed to receive the IRA accumulations.

## How the Qualified Domestic Trust Works

### *Graphic*

Here is an illustration that shows how the qualified domestic trust works.



## Chapter 9 Review Questions

1. Typically, the first part of a living trust instrument deals with the following items EXCEPT:
    - A. The grantor will receive all trust income.
    - B. The grantor may add or remove assets at any time.
    - C. The grantor may change the trust provisions at any time.
    - D. At the grantor's death, the trust property will be divided equally among the beneficiaries.
2. If a trust receives assets passing under the will from life insurance proceeds, the trust is called a/an:
    - A. Pourover trust
    - B. "Under the fence" trust
    - C. Irrevocable QPRT
    - D. GRAT
3. Assets in a revocable trust cannot be touched by creditors of the estate.
    - A. True
    - B. False
4. What can a grantor use to fund a QPRT?
    - A. Assets that are expected to increase in value
    - B. An interest in a closely held business
    - C. A home or vacation home
    - D. A life insurance policy
5. When it comes to a QPRT, the longer the trust term, the greater the value of the retained interest, and therefore, the higher the taxable gift the grantor is making to the ultimate remainder beneficiaries.
    - A. True
    - B. False
6. A rolling GRAT is actually a series of:
    - A. GRATs with very short terms
    - B. GRATs with very long terms
    - C. Revocable trusts
    - D. Codicils attached to a GRAT allowing it to last for the grantor's lifetime
7. A noncitizen takes an income-only distribution from a QDOT. No estate tax is due on this distribution.
    - A. True
    - B. False

## Answers to Chapter 9 Review Questions

1. D. The first part of a trust instrument deals with how the trust will be managed during the grantor's life. The second part deals with the disposition of trust property after the grantor's death.
2. A. A trust receiving assets passing under the will is called a pourover trust.
3. B. Assets in the trust at death may not escape the claims of creditors of the estate, just as if the grantor still owned the assets outright.
4. C. A Qualified Personal Residence Trust must be funded by a personal residence or vacation home.
5. B. If the retained interest has a greater value, then the taxable gift will be lower, not higher.
6. A. A rolling GRAT is actually a series of GRATs with very short terms (e.g., two-year GRATs) to reduce the likelihood that the grantor will die during the trust term.
7. A. Estate tax is due on distributions from principal, but not distributions of income.

# Chapter 10
# Passing Assets to Children

## Purpose of a 2503(c) Trust

### Key Points

- 2503(c) trusts provide means to give larger gifts to minors
- Tax-free gifts, up to limit, to any number of people
- Applies only to present interest gifts

**Section 2503(c) trusts** address the problem of giving larger gifts to minors. Let's examine the details of this problem.

The gift tax annual exclusion generally allows taxpayers to make tax-free gifts up to a certain amount per year to any number of people. This exclusion, however, only applies to present interest gifts. So, when it comes to gifts to minors, what legally constitutes a present interest gift versus a future interest gift?

## Trusts for Minors

### Key Points

- No problem for outright gifts of smaller size
- Gifts in trust minimize problems with larger gifts to minors

While modest outright gifts to minors pose no particular exclusion qualification problems, larger gifts often pose practical, property management problems. Typically, some states limit a minor's legal right to purchase, care for, sell, or transfer property.

To minimize such problems, many people make gifts to minor children or grandchildren in trust. However, if not properly structured, the trust itself can present difficulties. The donee's use and enjoyment of the property may be subject to the trustee's discretion, which causes a problem when it comes to eligibility for the annual gift tax exclusion.

The terms of the trust must therefore be drafted so there is no doubt that the minor's interest in the property is a present interest.

## A Solution: The Section 2503(c) Trust

### Key Points

- Three requirements for gifts of a present interest
- At age 21, principal may remain in trust if donee agrees
- State laws may limit minor's ability to exercise power of appointment, but do not deny present interest status
- Trust must not impose limits greater than state law

One way to qualify gifts to minors for the annual gift tax exclusion is to use a Section 2503(c) trust, which complies with this provision of the Internal Revenue Code.

Under Section 2503(c), gifts to minors are considered **gifts of a present interest** when the principal and income from the trust:

- may be expended by, or for the benefit of, the minor before the minor reaches age 21;
- will pass to the minor at age 21 or before; and
- are payable to the minor's estate or to the minor's appointee under a general power of appointment.

With respect to the second requirement, the principal may remain in trust after the minor reaches age 21 if the minor voluntarily consents to this.

Various state law limitations placed on a minor's ability to exercise a power of appointment will not cause the gift to be denied present interest status. However, if the trust instrument places greater restrictions than does applicable state law, the gift will not satisfy the requirements of the IRC for purposes of the exclusion.

## Tax Considerations

### *Gift Tax*

### Key Points

- Gift cannot exceed annual limits for exclusion
- Exclusion applies if gift to minor in trust meets 2503(c) requirements

There are no gift tax consequences unless a gift exceeds the annual limit.

The gift tax annual exclusion applies as long as the gift to a minor in trust meets the requirements of Section 2503(c), particularly the present-interest requirement.

### *Income Tax*

## Key Points

- Undistributed trust income taxable to trust
- Distributed income taxable to minor unless kiddie tax applies

Undistributed trust income is taxable to the trust. Distributed income is taxable to the minor in the minor's applicable tax bracket, unless the income is subject to what is commonly known as the **kiddie tax**.

This rule generally provides that a minor's unearned income above a certain threshold amount ($2,300 for 2022, assuming the child has no earned income) is taxed at the parents' top marginal tax bracket. The kiddie tax applies to the following:

a. all children under age 18 at the end of the year;

b. children under age 19 whose earned income does not exceed half of their own support; or

c. children ages 19 to 23 at the end of the year who are full-time students and whose earned income does not exceed half of their own support.

Furthermore, such children do not file a joint return, and they must have at least one living parent at the end of the tax year.

### *Estate Tax*

## Key Points

- Property must be payable to child's estate or appointee and is included in minor's gross estate
- If donor is trustee, principal of trust could be included in donor's gross estate

To qualify under Section 2503(c), the property must be payable to the child's estate or to an appointee. As such, it is included in the minor's gross estate.

A donor who serves as trustee of a Section 2503(c) trust risks having the principal of the trust included in his or her gross estate.

## Planning for Section 2503(c) Trusts

### *Must Meet Present Interest Requirements*

**Key Points**

- 2503(c) must be adhered to, avoiding forfeiture of gift tax annual exclusion
- Three requirements to qualify as a present interest
- Rules do not mandate current distribution of income

Parents, grandparents and other relatives making gifts in trust to minors must closely adhere to the requirements of Section 2503(c) or risk forfeiting the gift tax annual exclusion. Particularly, property and income from a gift in trust must meet the three previously mentioned requirements to qualify as a gift of a present interest:

- Principal and income may be expended by, or for the benefit of, the minor before the minor reaches age 21,
- Principal and income will pass to the minor at age 21 or before, and
- Principal and income are payable to the minor's estate or to the minor's appointee under a general power of appointment.

While one of these requirements is that income be distributed to the minor by age 21, the income does not have to be currently distributed. With the minor's voluntary consent, the principal may stay in the trust.

### *When Section 2503(c) May Not Be Appropriate*

**Key Points**

- Concerns about competence to handle trust property
- Outright distribution provisions may deter use of 2503(c) trust

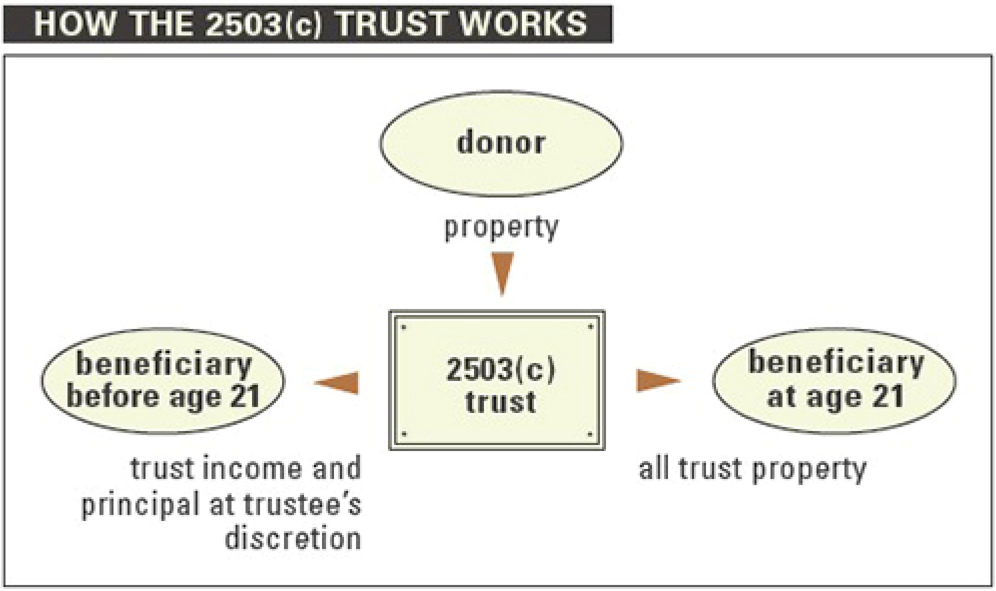
Many donors have reservations about the probable financial and emotional sophistication of their children or grandchildren upon attaining age 21, including pessimism about their competency to receive an outright distribution of all trust property.

However, because an outright distribution is one of the strict requirements mandated by Section 2503(c), clients and prospects who express such reservations should explore other alternatives.

## How the Section 2503(c) Trust Works

### *Graphic*

Here is an illustration that shows how the Section 2503(c) trust works.




## What Are UGMA and UTMA?

### Key Points

- UGMA legislation proposed in 1950s, revised in 1960s
- UTMA expanded legislation for more flexibility
- 48 states have adopted UTMA
- UGMA in effect in South Carolina and Vermont

The **Uniform Gifts to Minors Act (UGMA)** and the **Uniform Transfers to Minors Act (UTMA)** refer to model legislation proposed by the Commissioners on Uniform State Laws. The Uniform Gifts to Minors Act was proposed in the 1950s and revised in the 1960s.

In 1983, an expanded UTMA was proposed. It was designed to provide greater latitude and a good deal more flexibility than earlier statutes in the kinds of property that could be transferred.

All states have now adopted UTMA except South Carolina and Vermont, where UGMA remains in effect.

## Background on UGMA and UTMA

### Key Points

- Designed to overcome problems with making gifts to minors
- Early alternatives presented obstacles to transfers to minors
- UGMA introduced to provide language allowing more flexibility

The **“Minors’ Acts”** were proposed to overcome the problems that were once associated with making gifts to minors. Frequent gifts of securities and money in relatively modest amounts have always been popular among parents, grandparents, and other family members. Prior to 1956, these gifts could only be made outright, in guardianship, or in trust. Each of these alternatives presented significant obstacles to those seeking to transfer money or securities to younger family members.

The custodial gift concept grew out of the need to overcome these obstacles. UGMA provided individual states with suggested statutory language designed to offer donors a good deal more flexibility than was formerly possible.

## Uniform Gifts to Minors Acts (UGMA)

### *Basic Provisions*

### Key Points

- Streamlined way to transfer property through custodianship
- Custodian’s duties similar to trustee duties
- Custodian does not take legal title; minor is owner
- Custodianship ends at age 18 or 21

The **Uniform Gifts to Minors Act** provides a simple and inexpensive method of transferring certain property to minors by means of a **custodianship arrangement**. Custodianship can be compared to the only alternatives that were available in many situations under earlier rules, namely trusts and guardianships.

In fact, custodianship, under UGMA, shares common characteristics with both of these devices. The custodian’s duties resemble the duties of a trustee. However, unlike trust arrangements, the custodian doesn’t take legal title to the property. The minor is the owner of the custodial property, and such property will be included in the minor’s estate in the event of his or her death prior to termination of the arrangement. The custodial arrangement ends when the minor reaches a specified age (between 18 and 21, depending on the state). This age does not necessarily correspond to the state’s general age of majority.

### *Approved Custodial Property*

## Key Points

- Money and securities generally allowed
- Many states permit life insurance and annuity gifts
- Most states allow assets to be used to purchase life insurance

Generally, UGMA allows **gifts of money and securities**. And, while the specific rules vary from one state to another, most states have amended their statutes to permit gifts of **life insurance and annuity contracts**.

Most states permit the custodian to use custodial assets to purchase a life insurance policy covering the life of the child or a member of the child's family.

## Custodial Requirements and Duties

### *Nature of the Custodianship*

## Key Points

- Gifts are irrevocable
- Title is vested in child
- Custodian has all management rights and duties
- State laws vary concerning who may be the custodian
- Donor should not be custodian

Gifts in custodianship are irrevocable and vest title in the child. Although the child owns the property, the custodian assumes full property management rights. But since title vests in the child, the gift creates no legal entity as is the case with trusts. The custodian is required to invest and reinvest custodial property prudently. The statutes spell out the methods for making custodial gifts.

Rules vary from state to state. Some states allow any adult to act as custodian, while other states restrict eligible custodians to the child's legal guardian, parents, grandparents, brothers, sisters, uncles, and aunts. A trust company can also act as custodian. Donors may make themselves custodians except for bearer securities. However, in the discussion of tax considerations, we will see that it is unwise for donors or others who are legally obligated to support the minor to name themselves as custodians. In addition, property transferred to the beneficiary in custodianship is includible in the donor's gross estate if the donor dies while serving as custodian.

### *Succession to Custodial Position*

## Key Points

- Minors over 14 may designate another custodian
- If minors are under 14, child's guardian becomes successor or court appoints someone from child's family
- Some statutes require a trust company to be successor
- State laws may vary

When a named custodian dies or resigns, the minor may designate another custodian if the minor is over 14 and if the original custodian has not already named a successor. Alternatively, a custodian who wants to resign may petition the court to designate a successor. In many states, this is the only course for a resigning donor-custodian.

