Estate Planning Vol. I
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Estate Planning Volume I

Estate Planning. The term conjures up images of finality; perhaps the mournful duty of seeing a loved one off to the hereafter. Tears, sobs and, and....what's this? Cousin Bob and In-Law Jane are battling it out over a property deed. Dave and Aunt Fran are in a tug of war over possession of artwork.

Although hardly evocative of Renaissance period paintings of pastoral passing from earthly bondage, these scenes of chaos and confusion happen time and again when somebody dies. It only happens once in every life, but if a person has any assets at all they need to plan for an orderly transfer of title to property. Some people are of the mistaken belief that estate planning is only for the rich, the landed gentry, software, steel, or entertainment moguls. True, each plutocrat's passing makes for a good story on tabloid TV. The average person needs to have an estate plan as well. With fewer assets, there is less room for error in determining distribution. An error in phrasing or a word left unsaid by a wealthy decedent could mean a $500,000 mistake that costs time and resources to correct. A similar error could wipe out the entire legacy of the average person if a dispute broke out among heirs concerning who gets what.

Estate planning is a dynamic process. What seems like an equitable disposition of assets one day may look different the next. Except for the tax aspect, it is also subjective in nature. Fair to one heir may seem unfair to another heir or assign. Facing the issues and feelings about loved ones is a big part of what estate planning entails.

This volume is an introduction to the process of estate planning. It also covers the tax aspects of the topic. A big task in estate planning is the reduction or avoidance of taxes. Their effect on estate planning is important and ever changing. Changes in the tax code mandated by Congress alter the strategy and choice of tools in the estate planning process. Because these laws continually change, a professional in this field should understand tax terminology and such basics as how the Tax Code treats different kinds of estate plans. Exposure to tax treatment of the estate makes it easier to understand how tax changes affect the estate planning process.

Keep in mind that only high-value estates are subject to estate tax. Only estates valued at over $675,000 are taxed. Wait a minute, it is now $1,000,000- no, the tax is eliminated- no, budget shortfalls brought on by the Terror War, the Housing Crunch, the Fiscal Cliff, the Next Big Thing caused it to be reinstated. No matter where the Congress next puts the threshold, most estates fall short of this value. $674,999 is nothing to turn your nose up at and most people would probably consider 1% of that amount to be a big windfall. Instead of tax considerations, much of estate planning involves suiting the people involved. Avoiding controversy and making clear the wishes of the testator are of paramount importance.

Chapter 1 Profile of the Estate Planning Process

In order to design an estate plan, one must first be able to estimate its value. The layman thinks of an estate as the total of property owned less what is owed on it. Accounting definitions of wealth are the same, assets less liabilities equal net worth. For the average person, this can be a simple estimate. It should be remembered that there are different valuations for estate planning purposes;

- Taxable estate is the property that is exposed to federal estate taxes and state death taxes. This will normally consist of the estate's net worth. Some property in the estate is excluded from tax. This includes assets left to a surviving spouse or a charity.
- Probate estate is property that is left by will. Usually property left by will goes through probate. It is the act of proving that an instrument purporting to be a will was signed and otherwise executed in accordance with legal requirements. Going through probate takes time and money. With proper planning, the amount of property going through probate can be reduced or eliminated entirely.

Estate Planning Steps
There are several steps involved in the estate planning process;

- Examination and verification of asset values
- Devising a plan for asset disposition
- Picking the correct estate planning tools to use

One should try to observe the following maxims when formulating an estate plan;

- Keep the client involved in the estate planning process
- Differentiate between legal and taxable estate
- Contiguous planning for the taxable and legal estates
- A building block approach should be used
- Equate people and the estate plan- people are the important part

If the rules are kept in mind while the estate planning process unfolds, it will result in a comprehensive plan giving peace of mind to the eventual testator. A general objective of the estate planning process is to lessen shrinkage of the estate as a result of taxes or administrative costs. Most people want to maximize the portion of the estate going to heirs and minimize that part going to third parties. The vast majority of estates fall under the exemption threshold. Reduction of administrative, probate, and legal expenses are still vital and viable goals of estate planning.

Examination and verification of asset values: Fact finding expeditions are the first order of business when venturing on an estate plan. An interview with the client is the estate planner's way of obtaining the information necessary. The estate planner is examining three interrelated subjects- identification of assets, potential beneficiaries, and the client's perceived goals. The information gathering will focus on the needs of the beneficiaries and the value of estate property. The client should have an idea of goals. Since relationships and estate values can change over time, the estate planning process is dynamic. Plans change and should be reviewed periodically.

Example- Mr. Jones has two children and a loving wife. He expects to retire with a good pension and has an ongoing, effective investment program. Ten years later, Jones is about to retire. His investment efforts proved fruitful beyond his wildest expectations. On the other hand, it has come to light that he has a child he did not know about from a peccadillo many years ago. Will he make allowance for the illegitimate offspring or will the child be disinherited? Perhaps not as extreme, many changes occur that affect a person's decisions concerning the beneficiaries to an estate. Planning for the estate is an ongoing thing requiring periodic re-evaluation of objectives.

Estate assets will also change over time. The owner may accumulate or lose property as time passes. For this reason the liabilities of the estate must be reviewed. Property may be accumulated, but the debts owed on it could exceed total value. Will death trigger payment of loans through insurance arrangements? How will the debt encumbrances affect the transfer of title?

Co-ownership of property must be taken into consideration. The ownership of property with a spouse will affect the estate. Property that has been gifted to others may have to be brought back into the estate for estate tax purposes. Changing beneficiary needs, analysis of estate assets, and continued monitoring of the overall estate assets and condition is the first step in the estate planning process.

Formulating a Plan for Asset Disposition: After the initial examination of the estate, the estate planner should be able to draw preliminary conclusions as to the best method of disposing of the estate. Remember, we say "best method" within the context of our definition of estate planning: 'a process for the conservation and distribution of a person's property and wealth.' With this in mind, the tool or more likely, combination of tools, to be used in disbursement of the assets will be geared towards lowering overall costs associated with the estate.

Without a plan, the value of an estate can be substantially reduced after an individual dies. Numerous examples exist of substantial estate shrinkage due to lack of an estate plan or an improper or ill-advised plan. Estates shrink because of the costs associated with the death itself, such as funeral expenses and uninsured medical expenses. Installment debt, mortgage debt, and business claims must also be paid. Estates shrink because of legal costs of settling the estate. This includes attorney fees, court costs, and executor fees. The fees go up as an estate becomes more complex. This is especially so if no estate planning at all has been undertaken and attorneys must defend the estate in the event of a contested claim.

Forced liquidation of property can also reduce the value of the estate. If there is a lack of liquidity to pay administrative costs or taxes, property will have to be liquidated, perhaps at 'fire sale' prices in order to come up with the cash required. A plan should be created that deploys the property in the plan so as to meet the owner's objective, benefits the contemplated heirs, and reduces estate shrinkage to a minimum. Analysis turns now into creation. One of the goals of estate planning is to provide for the needs of the beneficiaries in the best way possible. For this reason the individual needs of the named beneficiaries must be considered. Their needs will change over time. Some will go from childhood to adulthood; others may develop physical or mental problems that require special attention. Creation of a plan might result in fundamental changes to the makeup of estate assets. Some property may be sold, life insurance may be purchased, and business ownership changes may be effected to aid in transfer of that part of the estate.

Picking the Correct Estate Planning Tools to Use

After the estate plan has been visualized, the estate planning professional should think about the estate planning tools available that will help the client in meeting the planning objectives. The tools are examined thoroughly in other chapters. We introduce them here.

The Will- This is a person's declaration of how they desire their property to be disposed of after death. A will may also contain other declarations of the testator's desires as to what is to be done after he or she dies so long as it disposes of some property. This is a key tool in estate planning. It is a legal instrument by which property is disposed of according to the decedent's wishes. A properly drawn will simplifies the distribution of estate property, minimizes legal and financial obstacles in distributing property to the heirs, speeds up the estate settlement process, and reduces family disputes among heirs with respect to the distribution of valuable property. It can also reduce federal estate taxes and assure the equitable distribution of property to family members.

Large numbers of people die without a will. This is known as dying intestate. Property is then distributed according to the intestate provisions of state law where the individual lived. Dying intestate often results in property being distributed to persons whom; the deceased would not have wanted to receive the property. In common-law states, for example, if an individual with children dies without a will, the surviving spouse receives only one-third of the estate property. The other two-thirds go to the children. It may have been the intention that all the property go to the surviving spouse. If there are no children, then part of the estate passes to the deceased's parents in many states. In this case, the surviving spouse may be deprived of needed financial assets for self-support.

Wills may be in written form. In some states verbal wills are acceptable in unusual situations. They can be changed, added to, or invalidated. Each state has statutes that regulate how a will is formulated, what can and cannot be done by will, the required age of the testator and other requirements for a valid will.

Marital Deduction- This toll can substantially reduce estate taxes. It applies when property is left to a surviving spouse. The marital deduction is a deduction of the value of the property that is included in the gross estate but is passed on to the surviving spouse, a non-taxable event.

If the estate is large, estate planning experts do not generally recommend leaving the entire estate outright to the surviving spouse by use of an unlimited marital deduction. All property would pass free of federal estate taxes to the surviving spouse, but it would be subject to the federal estate tax when the surviving spouse dies. The federal estate tax payable at that time on the second estate generally is higher than that paid on the first because the second estate does not qualify for the marital deduction. The marital deduction would apply again if the surviving spouse remarries. This can result in higher federal estate taxes and shrinkage in the estate property that can be passed on to the heirs.

Gifts- This planning tool entails the voluntary transfer of property made without adequate consideration, that is, for which no proper value is received in return, and which is accepted by the recipient. In federal tax law, the gift is excluded from the gross income of the recipient, but the transferor may be subject to the unified estate and gift tax. A gift could be in the form of an interest-free loan, asset transfer without consideration, or the forgiveness of debt.

Unconditional gifts can be made during the lifetime of the donor or gifts may be held in trust for the donee. They can be made by will or the transfer may be made via someone else's power of appointment. Unique tax advantages are a feature of the gifting process. They also have the potential to accrue income for the donee. Under current tax law, an individual can give a maximum of $15,000 annually (for 2018) to as many people as desired without incurring a federal gift tax on the transfer. If the spouse joins in the gift, a total of $30,000 can be given annually to each person.

A gift tax may have to be paid if the value of the gift exceeds $15,000 annually ($30,000 jointly). If a federal gift tax is payable, part or all of the unified tax credit can be used to defray the tax. However, any portion of the unified tax credit that is used to defray gift taxes is no longer available for reducing federal estate taxes.

Trusts- Another estate planning tool, often mentioned and frequently used. A trust is an arrangement where one entity holds assets (the *res* or *corpus*) for the benefit of certain other persons or entities. The person holding legal title or interest, who is responsible for protecting and distributing the assets, is the trustee. The cestui queue trust, or beneficiary, is the one for whom the trust is created. This person holds equitable title or interest, to the trust property.

A trust can provide security to the beneficiaries and assure the competent management of estate property after the death of the grantor. Certain kinds of trusts can also help reduce estate taxes and administrative costs in settling an estate. There are two broad categories of trusts; 1.) The living or *inter vivos* trust 2.) Testamentary trust. In a living trust, property is placed in the trust while the individual is still alive. If the creator of the trust has the right to revoke the trust and receive the property back, this is known as a **revocable living trust**. A revocable living trust can be used to reduce probate costs and provide privacy if the trust is still in existence at the grantor's death. Recently, revocable living trusts have become increasingly popular as an estate planning tool.

If the creator of the trust gives up the right to receive the property back, this is known as an **irrevocable trust**. An irrevocable trust can reduce estate taxes, since property is taken out of the estate. Probate costs are also reduced. However, there are gift tax implications when property is placed in an irrevocable trust. A gift tax may have to be paid if it exceeds the amount of the unified tax credit.

A second broad category of trust is a testamentary trust. It is provided for in the will and does not come into existence until the creator dies. The testamentary trust can be used to protect minors, handicapped family members, or spendthrift heirs. This type of trust adds flexibility to the estate plan. The trustee can be granted discretionary powers to deal with the beneficiary's problems and needs as they arise.

Life Insurance- This is the one tool that everyone should have. It is used to provide income and meet the client's financial objectives. The proceeds of a life insurance policy can be used to pay federal estate taxes as well as administrative and final expenses. This way, the liquidation of property at unfavorable prices can be avoided. The second-to-die policy is often used in estate planning to provide funds to pay the federal estate tax. Such a policy insures the lives of two people, a married couple. The death proceeds are paid only upon the death of the second spouse, which provides the estate with liquidity.

There are several advantages to life insurance as an estate planning tool. First, it provides estate liquidity. Cash is made available immediately. Second, life insurance proceeds paid to a named beneficiary are not subject to probate costs. The proceeds are paid immediately to the heirs without first having to go into a probate court. Third, life insurance can provide for the equitable treatment of heirs. This way, if one sibling is left a business or valuable property, the others can be given a cash settlement out of life insurance proceeds. That way, all heirs are able to receive benefit from the estate.

Investment Products- These can also be used in the estate planning process. Mutual funds, stocks, and bonds do not have the same guarantees as life insurance. For long term appreciation, time and again equities have been demonstrated as the place to be. A person with a long-term time horizon would be well advised to include equities in their portfolio. This is much smarter than sitting on cash, which loses its purchasing power over time. A portfolio of bonds could also be included in the strategy if a shorter time horizon is contemplated.

Guidelines for the Estate Planning

It is important to keep in mind these maxims when dealing with people, their assets, and the estate.

Process

Keep the client involved in the estate planning process- The punch line for a large investment firm's television ad goes something like this, "How did your broker know 10 years ago that you would be needing help with the kid's college tuition (or money for aging parents, a good retirement income, etc.)?"

"That's simple. She asked questions."

The broker asked the question... and kept on asking, and asking, and asking. Involvement of the client is important in creating an acceptable estate plan. Remember that after the fact the client will not be afforded any input. Their time for involvement is now. The client should be introduced to the process of estate planning at a slow pace, perhaps with pertinent articles from periodicals. Inundating a potential client with technical jargon is a waste of both parties' time. A book on the subject can be the next step. There are many one-dimensional tomes, addressing subjects like trusts or estate taxes. Such books should be avoided by the novice. As time goes on, the client will have changes in their life situation that will affect estate planning. The client will be able to communicate such changes quickly and succinctly when they are versed in estate terminology. Too many times an estate planner has a fact finding interview with a client and the client leaves thinking, "Well, my part's done; Time for someone to wave the magic wand." This mindset leaves the planner with incomplete or inconclusive data. The client is going to end up with an estate plan that is unsuitable. Both sides will have to start from scratch again, a time consuming process. Worse still, the customer will decide to take their business elsewhere.

Differentiate between legal and taxable estate- This is like the difference between financial accounting and income tax accounting. Both are related and contain the word 'accounting', but there are big differences. An individual's legal estate concerns ownership of property and how the title is held. The taxable estate involves taxation by state and federal authorities on the value of the estate. Transfers while living may be brought back into the estate for taxation. Post mortem transfers may be subject to taxes as well. The Internal Revenue Code adopted and periodically amended by Congress is the enabling legislation that dictates what and how much will be taxable. Most people do not have to worry about taxes on their estate at death. It will fall far short of the threshold for taxation. Everyone should be aware of the taxes, however. A lower threshold is an easy political target for a revenue hungry, balance the budget-minded Congress. Inflation has been benign for the last two decades, but if the inflation monster rears its ugly head, many more people will be pushed over the estate tax threshold. With appreciation and inflation, what seemed a relatively small estate today could easily double in dollar terms over a 20 year period? A tax strategy should always be kept in mind as a contingency.

Another factor to be considered is the step-up in basis of the estate's assets. When an asset is purchased for $1,000 and then later sold for $5,000, income tax is due on the profit from the sale, that is, $4,000. When a person holds the asset until they die, the tax code is written so that the beneficiary who receives the asset has a new basis. Here we assume that to be the market value of $5,000. Thus, if the beneficiary sells the asset for $5,000, there is no gain on the sale, because $5,000 - $5,000 = $0, the gain on the sale. This will be examined further in the chapter on estate taxation.

Contiguous planning for the taxable and legal estates- This rule is a logical extension of the thoughts above. It is essential that the property and tax strategy be formulated together. A working knowledge of state and federal law as it applies to the estate planning process is needed by the person doing the planning.

A building block approach should be used- 'You got to crawl before you can walk', the old saying goes. This is true any time a person is going up the learning curve.

- A familiarization with the terminology should come first
- The fact finding interview will identify areas of concern for the client
- Clients should talk to a variety of experts on the subject of estate planning. Questions should be encouraged to clear up uncertainties.
- A planning strategy should then be adopted. This will also serve as an on-the-job training for the client

Equate people and the estate plan, people are the important part. No matter how much or how little of material value a person passes down to the next generation, other intangibles are passed down that are invaluable. The most valuable things to give to offspring are love, a set of moral values, education, and a work ethic. A good example is set by simply planning ahead for the inevitability of death. Open and honest discussion between the estate owner and heirs, good communication, is a way to avoid mistrust. Writing down the plans of the estate owner assures that they will be carried out after death. One day tomorrow will not come. It is important that the client's changes in assets and changes in beneficiaries be reviewed from time to time.

Human Characteristics and the Estate Process

The chief concern of the estate planning process is not outwitting the government. The reduction or elimination of taxes on the estate is a big issue, to be sure. Still, most people will have no tax due on their estate. The dominant concern is to create a method of distributing the estate property that suits the people involved. Their particular circumstances goals and aspirations must be taken into account. The owner of the estate must be given the peace of mind that the plan of inheritance is right in their eyes. The potential estate beneficiaries are going to want fair treatment.

Individual involved in the estate planning process have to be read at different levels. When preparing an estate plan, people have to deal with their own demise. Coming to grips with this is a difficult concept for many of us mortals. Along with this issue is the need to parcel out affection, in dollars and cents, to loved ones; be it children, parents, grandchildren, or friends.

Often times the feelings of generosity will extend further. It is no secret that religious institutions, health care and research facilities, as well as *alma maters* actively solicit inclusion in the testaments of their spiritual sons and daughters.

On the other hand, one can find no shortage of people that are beset with feelings of parsimony when it comes to will making. Certain people feel they climbed the mountain alone. There is a reason why folks do not try to take it with them. They know that the streets of Heaven are paved with gold and they fear the money burning to cinders if they go the opposite direction. Heirs are included only by statutory necessity.

Another problem encountered in the estate planning process is the attitude of those who count on being heirs. Every shade of greed and avarice can be encountered. People will go to any length to put through their agenda. Feelings of jealousy abound as rivals jockey for their perceived place in the heir ship hierarchy.

It is just human nature that causes people to quickly forget any forays into the estate planning process. Perhaps it is denial or a deeply rooted fear of the unknown that causes the most well intentioned to simply lay aside any plans they have. This leaves survivors with a maze of procedures to navigate. Simplification, clarification, and maintenance are essential in the preparation of a good estate plan. As with life insurance, proper estate planning is an essential part of responsible financial planning, the benefits of which will unfortunately not be enjoyed by the originator. He or she will be thanked by those left to continue running life's race.

Documentation

Documentation is especially important when it comes to matters of the estate. Like matters of the heart, base human emotion will often be exposed when an inheritance is at stake. Sibling rivalries and a whole range of complexes will surface. It is the wise parent or grandparent that understands the choices that must be made for the best interest of the family. It is important that the testator's wishes be recorded in detail. This will help keep those who feel slighted in the inheritance process from spending enormous sums on lawyers to get what they feel is rightfully theirs.

Junior may feel slighted that Grandpa only saw fit to support him through undergraduate and two levels of graduate school while leaving him nothing but good wishes. A trust fund is left to Cousin Jane who never went to college but is raising kids and doing clerical work for her husband's small business. The perception of equity is Grandpa's right, not Junior's. A well-documented estate plan will help junior get past his Illusion of Central Position fixation and discourage his challenging Cousin Jane's right to her inheritance. For some people charity always begins at home, no matter how well off they may appear. Documentation plays an important part in estate planning. Discussions with lawyers, accountants and other family advisers should be recorded by the estate planner and the family member to demonstrate that all points of view are considered in the estate planning process.

Shop Before You Buy

Potential clients for estate planning have questions to ask before starting the process. They will often have a difficult time discerning good from bad advice and planners. As with many service related products, marketing is used as a substitute for qualifications. Inefficient and unqualified planners often have very effective promotions and it can be difficult to separate product sales pitches from sound advice. Potential clients need some way to winnow out the wheat from the chaff, to evaluate planners. Do not be afraid to tell people to shop around and evaluate services of other professionals. If someone else ends up getting the business, the customer will still remember you as helpful, straightforward, and honest. This can result in referrals from the client as well as from the professional who ended up with the account.

Client Questions

Here are some topics and questions that should be on the minds of all clients. In reality, the questions are generic in nature; they can be applied to an insurance agent, accountant, attorney, trust officer, or financial planner. Cheap is good, but not always the best. Few people have the time or resources to go through the process more than once. Most of all the qualities of honesty, reliability, knowledge and ethical behavior should be confirmed.

- **Interaction:** Does the planner listen well? Clients should make sure that they feel comfortable with the planner. Enough time should be set aside so the client can cover all their concerns and needs. This is someone to whom the client will be disclosing confidential personal and financial details. Listening skills along with a problem solving mind set are essential for a planner.
- **Preparedness:** Is the planner prepared for you the client. Not some canned speechify that gets delivered eight times a day. The planner should be ready and knowledgeable concerning the facts surrounding the individual planner with backup information to shed light upon complex subjects.
- **Training and Experience:** A competent estate planner should have an educational and training background commensurate with the task at hand. What sort of qualifications does the planner have in this area?
- **Succinct and clear explanations:** What are alternative estate planning techniques? A planner should be able to explain quickly and concisely the various paths that can be taken to achieve estate planning goals. Pros and cons of probate, insurance strategies, trusts and taxes should be explained in layman's terms. A planner can give broad brush stroke coverage to subjects that concern clients.
- **Charges and Fees:** "How much?" This is a question that client's should ask early on in a discussion with the planner. A fee schedule must be agreed to or both sides are just wasting their time. Estimates of total charges, hourly versus fee-based planning, commissions for recommending outside products are important issues.
- **Ongoing Relationship:** It is important that the client determines exactly who will be doing the work and for what length of time. Is a team of professionals going to be employed? Will this planner continue to be available? If the client dies, will someone be available to assist the executor of the estate?
- **Participation:** How will the client be expected to participate in the process? The client's input is important. It is not enough to just send invoices for services rendered, the client should be sent reports on proposed products to be used and their alternatives. Decisions to be made by the client should be handled professionally with plenty of information, alternatives and time available to formulate a well thought-out decision.

Common Mistakes in the Estate Planning Process

Here are some common attitudes held in the collective conscious of the public concerning estate planning. With each notion is presented a concept to counteract these mistakes. Any potential client should discuss estate planning ideas with a lawyer, accountant or financial adviser. It has been stated before and will be written again, the time to plan an estate is now, after the fact there is no looking back;

1. "I'm not dying and I don't need a Will"

- An estimated two of three American adults do not have a will or living trust. In effect, these people rely upon their state law and a judge's decision. A court will determine:
- Who will inherit their assets, in what proportions, and in what form- that is, outright or in a court-supervised guardianship of a minor.
- Who will serve as administrator of the estate and whether a bond premium must be paid.
- Who will serve as guardian of the person and of the estate of minor children?

Instead of dying without a will, known as intestate, a person should have a will or a living trust that expresses the person's own decisions on these important topics.

2. "Just Keep It Simple"
Sometimes clients tell their lawyer to keep it simple. "I want my will to leave all to my spouse, and I want my spouse's will to leave all to me," they say. Because of the marital deduction, this simple approach will avoid estate taxes in the estate of the first spouse to die; it also may allow probate avoidance or an expedited court proceeding in some states.