If a custodian dies in office while the minor is under 14, the child's guardian becomes successor custodian. If there is no guardian, the court appoints another custodian from among adult members of the minor's family or, under some statutes, a trust company.

Because all custodial gifts made to the minor are irrevocable and title to all property vests with the child, all custodial property becomes a part of the minor's estate if the minor dies before the custodial arrangement terminates.

# Uniform Transfers to Minors Act (UTMA)

## Key Points

- Permits transfer of any kind of property
- Allows gifts from other entities

The **Uniform Transfers to Minors Act** was proposed in 1983. While it was intended to permit the transfer in custodianship of any kind of property, the language of the model act was somewhat ambiguous on this point. Some states clarified the language in their specific statutes. Even when this was not done, the statute is generally interpreted to permit any kind of transfer, in accordance with its intention.

In addition to removing UGMA property limitations, UTMA allows gifts from trusts, estates and guardianships, depository institutions, and insurance companies.

## Income Tax Considerations

### *Minor Child Subject to Taxation*

**Key Points**

- Custodianship is not taxed
- Minor child is taxed
- Special rules for deductions apply

A custodianship is not a separate tax entity. Usually, the income from custodial property is **taxable to the minor child** since the minor actually owns the property.

Also, a child who is claimed as a dependent by another may only take a standard deduction of the greater of (1) $1,150 in 2022, as indexed, or (2) $400 plus earned income (up to a maximum of the regular standard deduction amount, set at $12,950 for single taxpayers in 2022).

### *Kiddie Tax*

**Key Points**

- Certain minors defined for application of "kiddie tax"
- Rule requires certain income to be taxed at parent's higher rate
- Restrictions apply

For many years, transferring income-producing property to minors was a popular method for reducing income tax liability by shifting income from a higher tax bracket to a lower one. However, the Tax Reform Act of 1986 restricted the benefits associated with income-shifting when it created what is commonly known as the "kiddie tax."

Just to review, the **kiddie tax** applies to the following: (a) all children under age 18 at the end of the year; or (b) children under age 19 whose earned income does not exceed half of their own support; or (c) children aged 19 to 23 at the end of the year who are full-time students and whose earned income does not exceed half of their own support.

This rule generally provides that when a minor's unearned income exceeds a specified threshold amount (set at $2,300 for 2022, assuming the child has no earned income), the excess is taxed at the parents' top marginal tax bracket.

## Gift and Estate Tax Considerations

### Key Points

- Custodial transfers eligible for gift tax annual exclusion
- Transfers not usually subject to estate taxation for donor if donor does not serve as custodian

Custodial transfers under Uniform Transfers to Minors Act provisions are considered gifts under the federal gift tax laws, but are eligible for the **gift tax annual exclusion**.

When a donor irrevocably transfers property to a minor in custodianship, the gift is generally includible in the minor's estate, and is therefore not subject to **estate taxation** in the donor's estate. However, if the donor also serves as the custodian and dies before the minor reaches the age of majority, the property may be considered part of the donor's gross estate for estate tax purposes. To avoid this potential problem, it is wise to name someone other than the donor or the person legally obligated to support the minor as custodian.

## Custodial Gifts of Life Insurance

### *Who May Be the Insured*

### Key Points

- Minor or member of minor's family may be the insured
- If member of family, minor must be beneficiary

Gifts of life insurance or annuities must be on the life of the minor or a member of the minor's family—parents, grandparents, brothers, sisters, aunts or uncles. If the minor is the insured, generally the beneficiary must be the minor's estate. If some other person is the insured, the minor must be the named beneficiary.

Gifts of life insurance can offer planners several advantages, not the least of which is that they tend to be uncomplicated and inexpensive. However, outright gifts to minors can lead to problems since the minor cannot legally manage the property until reaching the age of majority. A custodial gift, a trust or a guardianship eliminates many of these problems.

### *Typical Language for Gift*

Typical language for a custodial gift of life insurance would read as follows:

> I, John Doe (donor), have delivered to Jane Roe, as custodian for James Poe (minor), a life insurance policy on my life in the face amount of $100,000 issued by the Mystic Life Insurance Company and payable to James Poe. This transfer is made under the Indiana Uniform Transfers to Minors Act.
>
> ______________________________
>
> (Donor's signature and date)
>
> I, Jane Roe (custodian), acknowledge receipt of the life insurance policy described above, and agree to hold this policy as custodian for James Poe under the Indiana Uniform Transfers to Minors Act.
>
> ______________________________
>
> (Custodian's signature and date)

## Advantages of a Custodial Gift

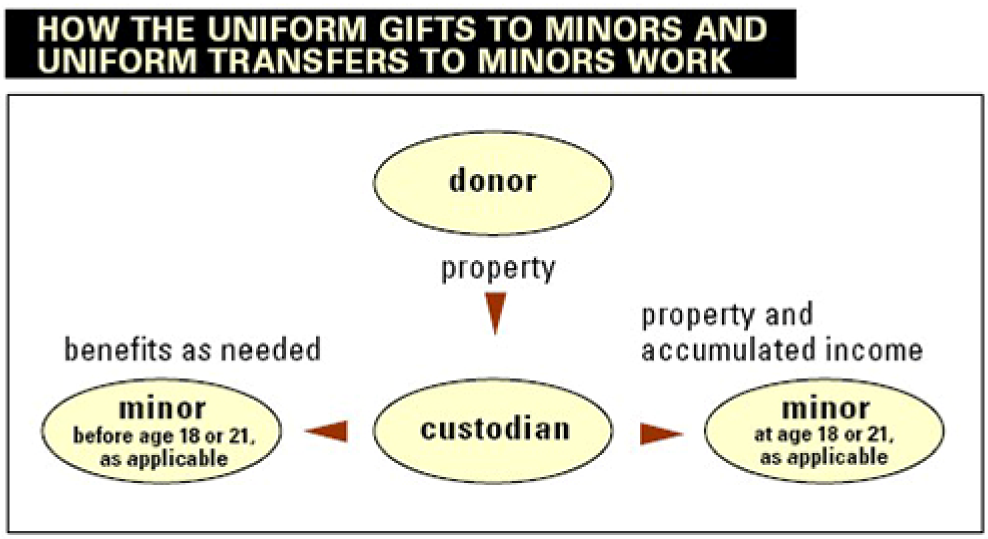
Custodial gifts:

- Provide a simple and inexpensive method of transferring property to a minor.
- Offer an alternative to more expensive and cumbersome trusts and guardianships.
- Qualify for the gift tax annual exclusion.
- Provide a method for shifting a small amount of income to the minor's lower tax bracket (limited by the "kiddie tax").
- Remove the property from the donor's gross estate (as long as the donor is not named custodian).

## How UGMA and UTMA Work

### *Graphic*

Here is an illustration that shows how UGMA and UTMA work.




- The donor transfers property to a custodian to be held for the benefit of the minor.
- The custodian can use the custodial property and any income that property produces on behalf of the minor. Unearned income above a certain amount is taxed at the parents' highest marginal rate.
- At age 18 or 21 (age will vary depending on state and type of transfer), the custodian must transfer the property outright to the minor.
- Note that if an individual is custodian of property that he or she contributed to a minor under UGMA/UTMA, at the custodian's death, these assets will be brought back into the custodian's gross estate.

## Chapter 10 Review Questions

1. A donor who serves as trustee of a Section 2503(c) trust risks having the principal of the trust:
   A. included in his or her own gross estate.
   B. not considered a gift of a present interest.
   C. held in the trust after the minor turns 21.
   D. be subject to the kiddie tax.
2. A donor with reservations about a child's financial and emotional sophistication at the time they receive an outright distribution of all property from a 2503(c) trust at age 21 can do which of the following?
   A. Delay the distribution by up to ten years.
   B. Dictate that the distribution be split into five equal parts spread over five years.
   C. Make a decision at the time the minor turns 21 on whether to go ahead with the distribution or whether to allow the trust property to revert back to the donor's estate.
   D. Consider alternatives to the 2503(c) trust, because full distribution at age 21 is a required part of the trust.
3. Generally, UGMA allows gifts of:
   A. Cash only
   B. Money and securities
   C. Money, securities and property
   D. Money, securities, property and business interests
4. Family members may *not* serve as custodians under UGMA or UTMA.
   A. True
   B. False
5. All of the following describe advantages to completing a custodial gift *except* which one?
   A. An alternative to more expensive and cumbersome trust and guardianship arrangements
   B. A way to remove property from the donor's gross estate (as long as the donor is not named custodian)
   C. The ability to pay any gift tax in installments over the minor's life expectancy
   D. A way to shift income to a minor's lower tax bracket (limited by the kiddie tax)

## *Answers to Chapter 10 Review Questions*

1. A. A donor who serves as trustee of a Section 2503(c) trust risks having the principal of the trust included in his or her gross estate.
2. D. There is no way around the mandated full distribution of trust property at age 21, so donors with reservations about the wisdom of such a distribution should look into other options instead of the 2503(c) trust.
3. B. UGMA generally allows gifts of money and securities, but most states have also amended their statutes to include life insurance and annuities.
4. B. In fact, rules vary from state to state, and in some states *only* family members may serve as custodian. In other states, any adult or trust company may serve as custodian.
5. C. Gift tax may not be spread out in installments.

# Chapter 11
# Family Limited Partnerships—The Basics

## What Are Family Limited Partnerships (FLPs)?

### Key Points

- Business of family members with a formal agreement
- Used to better manage a business and reduce estate transfer costs
- Can help combine various types of financial planning under one agreement
- FLP uses adaptation of limited partnership for family setting

A **family limited partnership (FLP)** is a business and financial planning device that can combine business operational planning, personal tax planning, transfer of family wealth, and business succession planning, all under one flexible arrangement. An FLP is a business created by an agreement between an individual and certain members of the individual's family. It is typically used when an individual who owns real estate, a business or a farm wants to centralize and consolidate management, and reduce estate transfer costs by shifting future increases in value to younger generations.

The FLP utilizes the limited partnership entity, which was the vehicle of choice for many syndicated tax shelters in the 1970s, until legal restrictions implemented in the mid-1980s curbed many tax shelter activities. Instead of syndicating an oil and gas drilling operation or a real estate development project, the limited partnership has been adapted for use in the family setting.

## Brief Partnership Review

### Key Points

- One form of business entity
- Often used by professional firms
- Need not be equal owners
- Partnership can have different types of ownership

Partnerships are one form of legal entity that may conduct a business for profit. Traditionally, many professional firms, especially law and accounting practices, were set up as partnerships. Small commercial businesses with more than one owner have also used the partnership form.

The owners of a business do not have to be equal owners, of course. In fact, not only may the ownership percentages be different, but there may be different classes of ownership. In a C corporation, for example, there may be preferred stock and common stock, and each of these broad classes may be further subdivided. Similarly, it is possible to have different classes of ownership in a partnership: general partners and limited partners. If a partnership has only general partners, it is called a general partnership. If it has one or more limited partners, it is called a limited partnership. There must always be at least one general partner in a limited partnership.

## FLP General Partners

### Key Points

- General partners have unlimited liability for partnership debts and actions
- Personal assets not sheltered from partnership's creditors
- General partner may be a corporation

A general partner has unlimited personal liability for the debts of the partnership. Unlike a corporate shareholder, the general partner's personal (non-business) assets are not insulated from the reach of the partnership's creditors if things go badly in the business. On top of that, the general partner is personally liable for partnership-related contractual commitments made by other partners and for their negligent or otherwise wrongful business acts, as well as for his or her own.

Thus, the general partner is exposed to considerable risk, much of which is beyond his or her control (except to the extent the general partner selects co-partners wisely). To protect against such risk, the general partner may be a corporation, which would insulate the owners from unlimited liability.

## FLP Limited Partners

### Key Points

- Liability of limited partners extends only to amount of each partner's investment
- Personal assets sheltered from business creditors
- Limited partners have no voice in operation of partnership
- Limited partner participates in profits of partnership

The situation is different for the limited partner. Much like the corporate shareholder, the limited partner's liability extends only to the amount of his or her investment in the partnership. Thus, the limited partner's personal assets are shielded from partnership creditors, leaving only the capital investment in the business at risk.

To gain this protection from personal liability, the limited partner must sacrifice any voice in the operational affairs of the partnership, which is strictly the prerogative of general partner(s). Nevertheless, the limited partner has the right to participate in the profits of the partnership as a proper reward for putting capital at risk.

## What Makes the FLP Attractive?

### *Older Members Generally Manage the FLP*

**Key Points**

- General and limited partners consist of two or more family members
- Often members of different generations
- Older members often manage FLP as general partners

That brings us to the **family limited partnership (FLP)**. This is just a special case of the limited partnership in which two or more members of a family, often members of different generations, fulfill the roles of general and limited partner(s).

Normally, older members manage the FLP as general partners. The standard rules for limited partnerships apply in the case of an FLP.

### *Objectives of the FLP*

An FLP is an effective estate and financial planning tool to accomplish some or all of the following:

- Centralize and streamline management of assets
- Protect assets from a limited partner's creditors
- Help to preserve and pass family wealth to members of younger generations
- Minimize gift and estate taxes as wealth shifts between generations
- Provide for successor ownership of the family business
- Save income taxes by splitting the income from the business among family members in lower tax brackets
- Provide great planning flexibility, allowing ample room for a change of heart or a change in circumstances

### *Protection of Assets*

**Key Points**

- Facilitates transfer and control of assets
- Assets protected against estate taxes
- Assets protected against personal creditors of limited partners

Much like a trust, the FLP facilitates the transfer and control of family assets through a succession of generations. Family assets are protected against unnecessary estate taxes, the personal creditors of family members who are limited partners, and judgment creditors arising out of litigation, which is especially important in high-risk businesses.