This simple will may cause major estate tax problems when the surviving spouse-call her Jane-dies because all of the couple's assets will count in her estate for estate tax purposes. This result could have been avoided if her husband had part of his estate (not exceeding his remaining exemption equivalent amount) held in trust irrevocably for Jane's benefit, thus keeping this amount out of her taxable estate. This kind of trust is often known as a bypass trust because the assets in the trust bypass inclusion in the surviving spouse's estate.

If the amount equal to the current estate tax threshold is kept out of Jane's estate, which can be accomplished even if she is the sole beneficiary of the bypass trust, then upon her death, the estate tax savings to the couple's children can equal hundreds of thousands of dollars. Most people think a hundred thousand dollars is a high price to pay for simplicity.

3. "I put everything in joint tenancy to avoid probate"
Putting everything in joint tenancy, which does avoid probate, can cause the same problems resulting from the simple will: overloading the surviving spouse's estate by failure to use a bypass trust, thus resulting in unnecessary estate taxes after the death of the survivor.

4. "My children will work things out"
Sometimes a parent wants to leave a bequest to one child who is expected to divide assets evenly among the other children. That child, however, will not be obligated legally to share them with the others. Even if the heir does so, he or she will be making gifts to the other children and may have to file gift tax returns and pay gift taxes. This factor alone may inhibit heirs from making gifts to siblings.

5. "My children should take care of their children"
Most people believe that individuals should be responsible for their own children. But tax law often causes a person to modify such beliefs. For example, if Grandfather leaves assets to his children, Henrietta and Claude, the assets will count in Henrietta's and Claude's estates; this can result in estate taxes when they die unless the assets are handed down in a manner that qualifies for the marital deduction or the charitable deduction.

On the other hand, under exemptions in the generation-skipping tax law, say that Grandfather leaves up to $1 million of assets in trust for Henrietta and Claude for life with the remainder to pass to his grandchildren after Henrietta and Claude die. Then the original amount left in trust for Henrietta and Claude, plus any appreciation on that amount during their lifetime, will not count in their estates.

6. "I'll do it later"
People can reduce their taxable estates by making annual exclusion gifts-gifts of not more than $14,000 each per calendar year per donee. However, many people with significant wealth delay making such gifts and thus miss an opportunity to minimize future estate taxes. People also delay purchasing life insurance. Years later they find that they have an insurability problem. Finally, people often assume when they are older they will have a revocable living trust established for both probate avoidance and estate tax planning purposes. Unfortunately, many never get around to it, and their estates go through probate.

7. "It can't happen to me"
Most people do nothing to minimize the problems that can arise if they become incapacitated. To minimize problems, a person, while mentally sound, should give a spouse, and adult child, or a trusted relative or friend separate durable powers of attorney for both health care and the management of financial matters. When phrased properly, these powers of attorney can stay in effect even if the principal-the person giving the power of attorney-becomes incapacitated later.

Understand the Basics
As we have seen so far in this chapter, there are a number of ways to effectively transfer assets at death in an economical manner. There are also pitfalls along the road for those who choose to procrastinate. The idiosyncrasies of our legal system allow generous savings of time and money when property is transferred through one means rather than another. The fundamentals of estate planning are easy to grasp even when a large estate is involved; follow the steps, employ the correct tools, consult with experts as needed and document, document, document. It is always good advice to consult with a lawyer or tax professional when estate planning instruments are composed. An understanding of the basics, along with an estate strategy will make things go smoother for clients. You need to care about something to feel the need to set up a plan for its future. Some people do not care about the estate after their death, but they are very concerned about it while living in the event that they become disabled. Others want to make sure minor children by a current or former marriage are cared for properly. Sometimes it is a determination that a certain person does not get their hands on any of the money. It could be a combination of things, but whatever it is planning is required.

Of course, the big concern for most people is who to leave the money to after they are gone. Most people have a good notion of where the money is going. Estate planning is an exercise in determining the best way to get it to them. That best way will often include the subject of death taxes and how to avoid them. Death taxes, state and federal, are imposed on the property of a person who dies. Such taxes are known by different names. Federal taxes are <u>estate taxes</u>. State taxes are often referred to as <u>inheritance taxes</u>. The states are taxing the recipients of the estate, but in reality the tax is paid out of the estate itself. It is easy to confuse probate avoidance tools, such as living trusts and joint tenancy, with tools intended to reduce death taxes. Avoiding probate has no bearing on the levying of death taxes. Some states impose no death taxes. Others are stiff, especially on assets left to non-family members. The text addresses the rudiments of taxation in another chapter. Whether or not estate taxes are due depends on two things. That is the value of the taxable estate and the laws of the state where an individual lived. 'Lived' here is a term with several meanings. It could better be said as where the individual last lived for purposes of establishing residence.

Who Will Oversee Disposition?
A big question for most people, they need someone to assure there last wishes are honored. Someone must be responsible for supervising the estate. This is the executor, if named in a will, or the successor trustee if named in a living trust. The same person can occupy both positions. Many people have someone in mind for the job; a child or their spouse. When a client cannot come up with a definite choice, a list should be composed. Experience or technical proficiency is not as important as honesty and integrity. Competence and expertise were purchased with the estate planning. The ability to carry out the wishes of the deceased in a fair and impartial manner must come from the heart. Oftentimes planners recommend that some type of 'corporate fiduciary' like a bank, or trust company be employed to handle the affairs of the estate. This idea too, has merit. The big drawback is that such an arrangement can result in the estate being 'nickeled and dimed' out of a large sum of money. A hefty fee is charged for even the smallest act. A trusted friend is often the best person for the job if no family member can get through the emotion and get on with the task.

If a client has minor children, planning ahead is imperative in the event of death. We live in an age of single parent families. If the custodial parent dies and the other parent is unwilling, unable or cannot be found to care for the children, other arrangements must be made. The state will intervene if the children are not of legal age, 18 in most states. When a client for estate planning has a minor child, it is important that they name a guardian for the children. If the parent dies, the court is not bound to confirm the appointment of the named guardian. However, they will normally do so if the other parent is unavailable.

How much property to leave to minor children is another concern. This is not a problem for the average person in such a situation. There are two acceptable methods in use.

- Establish a trust for the child
- Uniform Transfers to Minors Act (UTMA) is available in most states. It allows the naming of a trustee to manage the property of the child, parceling it out over time as needed. At a pre-determined age, the remainder of the trust is distributed to the child. The age of the child does not have to be 18, as many think this is still too young to effectively manage money.

The provision of cash for immediate family needs is another of the basics of estate planning. If a substantial savings account is not available, some other means will be necessary to provide living expenses. The most important alternative source is life insurance. Life insurance proceeds can provide the ready cash for the day to day expenses of living as well as providing for the cost of dying. These costs include final hospitalization expenses and burial costs. When the bulk of an estate is transferred by will, it is out of the family's reach while probate proceeds. Funds for family necessities can be obtained by petitioning the court, but this is counter-productive in that disproportionately large transaction costs in the form of attorney fees will be incurred.

When a substantial part of the estate is conveyed outside probate, those assets are readily available. The problem is that if the assets in a living trust or joint tenancy are illiquid, conversion to cash will have to take place for use in daily living expenses. This could result in assets being sold off at less than favorable terms. The life insurance policy payable to a survivor or survivors is the most effective method of providing ready cash.

Another part of the estate plan is arranging funeral plans. If some type of basic plan is in place, it takes a big load off the loved ones. The grief stricken survivors are not in any shape to deal with funeral arrangements. Another advantage is that more rational decisions concerning costs can be arrived at by the client in a before the fact approach to the issue.

The Client and Professional Help

Who needs help with estate planning? Everyone does. As stated earlier, almost two of three Americans die without a will. This leads to the expenditure of time and resources on straightening out estate distribution beyond the expenses associated with probate. Does everyone need <u>professional</u> help? 'Yes and no' is the only answer that seems to fit.

No; in that most people die with few assets left. This is especially true with the high cost of medical care these days. Anecdotal evidence abounds of people being driven to the poor house by the expense of a terminal illness. "We're spending our children's inheritance" is a bumper sticker spotted from time to time on the back of a motor home. This statement summarizes the mind-set of some people towards sharing the bounty of their lives.

Yes, people do need to be advised concerning what will happen to their assets when they die. Most people die with estate property worth less than the estate tax threshold. The reality is that these are the people who need help the most. Now, such people do not need elaborate plans produced by a pack of top lawyers, but they do need advice to buy insurance, put the house in a trust, write a will <u>now</u>, and many other things. People who have family members that are mentally or physically disabled are among those who have special needs no matter what their income group. For most people estate planning should be no more difficult than filling out tax forms. This is not to say that seeking competent legal advice should be discouraged. Many clients will feel more comfortable with the advice of a lawyer. People who explore their estate plan thoroughly and then consult an attorney will be in a position to evaluate the attorney's advice.

Reduction or Elimination of Estate Fees

The expenses associated with administration of an estate vary from 1% to over 8% of the gross estate. It is dependent on the arrangement of the estate plan, size and complexity of the estate, residence at time of death, and the fees and commissions associated with various agreements. Administration expenses originate in the services provided by executors and attorneys. Such compensation can vary greatly from state to state, even from attorney to attorney. To shop around is good advice. Often times the fees are fixed by state statute, others by market forces. Clients in the estate planning process should be encouraged to ask questions concerning fees. This helps to avert surprises and the ill will that can accompany same.

It is standard practice for sales personnel and literature aimed at the estate planning market to publicized high-fee cases. This is done for the shock value. Still, it is a good idea for anyone involved in the estate planning process to be mindful of such occurrences. Court order can reduce outrageous fees, but this takes time and resources in itself, and the court could find the fees in question acceptable.

For routine estate administration, attorneys should be remunerated on an hourly charge basis. A fixed fee not to exceed a dollar amount or perhaps a percentage of the estate may also be considered reasonable. The objective is to pay only for work done. Hourly rates can lead to inefficiency while a percentage could be too high for the actual work that needs to be done. Monitoring, feedback, and correction are important.

Persons serving in the capacity of executor or trustee are also entitled to compensation. The amount varies depending on services performed. Family members often serve without a fee. If this alternative is not available, professional fiduciaries often provide a fee schedule or simply charge the going (market) rate. Any rate is subject to negotiation and the fee structure should be agreed upon <u>in writing</u> for the protection of all parties concerned. Attorney, accounting, and appraisal costs seem to always arise in the estate disbursement process. These costs can be controlled or eliminated with sound planning and good communication.

Chapter 2 Life Insurance Role in the Estate Planning Process

Life insurance is one of the most important components of the estate planning process. There cannot be produced a single example of an estate where life insurance is not an integral part. This is so because life insurance is relatively inexpensive, provides an instant estate, is flexible and is a familiar, easily understandable concept for even the most inexperienced client in estate planning. The reality is that, like estate planning, life insurance is one of the consumer's least favorite topics of discussion.

Insurance contracts, like many others, tend to have long, legalese-ridden clauses that make it difficult for people to digest. The language is a result of court decisions in which attorneys for the insured and insurers were at variance over what was or was not covered under a specific policy. These disputes, in effect, required the insurer to be very specific in outlining what constitutes coverage. The minutia has gotten so bad that many state legislatures (also chock full of lawyers) now require disclosure sheets on the front of many types of policies stating in plain English what the policy covers.

The most obvious reasons to buy life insurance are to provide liquidity to pay debts, funeral expenses, taxes, or to provide support for beneficiaries. This is especially true if your assets are illiquid in that they cannot be turned into cash readily. This situation is often found with owners of real estate, small businesses, or partnership interests. At death, these assets need to be managed, maintained, and have the mortgages paid. This causes a quick drain of cash. Whether an estate is worth thousands or millions, the use of life insurance is the same: To pay off bills and give the family breathing room after the insured's death. This is especially so when the insured is the family's bread winner and the death terminates the income flow.

Integral Part of Estate Planning
Life insurance has been a part of estate planning for a long time. When a provider's estate is not large enough to provide for dependents, life insurance does the job. It can serve several other functions, too.