### *Preserving and Passing Family Wealth*

## Key Points

- Effective vehicle to handle family wealth
- Ownership interest is a property right
- FLP can provide for family succession
- Can shelter assets from taxes and creditors

FLPs can be effective vehicles for the management, accumulation, preservation and transfer of family wealth. An interest in the FLP, whether as a general partner or as a limited partner, is a "property right" and has value just as other types of property do.

Part of the FLP's usefulness is that it can provide for the succession of family ownership and control between generations as it shelters assets from taxes and creditors.

### *Saving Gift and Estate Taxes*

## Key Points

- Reduction of gift and estate taxes
- Gift of FLP is gift of present interest for exclusion purposes
- Special valuation discounts may be available

The FLP can facilitate the transfer of wealth by reducing gift and estate taxes. The tax-savings provisions of the federal transfer tax laws (the applicable exclusion amount and the gift tax annual exclusion) work well in the FLP planning environment.

The IRS has ruled that a gift of FLP shares was a gift of a present interest for Section 2503 (gift tax annual exclusion) purposes.

If partnership interests are transferred to younger family members when the business itself is young, the transferred interests may not yet have risen to the high values they will reach later on for gift or estate tax purposes.

In addition, there may be special valuation discounts the courts have recognized for transfers of FLP interests: the "lack of marketability discount" and the "minority interest discount." For now, it is sufficient to observe that these discounts, when available, enable wealth to pass to younger generations via an FLP at a significantly lower tax cost than might otherwise be possible.

### *Successor Ownership of Family Business*

## Key Points

- Family discord can occur at disposition of business
- Active members vs. non-active members
- Non-family members may also be important to business
- FLP helps with these problems

Federal transfer taxes are only part of the problem. The disposition of a family business can create family discord. Family members who are active in the business expect to be rewarded and given the opportunity to participate in its ownership. Those who are not active in the business expect to be treated fairly when the estate is distributed, which may be difficult if the business makes up the bulk of the estate.

Sometimes, non-family members who play key roles in the business must also be taken into account.

Many of these practical aspects of transferring a family business can be resolved through the use of an FLP.

### *Splitting Family Income*

## Key Points

- Earnings can be split to reduce income taxes for members
- Income may be taxed in lower brackets

FLPs permit the net earnings of a family business to be split among several members of the family, thereby reducing the annual income tax burden.

Rather than all the net earnings being taxed at the top federal tax bracket of the highest-earning family member, some of the income may be taxed in the lower brackets of other family members.

For example, assume that Brilliance Lighting Company has average annual net earnings of $500,000. If this were all taxed to one individual in the 37% top federal tax bracket, roughly $185,000 would be lost to federal income taxes.

However, if the earnings were split among five family members, they might be taxed at lower rates, thereby reducing the total tax burden substantially. If we assume that the other four family members are all in the 24% marginal tax bracket, the total tax on $500,000 would drop to $133,000. (Four partners at 24% = $24,000 per partner, for a total of $96,000, plus one partner at 37% = $37,000; the total is $133,000.)

Thus, splitting income through the use of an FLP can save the family almost $52,000 that would otherwise be lost to taxes.

### *Flexibility of the FLP*

## Key Points

- Is not irrevocable
- Can change as needed

Some financial and estate planning arrangements are irrevocable. To secure the benefits they offer, one must commit to an absolute course of action. If circumstances change so as to render the selected course undesirable, it may be difficult or impossible to realign the planning arrangements with new family or financial realities.

The FLP is *not* an irrevocable arrangement, and allows plenty of "elbow room" if changes become necessary. Indeed, since the FLP usually allows for the gradual relinquishment of an older family member's ownership of a business to members of younger generations, the partnership agreement can provide for the partnership to be amended or to terminate if some change is necessary.

## When Is the FLP Appropriate?

## Key Points

- Use the FLP's natural advantages
- Older members reduce value of estates, but maintain control of assets

The FLP is most suitable in situations where some or all of the following factors are present:

- The older family members are reluctant to relinquish control of family assets, or to lock themselves into inflexible planning arrangements.
- The family faces significant potential income tax problems in accumulating wealth, and significant gift and estate tax problems in transferring wealth.
- The older family members are pessimistic about the ability of younger family members to manage assets competently while the older members are still alive.

It is important to emphasize one essential point about the FLP that may appeal to a large percentage of clients and prospects: The FLP permits older family members, as general partners, to reduce the value of their estates without losing control of their assets. This is a highly beneficial opportunity under the federal estate and gift tax laws.

## FLP Case Study

### *Establishing the FLP*

Frank and Eloise are in their early 50s and own several rental properties. They have three children, all in their 20s. The youngest child is still in college.

Frank and Eloise set up an FLP and make a capital contribution of their rental properties, which have a total fair market value of $3,200,000. In exchange for their capital, they receive 100 units of ownership. Thus, each unit is worth $32,000. Two of these units are general partnership units, and the rest are limited partnership units.

### *Gifting Partnership Units*

Frank and Eloise begin a program of giving the limited partnership units to their three children. To keep things simple, we will assume that the valuation discounts for lack of marketability and for a minority interest add up to an even 50%. This will reduce the gift tax value of a unit to $16,000 instead of the $32,000 fair market value (FMV) of a unit.

If Frank and Eloise use the gift-splitting technique available under federal law [IRC Section 2513], they can give $32,000 (FMV = $64,000) to each child each year to fully utilize their gift tax annual exclusions.[1]

That means Frank and Eloise could give two limited partnership units to each child, or six units total per year.

### *Transferring Wealth, Maintaining Control*

If we make the assumption that the value of the units stays the same (or increases in the same proportion as indexed increases in the gift tax annual exclusion), all 98 of the limited partnership units would be completely transferred to the children in 17 years at no gift tax cost, and without even utilizing Frank's and Eloise's applicable exclusion amounts.

By age 70, Frank and Eloise plan to have shifted nearly all of the estate tax value of the rental properties to the younger generation, while maintaining control as the general partners.

Without the valuation discounts often available with the FLP, but leaving all other assumptions the same, it would have taken Frank and Eloise twice as long, or 34 years, to accomplish the same wealth transfer objective.

### *Protecting the Children and the Business*

Meanwhile, what do the children receive? They each have a certificate of ownership that entitles them to share in partnership profits. However, they are constrained by the partnership agreement and applicable state partnership law with respect to the transfer of their partnership interests.

In short, the children cannot convert these interests into cash, and perhaps spend the cash unwisely. Parents can fulfill their desire to protect their children from financial profligacy and missteps.

## How Are FLPs Established?

An FLP must be established under the laws of a particular state. The process may vary somewhat from one state to another, but will generally require the following steps:

- Reservation of the name under which the partnership will do business, usually with the Secretary of State's office
- Application for a federal tax identification number
- Preparation by an attorney in the relevant state of the partnership agreement, the articles of limited partnership and the certificate of limited partnership, and the filing of these documents with the Secretary of State
- Execution by each limited partner of a subscription and acceptance reflecting the ownership of a limited partnership interest
- Transfer of property into the partnership name, representing the capital contributions of the partners, and the issuance of the general and limited partnership interests

## Where Life Insurance Fits

### *Purpose for the FLP*

**Key Points**

- FLP not created to own policies
- FLP facilitates acquisition of life insurance for planning purposes
- Often used to provide estate liquidity
- Partner's death results in insurance proceeds to FLP
- Ensures needed cash is available

An FLP should have a substantial independent business purpose. Unlike an irrevocable life insurance trust, an FLP is not created for the primary purpose of owning life insurance policies. It does, however, facilitate the acquisition of life insurance for conventional estate and business planning needs.

A major use of life insurance is to help provide **estate liquidity**. The FLP can acquire a policy on an older generation partner. Upon that partner's death, the insurance proceeds pour into the FLP, where they may be used to purchase assets or make loans to the estate of the deceased partner. Through this transaction, the estate secures the cash it needs to help pay death taxes and other costs.

### *Inclusion in Deceased Partner's Estate*

**Key Points**

- If deceased is a general partner, percent of interest determines amount of life insurance proceeds included in estate for tax purposes
- Alternative approach includes all proceeds in general partner's estate

A proportional percentage of the proceeds may boost the value of the decedent's partnership interest. It is important that the general partner not have any incidents of ownership in the policy. If the deceased was a general partner of the FLP, the percentage of the deceased's general partnership interest will determine the percentage of death proceeds includable in the deceased's estate for estate tax purposes.

However, an alternative approach includes the entire proceeds of a life insurance policy owned by a partnership on the life of a general partner in the general partner's estate, similar to the majority shareholder situation. It is important to insulate the general partner from any action with respect to that policy in the partnership agreement. The client should contact an attorney and accountant for advice with respect to this issue.

### *Other Business Insurance Needs*

The full complement of business insurance needs exists, including:

- Life insurance to help fund a buy-sell agreement among the partners
- Key person life insurance
- Split dollar life insurance
- Non-qualified deferred compensation

## Tax and Legal Basics of Partnerships

### *The Legal Nature of a Partnership*

#### Legal Definition

**Key Points**

- Two or more people carrying out unincorporated business for profit
- Voluntary contract with all parties contributing to partnership
- Partner may be other than a natural person

A partnership exists when two or more people agree to carry on any unincorporated business or financial operation for profit. It is usually a voluntary contract of mutual agreement (the term "partnership" may include groups not commonly thought of as partnerships) where each partner can act on behalf of the partnership and the other partners. Those forming a partnership contribute money, property, labor, or expertise, and each partner shares in the profits or losses of the partnership.

The "partner" in a partnership is not required to be a natural person. A partner can be an individual, corporation, trust, estate, or another partnership.

#### Uniformity Regulation

**Key Points**

- RUPA or UPA adopted
- Louisiana is exception
- Uniformity of partnership laws

Every jurisdiction except Louisiana has adopted either the Revised Uniform Partnership Act (RUPA) or the Uniform Partnership Act (UPA). The purpose of this legislation is to provide uniformity among the states of the law governing the formation, operation, modification, and dissolution of partnerships.

RUPA and UPA seek to standardize the legal relationship between the partners, the partnership, and creditors. While the articles of partnership may deviate from RUPA or UPA, they cannot do so to the detriment of third parties.

### *General vs. Limited Partnerships*

#### General Partnership

## Key Points

- All partners personally and individually liable for partnership debts
- All partners participate in management

A **general partnership** is one in which all partners are individually and personally liable for all debts of the partnership. All partners can also participate in the management of the partnership.

A typical business or professional (law, accounting) partnership is a general partnership.

#### Limited Partnership

## Key Points

- Special type created under state law
- Liability limited to investment in partnership
- Limited partners similar to corporate shareholders
- May not participate in management

A **limited partnership** is a special type of partnership that may be created under state law. Most states have adopted the Uniform Limited Partnership Act, the Revised Act or some variation.

The various limited partnership acts create by statute a category of partner—the limited partner—whose liability is limited to his or her investment in the partnership. Therefore, unlike the general partners of the limited partnership, creditors of the partnership cannot reach the personal assets of the limited partners. In this respect, limited partners are similar to shareholders in a corporation. Note also that limited partners are not allowed to participate in the management of the partnership.

In short, limited partners have limited liability but no managerial control over the partnership, while the general partner(s) have control over the business operations but also have unlimited personal liability for partnership debts and losses.

### *Unique Aspects of Family Limited Partnerships*

#### Benefits as a Planning Tool

## Key Points

- FLP is planning tool
- Provides tax and non-tax advantages

The family limited partnership is a planning tool that provides both **tax and non-tax advantages**. As an estate planning device, an FLP may provide:

- Significant discounts in valuing transfers of partnership interests (a valuation discount of, say, 40% can result in federal estate tax savings of almost 16% for estates that are subject to the 40% estate tax.
- A convenient method of making gifts of multiple assets or of assets difficult to break into pieces small enough to easily accommodate gifting using the gift tax annual exclusion
- A method to shift future appreciation in the value of assets to the next generation
- Asset protection from the claims of creditors or divorcing spouses for limited partners
- A means of giving away property and still maintaining control, with a small estate tax cost for a general partner

## Ease of Property Transfer

### Key Points

- Certain transfers require new documents when annual gifts are made
- With FLP, general partner maintains records
- Transfers remain private

For example, consider what would be involved with annual gifts of real property—perhaps the family farm, rental property, or property held for commercial or residential development. Annual gifts of fractional undivided interests of real property would require preparation of a new deed, recording of the deed, and payment of the fees incurred with each transfer.

The transfer of a limited partnership interest can be as simple as the general partner having a limited partner sign a document acknowledging receipt of the limited partnership interest. This record is maintained by the general partner at the partnership's office. In addition to its simplicity, the transfer of a limited partnership interest is a private transaction and not a matter of public record.

## Family Eligibility

### Key Points

- Family member who is a limited partner must have true limited partner status
- Only certain members may be limited or general partners

Members of a family who can be limited or general partners of an FLP include the following:

- Spouses
- Parents, grandparents (ancestors)
- Children, grandchildren (lineal descendants)
- Other collateral relatives, such as siblings, nieces and nephews, et al.
- Trusts for the primary benefit of those mentioned above

### Rules that Govern Eligibility and Ownership

The past use of family partnerships to shift income to lower tax bracket individuals, typically the children, led to formal rules that govern family partnerships. IRC Section 704(e) requires that for the partnership to be valid, each participating family member must have true limited partner status. In other words, they must actually own their partnership interests and must have acquired such interests in a bona fide transaction, including gifts or purchases from another family member.

The key questions regarding ownership are:

- Does the nominal partner actually own the interest?
- Does the limited partner have the rights ordinarily exercised by limited partners?
- Does the entity comply with applicable state law?
- Is the donee perceived by third parties as a partner?
- Are there restrictions on the right to exercise ownership rights retained by the donor that are inconsistent with normal business practice?
- Is capital a material income-producing factor?
- Does the limited partner share in profits generated by the partnership?
- Does the limited partner share in partnership profits that are not generated by the personal services of the partners (e.g. business profits, rather than fee or commission income)?

### Capital as a Material Income-Producing Factor

**Key Points**

- Capital must be a material income-producing factor
- If it is not, the family members must work to contribute to the generation of fees, commissions or other compensation

Capital must be a material income-producing factor in the family limited partnership. If capital is not a material income-producing factor, then the business will generate its income from fees, commissions, or other compensation for personal services provided by each partner.

For example, a real estate brokerage firm operating as a family partnership would generate most of its income from fees and commissions, and each family member who is a partner must contribute to the income of the partnership. In other words, where capital is not a material income-producing factor, the family members cannot be non-working limited partners.

### *Tax and Accounting Aspects of Partnerships and Partners: Conduit or Pass-Through Nature*

## Key Points

- Not taxed as separate entity
- Income passes through partnership to partners
- Special partnership tax form used

Unlike a corporation, partnerships are not taxed as a separate entity; instead, partnership income passes through the partnership to the partners. This **conduit or pass-through** taxation may be the most significant aspect of doing business as a partnership.

The partnership files an annual Information Return (Form 1065) with the Internal Revenue Service and provides each partner with a Schedule K-1. This Schedule details the partner's share of partnership income, losses, and deductions. It also identifies the character of these items (e.g., short or long-term capital gains or losses, etc.).

### *Federal "Check-the-Box" Regulations*

## Key Points

- Must lack two or more corporation characteristics
- Check-the-box generally allows company to elect tax treatment

Generally, business entities are taxed as partnerships when they lack two or more of the following characteristics of a corporation:

- Limited liability
- Continuity of life
- Free transferability of interests
- Centralization of management

However, federal "check-the-box" regulations generally permit entities to elect the form in which they will be treated for tax purposes, subject to certain restrictions.

### *Methods of Accounting*

## Key Points

- May choose cash method or accrual method
- Method must clearly reflect income
- Uses tax year of partners who own more than 50%
- FLP usually cash method, calendar-year

The partnership chooses the accounting method, depreciation method, and the partnership's tax year. The two accounting methods generally used are:

1. **The cash method**, under which income is reported in the year it is actually or constructively received and expenses are deducted in the year they are paid
2. **The accrual method**, under which income is reported in the year earned and expenses deducted in the year incurred

The method of accounting used by the partnership in computing income will normally be the same one used to maintain its books and records; nevertheless, the method used must clearly reflect income. Generally, a partnership must use the tax year of the partners who own more than fifty percent of the partnership. Typically, the family limited partnership will be a cash method, calendar-year taxpayer.

### *Expenses*

## Key Points

- Organizational expenses not deductible
- Amortized over at least 60 months

Expenses paid or incurred to organize the partnership are not deductible as a current expense by either the partnership or the partners. These expenses include:

- Legal fees for services such as negotiating and drafting the partnership agreement
- Accounting fees for services performed incidental to the organization of the partnership
- Filing fees

Organizational expenses must be amortized over a period of not less than 60 months.

### *Basis*

#### Property Contribution to Partnership

## Key Points

- Contribution of property to partnership in exchange for interest
- No gain or loss recognized

When property is contributed to a partnership in exchange for a partnership interest, no gain or loss is recognized to the contributing partner or the partnership.

The contributing partner's basis in the partnership interest is the property's adjusted basis plus any money contributed. The partnership's basis in the contributed property is the same as it was in the hands of the contributing partner.

Where the partnership interest is inherited, the initial basis is the fair market value of the property on the decedent's date of death or the alternate valuation date. If the partnership interest is acquired by gift, the initial basis of the interest is the donor's adjusted basis plus any gift tax paid by the donor.

## Increases and Decreases

### Key Points

- Basis may be increased or decreased
- Increase can result from partner's distributive shares, deductions
- Decrease can result from distributive shares, nondeductibles, depletion

Once the initial basis of a partner's interest has been determined, that basis may be increased or decreased. A partner's basis in the partnership interest determines whether or not a distribution is taxable to the partner.

An increase in basis may be brought about by a partner's distributive share of partnership taxable income, tax-exempt income, and the deduction for depletion in excess of the basis of property subject to depletion (oil and gas partnerships). A distributive share is the partnership's profit from the partnership's business as well as such items as interest and dividends, rental income, and capital gains.

A decrease in basis may occur as a result of a partner's distributive share of partnership losses, expenditures not deductible in calculating partnership taxable income, and the depletion deduction. A partner's basis can go below zero as long as basis plus personal liability for recourse debt plus the partner's allocable share of nonrecourse debt is an amount greater than zero.

### Example: Basis and Adjusted Basis

In year one, Mack and Jean form a partnership. The partnership agreement provides for equal sharing of partnership profits and losses by the partners. Mack contributes property valued at $100,000. His basis in the property is $40,000. Jean contributes $100,000 in cash. Under the partnership agreement each has a capital account of $100,000 which will be reflected in the partnership's books. However, Mack's adjusted basis in his partnership interest is $40,000; Jean's is $100,000.

In year two, the partnership has taxable income of $50,000 and tax-exempt interest income of $3,000. No distributions are made to the partners. Each partner's basis in his or her partnership interest is increased by $26,500—their share of the partnership's taxable and nontaxable income. Mack's adjusted basis is now $66,500 and Jean's is $126,500.

In year three, the partnership distributes $80,000. Mack's adjusted basis is now $26,500 ($66,500 adjusted basis less $40,000, or half of the amount of money distributed). Similarly, Jean's basis is adjusted downward by $40,000 to $86,500.

Note that we are discussing basis adjustments and not taxable income. For example, in year two, Mack and Jean would have taxable income of $25,000 each to report on their own Form 1040s. Since the partnership is a conduit or pass-through entity for income tax purposes, the partners must report taxable income, whether or not the income is actually distributed to them.

### ***Community Property Considerations***

## Community vs. Separate Property

### Key Points

- Nine community property states
- Treatment of spouse's income and the property acquired or brought to marriage by each spouse varies by state

There are nine community property states. In Idaho, Louisiana, Texas, and Wisconsin (which uses the term "marital property"), the income from the separate property of one spouse becomes community property income. And, any property acquired with community property income is community property.

In Arizona, Nevada, New Mexico, California and Washington, the income from the separate property of a spouse remains separate property.

Typically, property acquired prior to the marriage (the formation of the "community") is separate property. In Wisconsin, property acquired after the marriage but before 1986 may also be separate property. In addition, property acquired by gift or inheritance may remain separate property.

The use of separate property income to purchase property taken jointly by both spouses constitutes a gift of one-half the value of the property acquired. Because of the unlimited marital deduction, this does not cause any federal gift tax liability. However, spouses in jurisdictions having state gift tax statutes should exercise caution.

## FLP Income

### Key Points

- Could be both community and separate property income
- Determination is variable by state
- Statutory marital partition agreement may be necessary

It is important to note that income from a family limited partnership could be construed as either separate property or community property, depending on the property regime in the state where the income is received. For example, assume Rick and Jill are married and live in a community property state. Rick holds a limited partnership interest in an FLP. The FLP holds community property managed by Rick (for which he receives a management fee) as well as other property that Rick owns separately. The FLP distributes income to all who hold limited partnership interests.

Rick's earnings for personal services are probably community property. However, the income Rick receives as a result of his limited partnership interest would be separate property income in five of the community property states (Arizona, Nevada, New Mexico, California and Washington) and community property income in the other four (Idaho, Louisiana, Texas and Wisconsin).

If Rick and Jill want the FLP interest to be the separate property of one spouse, they may need to convert the community property to separate property before transferring the property to the partnership. If this is the case, they should execute a statutory marital partition agreement with regard to the property to be transferred to the FLP.

## Chapter 11 Review Questions

1. Which of the following statements is *not* true of a general partner?
    A. The general partner's capital investment is vulnerable to partnership creditors.
    B. The general partner's personal assets are shielded from partnership creditors.
    C. The general partner has a voice in the operational affairs of the partnership.
    D. The general partner is personally liable for partnership-related contractual commitments made by other partners, and for their wrongful business acts.
2. In an FLP, there may be special valuation discounts available to enable wealth to pass to younger generations at a significantly lower tax cost than would otherwise be possible. One of these is the "lack of marketability" discount. The other is:
    A. The "limited partner" discount
    B. The "succession of generations" discount
    C. The "minority interest" discount
    D. The "property right" discount
3. An FLP is an irrevocable arrangement.
    A. True
    B. False
4. The FLP offers all of the following advantages EXCEPT:
    A. Significant discounts in valuing transfers of partnership interests
    B. A convenient way to gift assets that are generally difficult to break into easily giftable pieces
    C. A method of keeping appreciation taxable to the older generation
    D. A means of giving away property while still maintaining control
5. If an FLP generates most of its income from fees and commissions, who is required to contribute to the income of the partnership?
    A. The general partners
    B. The limited partners
    C. All partners
    D. At least one general partner; all other partners are allowed to be non-working partners

## *Answers to Chapter 11 Review Questions*

1. B. The general partner's personal assets are *not* insulated from the reach of the partnership's creditors if things go badly in the business.
2. C. The other discount is called the "minority interest" discount.
3. B. An FLP allows for a great deal of flexibility.
4. C. An FLP provides just the opposite-a method of shifting future appreciation in the value of assets to the next generation, who would likely be in a lower tax bracket.
5. C. Each member of the family in an FLP must contribute to the income of the partnership if capital is not a material income-producing factor. Family members cannot be non-working limited partners.

# Chapter 12
# Family Limited Partnerships and Estate Planning

## Estate Planning with FLPs

### *Planning Objectives*

**Key Points**

- Protecting assets
- Managing assets
- Minimizing taxation

Estate planning involves ordering an individual's affairs to promote effective protection and management of assets, with a view to their eventual transfer to members of succeeding generations.

Individuals often desire to **protect assets** from:

- Spendthrift offspring,
- Failed marriages, and
- Claims of creditors.

In addition, planners frequently seek **better management** through:

- Consolidation of family assets,
- Ability to control distributable cash flow, and
- Flexibility in making and changing investment and planning objectives.

Finally, estate planners work to **minimize taxation** on transfers of wealth, whether during life or at death.

### *Spendthrift Protection*

#### Why It Might Be Needed

**Key Points**

- Deterrent to non-productive activities of younger generation
- Cash flow may be adjusted

Occasionally, members of the older generation worry that members of the younger generation may waste assets transferred to them or use such assets as an excuse not to engage in productive activity.

FLPs permit older generation members to adjust the cash flow received by younger generation members who are FLP limited partners. If older generation members think that younger generation members lack the initiative to work, or are squandering assets, distributable cash flow may be reinvested, rather than distributed.

### Tax Consequences of Retained Power

## Key Points

- Older individual may be owner for income tax purposes
- Transferred units should not be subjected to taxation in the estate

The indirectly retained power just described could cause the older generation member to be treated as the owner of the interest for income tax purposes, but should not subject the transferred units to taxation in the estates of older generation members.

However, older generation members must take care not to retain an interest in the entity after the transfer of units to the younger generation because it can cause special valuation rules to apply.

### Divorce Issues

## Key Points

- Gifting can segregate the separate property
- Separate property rarely awarded to divorced spouse
- FLP agreement may address other issues

Divorce is a concern to many older family members as they embark on a gifting program. The gifting of limited partnership units offers a convenient way to segregate the separate property of the donee. Courts in most jurisdictions will not award separate property to a divorced spouse.

If a court awards a limited partnership interest to a divorced spouse, the FLP agreement may provide that upon involuntary transfer, the other partners (or the divorced partner) may purchase the interest at its fair market value. This may also force dissolution and/or reorganization of the partnership, and is dependent on the FLP agreement.

### Creditor Issues

## Key Points

- Transfer of assets to defraud creditors prohibited
- FLP agreement may address purchase of units from debtor
- Creditors have same rights as the limited partner

A debtor may not transfer assets into the FLP as a means to defraud existing creditors. However, after the family members have established the FLP, the only remedy for future creditors against the partnership is to receive a charging order against the FLP unit owned by the debtor. The FLP agreement, however, may mandate that such a unit or units be purchased by either the partnership or by the remaining partners at its fair market value.

Creditors stand in the shoes of a limited partner, with no more rights than a limited partner.

### *Better Asset Management*

#### Management Consolidation

## Key Points

- Varied assets can be difficult to manage
- Management consolidation can simplify task
- Cash control also can be consolidated with skilled family members

It is difficult to manage disparate assets (such as undeveloped land, rental property, and unincorporated business enterprises) and to plan for their transfer. Contributing such assets to an FLP consolidates their management and makes their transfer easier through gifts of FLP units.

We have already discussed the ability to control distributable cash flow. Older family members often have management or investment skills that are vital to the continued success of the family business. Such skills can be better used in an FLP than with a trust or an outright gift.

#### Flexibility

## Key Points

- FLP can ease changes in family circumstances
- FLP tax advantages provide relief from tax issues

As family circumstances change, or as the behavior of family members changes, older family members may be able to adjust their response in an FLP environment, if the FLP agreement may be amended or terminated.

The reduced transfer tax advantages of an FLP mean time and money that would have been devoted to planning for costly transfer tax liabilities can now be focused on profitably running a successful business. In addition, FLP ownership of out-of-state property can save legal and other costs associated with out-of-state (ancillary) probate.