- Life insurance provides immediate cash at death. Assets that can be converted to cash quickly are called 'liquid' assets. Many estates contain 'non-liquid' assets. This can include real estate, business interests, or collections of art, coins, or jewelry. Such cash poor estates can suffer if the assets must be sold in a down market. Diminution of estate value also occurs if the assets must be sold quickly, at 'fire sale' prices. It is quite common for the liquid assets to be expended by the estate's owner during a last illness or emergency. The most illiquid assets remain in the estate. Commonly this is done for sentimental reasons or due, again, to non-marketability of the assets.

- Life insurance can be used as a means of probate avoidance. Life insurance proceeds are normally excluded from the probate process. This is so because the beneficiary is named in the policy rather than in a will. The money is thus transferred quickly to the survivors without much administrative delay. If the life insurance is put in a trust to keep its value out of the estate, things change. Ownership strategies will be discussed later in this chapter.
- Life insurance can help reduce death taxes. Actually, it helps to reduce the amount of death tax owed. Nothing, short of an Act of Congress, can reduce the death tax. Table 2-1 and the accompanying Chart 2-1 show how the estate tax outlook changes over the years, despite the fact that the threshold for a taxable estate has increased. It is important to keep money out of the taxable estate. When the insurance policy is not owned by the person who is the named insured, the proceeds are excludable from the insured's taxable estate. This can be especially important for people who have a moderate sized estate that would be put over the estate tax exclusion limit if the value of the life insurance were included in their estate. It is important that ownership of the policy be given consideration if such a situation should arise.
- Life insurance can provide for the equitable treatment of heirs. As an example, assume a small business owner has two grown children. The daughter takes an active role in the management of the enterprise. The son works in a coffee shop and sees himself as a starving artist who will make it "someday". The firm is worth $400,000 and is to be left to the daughter by will. The entrepreneur can purchase a $400,000 life insurance policy and name the son as beneficiary. Both children would thus receive equal treatment when the business owner dies. There would be no battling over potential interests in the business

Life insurance is often the first major purchase made by the family breadwinner. Life insurance is the only way to create an instant estate while buying time for the survivors. It is a flexible estate planning tool, often representing the largest single continuing outside venture engaged in by a family. Its many uses make life insurance useful to owners of large as well as small estates. The financial loss that results from the death of an individual can be averted. The proceeds represent a savings that is generally available on a tax-free basis during a time of need when liquidity is important. The insurance market today provides policies that can meet almost any estate planning need or objective.

The time to buy life insurance is when there is a risk that an individual perceives is too great to take. This risk will normally involve other people such as a spouse, parents, or children. Life insurance is important for everybody who has dependents or cash needs. Life insurance purchases have increased dramatically over the last quarter century. New types of policies have been developed to meet the consumer's needs.

Types of Life Insurance and the Effect on the Estate

We have discussed some of the reasons that life insurance is a favorite estate planning tool. Many estate planning experts point out that simply buying life insurance is no way to plan an estate. People without financially strapped dependents have no need for life insurance. This statement is true at face value. The reality, as will be pointed out several times in this text, is that for most people life insurance will be one of the few legacies left to others. Everyone has "cash strapped" dependents. They may not be income tax deductible, *de jure* dependents, but they can use the money just the same. It may be a niece, nephew, or other relative. It could be a religious or educational institution. Whatever it may be, the person or entity would be grateful for the windfall and would (hopefully) put it to good use. For most people, no mansions, trusts, or art treasures will be left behind. Life insurance, perhaps a small pension, and social security benefits will be the three elements of the estate. As a person advances in years the need for insurance will diminish. Until that point in life the need for insurance remains critical. Figure 2-1 shows the distribution of life insurance company investments. The investments are arrayed so that cash can be readily produced to meet the demands of policy holders

Table 2-1 REVENUES FROM ESTATE TAX

Gross Estate Tax Receipts

	Total Internal Revenue Collections (in 1,000's)	Estate Tax (in 100's)	Gift Tax (in 100's)
2008	$2,745,035,410	$26,543,433	$3,280,502
2009	$2,345,337,177	$21,583,131	$3,094,191
2010	$2,345,055,978	$16,930,741	$2,820,095
2011	$2,414,952,112	$2,506,991	$6,572,384
2012	$2,524,320,134	$12,340,655	$2,109,594
2013	$2,855,059,420	$14,051,771	$5,778,377
2014	$3,064,301,358	$17,572,338	$2,582,617
2015	$3,302,677,258	$17,952,938	$2,089,101

Chart 2-1 Federal Transfer Tax Rates

Effective Exemptions, by Year of Transfer

Source: IRS

Year	Basic Exclusion Amount	Credit Equivalent
1977 (Q 1&2)	$30,000	$6,000
1977 (Q 3&4)	$120,667	$30,000
1978	$134,000	$34,000
1979	$147,333	$38,000
1980	$161,563	$42,500
1981	$175,625	$47,000
1982	$225,000	$62,800
1983	$275,000	$79,300
1984	$400,000	$96,300
1985	$400,000	$121,800
1986	$500,000	$155,800
1987-1997	$600,000	$190,800

Year	Basic Exclusion Amount	Credit Equivalent
1998	$625,000	$199,550
1999	$650,000	$208,300
2000 & 2001	$675,000	$217,050
2002-2010	$1,000,000	$330,800
2011	$5,000,000	$1,730,800
2012	$5,120,000	$1,772,800
2013	$5,250,000	$2,045,800
2014	$5,340,000	$2,081,800
2015	$5,430,000	$2,117,800
2016	$5,450,000	$2,125,800
2017	$5,490,000	$2,141,800

	Gift Tax		Federal Treatment of States' Wealth Transfer Taxes (Pct)	
	Basic Exclusion Amount	Top Rate		
Year	(Millions of $)	(Percent)	Credit	Deduction
2001	0.675	55a	100	0
2002	1.0	50	75	25
2003	1.0	49	50	50
2004	1.0	48	25	75
2005	1.0	47	0	100
2006	1.0	46	0	100
2007	1.0	45	0	100
2008	1.0	45	0	100
2009	1.0	45	0	100
2010	1.0	35	0	100
2011-2017	Combined, again with estate in unified tax		100	0

Criteria for Life Insurance Purchase- People that decide to buy insurance should know why they are buying it and the best type of policy for their needs. Several criteria should be used in determining the level and type of life insurance needed:

- The number of people dependent on the client's earning capacity over the long term.
- The amount of money your dependents need, and for what length of time, if the client suddenly died. One should keep in mind that supporting people for the rest of their lives is an unrealistic goal. Not many people could support the premiums for such an immense payout.
- Factor in the amount that will be available from other private insurance or pension plans through work. Social security benefits should also be considered.
- Other likely sources of income should be considered, such as well-off grandparents. It should be kept in mind that dependent spouses caring for children can return to work in the future.
- The length of time after a person dies that it takes for property to be transferred to beneficiaries is another consideration in determining the amount of life insurance.

If only a small amount of property goes through probate, the need for insurance will be less. Only an amount to cover hospitalization and final expenses will be needed. Of course, this does not take into consideration any funds required to carry through the difficult time period after the death of family member. If the extent of property transferred by will is great, it could be tied up in probate for months. The probate court will usually provide a family allowance from the funds. It is still preferable to have insurance proceeds available. Other assets may be available to take care of immediate financial needs. This includes joint or pay-upon-death bank accounts, and stocks or other securities held in joint tenancy.

Individuals with ownership interest in a small business have other cash considerations. If a family member is to take over the small business, cash flow considerations must be considered. The businesses' cash flow will almost certainly be affected during the transition period and life insurance is an excellent way to protect the business from any shortfall during that period. If a family member is not going to stay in the small business, the problem still remains. The business must be continued and an outside manager must be retained until the business can be sold. Often times when the business owner dies there is really nothing left of the business. This is especially true of service oriented businesses. In such a case life insurance is necessary to provide ready cash until alternate streams of income can be found.

Any client who is interested can get an army of life insurance sales persons to come and explain the various policy types. It is best that any candidate for estate planning be educated as to the purposes of insurance. There are two main types of life insurance used for estate planning purposes. Term insurance provides insurance only, with no cash component. Cash-value life insurance provides money to the policy holder who survives the coverage period. Among cash value policies are whole life, universal life, and variable life. These life insurance policies can be purchased with a lump-sum payment, referred to as a single premium payment. Individuals with adequate cash can lock in the cost of life insurance for estate planning purposes through purchase of a single premium policy. Various types of life insurance policies are described below.

Term Insurance

This type of insurance provides a pre-determined amount of cash if the insured dies during the policy period. It is usually written as one-year renewable term insurance. If the named insured dies within that 12 month period, the face value of the policy is paid to the named beneficiary. If a person lives past the end of the term specified in the contract, nothing is paid. Term insurance is normally renewable from one period to another as a means of providing continuous coverage. Certain restrictions, or higher premiums, may apply to the renewal of the policy. Term insurance is in essence pure insurance coverage. There is no cash value feature accumulating as the policy matures.

Term insurance is the cheapest form of life insurance coverage. It is well suited for younger people with families. Generally, such people fit the profile of being healthy but have low income or large expenses. The risk of dying is low so the cost of the insurance is reasonable. The older a person is the more the risk of dying increases. Costs of term insurance begin to increase and the premiums increase. Term policies offered by different companies have different features. Policies may be automatically renewable at the end of the term without another medical examination. Some have premiums set for a number of years. With others, rates can go up every term. Policies may require that a person re-qualify each term.

The commonality of term insurance is that the named insured pays a fixed amount in premium for the period of the term. If the person does not die, the policy expires and the protection ends unless the policy is renewed. Renewal options usually expire at age 65 or 70. Of the various kinds of insurance, term requires the smallest outlay of cash. Over long periods, term is not so inexpensive. Over a long period the total cost will exceed that of permanent insurance. This is because the premiums for term increase with advancing years. There are certain situations where term insurance is a useful solution, including mortgage insurance and many business and investment situations.

Cash Value Life Insurance

Premium payments cover more than the actuarial cost of the risk of death with cash value life insurance. The surplus premium payment goes into a reserve account for the policyholder that will earn interest on the policyholder's behalf. This cash is then used as a savings vehicle for the policyholder or it can be used to help defer future premiums on the policy. The income that accrues in this account is not taxable until the money is paid out to the policy owner or the beneficiaries, in some cases.

Many kinds and variations of cash value life insurance policies exist. When it comes to piecing together and establishing precise client needs, a good agent is critical. Otherwise a tremendous amount of legwork and research will have to be undertaken by the estate planning client.

Whole Life Insurance

It may also be referred to as 'straight life'. This category generally includes ordinary life and limited payment life insurance. The difference is in the length of time premium payments are to be made. With ordinary life insurance, the policy and premium payments are divided into two parts, risk protection and investment. The risk in this sense means the insurance component. It is the same protection as term insurance. The investment segment represents the savings component of the policy and forms a cash value. In the early years of the policy, premiums go toward covering risk and the load factors associated with the policy. That is the cost of commissions and administrative expenses. With time, the cash value rises. The risk of dying increases as the named insured gets older. The risk is dispersed because of prepayments represented by value in the cash portion of the policy. The cash value has an earning feature that is free of income tax during the life of the policy. If the policy is terminated, income tax is due only on the amount received, less the total amount of premiums paid, less dividends received by the policyholder.

Similar to ordinary life is limited payment life. Only here the period of premium payment is limited to a certain number of years, say 10, or until a person reaches a certain age. Subsequent to that date the policy remains in force with no further premium payments due. With the shorter payment period, premiums will be higher. Set ups such as these are good for individuals with a high income over a short period of time. If the entire premium is paid in one installment, the policy is referred to as paid-up permanent life insurance.

Whole life provides a set dollar amount of coverage if a person dies while the policy is in force in exchange for a fixed, uniform payment schedule. Again, it is different from term insurance in that it has a savings feature. In the initial years of a younger person's policy, the premiums for whole life are greater than that needed to cover the actuarial risk of death. Insurers take in more money on whole life policies during the first few years than they pay out in the form of death proceeds. The surplus is then invested by the insurer. This includes the cash reserve of the insured. This cash reserve earns interest. After a stipulated period of time, the policyholder has the right to cash in the policy and obtain the cash reserves. This amount is also known as the cash surrender value of the policy. If the policy is cashed in, the policyowner receives a lump sum payment from the insurance company and insurance coverage under the contract is dropped. Cashing in the policy terminates the contract of insurance.

It is possible to have your cake and eat it, too. A policyowner can get money back on the policy and keep insurance in force by borrowing against the cash value of the policy. Capital borrowed from the cash value of the insurance policy is paid back at an interest rate agreed upon in the insurance contract. If the loan is not paid back or only partially paid at death, the balance is deducted from the proceeds paid at death. At the end of the policy, the insured may choose to receive the accumulated cash. A list of other disbursement options is also available, including conversion to annuity payments.

Whole life insurance is typically more expensive than term insurance because buying insurance and a savings component is more expensive than only buying the insurance. Insurance is mostly needed by younger people with small children who do not have adequate savings to handle difficult situations should a main income-provider die. But people in this group usually cannot afford relatively expensive whole life policies either. Usually it's better to buy a much more affordable term policy. It costs a middle age person much more to obtain the same amount of coverage if that person chooses whole life rather than term insurance. Beware; this is not to say that over the life of the contract term is cheaper. Whole life is usually automatically renewable, unlike many term policies. Older people who purchase term insurance will pay more than the whole life, if they can get insurance at all. As pointed out before, the exact cost will vary on a case by case basis, depending on the age and health of the applicant for insurance. Consumers, clients, and custom estate planners need to asses personal situations carefully. Obtain competent advice and weigh all factors before committing to the purchase of any insurance product.

Variable Life Insurance

A variation on whole or ordinary life, as the name implies. It is based on the payment of a fixed annual premium, establishment of a cash value, and the guarantee of a minimum death benefit. Variable life has an additional feature in that the insured may elect to have the cash value invested in stocks, bonds, or other investment vehicles. The investment mix can be changed within reason and income accrues free of taxes. The value of the investments naturally depends on the success of the investment program. The death benefit remains at the same level. When the cash value increases beyond the policy's assumed growth rate, the excess will be added to the full amount of the policy and will be paid tax free to the beneficiaries in the form of death proceeds of the policy.

In a way, these policies combine life insurance with the benefits of a mutual fund. As the stock market rises, variable life policies produce a great return. The opposite will be true when the market goes into a protracted decline.

Universal Life Insurance

This type of insurance combines the best features of term and whole life insurance. The net cost to the consumer will normally be lower than the cost of whole life insurance. A cash reserve or surplus is accumulated and invested in fixed income assets. These assets normally include fixed-income securities such as treasury instruments or short-term commercial paper. The return will fluctuate with the prevailing market interest rate. This rate of return will normally be higher than the return on a whole life policy, but it can vary between companies. For this reason, it is again stressed that the consumer or adviser scrutinizes the individual companies carefully.

Universal life is much more flexible than whole life. It differs from other forms of insurance because once the initial premium is paid in the amount necessary to pay the costs of establishing the policy, paying the term insurance rate, and setting up a cash value account, annual fixed premiums are no longer required. The amount of coverage and policy payments can be changed from year to year. This type of insurance also has certain tax advantages. The interest paid by the company on the cash value of the policy is not taxed as it accumulates. A taxable event only occurs when the insured makes withdrawals. The policyholder may invest selected amounts when he or she wishes into the cash value account within certain tax restrictions to avoid becoming a modified endowment contract. Partial interest withdrawals can be made without payment of income tax if the insured has owned the universal policy for at least 15 years. The opposite is true of bank accounts. The interest on which is subject to income tax in the year it is paid, even if it is not used by the owner of the account.

Single Premium Life
All premiums are paid up-front for the entirety of the policy. Just about any policy with a savings feature can be purchased with a single premium. Such a purchase requires the expenditure of a large sum of money. The total will depend on the age of the insured and the face value of the policy. One good reason for purchase of such a policy is that the purchaser can donate the paid-up policy to new owners. Such a strategy can result in estate tax savings if someone other than the insured owns the policy. The gift tax obligation is computed on the current value of the policy. It is not the future, or face value, of the policy. No more payments are due on the life insurance contract so there is no risk of default by the new policy owners due to non-payment.

Second-to-Die Policies
This is sometimes known as joint life or survivorship life. This is whole life insurance. It is one policy insuring two lives and it pays after the second death. It is especially useful for a husband and wife. The unlimited estate tax marital deduction shifts all the estate tax payments to the estate of the second to die. After the second death the estate taxes will be due. This applies to couples with a joint estate valued at over twice the estate tax threshold. None of this applies to couples with moderate size estates. As the name implies it is not applicable to single people with estates over the current exclusion amount, either. Many spouses make use of "marital life estate" trusts to effectively guarantee that each spouse gets to take advantage of his or her own exclusion amount ($5.43 million in 2015) estate tax exemption, with the result that the couple will have no estate tax liability for a combined estate of twice the exclusion amount ($10.86 million in 2015).

The death benefit is paid after the second death so the premiums are lower than two separate policies. When the first spouse dies, the cash value and death benefit increase. This is an advantage to estates appreciating in value.

Thus we have second-to-die life. The additional funds needed to help pay estate taxes on the death of the second spouse are made available. An insurance setup like this is useful when a major family asset is the family business or real estate; Non-liquid assets that the family is unable or unwilling to sell. The amount of insurance selected should be enough to make up any projected cash shortfall over a given time period. Another scenario where such a product is useful would be a family business inherited by two siblings. If one child does not want to participate in the business, the other could use the share of the death benefit as an initial buy-out payment so that the business could be retained.

As with all life insurance, how much coverage and whether or not this product is appropriate depends on the individual situation. Only the client can answer that question based on individual need and ability to pay. Also, the federal tax statute covering second to die policies is ambiguous. Tax experts have questions on how it will be read by the tax courts. One thing is certain. No part of the policy should be allowed to be included in the estate of the first spouse to die. Otherwise, double taxation may result, with the proceeds also included in the estate of the second spouse to die. This is a relatively new area of tax law. A good tax lawyer should be consulted before proceeding so that the joint policy has the effect that the client intends.

First-to-Die Life Insurance
This is the reverse of second-to-die or joint life insurance. With a first-to-die policy, two or more people are insured under one policy. Such agreements are usually found among business partners, as part of a business buy-out agreement. When the first insured dies, the policy pays off, with the funds paid to the company or partnership.

A first-to-die policy is much cheaper to pay for than several policies taken out on each of the other partners. Insuring against one death is less of a risk to the insurer than several potential losses. Also, the transaction costs are lower with this method than if several policies are carried. When one of the owners dies, the proceeds are used to pay off the value of the deceased owner's interest under the terms of the buyout agreement. Another way this can be structured is to compensate existing partners for time and expense if one of the deceased owner's heirs is allowed to participate in the business.

Logic would dictate that the face value of the first to die policy would be the proportional equivalent of the ownership interest of the partners. So, if there were two partners, the policy would be worth half the business value, three partners would be one-third, etc. This may not be the case, as appreciation of the business' value should be anticipated and costs associated with transition should also be taken into consideration. For this reason, the partners sign a formal agreement with a formula stipulating the value of the business and what mechanism goes into place when a partner dies. This way, when a partner dies, the insurer pays the death benefit to the partnership. The value of the deceased partner's interest is then determined from the agreed-upon formula. The surviving partners pay the sum in question to the beneficiaries of the deceased. Any amount left is divided among the partners. When all is said and done, the partnership continues with ownership interests divided among the surviving partners.

Life Insurance Trusts
The irrevocable life insurance is a helpful estate tax shelter. So far it has remained untouched by Congress. The trust is one of the surest and most efficient methods of leaving money to children or other descendants free of all death taxes. An individual can leave an unlimited amount of insurance proceeds to their spouse tax-free. This will delay rather than avoid death taxes; the amount received will be taxed in the surviving spouse's estate unless the money is spent. The primary purpose of a life insurance trust is to avoid an estate tax in both spouses' estates and leave the insurance proceeds to younger generations tax-free. This strategy will be examined further in the chapter on trusts.

Annuities
An annuity is a regular series of payments (this used to be called 'rents'). If payments are made for a lifetime, the contract is called a <u>pure annuity</u> or <u>straight-life annuity</u>. If payments are guaranteed for a specified period, regardless of the annuitant's survival or death, the arrangement is called an <u>annuity certain</u>. If payments are guaranteed for a lifetime or a certain period, whichever event is last, the arrangement is called a <u>life annuity, period certain</u>.

A contract calling for a refund when the total amount of rent received by the annuitant is less than the premium paid for the contract is called a <u>refund annuity</u>. If the refund is made in a lump sum, the contract is called a <u>cash refund annuity</u>. As an example, payments received by an annuitant total $45,000 while the total premium paid for the contract is $75,000. The refund due in this case is $30,000. If the refund is made by continuing the regular installment payments to contingent beneficiaries, the contract is called an <u>installment refund annuity</u>.

We will now look more closely at annuities and their place in the estate and the estate planning process. Annuities permit the systematic liquidation of an estate with the assurance that the annuitant cannot outlive the stream of income produced by the liquidation. The reason annuities are sold by insurers is that the same principles apply;

- Many similar exposures to loss are pooled
- Premiums are paid in advance
- The law of large numbers is the basis for predictability

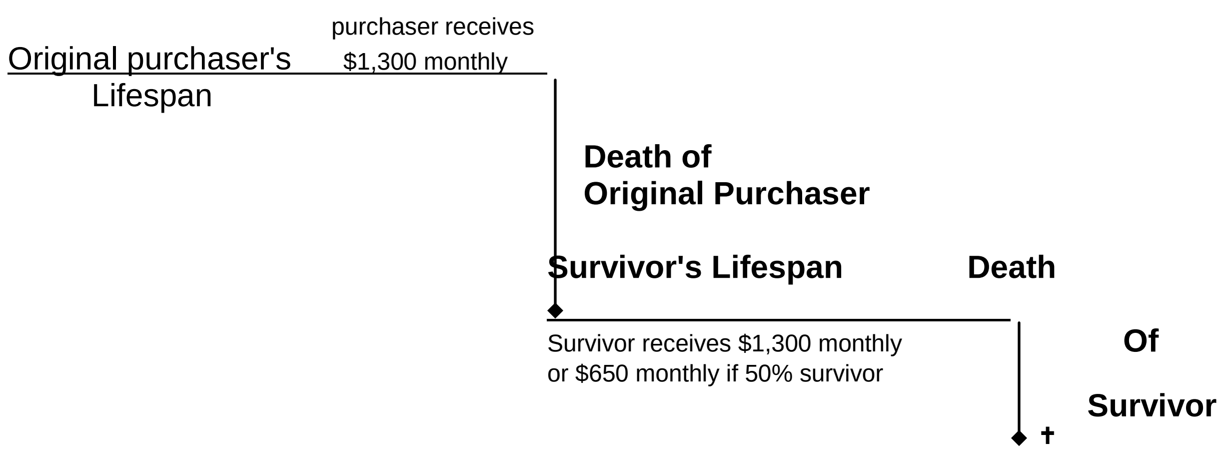
Most people gain annuity protection from their employers as a result of participation in a pension plan. When the employer agrees to provide retirement income, the income represents an annuity promise to the retiree. In addition to pension plans, privately purchased annuities are frequently obtained from life insurance companies. Either way the basic principles are the same as those that underlie all insurance operations.

The "loss" that is insured against with an annuity is that of living too long. It is natural to look forward to a long life, but living a long time without any money can be a nightmare. From the estate planning perspective, an advantage of annuities is that it will provide periodic payments to another person who may be unable to deal with one large lump sum insurance payment. In this way annuities perform the same job as a trust. The reality is that before arranging periodic payments to a beneficiary perceived as not fiscally responsible, one should consider other alternatives. The reason is that annuities may be a relatively expensive way to meet the objective of a long-term stream of payments. They also lack the flexibility of other forms of payments. In a scenario such as this, it may be better to buy plain vanilla life insurance and put the benefits in trust in the event of death. The trust administrator can then vary the amount of payout if the beneficiary suffers an illness, goes to university, or the like.