### *Life Insurance Needs*

#### Including Life Insurance in the Estate

## Key Points

- FLP may buy and own life insurance
- Pro rata amount of proceeds to be included in general partner's estate
- Alternative approach may be used

An FLP can buy and own life insurance on a partner's life. The amount of death proceeds includable in a general partner's estate will be a pro rata amount proportionate to the general partner's retained percentage interest. For example, a 2% interest would mean that 2% of the death proceeds received by the FLP would be included in the general partner's gross estate.

This approach to estate inclusion is not based on settled law. An alternative approach would include the entire proceeds of a life insurance policy owned by a partnership on the life of a general partner in the general partner's estate, in a manner similar to the majority shareholder situation. It is important to insulate the general partner from any action with respect to that policy in the partnership agreement. The client should contact an attorney or accountant for advice with respect to this issue.

If the FLP is owner, premium payer, and beneficiary of a life insurance policy, the proceeds will not be included in the estate of the deceased insured under the three-year rule, unless other incidents of ownership exist and the policy insures a general partner.

## Funding the FLP

### Key Points

- Face amount may be less than value of assets
- Proceeds may fund a cross-purchase buy-sell agreement
- Tax benefits may result from step-up in basis

When life insurance is used to help fund an FLP buy-sell agreement, the face amounts may be less than the value of the underlying assets, since the fair market value of FLP interests may be depressed by minority and marketability discounts. Such depression of value can enable family business owners to insure the fair market value of an interest, when the underlying asset value might otherwise make full coverage unaffordable.

Policy proceeds generally flow through to partners as income-tax-free life insurance proceeds, and may be used to fund a cross-purchase buy-sell agreement. Such an agreement may allow for a step up in cost basis for the survivor's units. Thus, capital gains taxes may be reduced upon the subsequent sale of such units.

Policies must have a reasonable business purpose and be owned by an FLP that has an independent or reasonable business purpose.

## Valuation Discounts

### *Increased Interest in FLPs*

#### Key Points

- RRA of 1990 addressed fragmented ownership discounts
- Rev. Rul. 93-12 made it more beneficial to transfer family partnership units during life

The surge in interest in FLPs can be traced back to two developments.

In the Revenue Reconciliation Act of 1990, Congress recognized the reality of fragmented ownership discounts, which have generally been approved by the courts.

Then, in January of 1993, the IRS issued Rev. Rul. 93-12. This ruling abandoned the long-time contention by the IRS that intra-family gifts of business interests could not be discounted as minority interests since control remained in the family. This concession makes it financially more beneficial for older family members to transfer partnership units during life, rather than waiting until death.

### *Facts Relevant to Gift and Estate Taxation*

#### Key Points

- Property taxed at fair market value
- Degree of control of the interest
- Marketability of interest

For gift and estate tax purposes, property is taxed at its fair market value, which is 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 the relevant facts.

Among the relevant facts are the degree of business control afforded by the interest being valued, and the extent to which that interest is marketable.

### *Minority Interest Discount*

#### Key Points

- May be available when holder of interest lacks voting control
- Holder also lacks other powers
- Value determined in hands of transferee
- Property worth less because transferee has little control

A **minority interest discount** may be available when, lacking voting control of the partnership, the holder of a limited partnership interest does not have:

- A management role or control over the operations of the FLP
- An ability to dissolve the FLP and/or to reach the value of its underlying assets, or
- An ability to require a return of personal capital contributions, or to require other distributions

The value of a transferred limited partnership interest will be determined in the hands of the transferee and not in the hands of the transferor. The transferee has little control over the property; therefore, it is worth less.

### *Example: Minority Interest Discount*

A decedent owned 50% interests in five general partnerships. Each partnership owned and operated residential housing for the elderly. Upon the decedent's death, the decedent's son purchased his father's partnership interests for a nominal price of $10,000 per partnership. The decedent's estate reported the total value of the partnership interests as $50,000 on the decedent's federal estate tax return.

The Tax Court applied a 20% discount for lack of marketability, but did not apply a minority-interest discount in valuing the partnership interests. On appeal, the Fourth Circuit agreed with the Tax Court that a minority-interest discount did not apply in the case of a 50% interest.

### *Lack of Marketability Discount*

## Key Points

- May be available for lack of ready public market
- FLPs often have restrictions and agreements that contribute to lack of marketability

A **lack of marketability discount** may be available when there is no ready public market for limited partnership interests. In an FLP there are likely to be:

- Restrictions on transfer or assignment,
- A right of first refusal by the partnership or by other partners, and
- Agreement that no assignee will be admitted as a member unless approved by the general partner or by other limited partners.

Under such circumstances a partnership interest will be difficult to sell and, consequently, will be reduced in value.

## Appraisers and Appraisals

### *Professional Organizations*

**Key Points**

- Valuation should be done by a professional appraiser
- Variety of professional organizations exist

The valuation of a closely held entity such as an FLP and the calculation of appropriate minority or lack of marketability discounts which should be applied to FLP interests are the province of professional appraisers. These individuals belong to, and are accredited by, a variety of organizations, including:

- The American Society of Appraisers
- The Institute of Business Appraisers
- The National Association of Certified Valuation Analysts
- The American Institute of Certified Public Accountants

### *Case-by-Case Appraisals*

**Key Points**

- Unique situations considered
- No specific rule of thumb for discounting

Appraisal depends on the unique and varying facts of individual cases. Transferred interests have been discounted up to 50% and more relative to the value of the business interest being transferred, or the value of the underlying assets.

There is no accepted rule of thumb—a partner in a partnership simply cannot assume a 30% minority discount along with a lack of marketability discount of 20%, for a total discount of 50%. Appraisers disagree as to whether minority and lack of marketability discounts should be calculated in an additive or sequential fashion. The final determination of fair market value should theoretically be the same, whichever approach is taken.

In any case, proper valuation analysis is vital. It is a job for accredited professionals who have expert knowledge and experience with respect to the type of property being valued, and who are able to act as effective expert witnesses should the valuation be challenged by the IRS or in Tax Court.

## Gift Considerations

### *Transfers During Life*

**Key Points**

- Transferring FLP interest allows discount
- Reserves some control for donors
- Future appreciation occurs for younger generation

Use of FLP interests in intra-family giving can permit the discounted transfer of family assets, while reserving for the donors a substantial degree of control. Such control is in a fiduciary and managerial capacity, as general partners.

By transferring FLP interests during life, the future appreciation in value of these business interests will occur in the hands of the younger generation family members, rather than adding to the gross taxable estate of older family members.

### *Annual Gift Tax Exclusion*

**Key Points**

- Permits gifts free of gift tax; amount indexed annually
- Must be gift of a present interest
- May be risk of loss of exclusion for gifts of FLP interests

Every donor has an annual gift tax exclusion that permits tax-free gifts of $16,000 (indexed amount for 2022) per donee. To qualify for the annual exclusion, gifts must be of a present interest, and the IRS has allowed a gift of an FLP interest to be considered a gift of a present interest.

However, a case in which the gift tax annual exclusion was denied for gifts of units in a limited liability company (LLC) poses potential risks for gifts of FLP interests as well.

If a limited partner's rights are so limited by the partnership agreement that there is a question as to whether the transferred interest will qualify as a gift of a present interest, then the donor may prefer to give cash to family members. The donees may then use the cash to buy partnership interests.

### Other Issues

**Key Points**

- Should not cut too close to maximum exclusion figure
- Income taxation might also be affected with FLP gifts

Gifts valued at less than the exclusion amount do not require the filing of an IRS Form 709 (gift tax form). It is better to have enough partnership units so that one need not cut too close to the exclusion amount ($16,000 in 2022), after applying any discount(s), in order to give away one share. Minority and lack of marketability discounts may be somewhat less in the eyes of the IRS than in those of the client's professional advisors.

Gifting of FLP interests may affect income as well as estate taxation. Consider an FLP where income arises from assets and not primarily from the donor's personal services. When capital is a material income-producing factor, partnership income may be shifted to lower income tax bracket taxpayers, who are typically the limited partners.

## Tax Outcomes

### *Plan for Desired Outcomes*

**Key Points**

- FLPs can minimize gift, estate and income taxation
- Careful planning required in order to maintain tax benefits

As we have seen, FLPs can minimize gift and estate taxation, and in some cases, income taxation.

In order to realize these expected tax benefits, however, the FLP agreement must be planned and drafted with care, and the FLP and its assets must be managed with care. Encourage clients forming FLPs to work with attorneys with expert knowledge and experience in FLP matters.

It is essential that the IRS view the FLP as a business entity with an independent or reasonable business purpose, and not as a mere token entity constructed to evade taxation.

### *Problem Areas*

The areas that typically cause the most problems are:

- "Deathbed" FLPs
- Excessive or unsubstantiated valuation reductions
- FLPs without any reasonable independent business purpose
- Failure to adhere to the appropriate formalities

## Transfers with a Retained Life Estate

**Key Points**

- Potential problems if decedent retained a life estate
- Potential problems if the decedent retained voting rights in transferred shares

IRC Section 2036 includes in the gross estate transfers made during life in which the decedent retained a life estate or the power to control the beneficial enjoyment of the transferred property. Some FLPs have run afoul of IRC Section 2036, while others have been vindicated.

IRC Section 2036(b) relates to the direct or indirect retention of voting rights in transferred shares of a controlled corporation. This could cause problems in an FLP that holds primarily close corporate stock.

## Other Potential Problem Areas

### *IRC Section 2701*

**Key Points**

- IRC Section 2701 contains less favorable valuation rules
- IRC Section 2701 can apply to FLPs under certain circumstances

The FLP agreement should be drafted to avoid the possible application of the provisions of IRC Section 2701, which contains valuation rules that are far less favorable than the “willing buyer and willing seller” test.

Generally, FLPs are drafted so they are deemed to have only one class of partnership interest (limited and general partnership interests are generally not regarded as two classes of partnership interests). However, in a Technical Advice Memorandum, the IRS ruled that IRC Section 2701 valuation rules apply to entities formed by the transfer of an interest in a family-controlled corporation or partnership when:

- The transfer is for the benefit of family members
- The transferor retains some interest in the new entity
- This retained interest of the transferor is in a different class of equity than the transferred interest, or is not proportional to the transferred interest

### *IRC Section 2703*

**Key Points**

- Rules on fair market value
- Should not pose a problem for properly planned and drafted FLPs

IRC Section 2703 provides that the fair market value of property shall be determined without regard to any agreement to acquire or use the property or any restriction on the right to sell or use the property. This rule does not apply to an agreement or restriction that:

- Is a bona fide business arrangement
- Is not a device to transfer property to the decedent’s family for less than full and adequate consideration, and
- Has terms comparable to similar arrangements in arm’s length transactions

These rules need not pose a problem for the FLP if qualified counsel does proper planning and drafting.

### *IRC Section 2704*

IRC Section 2704(a) provides that if an entity contains lapsing voting or liquidation rights, then the individual possessing those rights will be deemed to have transferred, by gift or through inclusion in his or her gross estate, the difference between the value of the shares before and after the lapse.

IRC Section 2704(b) requires the disregarding of certain applicable restrictions that limit the ability of the entity to liquidate, and that either lapse or may be removed by the family after the transfer.

Counsel must therefore design an FLP so that it does not have an applicable restriction. The default provisions of state law will not be considered applicable restrictions. If the FLP's provisions are no more restrictive than these, then there may be no applicable restrictions. Commercially reasonable restrictions that arise from financing by an unrelated party will not be seen as applicable restrictions.

## FLP Compared to Irrevocable Life Insurance Trust

### *Estate Planning Drawbacks for ILITs*

**Key Points**

- ILITs acceptable for estate planning
- Provide some benefits, but also drawbacks

Irrevocable life insurance trusts (ILITs) are an accepted estate planning tool. They can help to provide non-estate-taxed liquidity for the estate, and they can offer protection from the beneficiary's creditors and, possibly, from the donor's future creditors. They can provide for centralized control and continuity. However, ILITs have several drawbacks:

- They cannot be revoked.
- They cannot be amended.
- The grantor may not use the ILIT's assets for personal benefit.
- Income taxation may be unfavorable.
- Trust law is complex and may unduly restrict flexibility.

Also, Crummey beneficiaries of ILITs are occasionally tempted to exercise their withdrawal rights against the wishes of older generation family members. This is not a problem in the FLP context.

There is a downside to using FLPs: A general partner's interest in the FLP will be included in his or her gross estate for federal estate tax purposes. This includes a portion of life insurance proceeds paid to the FLP.

### *Estate Planning Advantages of FLPs*

#### Legal Requirements and Benefits

**Key Points**

- State laws govern establishment of FLPs
- Estate planning advantages result

FLPs are more than just an estate planning tool, but a business organized as an FLP can offer a number of estate planning advantages:

- FLP agreements are not difficult to amend.
- FLP assets may be, at least in part, used for the benefit of a general partner.
- FLPs are subject to favorable partnership income tax rules.
- FLP issues are interpreted, in many respects, in terms of well-settled rules of partnership law.

In setting up an FLP, attorneys must comply with state partnership law and formal requirements.

#### Uses for Life Insurance

**Key Points**

- Death proceeds to FLP not income-taxed to decedent's estate
- FLP must be policy's owner, premium payer and beneficiary
- Special care for policy covering general partner
- Proceeds could be included in decedent's estate for estate tax purposes

Life insurance death proceeds payable to an FLP will not be taxable to the decedent partner's estate for income tax purposes as long as the FLP is the owner, premium payer and beneficiary of the insurance policy, and the partnership is not required to make any payments to the decedent's estate or to the creditors of the decedent's estate.

If the insurance is on a general partner, the insured general partner must take care to insulate him/herself from incidents of ownership by restricting his/her control over the policy in the partnership agreement itself. If incidents of ownership exist, the proceeds will be included in the deceased general partner's estate.

As previously discussed, proceeds will be indirectly included in the decedent's estate for federal estate tax purposes to the extent they increase the value of the decedent's FLP interest.