Estate Tax Treatment of Annuities

The balance of a guaranteed amount is paid to a beneficiary when an annuitant dies. When this occurs, the payment is not taxable as income until the investment in the contract has been received tax free. The amount received by the beneficiary is added to the tax free amounts received by the annuitant. Only the amount received that exceeds the total amounts paid in will be taxable.

Figure 2-2 Joint and Survivor Annuity



The annuity owned by a decedent may be subject to federal estate tax when any residual value is passed on to a survivor or beneficiary. Section 2039 of the Internal Revenue Code addresses estate taxation of annuities. It provides for a premium payment test to be used to determine value. The following guidelines are used:

- If the decedent did not pay any of the premiums, nothing will be included in the estate.
- When the decedent paid the premiums, all of the remaining annuity payments or benefits are includable in the gross estate of the annuitant.
- If only part of the premiums was paid by the deceased, only that part of the subsequent payments or benefits is includable in the decedent's gross estate. The same ratio as the value of premiums paid relative to the total value of premiums paid on the contract will be the determining factor.

Annuity benefits payable to the estate will be included in the gross estate. Any other amounts in question will be determined using the guidelines above. When annuity payments terminate at or before the annuitant's death, then no amount will be ascribed to the gross estate of the decedent. Many times a GRAT, or grantor retained annuity trust, is a useful tool to consider in transferring wealth to descendants without incurring a federal gift or estate tax. It is a relatively new estate planning device that is well suited to people capable of generating consistently high returns on their investments or expect the asset to experience noteworthy short term appreciation.

Distributions from Qualified Retirement Plans

Company qualified pension or profit-sharing plans cover many workers in the U.S. After death of the retiree, payments of vested benefits must be in a specific annuity form to protect the surviving spouse. Tax law normally requires that payments be in specific annuity form if married for at least one year. Only if the retiree, with written consent of the spouse, elects a different form of payment. Then an alternative means of distribution can be effected. The qualified joint and survivor annuity must be provided by profit-sharing or stock bonus plans also. This is not the case if the retiree does not elect a life annuity payment and the plan provides that the nonforfeitable benefit is payable in full upon the plan participant's death to the surviving spouse or another beneficiary if the spouse consents or is deceased.

A qualified joint and survivor annuity pays the retiree an annuity for life and then the surviving spouse receives an annuity for the balance of their years. The surviving spouse's annuity can be no less than 50% of the amount payable during the joint lives. A lump-sum distribution of a single life annuity cannot be chosen without spousal consent. It is also required by tax law that a pre-retirement survivor's annuity be paid to the surviving spouse if the retiree dies before the date vested benefits become payable. All qualified retirement plans should provide their participants with a written explanation of the annuity rules. This along with rules for election to waive the joint and survivor annuity benefit and the pre-retirement survivor annuity benefit should be provided to the plan participant within a reasonable period of time before any contemplated annuity starting date. Basically, if distribution by some means other than joint and survivor annuity is desired, then approval is required.

The spouse of a plan participant must consent in writing to any waiver and selection of a different type of distribution plan. The consent must be witnessed and in writing. In cases where the present value of the qualified joint and survivor annuity is less than an IRS prescribed value, the employer may choose to buy out the interest of the plan participant by making a lump-sum distribution of the present value of the annuity before the annuity start date. After the annuity start date, both the retiree and spouse must consent to a cash buyout.

Life Insurance and the Estate

There is one very important point to remember concerning life insurance and the estate. If the insured has any **rights of ownership** in a life insurance policy or if the proceeds are payable to the insured's estate, the proceeds of the life insurance policy will be included in the taxable estate and subjected to the estate tax. Rights of ownership include the right to change the beneficiary, the right to take out a loan on the policy, and the right to the dividends. If the policy ownership changes hands within three years of the death of the previous owner, the transfer is said to have been done "in contemplation of death" and the policy value is still counted in the previous owner's estate. To illustrate, suppose Jane Adler designates her son, Willi Adler, to be beneficiary on a $250,000 life insurance policy. One of several scenarios could play out when Jane dies. If Jane retained one or more of the incidents of ownership, the proceeds of the life insurance policy will be subject to the estate tax. Will he be required to pay income tax on the proceeds? No, Willi will not be.

If Jane had transferred all ownership rights to her husband, Pablo, there would be no federal estate tax when she dies and no federal income tax either. Suppose the ownership transfer is made and then Pablo dies before Jane. In this case the value of the policy at the time of his death is included in his estate. Value in this sense means any cash or residual value of the policy. It does not refer to the death benefit payable upon the death of Jane. The cash value will most likely be much less. This loophole in the federal tax laws allows the proceeds of a life insurance policy to escape both the federal estate and income tax. It is often used as a component of the estate planning process. It is pointed out again that the value of an estate must exceed the exclusion amount ($5.43 million in 2015) before any federal estate tax is due.

Good Timing

The example above illustrates the way that a person can avoid the irrevocability of an insurance trust as well as the gift tax consequences of large insurance premium payments. A married couple would own individually a policy on the other's life and would pay all the premiums. If the owner-spouse does not have funds to make premium payments, funds can be transferred to the owner by the insured spouse for the purpose that would qualify for the marital deduction. There would be no gift taxes owed on any transactions involving premium payments and the $28,000 annual gift tax exemption would be available for other purposes.

When an insured-spouse's health deteriorates and appears likely to die, the owner-spouse transfers ownership of the policy to their children or to a trust. The cash value of the policy would be counted as a taxable gift, but it would be much less than the face value of the policy. The insured-spouse had, nor has, incidents of ownership in the policy. It will not be included in that spouse's estate. The three-year rule does not apply in this case (it is the insured on the brink of death, not the owner). It is not important how soon after the transfer that the owner dies. This way, the owner-spouse transfers ownership of the policy in a timely manner that avoids the problem of the full face value of the policy included in either spouse's estate.

If the insurance policy owner-spouse is the first to die, ownership of the policy can pass by will to the children or to a trust. The cash value of the policy is the only thing included in the owner-spouse's estate. The children will be responsible for the payment of subsequent premiums. One variation on this theme is to have each of the spouses own a second-to-die insurance policy on each other's life, preferably one that does not manifest a significant increase in cash value with the death of the first spouse. As illustrated above, the owner-spouse would make all premium payments. Two events would transpire upon the death of the first spouse; 1.) The surviving spouse would transfer ownership of the policy to children or a trust for their benefit.

As illustrated above, this would be a taxable gift of the cash value of the policy. If the surviving spouse lives more than three years after the transfer, the policy would not be includable in either spouse's estate for tax purposes. 2.) By will the policy owned by the deceased spouse would pass to children or to a trust for their benefit. The only thing that would be included in the deceased spouse's estate would be the cash value of the policy. It is a second-to-die policy and the other spouse would still be alive. Subsequent premiums on the policies would be paid by the children or trust.

If the spouses die within a short time (three years) of each other then no estate tax savings will be realized. The transfer of ownership cannot be completed. It may be advisable, depending on the specific situation, to also put some life insurance in an irrevocable trust. This will insure the exclusion of the policy proceeds from both spouses' estates.

Every person involved in the estate planning process needs to bring up the following points when discussing insurance with a potential customer:

- The financial strength of insurance companies that may be of service should be carefully evaluated.
- It may prove sensible, especially with more involved estate plans, to seek a second opinion concerning a product (or its intended use). An opinion from a third party could also shed light on other tactics that could be employed to achieve the desired goals.

Individuals who have a high net worth are normally concerned with keeping their affairs confidential. It is wise for the professional to keep in mind that the normal means of insurance processing might be a pipeline for gossip in smaller communities. Discretion is paramount and it may sometimes require the use of outside insurance or legal professionals to help maintain confidentiality.

Chapter 3 Estate Tax Summary

As stated before, estate tax effectively does not apply to estates valued at less than $5,430,000 (for year of death 2015). This is the value of the current applicable exclusion/applicable credit amount. It can be changed by Congress.

The American Taxpayer Relief Act (ATRA; P.L. 112-240) established a new set of rules for the estate and gift tax for 2013 going forward. Proposals had been made to eliminate the estate tax, while retaining a gift tax with a lower rate. The estate tax is imposed on bequests at death as well as inter-vivos (during life) gifts. A certain amount of each estate, $5.43 million in 2015, indexed for inflation, is exempted from taxation by the federal government. The taxable estate is taxed at a maximum rate of 40%. The exemption applies to total bequests and gifts (separate from the annual intervivos gift exemption of $14,000 per donee). Transfers between spouses are exempted, and any unused exemption can be inherited by a surviving spouse. Other elements of the tax remain, including deductions for charitable bequests and a number of special provisions for farms and small businesses.

The permanent tax treatment of estates and gifts had been uncertain for some time. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16), among other tax cuts, provided for a gradual reduction and elimination of the estate tax. Under EGTRRA, the estate tax exemption rose from $675,000 in 2001 to $3.5 million in 2009, and the rate fell from 55% to 45%. In 2010, the estate tax was eliminated. There was general agreement that some sort of estate tax would be retained. A proposal to make the 2009 rates ($3.5 million exemption and 45% rate) permanent was included in the 2010 and 2011 budget outlines and was passed by the House in December, 2009. In addition, in 2009, Senate Democratic leaders supported the plan to enact the 2009 rules permanently. The Senate Republican leadership proposed a $5 million exemption and 35% rate. This latter provision was eventually adopted for a two-year period, through 2012. For estates of decedents in 2010, either the 2010 or 2011 rules can be elected. Spouses can inherit unused exemptions. The permanent provisions retained most of the rules adopted for 2011 and 2012, but with a higher rate. Compared with the $1 million exemption and 55% rate under pre-EGTRRA law, the new rules were estimated to lose an average of about $37 billion over 10 years, a two-thirds reduction in estate tax revenues. Regardless of the exemption levels considered, few estates are affected by the tax. The estate tax is a highly progressive tax, with about three-fourths collected from estates in which decedents are in the top 1% of the income distribution. At a $5 million exemption, less than 0.2% of estates will be subject to the tax. Although concerns have been raised about the effects of the tax on small businesses and farmers, estimates indicate that only a small share of these decedents would be affected.

Property Transfer

Federal estate tax applies to the transfer of property at death. The estate of a person who died is liable for the tax on the entire taxable estate. The beneficiaries of the estate may have to pay the tax if the estate does not pay it when it is due. Each beneficiary's liability is limited to the value of the part of the estate he or she received.

Usually, the value of the estate is determined on one of two dates: the date of death or, if the alternate valuation method is used, 6 months after the date of death. The date at the location of a person's domicile (legal residence) at the time of death determines the date of death. Thus, if one were abroad and died of a heart attack in Kyoto, Japan, the date of death may be fixed differently if the decedent resided in Joplin, Missouri. The person's domicile also determines where the estate tax return must be filed.

Citizen or Non-Citizen- A decedent's status as a U.S. citizen or resident or as a nonresident non-citizen on the date of death determines the property to be included in the estate, the requirements for filing a return, and the form that must be filed. If a person is a citizen or resident of the United States at the time of death, the value of his or her entire estate is subject to estate tax. This rule applies regardless of where the individual's property is located. For estate tax, a **resident** is someone who had a domicile in the United States at the time of death. A person acquires a domicile in a place by living there, for even a brief period of time, with no present intention of moving from that place.

It is possible for someone to establish a domicile even if he or she is subject to deportation. Therefore, a person who is in the United States illegally and who lives her until death may be considered a resident for estate tax purposes. A non-immigrant alien holding a 'G-4' visa can also establish a domicile in the United States and is treated as a resident if he or she intended to stay indefinitely in the United States.

Nonresident Non-citizens- For a nonresident who is not a citizen of the United States, only the value of the property located in the United States at the time of death is subject to the estate tax. If a person is a resident of any U.S. possession, they are considered a nonresident non-citizen, for estate tax purposes.

U.S. citizens who became expatriates within 10 years of death, property subject to estate tax is limited to property located in the United States and certain foreign corporation stock.

The Estate Tax Return

As the executor of an estate, an individual must file any required returns relating to the decedent. The term *executor,* as used in this book, includes an executor, executrix, administrator, or administratrix of an estate. If there is no executor appointed, qualified, and acting within the United States, the term includes any person in actual or constructive possession of any of the decedent's property located in the United States.

Filing the Return

If one is unable to make a complete return for any property interest in the gross estate, they must include on the return the name of everyone holding a legal or beneficial interest in that property and furnish a description of the property: If notified by the district director, anyone holding legal or beneficial interest in this property must file a return for that part of the gross estate.

Citizens or residents- As the executor of an estate of a U.S. citizen or resident who died after 1987, one must file an estate tax return if the value of the gross estate at the date of death was more than the exclusion amount. This amount is reduced by the total amount of adjusted taxable gifts made after 1976 (other than those gifts included in the decedent's estate), and the total amount allowed as a specific exemption for gifts made after September 8, 1976, and before 1977.

If a return must be filed, one should use Form *706, **United States Estate** (and Generation Skipping Transfer) **Tax Return**,* that applies for the year of the decedent's death. The return is due 9 months after the date of death unless an extension of time for filing has been granted. Interested readers can visit the IRS website and access Form 706 and its instructions.

Extension of Time for Filing
A reasonable extension of time to file the estate tax return, or related statements or documents, may be granted if it is impossible or impractical for the executor to complete the return within 9 months after the date of death. The extension may not be for more than 6 months unless the executor is abroad.

Note. An extension of time to file does not extend the time to pay. The executor must include payment for the amount of the estimated estate tax at the time they request an extension of time to file.

When to file. *The executor* must file Form 4768 early enough to permit the Internal Revenue Service to consider the application and reply before the estate tax return due date.

Where to file. File the application with the Internal Revenue Service office or Service Center where the estate tax return will be filed. An individual may hand carry the application to the district director of the district in which the decedent was domiciled.

Information needed. Include a written statement with the application, showing why it is impossible or impractical for the executor to file a reasonably complete return by the due date.

Penalties
Late filing and late payment- Section 6651 provides for penalties for both late filing and for late payment unless there is reasonable cause for the delay. The law also provides for penalties for willful attempts to evade payment of tax. The late filing penalty will not be imposed if the taxpayer can show that the failure to file a timely return is due to reasonable cause. Executors filing late (after the due date, including extensions) should attach an explanation to the return to show reasonable cause. There is a penalty for not filing an estate tax return when due (determined with regard to any extensions of time for filing).

Valuation understatement- Section 6662 of the IRC provides a 20% penalty for the underpayment of estate tax of $5,000 or more when the underpayment is attributable to valuation understatements. A valuation understatement occurs when the value of property reported on Form 706 is 50% or less of the actual value of the property. This penalty increases to 40% if there is a gross valuation understatement. A gross valuation understatement occurs if any property on the return is valued at 25% or less of the value determined to be correct.

Paying the Tax

The executor must pay the estate tax when the return is due. An extension of time for filing the return does not extend the due date for paying the tax. However, the executor may be allowed an extension of time to pay the tax if they can show reasonable cause, or they may be able to pay the tax in installments if the estate consists of certain kinds of property. One must pay the entire estate tax, even if some of the property of the gross estate is not in their possession. However, if someone is the executor because no other person was appointed, qualified and acting within the United States, the tax liability is limited to the value of the property in the executor's possession.

See *Executors and Administrators,* discussed later, for more information on the liability for paying the tax. See also *Assumption of Estate Tax Liability,* if employer securities are transferred to an employee stock ownership plan or eligible worker owned cooperative.

Extension of Time for Paying
There are provisions that allow additional time for paying the estate tax. The usual extension of time to pay is up to 12 months from the date the payment is due. The Internal Revenue Service, however, may extend the time for payment for up to 10 years. These extensions will be allowed if the executor can show *reasonable cause.* When application is made the executor should show why it is impossible or impractical to pay the full amount of the tax on the due date.

Reasonable cause- The following illustrates reasonable cause;

1) An estate includes enough liquid assets (cash or assets readily convertible to cash) to pay the estate tax when normally due. However the liquid assets are located in several jurisdictions and are not within immediate control. Thus, the executor cannot readily collect all the assets, even with the exercise of due diligence.

2) Most of an estate's assets consist of rights to receive payments in the future. Examples of these assets include annuities, copyright royalties, contingent fees, and accounts receivable. These assets do not provide enough cash to pay the estate tax due, and the estate cannot borrow against these assets without causing a loss to the estate.

3) An estate includes a claim to substantial assets that cannot be collected without a lawsuit. Thus, the amount of the gross estate cannot be determined when the tax is due.

4) The executor has made a reasonable effort to convert the decedent's assets (other than an interest in a closely held business as discussed later) into cash. The estate would have to borrow at an interest rate higher than generally available to have enough funds to:

> a) Pay the estate tax when due,
> b) Provide a reasonable allowance for the decedent's surviving spouse and dependent children while the estate is being administered, and;
> c) Satisfy claims against the estate that are due and payable.

Paying the tax. Generally, additional time is granted for paying the amount of the cash shortage (difference between estimated estate tax due and available cash). However, the executor must pay the rest of the estate tax that is due when the application is filed.

<u>An extension of time to pay does not extend the time to file</u>. It also does not relieve the estate from liability for paying interest on the balance due during the period of extension.

Deficiency- The Service might find that an amount is still due after the tax is paid. If so, the executor may be able to extend the time to pay this deficiency for up to 4 years from the date that was fixed for payment of the deficiency. The executor must show reasonable cause to get this extension. The deficiency must not be due to negligence, intentional disregard for rules and regulations, or fraud.

Penalties- If the executor do not pay the tax shown to be due on the return and does not show reasonable cause, a penalty of .5% a month will be charged (up to 25%) on the unpaid amount. There is a similar penalty for failing to pay a tax deficiency within 10 days from the date of notice, unless one shows reasonable cause.

Reversionary or remainder Interest- If the gross estate includes the value of a reversionary or remainder interest, the executor may elect to postpone the payment of the tax attributable to that interest until 6 months after the preceding interests in the property have ended. If, at the end of this 6-month period, the executor shows reasonable cause, the Service may grant additional time of up to 3 years for payment of the tax attributable to these interests.

Installment Payments

If the gross estate includes an interest in a closely held business, the executor may be able to elect to pay part of the estate tax in installments. For the estate to qualify for the election, the decedent must have been a U.S. citizen or resident at the time of death. The maximum amount that can be paid in installments is that part of the estate tax that is attributable to the closely held business. This amount is the value of the interest that is included in the gross estate and that meets the percentage requirement (discussed later). For example, if 50% of the adjusted gross estate is attributable to the closely held business amount, the executor of the estate could elect to make installment payments on up to 50% of the estate tax.

Percentage requirements- To qualify for installment payments, the value of an interest in a closely held business that is included in the gross estate must be more than 35% of the adjusted gross estate (the gross estate less expenses, indebtedness, taxes, and losses).

Interest in two or more closely held businesses are treated as an interest in a single closely held business if at least 20% of the total value of each business is included in the gross estate. For this purpose, an interest in a closely held business that represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as having been included in the value of the decedent's gross estate.

Example: The decedent had an interest in two closely held businesses. The value of these interests was included in the gross estate. The first interest consisted of corporate stock that had a value equal to 25% of the decedent's adjusted gross estate and represented 10% of the total value of the corporation. The second interest was a partnership interest that had a value equal to 20% of the adjusted gross estate and represented 20% of the total value of the partnership.

The estate cannot elect to pay any of the estate tax in installments. Neither interest by itself meets the 35% requirement nor can they be treated as a single closely held business because the interest in the corporation does not meet the 20% requirement.

Value. The value used for determining the gross estate is the value used for meeting the percentage requirements. Therefore, if the estate is valued under alternate valuation or by using special-use valuation, the executor must use those values to meet the percentage requirements.

Transfers before death- Generally, gifts made before death are not included in the gross estate. However, the estate must meet the 35% requirement by both including and excluding in the gross estate any gifts made by the decedent within 3 years of death.

Example The decedent had made a taxable gift within 3 years of her death. Her gross estate included an interest in a closely held business. The value of that interest was $130,000, which was equal to 40% of her adjusted gross estate of $325,000. The value of the gift that is included in the gross estate, for purposes of the 35% requirement, is $75,000. Therefore, the value of the interest in the closely held business ($130,000) equals 32.5% of the adjusted gross estate that includes the value of the gift ($400,000). Her estate does not qualify for paying the estate tax in installments.

Passive assets- The value of any interest in a closely held business does not include the value of that part of the interest that is attributable to passive assets held by that business. This only applies in determining the closely held business amount and whether the more than 35% requirement is met. *A* passive asset *is* any asset not used in carrying on a trade or business. Stock in another corporation is a passive asset unless the stock is treated as held by the decedent because of the election to treat holding company stock as business company stock, as discussed later, and the stock qualified under the percentage requirement. If a corporation owns at least 20% in value of the voting stock of another corporation, or the other corporation had no more than 15 shareholders and at least 80% of the value of the assets of each of these corporations is attributable to assets used in carrying on a trade or business, then these corporations will be treated as 1 corporation and the stock held will not be treated as a passive asset. Stock held in the other corporation is not taken into account in determining the 80% requirement.

Interest in closely held business- For purposes of making installment payments, an interest in a closely held business means:

- An interest as a proprietor in a trade or business carried on as a proprietorship.
- An interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest was included in the gross estate of the decedent or the partnership had no more than 15 partners.
- Stock in a corporation carrying on a trade or business if 20% or more of the voting stock of this corporation is included in the gross estate of the decedent or the corporation had no more than 15 shareholders.

The partnership or corporation must be carrying on a trade or business at the time of the decedent's death. In determining the number of shareholders or partners, a stock or partnership interest is treated as owned by one shareholder or partner if it is community property, or held by husband and wife as joint tenants, tenants in entirety, or tenants in common.

Property owned directly or indirectly by or for a corporation, partnership, estate, or trust is treated as owned proportionately by or for its shareholders, partners, or beneficiaries. However, with trusts, only beneficiaries with present interests are considered. A present interest means that the beneficiaries have a present right to the trust income.

The interest in a closely held farm business includes the interest in the residential buildings and related improvements occupied regularly by the owners, lessees, or employees running the farm.

Holding company stock- The executor may elect to treat the portion of the holding company stock that represents direct ownership (or indirect ownership through one or more other holding companies) by that company in a business company as business company stock. A *holding company is* a corporation holding stock in another corporation. A *business company is* a corporation carrying on a trade or business. This election applies only to stock that is not readily tradable. For purposes of the 20% or more voting stock requirement, this stock is treated as voting stock to the extent the holding company owns directly (or indirectly) voting stock in the business company. If the executor makes this election, the first installment payment is due when the estate tax return is filed. The 5-year deferral for payment of the tax, does not apply.

Special rule. If a corporation has no more than 15 shareholders on June 22, 1984, and at all times before the date of the decedent's death, and the corporation's stock is included in the gross estate the executor may elect to treat all other corporations that are wholly-owned, directly or indirectly by that corporation as one corporation for purposes of the installment payment provisions. An election under this provision is treated as an election under the holding company stock provision, discussed earlier.

Time for payment. Under the installment method, the executor may elect to defer the payment of principal (the estate tax), but not interest, for up to 5 years from the original due date for paying the tax. After the first installment of tax is paid, the executor must pay the remaining installments annually by the date one year after the due date of the preceding installment. There can be no more than 10 installment payments. Interest on the unpaid portion of the tax is not deferred and must be paid annually. Interest must be paid at the same time and as a part of each installment payment of the tax.

Deficiencies- Generally, if the executor makes the election when the return is filed, the election applies both to the tax originally due and to certain deficiencies. If the executor does not make the election when the return is filed, they may still elect to pay certain deficiencies (but not the original tax) in installments. As executor, one also may make a protective election (discussed later) under certain conditions.

The executor makes the election by attaching a notice of election to a timely filed estate tax return. The notice must contain the following information:

- The decedent's name and taxpayer identification number as they appear on the estate tax return,
- The total amount of tax to be paid in installments,
- The date chosen for paying the first installment,
- The number of annual installments, including the first installment, in which the tax is to be paid,
- The properties shown on the estate tax return that make up the closely held business interest (identified by schedule and item number), and
- The reasons the executor thinks the estate qualifies for installment payments.