## Business Succession Planning

### *Owner's Needs*

#### Key Points

- Important issues occur when business owner leaves
- Certain characteristics may be perceived to be gone along with owner
- Financial stability can be affected

Business owners confront difficult problems when planning to ensure the continued success of their business. The owner's disability, retirement or death may have a pronounced effect on the business. Successful businesses often rely on the unique drive and personality of their owner. When that owner is gone, with the owner may go skills, abilities, contacts and credibility that are indispensable—or so it may appear to clients, creditors, or valued employees.

In addition to addressing these important issues, a business owner planning for successful succession management must address the financial stability of the entity. This may be adversely affected not only by the loss of a key executive, but also by the liquidity demands resulting from substantial business and estate tax liabilities.

### *Owner's Objectives*

#### Who Will Succeed the Owner?

#### Key Points

- Heirs or others
- Planning before owner leaves is best
- Burden on others must be considered

The business owner must decide whether there is an heir or heirs who are willing and able to run the business. If such individuals are not available, the business may be sold to a key employee or employees, or to outside interests. Better arrangements are almost always made by business owners who plan ahead than by distraught and often uninformed survivors, who may have little bargaining power.

The business owner must structure financial and tax arrangements so that the transfer of the owner's interest does not place an undue burden on family members, business associates, or on the business itself.

### Common Objectives

The business owner’s objectives may be summarized as follows:

- Management succession
- Business liquidity and financial stability
- Effective transfer of the business interest
- Tax minimization

If solutions to meet the owner’s objectives are planned for in advance, the business should be able to continue successfully.

### *The Role of Life Insurance*

The use of an FLP may enable family business owners to effectively plan and control the transfer of the business to younger generation members while minimizing tax expenditures.

We have seen that life insurance can play an important role in planning the business owner’s estate. Its role in business planning for the FLP can be equally vital.

Life insurance can be useful in business succession planning in four ways:

- Key executive life insurance
- Split dollar life insurance
- Section 162 executive bonus life insurance
- A pre-retirement death benefit in qualified retirement plans

## FLPs Compared to Other Business Entities

### *Ownership Requirements*

#### Key Points

- Natural person or legal entity may own FLP interest
- FLPs may have any number of partners
- Some entities may not hold long-term shares of S corporation
- S corporations limited in number of shareholders

FLPs are frequently considered in contrast to limited liability companies (LLCs), S corporations and C corporations. These entities are subject to different rules regarding ownership, taxation, liability and legal status.

Ownership of an FLP interest may be held by any natural person or legal entity, and FLPs may have an unlimited number of partners. This is also true of LLC memberships and of shareholders in C corporations. For S corporations, however, there are many entities that may not be long-term shareholders, and the number of S shareholders is also limited.

### *Pass-Through Taxation*

## Key Points

- FLPs have pass-through taxation
- C corporation profits taxed at corporate level
- Corporate dividends also taxed to shareholders
- FLP partners may receive disproportionate distributions and other special treatment; C corporations may not

FLPs have the advantage of pass-through taxation accorded to partnerships, as do S corporations and most LLCs. In contrast, a C corporation is a separate taxable entity, with profits taxed at the corporate level. Dividends declared, if any, are not deductible to the corporation and are taxed at ordinary income tax rates to the shareholders.

FLP partners, like LLC members, may receive disproportionate distributions, or special allocations of profits and losses, and may contribute appreciated property to the entity without recognizing taxable gain. None of these are permitted with respect to a C corporation shareholder.

### *Liability*

## Key Points

- Limited liability for FLP limited partner; unlimited liability for general partner
- All LLC members may have limited liability protection
- S and C corporations have limited liability, at least in theory

Liability of an FLP limited partner is limited to his or her personal investment, although the liability of general partners is unlimited. On occasion, an entity such as an LLC or a corporation will act as general partner (although minimum net worth requirements apply). This may limit the liability of the general partner.

In contrast, all LLC members may be afforded limited liability protection. S and C shareholders have liability limited to their investment in the absence of personal responsibility as an officer or director, although piercing the corporate veil is more common today than it was in former years.

### *Legal Status*

## Key Points

- FLP has more stable legal status than LLC
- C corporation law varies

The legal status accorded to FLPs is more stable and fully developed than is the case with LLCs. A limited partner in an FLP may depart without necessitating dissolution. The termination of any owner's membership in an LLC may cause dissolution, and it is possible that other states may not accept the limited liability of members.

Although C corporation law varies from state to state, such law is generally based on many well-established principles.

### *Comparison Chart*

Here is a chart that compares FLPs with other forms of business organization.

| Comparison of Business Entities | | | | | |
|---|---|---|---|---|---|
| | **LLC** | **C Corp.** | **S Corp.** | **FLP** | **Partnership** |
| **Who can be an owner** | Any person or entity; no limit on number of owners | Same as LLC | Certain entities and foreign nationals cannot be owners; number of owners limited to 100 | Same as LLC | Same as LLC |
| **Limited liability of owners** | For all members | For all shareholders | Same as C corporation | Only for limited partners | None |
| **Pass-through taxation** | Income and losses pass through to members | No pass-through taxation exists | Same as LLC | Same as LLC | Same as LLC |
| **Tax and legal certainty** | All states have an LLC statute, but variations exist in both tax and legal treatment | Law is well established | Same as C corporation | Uniform Limited Partnership Act (or Revised Act) adopted in all states; however, variations exist | Partnership Act adopted in most states; however, state variations exist |

## Careful Planning Is Critical

Although the IRS has lost some court cases on FLPs, it has also won some cases. It's no secret that the IRS is not favorably disposed toward them. Certain basic planning issues must be considered to secure the tax benefits of an FLP. Here is a list of planning guidelines and precautions:

- Establish and operate the partnership with a business purpose. Avoid any appearance that the FLP was set up for no purpose other than to avoid tax.
- Don't go the do-it-yourself route in setting up an FLP. Use expert assistance to ensure that the FLP is established in the proper manner.
- Don't wait until the estate owner is in failing health to set up an FLP. At that point, it could be viewed as nothing more than a last-ditch tax-saving device that has no real economic substance.
- Don't attempt to retain too much control over the assets transferred to the FLP. Consider naming an independent third party as general partner.
- Don't commingle partnership assets and accounts with personal assets and accounts.
- Don't use partnership assets to pay personal expenses. Instead, partners should take distributions from the partnership and then use these funds for personal purposes.

- Don’t put an IRA into an FLP. This terminates the IRA and triggers income tax on the entire IRA balance.
- Don’t put a personal residence in an FLP. It could result in the loss of the $500,000 (for a married couple) capital gains exclusion when the home is sold, and the possible loss of the special homestead exemption in some states. A “qualified personal residence trust” is usually a better alternative.

## Chapter 12 Review Questions

1. After an FLP has been established, the only remedy for future creditors against the partnership is to receive a:

   A. Charging order against the debtor's FLP unit

   B. Bankruptcy protection exclusion

   C. Debt repayment plan from the FLP

   D. Partial repayment from a general partner

2. A minority interest discount is typically available to a person holding a limited partnership interest when:

   A. The person has a management role

   B. The person has voting control

   C. The person has no power to dissolve the FLP

   D. The person can require the FLP to return his or her capital contributions

3. The valuation of a closely held entity such as an FLP and the calculation of appropriate minority or lack of marketability discounts should be performed by:

   A. The general partners

   B. The limited partners

   C. The IRS

   D. Professional appraisers

4. IRC Section 2703 provides that the fair market value of property shall be determined without regard to any agreement to acquire or use the property of any restriction on the right to sell or use the property. To which of the following FLPs would this rule apply?

   A. An FLP that is a bona fide business arrangement

   B. An FLP that is merely a device to transfer property to the decedent's family for less than full and adequate consideration

   C. An FLP with terms comparable to similar arrangements in arm's length transactions

   D. All of the above

5. Which of the following does *not* have the benefit of pass-through taxation?

   A. FLP

   B. LLC

   C. C corporation

   D. S corporation

6. The liability of an FLP general partner is limited to his or her investment.

   A. True

   B. False

## *Answers to Chapter 12 Review Questions*

1. A. The only recourse for a creditor against an FLP is to get a charging order against the debtor's FLP unit(s).
2. C. A person holding a limited partnership interest can receive a minority interest discount if he or she has no power to dissolve the FLP. Minority interest discounts are not available if a person has voting control or a management role in an FLP.
3. D. Professional appraisers should be used to determine valuation of an FLP as well as appropriate discounts.
4. B. In order to avoid IRC Section 2703, an FLP must not be viewed as a device to transfer property to family members for less than full and adequate consideration.
5. C. A C corporation is a separate taxable entity.
6. B. The liability of a limited partner is limited to his or her investment; however, a general partner has unlimited liability.

# Chapter 13
# Planning for Incapacity or Incompetence

## Advance Medical Directives

### Key Points

- Treatments can sustain life beyond hope of recovery
- How can we use these treatments ethically?
- Legal documents let the patient decide treatment parameters

Modern medicine has advanced to the point where it can sustain life beyond any reasonable expectation of recovery. These advances have raised ethical and legal questions about a patient's wishes to receive such life-sustaining treatment during terminal illness or incapacity.

When a patient is no longer competent to specify the type of treatment desired, the courts have struggled to determine who has the right to make this decision while maintaining the patient's dignity and final wishes. Because the ideal solution is for the patient to make the decision about end-of-life treatment, the legal community created documents collectively referred to under the umbrella term **advance medical directives**.

Advance medical directives include:

- Living wills,
- Health care powers of attorney,
- Medical directives, and sometimes,
- Instructions about organ donation.

## What Is a Living Will?

### *Definition and Purpose*

**Key Points**

- Specifies acceptable life-sustaining treatments
- Laws exist in 48 states and DC
- Deals with treatment versus recovery expectations

A **living will** is a document that allows people to specify the life-sustaining treatments they would find acceptable in the final days of terminal illness or incapacity. Forty-eight states and the District of Columbia have living-will laws (all states except Massachusetts and Michigan).

Living wills allow dying patients to maintain their dignity while making their treatment wishes known. The focus on these two equally powerful forces has produced a gradual and continuing shift in public opinion on death and dying, which has in turn affected public policy. Today, people are not only concerned with providing for the disposition of their property at death, they are also seeking to leave clear advance directives on their wishes as they relate to life-sustaining care.

### *Background*

**Key Points**

- Attempt to define individual rights about receiving or refusing treatment
- U.S. Supreme Court case clarified rights of states to write their own rules on ending life support

Living will statutes have proliferated in an attempt to define an individual's right to forgo life-sustaining treatment. The United States Supreme Court clarified this matter in *Cruzan v. Director, Missouri Department of Health* (1990). While the Court recognized the right of a competent person to direct that life support be removed, it upheld the state's right to require that clear and convincing evidence be shown as to the wishes of an incompetent person.

Absent proof, the Court found that the state was not required to assume the family's wishes were those of the comatose daughter. Although the Supreme Court's position is clear, the case allows each of the 50 states to write its own rules, resulting in a patchwork of statutes that vary from state to state.

### *Natural Death Statutes*

**Key Points**

- Statutes exist in all 50 states
- Allow individual to require withholding or withdrawing certain treatments during terminal illness
- Requirements must be followed carefully
- Absolve caregivers and family members from liability

All 50 states have enacted statutes laying down the rules for establishing a living will or health-care agent. Generally, these statutes permit a competent person to instruct a physician to withhold or withdraw life-sustaining procedures in the event of a terminal illness.

The requirements of these statutes must be followed precisely or substantially, depending on state law, so they achieve the desired result—namely, to absolve hospitals, physicians, and family members from liability as long as the instructions contained in the living will are followed.

## State Variations in Living Will Laws

### *Typical Basic Requirements*

#### Key Points

- Adult making the directive must be competent
- Witnesses to directive must be competent adults
- All must sign directive in the presence of the others

The requirements of a living will vary from one state to another. Generally, however, the statutes require that living wills be:

- Executed by a competent adult, and
- Witnessed and signed by two or more competent adults (who do not stand to benefit from the estate) in the presence of each other and the creator of the living will.

A few state statutes require that a person be terminally ill when a living will is executed. Some enforce a living will only if the person is terminally ill, holding that it is not sufficient for the patient facing a long period of incompetence.

### *Physician Involvement*

#### Key Points

- Physician typically must certify terminal illness and imminent death
- Document is advisory from the physician's perspective
- Physicians in some states may face penalties for refusal to honor living will

In addition to the restrictions placed on the living will by statute, living wills generally become viable only when physicians who have examined the patient certify that the patient suffers from a terminal illness, that there is no reasonable expectation of improvement, and that the now-incompetent patient's death is imminent.

#### Note

Physicians are not required to adhere to the instructions outlined in a living will, making the document solely advisory. However, some state statutes impose penalties on physicians who refuse to follow the patient's wishes as outlined in a living will.

## Durable Power of Attorney for Health Care

### *Why It Is Needed*

**Key Points**

- Statutory language of living wills may result in lack of clarity
- Some statutes prohibit certain actions
- Durable power of attorney aims to add clarity

Because of these restrictions and other shortcomings in statutory language, living wills often fail to leave families and physicians with clear directives reflecting the competent person's wishes regarding the decisions these caregivers and family members must make. In addition, many state living will statutes are explicit on the life-sustaining procedures that may *not* be withheld or withdrawn.

For this reason, individuals often use a **durable power of attorney for health care** (or **health care proxy**) alone or in conjunction with a living will to fill this gap.

### *What It Does*

**Key Points**

- Delegates decision-making power to a specified agent
- Power does not lapse
- Provides some basic powers

The health care power of attorney grants a delegation of decision-making powers to an agent. It directs who will decide and it specifies those decision-making powers the agent will have. It's durable because the power conveyed to the agent does not lapse if the principal becomes incompetent.

Statutes vary from state to state, but generally a durable power of attorney for health care provides for the right to:

- Remove a physician
- Have the incompetent patient discharged against medical advice
- Obtain medical records
- Have the patient moved
- Engage other treatment

### *Other Powers*

## Key Points

- Should empower agent to make any type of health care decision
- Overcomes need for guardianship in order to make decisions for another

These laws should have the effect of empowering agents to make any type of health care decision that the patient would otherwise dictate under applicable state law.

A durable power of attorney for health care can also overcome considerable obstacles for an elderly or incompetent patient who is not dying. Where once guardianship was the only route to making decisions with regard to difficult or dangerous medical procedures, the health care power of attorney gives competent individuals the right to choose who will make decisions for them if they become incompetent.

# Medical Directive

### *Four Preferences*

## Key Points

- Further clarifies individual's wishes
- Four specific situations defined

Even with a living will and a durable power of attorney for health care, physicians and families still may be left with unanswered questions about the patient's wishes with regard to the termination of life support under various circumstances. For this reason, some individuals choose to execute another document that clarifies the amount and type of care to be given in extreme situations. This document is a **medical directive**.

Generally, the medical directive sets forth the individual's preferences in four specific situations:

1. **Coma with no known hope of recovery**. This is the most extreme situation because patients in prolonged comas may survive for years or even decades. The medical condition is sometimes called "persistent vegetative state."
2. **Coma with very slight and uncertain chance of recovery**. While similar to the first situation, this one involves more statistical uncertainty. The person is in a coma but does not meet the criteria for persistent vegetative state. The chance of recovery is present but remote. Survival with permanent brain damage is more probable and death with no recovery is the most likely result.
3. **Irreversible brain damage or disease with a terminal illness.**
4. **Irreversible brain damage or disease without a terminal illness.**

In the third and fourth situations, the person is alert but suffering from severely diminished mental capacity. Making a choice in the third situation, dementia combined with terminal illness, may be somewhat easier than in the fourth. The fourth category asks people to decide what they would want if they had a severe mental impairment but were physically well and then became sick. How would they want their physicians and family to proceed? Would they want to be treated under this condition for something that could become terminal if left alone?

### *Providing More Direction*

## Key Points

- Preferences for variety of treatments in variety of situations
- Physician must be consulted

A medical directive gives people an opportunity to express their wishes on different interventions in each of the four situations. Individuals completing the document make their preferences known on a variety of treatments ranging from relief of pain to resuscitation and artificial hydration and nutrition.

The language of the medical directive often advises completion only after consulting a physician. The medical directive is usually worded to specify that choices are to be honored only if they are considered medically reasonable.

# Planning Considerations

## Key Points

- Individuals want to control events in their final days
- Medical directives allow individuals to state preferences
- Directives also remove burden of responsibility from family members

Clients and prospects eager to put their affairs in order regarding the disposition of their property at death are often equally interested in ensuring that their wishes be respected during their final days. Recent court cases and the health insurance reform debate have produced a growing interest in the concept of living wills and health care powers of attorney.

Though the terms "living will" and "right to die" are often linked in people's minds, the notion of the right to die may not truly express a person's concerns about terminal care. When properly used, living wills, durable powers of attorney for health care and medical directives can give people an opportunity to state their preferences. These devices can help to lift the burden of responsibility from family members while giving individuals peace of mind that their wishes are likely to be respected.

## What Is Medicaid?

### *Purpose*

**Key Points**

- Government medical program for low income people
- Insurance agent interest in extended nursing care

Medicaid is a **government medical assistance program** administered by the states for individuals and families who qualify for benefits because their income and assets fall below government-defined limits. Although Medicaid provides a wide variety of health and human services to extremely diverse groups, its primary interest to insurance agents and financial professionals is the role this government program may be expected to play in providing funds for extended nursing home stays.

### *Role in Retirement Income Planning*

**Key Points**

- Usual retirement income sources do not always cover nursing home care
- Costs vary but are significant

The central concern in retirement planning is outliving available funds. Social Security, pensions and well-planned savings programs go a long way toward solving this problem; however, they don't meet a major concern connected with aging—providing for nursing home care.

While mortality has decreased over the years, morbidity has increased—in other words, we're living longer but dealing with more disease. Where once morbidity was largely the result of strokes, cancer, or other acute diseases, now that people are living longer, it's just as likely that the elderly will develop chronic ailments that require years of long-term care.

Consider the prevalence of Alzheimer's disease, severe arthritis, osteoporosis, and an entire range of cardiovascular diseases. These conditions seldom require long hospital stays, but they often render their victims increasingly helpless.

Nursing home care can be a significant health care expense facing the elderly. According to Genworth's 2020 Cost of Care Survey, the median annual cost of a private room in a nursing home was $105,850. The annual cost varies from one nursing home to another and from one region of the country to another. According to the survey, Alaska was the most expensive state with a $436,540 median annual cost, and Missouri was the least expensive at $68,985.

## Medicare vs. Medicaid

### *What Medicare Pays*

#### Key Points

- Can be distinguished by what each pays for nursing home costs
- Medicare pays only for skilled care for limited days

Consumers often confuse Medicare—the federal government's medical insurance program for people 65 and older—with Medicaid, the government's medical and assisted-living program for the poor. We'll distinguish them here only with respect to what each program provides toward nursing home costs.

**Medicare** pays only for care in skilled nursing homes (those facilities that provide 24-hour licensed nursing care), and then only if admission:

1. follows a 3-day minimum hospital stay, and
2. is in an approved Medicare facility.

Furthermore, Medicare coverage is limited to 100 days per episode of illness, which means that after 100 days, if a patient returns to a nursing home with the same illness, benefits may not be available.

### *What Medicaid Pays*

#### Key Points

- Supplements Medicare payments
- Pays for care but only within strict financial limits

**Medicaid**, on the other hand, provides a supplement to benefits provided by Medicare, including nursing home care. Although Medicaid pays for extended nursing home stays—skilled care as well as custodial care—it does so only when patients meet extremely restrictive financial and income requirements.

## Medicaid Eligibility

### *State Statutes Apply*

**Key Points**

- Rules vary from state to state
- Federal guidelines apply
- Individual states administer program

Medicaid eligibility requirements vary from state to state. Broad general guidelines are drawn by the federal government, which pays a portion of the medical assistance costs; however, individual states actually administer the program. Thus, each state determines:

- Eligibility,
- The amount, duration and scope of services, and
- Reimbursement rates.

It is important for consumers to consult with elder-care attorneys regarding the specific Medicaid rules applicable in each state.

### *Determining Who Qualifies*

**Key Points**

- States determine precise qualification requirements
- Countable assets of able-bodied spouse also considered

Medicaid is available to the impoverished, as defined by law. Federal Medicaid law sets forth the parameters for eligibility, but the actual definition is determined under state law. As long as a person has sufficient income or countable assets (as defined by each state) available to pay for nursing home expenses, Medicaid is generally not available.

Medicaid also considers the combined countable assets of the able-bodied spouse (the "community spouse") who does not need nursing home care. (An "institutionalized spouse" is the spouse domiciled in a long-term care facility.)

## Financial Requirements: Asset and Income Tests

### *Exempt Assets*

For calculation purposes, assets are divided into two categories: exempt assets and countable assets.

**Exempt assets** are the assets of a Medicaid applicant that are excluded from Medicaid financial requirements (these requirements vary from state to state). Exempt assets may include:

- Cash-value life insurance with a face value less than $1,500, and all term insurance
- Personal property, including furniture, clothing, jewelry, etc., up to reasonable limits
- Burial funds up to $1,500, reduced by the face value of cash value insurance policies that are exempt
- Property used in a trade or business
- One automobile, within certain limits
- Home that is the applicant's principal place of residence and is in the same state in which the individual is applying for coverage. However, the equity in an applicant's home is only exempt up to $636,000. Individual states may raise that limit to a maximum of $955,000. (These numbers are for 2022 and are adjusted annually for inflation.) Note: This limit does not apply if an individual's spouse or minor child (or blind or disabled child, regardless of age) lives in the house and would allow exemptions in the case of hardship.
- Property owned jointly with the applicant, provided it is the principal residence of the other owners and they would be forced to move upon the sale of the property

### *Loss of the Asset Exemption*

#### Key Points

- Exemption may be lost when Medicaid recipient dies
- States may claim reimbursement from estate
- Homes remain exempt under certain circumstances

Such assets generally lose their exempt status when a Medicaid recipient dies. At this time, states may claim reimbursement from the decedent's estate for benefits provided.

To compensate states for benefits paid to homeowners, for example, Medicaid authorities sometimes seek and are granted liens against the home which may be collected after the death of the recipient. In some instances, these liens may not be collected until after the death of other relatives living in the family home. A home may lose its exempt status if the individual has been institutionalized for at least six months. However, a home will remain exempt after that time period if:

- The community spouse or the applicant's minor, disabled or blind child continues to live in the home, or
- Evidence can be shown that the applicant may be able to return to the home.

### ***Countable Assets***

#### Unmarried People

## Key Points

- Refers to non-exempt assets
- Medicaid qualified if countable assets less than minimum set by law

Non-exempt assets are referred to as **countable assets.**

A single individual may qualify for Medicaid in most states if that person has less than $2,000 in countable assets.

#### Married Person's PRA

## Key Points

- PRA protects resources for community spouse
- All resources calculated, divided equally

Medicaid laws seek to protect the community spouse against spousal impoverishment by providing special asset eligibility rules. Federal law governs minimum and maximum amount of assets that the community spouse can retain without affecting the Medicaid benefits of the institutionalized spouse. This is called the **protected resource allowance (PRA)**.

To calculate the PRA, all resources held by either spouse or both spouses are added together, except for the exempt assets. The total is divided equally between the spouses. If the spouse's half of the couple's total assets exceeds an amount determined by each state, the excess is attributed to the institutionalized spouse.

#### Determining the PRA

## Key Points

- Laws determine community spouse share
- PRA must be transferred in 90 days of other spouse's eligibility

The community spouse can keep the greatest of:

- An amount between $27,480 and $137,400 as established by each state
- Half of the couple's countable assets, if that amount does not exceed $137,400
- A higher limit established through a Medicaid fair hearing

These dollar amounts are for 2022 and are inflation-adjusted each year.

The protected resource allowance must be transferred to the community spouse within 90 days of the initial eligibility determination.

### *Income Limits*

State and Federal Income Caps

## Key Points

- No limits apply in about 30 states; others have income caps
- In no-cap states, person is eligible by meeting countable asset test
- Federal law limits amount of cap
- States may or may not have caps set at maximum

There are also **income limits** for Medicaid applicants. These, too, vary by state. In about 30 states, there is no stated upper limit for nursing home patients. However, the remaining states have upper income limits, or “income caps,” that govern eligibility.

Let’s look at how this requirement works in one of the no-income-cap states. Let’s say that Mary Kirkwood has monthly income of $3,000, which is less than the average monthly cost of nursing home care. She may qualify for Medicaid as long as she meets the countable asset test. In this example, Mary would have to turn over all of her income, subject to certain deductions. Medicaid would then pay the balance of the nursing home bill. (We will discuss allowable deductions later.)

Federal law requires that income-cap states set their income caps no higher than 300% of the federal supplemental security income (SSI) benefit level ($841 in 2022). Therefore, in 2022, a state income cap can be no greater than $2,523. Not all of the states imposing income caps set their limits at the maximum allowable level.

### Minimum Monthly Maintenance

## Key Points

- Community spouse may be eligible for allowance
- Allowance based on formula based on housing costs

In our example, Mary’s husband Bill is the community spouse. As such, he does not have to use the income in his own name to support Mary (the institutionalized spouse). Should Bill not have enough income in his own name to live on, then he may be entitled to a monthly income allowance.

The Medicaid agency determines this allowance by calculating the community spouse’s **minimum monthly maintenance needs allowance (MMNA)** using an elaborate formula based on that spouse’s housing costs. The MMNA may be as high as $3,435 in 2022. If the spouse’s income falls below the MMNA, then the income allowance may be used to make up for the deficiency.

### Permitted Deductions

## Key Points

- Income for certain purposes may be retained
- All other income contributes to cost of care
- Some states require any annuities to name state as remainder beneficiary

As we've discussed, federal Medicaid law requires individuals living in long-term care facilities to contribute all of their income to cover resident expenses, subject to certain deductions. Allowable deductions include:

- A personal needs allowance of at least $30
- The community spouse's monthly income allowance—between $2,177.50 (effective 7/1/21 to 6/30/22) and $3,435.00 in 2022 (the minimum amount is higher in Alaska and Hawaii—$2,721.25 and $2,505.00, respectively)
- An income allowance for certain family members
- Certain medical expenses

States may require Medicaid applicants with annuities to name the state as remainder beneficiary to the extent of Medicaid's expenditures for that individual.

## Transfer of Property Rules

### *Transfers for Less Than Full Value*

**Key Points**

- Limits on transfers for less than full value
- Applies to period within 60 months before applying for Medicaid
- Elder law attorney should be consulted

To preserve assets for the nursing home patient's spouse and/or family, a number of people facing the prospect of entering a nursing home have sought to transfer assets to family members prior to filing for Medicaid benefits. This strategy has produced extremely strict benefit eligibility requirements. Individuals must document and explain on their application all transfers of assets within the 60-month period prior to application. If the state determines that the individual has made a transfer for less than full value, the state may delay eligibility for Medicaid benefits.

In most cases, it is beneficial for the individual to consult an elder-law attorney.

### *Penalty Period*

**Key Points**

- States may delay eligibility
- Penalty period is later of several occurrences

Furthermore, the delayed eligibility "penalty period" does not begin with the month in which the individual transferred the assets for less than full value, as was previously the case. Now, the penalty period does not begin until the date that:

1. The individual applies for Medicaid; and
2. Is receiving an institutional level of care in a nursing home or equivalent facility, or home or community-based services furnished pursuant to a Medicaid-waivered program; and
3. Whose application would be approved but for the imposition of a penalty period at that time.

For income and assets disposed of prior to January 1, 2006, the "look back" period of 36 months for transfer of income and assets to family members and 60 months for certain trusts will continue to apply.

Counseling anyone, for a fee, to dispose of assets in a manner that results in the imposition of an ineligibility period for Medicaid is a federal crime. One New York court, however, has struck down this law as unconstitutional with respect to attorneys.

### *Exceptions for Family Home*

## Key Points

- Specific transfers permitted with respect to family home
- Fee-based counseling to dispose of assets for Medicaid eligibility is a federal crime

Within 60 months of application, and without losing Medicaid eligibility, a person may transfer the family home to:

- Their spouse
- A child who is under the age of 21
- An adult son or daughter residing in the home and providing care that delayed the person's need for nursing home care for at least two years
- A dependent child, disabled child, or brother or sister with an ownership interest in the house who had been living in the home for at least a year immediately prior to nursing home admission; or
- Certain trusts for the benefit of a disabled child or grandchild under the age of 65

## Permissible Asset Transfers

### *Exceptions for Property other than the Family Home*

## Key Points

- Permissible transfers include transfers for fair market value and certain gifts
- Transfers to trust for a disabled child or grandchild also permitted

Here is a list of permissible transfers of other property besides the family home:

- Transfers for fair market value
- Gifts to celebrate a birthday, anniversary or other holiday
- Gifts of exempt property (though there are specific rules concerning a house, as previously noted)
- Gifts to a spouse (or to a trustee or other fiduciary for the sole benefit of the individual's spouse)
- Transfers to certain trusts for the benefit of a disabled child or grandchild under the age of 65

### *"Medicaid Planning"*

## Key Points

- Planning, if any, must be carried out far in advance
- Deficit Reduction Act of 2005 changed rules

Today, the only other permissible transfer of assets to family members that will not trigger criminal penalties or prevent applicants from a timely qualification for Medicaid benefits is a (far-sighted) transfer of assets to family members more than 60 months in advance of application for benefits. However, transferring assets in an attempt to qualify for Medicaid benefits to pay for nursing home or other long-term care—sometimes referred to as "Medicaid planning"—may be ethically objectionable to many prospects and clients, and is subject to state-specific rules.

Prior to the enactment of the Deficit Reduction Act of 2005, however, an individual who was in or who planned to go into a nursing home could plan for their spouse or family member to retain sufficient (transferred) assets to pay for 36 months of nursing home care. Then, after the requisite time following the transfer of assets, the individual would apply for benefits. However, now, the time elapsed under the penalty period does not begin until the applicant applies for Medicaid, so this strategy is not effective.

## What Is a Durable Power of Attorney?

### *Definition and Purpose*

## Key Points

- Allows one person to act on behalf of another
- Specifies decision-making powers conferred
- Grants power to make financial decisions for principal
- Springing power may also be created

A **durable power of attorney** is a document that allows one person (the principal) to authorize another person (the attorney-in-fact or agent) to act on his or her behalf with respect to specified legal obligations, even if the principal subsequently becomes incompetent. This document names the person(s) authorized to make decisions and specifies precisely what decision-making powers it confers.

A durable power of attorney can play a significant role in estate planning. Once in place, the power grants a delegation of financial decision-making powers immediately upon execution to an appointed agent for the life of the principal. An individual can also choose to create a **springing durable power of attorney** to become active at a future date, usually when the principal is deemed to be incompetent.

### *Benefits*

## Key Points

- Helps principal if incompetent or incapacitated
- Overcomes certain obstacles for the elderly, incompetent or dying

By granting these rights to a family member, an advisor or a trusted friend, the principal is assured that transactions which might otherwise have been impossible can occur even if the principal becomes incompetent or incapacitated.

Having a durable power of attorney can overcome considerable obstacles for an elderly, incompetent, or dying person. Today, people are not only concerned with the disposition of their property at death, but also with the management of their property during life.

## How a Durable Power of Attorney Works

## Key Points

- Document describes the authority or power granted
- May be a general power or a special or limited power.

The purpose of a durable power of attorney is to grant an appointed agent the legal right to act on behalf of the person who grants the power—the principal. The agent's authority is set forth in the document.

Some grantors execute a "general" power of attorney, which authorizes broad decision-making powers in virtually all legal matters. Others, with more narrow goals and objectives, execute a "special" or "limited" power of attorney that substantially limits the agent's authority.

## The Agent or Attorney-in-Fact

## Key Points

- Anyone may be an agent
- Need not be a licensed attorney
- May include an alternate agent

The principal can assign anyone to act as the agent or attorney-in-fact, such as a spouse, friend, or family member. There is no requirement that the agent be a licensed attorney.

In addition, most durable powers of attorney include an alternate agent that will step in should the acting agent become disabled or deceased.

## Creating a Durable Power of Attorney

### Key Points

- Mentally competent principal at document execution
- State statutes may have other requirements

A durable power of attorney requires the principal to be mentally competent when executing the documents. If questions arise as to the principal's competency, a physician can examine the principal and make a certification as to competency.

In addition to competency, state statutes may impose certain language requirements and witnessing requirements, which vary by state.

## State Requirements Vary

### *Typical Requirements*

Power-of-attorney requirements vary from one state to another. Generally, however, they include detailed powers which relate to:

- Real property transactions
- Bond share and commodity transactions
- Banking transactions
- Business operating transactions
- Insurance transactions
- Retirement and pension benefits
- Beneficiary transactions*
- Gift transactions*
- Fiduciary transactions
- Claims and litigation
- Family maintenance
- Benefits from military service
- Records, reports and statements
- Estate transactions
- Delegation of authority
- All other matters

** These powers must be clearly authorized in the power of attorney document to be effective.*

### *Health Care Powers*

Agents may also be given the power to make some health care decisions, including the right to:

- Employ or contract with servants, companions or health care providers
- Admit or release the principal from a hospital or health care facility
- Inspect records (including medical records)
- Make anatomical gifts
- Request an autopsy
- Refuse or consent to medical treatment

## Selecting the Agent or Attorney-in-Fact

### *Key Qualities in an Agent*

**Key Points**

- Selecting the agent is a critically important decision
- Agent must be trustworthy, competent and willing to serve

When it comes to executing a power of attorney, the most important decision anyone can make is selecting the agent (also known as the "attorney-in-fact"). The chosen individual should have the following characteristics:

**Trustworthy.** Because of the broad powers involved and the possibility of abuse, trust is the most essential factor in the selection process. As such, it's imperative that the agent be a person of impeccable character—someone the grantor trusts implicitly.

**Competent.** The agent must have the financial expertise and intelligence necessary to make appropriate decisions on a wide range of property, savings and investments.

**Willing to serve.** The chosen person must have the time and the interest required to properly execute the agent's duties.

### *Potential for Abuse*

**Key Points**

- Durable power of attorney presents potential for abuse
- Agent is free to make unilateral decisions without supervision
- Some clients prefer a more cautious approach

To meet one of the most difficult planning goals (namely, providing property management during incompetency), a durable power of attorney grants broad powers. However, these broad powers present the potential for abuse.

Generally, the appointed agent is free to make unilateral decisions without consultation or supervision from a court or any other agency. These broad powers cause some planners and their clients to adopt a more cautious approach to property management during incapacity.

## Alternatives to a Power of Attorney

There are alternatives to granting the broad powers that typically characterize a durable power of attorney:

**Representative Payee**— If managing Social Security or other government pension income is a concern, a representative payee can be authorized by the Social Security office. This representative can receive and manage federal funds for an incapacitated person.

**Bank Account Power**—Banks and other institutions may allow the owner of an account to designate a person, in writing, who will manage a specific account.

**Durable Power of Attorney for Health Care**— The health care power of attorney, also called a health care proxy, grants a delegation of decision-making powers designed to meet the challenges of health care decision-making for incapacitated patients.

**Trusts**— Overall asset management can also be accomplished by creating a trust.

**Guardianship**— Guardianship is always available to protect an incapacitated person. However, many planners find guardianship a cumbersome alternative to effective property management. Guardianship requires a court proceeding that declares the person incompetent. And once established, all guardianships are under the strict supervision of the court. Although creating a guardianship can protect against abuses, it can also be a costly and time-consuming process.

## Planning Considerations

### Key Points

- Assistance for the incompetent or incapacitated
- Eliminates need for court proceedings
- Caution advised in executing the power

A durable power of attorney can play an important role in estate planning. It can provide property management for an incompetent or incapacitated person that would otherwise be impossible without a court proceeding to establish guardianship. Executing a durable power of attorney eliminates the need for costly court proceedings and bypasses additional fees and unnecessary time delays.

The broad powers it conveys to achieve planning goals also present significant reasons for caution. For that reason, an individual should only execute a durable power of attorney after careful consideration and consultation with family members and qualified professionals.

## Advantages of a Durable Power of Attorney

- Ensures that an agent is empowered to act on the principal's behalf in the event of incompetence or incapacitation
- Provides property management, which relieves the property owner of burdensome obligations
- Enables the agent to act in the principal's interest during incapacity with respect to, among other things, making gifts, buying or selling assets, negotiating leases or filing suits
- Enables the agent to continue operating the principal's business as a going concern until the principal recovers or the business is sold
- Does not disrupt the estate's distribution upon the principal's death because a durable power of attorney is extinguished at the principal's death
- Requires less time and money than other methods, such as guardianships
- Protects the principal's privacy by not requiring participation in potentially embarrassing court proceedings

## Disadvantages of a Durable Power of Attorney

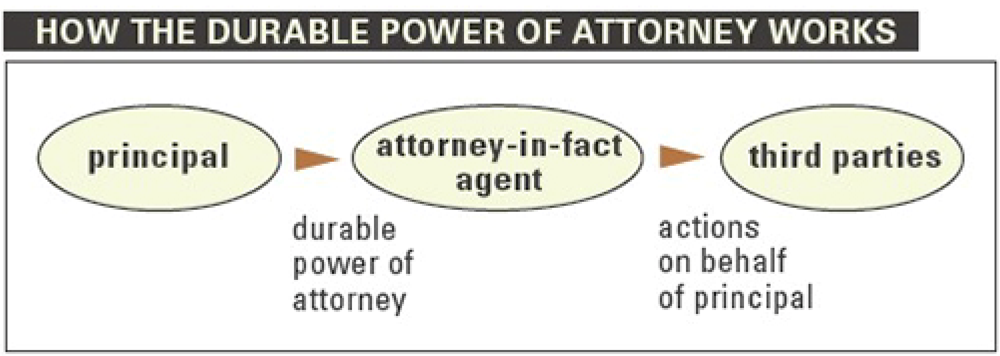
The selection of the agent is so important because the real disadvantage of a durable power of attorney lies in the possibility of the agent acting in a way that does not represent the principal's best interests. This may happen if the agent:

- Mismanages funds or abuses given powers
- Makes decisions that cause assets to shrink
- Makes decisions that do not reflect the property owner's wishes

## How the Durable Power of Attorney Works

### *Graphic*

Here is an illustration that shows how the durable power of attorney works.




The principal executes a durable power of attorney, giving the agent (or attorney-in-fact) "special" or "limited" powers, or a general power to act on the principal's behalf. The agent can act on the principal's behalf when dealing with third parties.

The power is "durable" in that it remains in effect during a subsequent disability or incompetency of the principal. The power can also be designed to go into effect only in the event the principal becomes disabled or incompetent.

## Chapter 13 Review Questions

1. An individual can use this document to specify the life-sustaining treatments that he or she would find acceptable in the final days of a terminal illness or incapacity:
   A. A living will
   B. A health care power of attorney
   C. A medical directive
   D. Instructions about organ donation
2. Which of the following statements is *not* true concerning a living will?
   A. Requirements vary from state to state.
   B. It must be executed by a competent adult.
   C. It must be witnessed by a physician.
   D. In some states, a person must be terminally ill to execute a living will.
3. Which of the following statements is true about Medicaid?
   A. It's the government's medical insurance program for those 65 and older.
   B. It's the government's medical and assisted living program for the poor.
   C. It only pays for care in approved, skilled nursing homes after a hospital stay.
   D. Coverage is limited to 100 days per episode of illness.
4. Nancy is on Medicaid and in a nursing home. John, her husband, is still at home, but does not have enough income in his own name to live on. John may be entitled to:
   A. Receive a one-time Medicaid "living allowance" payment
   B. Enroll in Medicaid himself
   C. Stay in the house without making any mortgage payments until such time as Nancy comes home or passes away
   D. Receive a minimum monthly maintenance needs allowance
5. When applying for Medicaid, the look back period for transfers of income and assets to family members is _________ months; for certain trusts, it is _______ months.
   A. 9, 12
   B. 12, 24
   C. 24, 36
   D. 36, 60
6. A durable power of attorney can be created to become active only when the principal is deemed to be incompetent.
   A. True
   B. False

## Answers to Chapter 13 Review Questions

1. A. A living will allows you to specify the life-sustaining treatments you would find acceptable. All states except Massachusetts and Michigan have living-will laws.
2. C. A living will must be witnessed (and signed) by two or more competent adults who do not stand to benefit from the estate.
3. B. Medicaid is the government's medical and assisted living program for the poor. The rest of the statements all apply to Medicare.
4. D. A community spouse may receive a minimum monthly maintenance needs allowance (MMNA).
5. D. The look back period is 36 months for income and asset transfers, 60 months for certain trusts.
6. A. This is called a springing durable power of attorney.

# End Notes

[1] IRC Section 2503(b)