If the executor does not include information for items (2), (3), and (4), the election is presumed to be for the maximum amount payable in installments and must be made in 10 equal installments. The first payment of which is due 5 years after the due date for paying the estate tax.

Protective election- The executor may make a protective election to defer payment of any part of the tax that is still unpaid when the values are finally determined (or agreed to, following an examination of the return). This protective election also covers any deficiencies attributable to the closely held business interest. Extension of tax payments under this election depends on whether the final values meet the requirements. However, a protective election does not extend the time for paying the tax. Such an extension must be granted under another provision of the Code.

The executor makes a protective election by filing a notice of election with a timely filed estate tax return. Within 60 days after the values are finally determined or agreed to, the executor must send a letter containing a final notice of election with the required information to the Service office where the executor filed the estate tax return. The executor must pay any previously unpaid tax and interest now due, plus any unpaid tax and interest that is not attributable to a closely held business and that is not eligible for further extension (or currently extended) under another section of the Code.

Example. As executor of John Blue's estate you file the estate tax return on time. The return showed that 30% of the value of John's adjusted gross estate consisted of a farm that was a closely held business. You made a protective election when you filed John's estate tax return. You also applied for an extension of time to pay $15,000 of the $60,000 of estate tax due on the return. The extension was granted and was renewed at the end of one year. Eighteen months after the return was filed and after examination of John's estate tax return, the value of the farm was found to be 37% of the adjusted gross estate. You agreed to the values as established on examination and to a deficiency of $5,000.

You then filed a final notice of election. This terminates the previous extension because that amount of tax is now included under the installment election. You could have extended payment of 37% of the total estate tax, or $24,050 ($65,000 X 37%). This amount is eligible for installment payments and the election is considered to be for that amount. You are considered to have prepaid $4,050 of the tax since only $20,000 ($15,000 extension + $5,000 deficiency) of the tax remained unpaid. The $4,050 is attributed to the first installment of $2,405 and to $1,645 of the second installment that is payable under the election.

Had you been granted an extension of time to pay $20,000 of tax, $25,000 would remain unpaid when the final election is made. Payment of the full $24,050 (37%) of tax that is attributable to the closely held business interest is included under the election. The balance of unpaid tax ($950) is due when the estate's previous extension expires.

All unpaid accrued interest must be paid with final election notice. Since only 18 months have passed, no tax installments are due. Interest on the $5,000 deficiency is computed at the current IRS approved rate, and interest for 12 months of that period is currently due to be paid. Interest for the remaining 6 months is due at the next date for payment of interest. Interest on the $15,000 of tax extended under the general extension is figured at the rate determined under the general extension until the date of the final election and is due upon termination of the extension. After that date, the interest on the $15,000 will accrue.

Acceleration of payment- If any part of an interest in a closely held business that qualifies for installment payments is distributed, sold, exchanged, or otherwise disposed of, or if money and other property attributable to that interest is withdrawn from the trade or business, the extension of time for payment of the tax in installments will end. The installment method of payment will end only if the withdrawals, distributions, sales, exchanges, or other dispositions, total 50% or more of the value of the interest. The unpaid part of the tax payable in installments must be paid upon notice and demand from the Service.

Disposition does not include the transfer of an interest because of the death of the original transferee, or a later transferee, if it is transferred to a family member of the last transferor. For example, if an interest for which an election had been made was inherited by a son and that son died, the transfer to a member of that son's family is not considered a disposition. A qualified redemption of stock to pay death taxes is not considered a disposition for purposes of accelerating payments. See *Stock Redemptions to Pay Estate Taxes* discussed later under *Miscellaneous Provisions.* The acceleration rules apply in the case of the disposition of any interest in holding company stock or any withdrawal of money or other property from the holding company, if the election to treat holding company stock as business company stock, as discussed earlier, had been made. If the election was made, the acceleration rules apply to any disposition of the business company stock by the holding company or any withdrawal of any money or other property from the business company attributable to its stock by the holding company owning that stock.

Failure to make payments- If any payment of ***principal or Interest*** *is* not paid by the due date of the installment (including extensions), the unpaid part of the tax payable in installments must be paid upon notice and demand from the Service. This provision does not apply if the payment is made within 6 months of the due date. There is an interest penalty on the amount of the late payment.

Gross Estate

The gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of death. Qualified disclaimers by beneficiaries may have effect on federal estate, gift, and generation skipping transfers. See *Qualified Disclaimers,* in the Gift Tax chapter

Property Owned by the Decedent

The gross estate includes property that was owned by a decedent at the time of death and was transferred at death by a will or by intestacy laws. It may also include other property interests that the decedent did not own at death. These are discussed later. The gross estate does not include property that the decedent owned at death that could not be transferred by a will or by the intestacy laws, such as a life estate created by another. (See *Qualified Terminable Interest Property,* discussed later.)

The value of a remainder interest that can be ended by the act of a third party is included in the gross estate if it is not actually ended before the decedent's death. A claim for damages for pain and suffering is includible in the estate because the decedent could have recovered it before death. However, a wrongful death claim brought by the decedent's heirs generally is not included because the decedent could not have recovered Unenforceable death benefits paid to the surviving spouse are not included in the estate.

Outstanding dividends declared to stockholders of record on or before the date of death are included in the gross estate. Those declared after the date of death are not.

Unpaid interest that has accrued on savings certificates (redeemable after death without forfeiture of interest) from the date of the last interest payment to the date of death, plus the face amount of the certificates, is includible in the gross estate.

U.S. Government bonds and other U.S. Government indebtedness are included in the gross estate even if, by law, they are generally exempt from all federal taxes. The estate tax is a tax on the transfer of property and not a tax on the property itself. This also includes bonds issued by a state government agency and secured by a pledge of a loan by the federal government.

No-Fault Insurance*.* Benefits paid under a no-fault automobile insurance policy may be includible in the gross estate. If a "death benefit" is paid under the policy to the estate of the decedent, the value of the benefit is includible in the gross estate' as proceeds of life insurance (discussed later). However, a "survivors' loss benefit" paid only to the survivors of the decedent is not includible in the gross estate, because it could not be recovered by the decedent or the decedent's estate.

Income tax refund- If the estate is entitled to a refund because of an overpayment of income tax the overpayment is an asset includible in the gross estate. If the estate and a surviving spouse are entitled to a refund because of an overpayment o income tax on a joint return, part of the overpayment is includible in the gross estate. The includible amount is the amount by which the decedent's payment of the joint income tax exceeds his or her income tax liability.

The decedent's income tax liability for the period covered by the joint return is figured as follows:

1) Figure the amount of income tax for which the decedent would have been liable on a separate return (as if a separate return had been filed).
2) Figure the amount of income tax for which the spouse would have been liable on a separate return.
3) Multiply the joint tax liability by a fraction. The numerator of the fraction is the amount figured in (1). The denominator of the fraction is the total of the amounts figured in (1) and (2).

The amount arrived at in (3) is the decedent's income tax liability for the period covered by the joint return. Any excess of the decedent's payment of the joint income tax over this amount is includible in the gross estate.

Medical Insurance reimbursements- are included in the gross estate if the decedent had a right to the amount at death.

Form 706- List real estate that the decedent owned at death on Schedule A, Form 706. List stocks and bonds on Schedule B and include the CUSIP (Committee on Uniform Security Identification Procedure) number, if available, for each of the securities. Enter bank accounts, promissory notes or other evidence of debt payable to the decedent on Schedule C. List miscellaneous property, such as furniture, jewelry, personal effects, and interests in partnerships or unincorporated businesses on Schedule F.

Dower and Curtesy Interests

The gross estate includes the value of a surviving spouse's dower or curtesy interest in the decedent's estate, including a statutory interest in place of the dower or curtesy interest.

A **dower interest** is the part of a deceased husband's real property allowed to his widow for her lifetime. A **curtesy interest** is a deceased wife's real property that passes on her death to her husband for his lifetime if they have had children who are able to inherit the property.

Transfers with Retained Life Estate
The gross estate includes the value of property transferred after March 3, 1931, but before the death of the transferor, if that person kept possession or enjoyment of the property, or reserved certain rights or interests in it. This includes the right to income from the property for life (or for a period that does not in fact end before death, or that cannot be determined without reference to the decedent's death). However, if the transfer of property was made for its full worth in money (or other equal value), it is not included in the gross estate.

Rights or interests The rights or interests that may be reserved for life include the use, possession, income or other enjoyment of the transferred property or the right to name persons who will possess or enjoy the transferred property or its income. The right to designate may be exercisable alone, or, if created after June 6, 1932, with others. It does not matter if the others have adverse interests, or if they or the person that made the transfer (the transferor) act in a special position, such as a trustee or agent.

If the decedent kept or reserved one or more of these rights or interests, the amount includible in the gross estate is the value of the property transferred, minus the value of any outstanding income interest not subject to the decedent's interest or right. For its value to be excluded from the gross estate, the income interest must actually be enjoyed by someone else at the time of the decedent's death. If the decedent kept or reserved an interest or right to only a part of the transferred property, the amount includible in the gross estate is a corresponding part of the entire value of the property.

The use, possession, right to the income, or other enjoyment of the property is considered kept by or reserved to the decedent to the extent that this use, etc., is to be applied toward the discharge of a legal obligation of the decedent or otherwise for the decedent's profit. This includes a legal obligation to support a dependent prior to the decedent's death.

The retained life estate does not have to be legally enforceable. What matters is that a substantial economic benefit is in fact reserved. If a father transfers the title to his residence to his daughter, but at the same time privately reaches an understanding that he is to continue living there until his death, the value of the residence is included in the father's estate even though the understanding could not be legally enforced. However, if a husband transfers the title to his residence to his wife and they both continue to occupy it, no presumption of a retained life estate is present unless an agreement exists.

Example; A decedent reserved the right to receive income from transferred property after the death of another person who, in fact, survived the decedent and who was enjoying the income from the property at the time of the decedent's death. In this case, the amount to be included in the decedent's gross estate as a transfer with a retained life estate is the value of the entire property, minus the value of the outstanding income interest of the other person. If the other person had died before the decedent, the reservation by the decedent could be considered to be either for the decedent's life, or for a period that does not in fact end before the decedent's death.

The gross estate includes the value of property placed in trust by the decedent if the income beneficiary of the trust in turn created a comparable trust naming the decedent the income beneficiary. The trusts must have been interrelated, and the parties must have been in substantially the same position after the creation of the trusts as they would have been had they named themselves income beneficiaries of their own trusts.

Transfers to testamentary trust by a life Income beneficiary- If a life income beneficiary has made lifetime contributions of property to a trust established by another person and that property remains in the trust at death, the retained interest to be included in the estate of the beneficiary is the value of that property at the time of death.

Example. Robert Blue was the life income beneficiary of a trust created by his father's will in 1994. The terms of the trust provided that the trustee had the power to receive and invest additions to the corpus and that the trust ended upon Robert's death with all assets passing to Robert's heirs. When created, the trust corpus had a value of $10,000, and by December 21, 1996, the trust assets were worth $15,000. On that day, Robert transferred 400 shares of Maple Corporation common stock valued at $45,000 to the trust.

Robert died on May 1, 2014, when the total trust assets were worth $400,000. This included the 400 shares of Maple Corporation stock that had a value of $350,000.

Since the value of the 400 shares of Maple Corporation stock could be determined on the date of Robert's death, his gross estate includes, as a retained interest, $350,000. This $350,000 is the part of the trust equal to the value of the Maple Corporation stock on the date of his death. If the trustee sold or otherwise disposed of the property contributed, and replaced it, the value of the interest the decedent had retained at death is that part of the trust assets the decedent contributed, figured at the time of the transfer.

Voting rights in controlled corporation stock- If a decedent transferred stock of a *controlled corporation* after June 22, 1976, and kept the right to vote in the shares (either directly or indirectly), the retention of the voting rights is a retention of the enjoyment of transferred property. The value of the transferred stock is included in the gross estate. This does not apply to the transfer of stock in a controlled corporation if the decedent could not have voted the transferred stock.

Voting rights are indirectly retained if there is an agreement or arrangement with a trustee to vote the stock according to the transferor's directions. Voting rights may be indirectly retained under an oral agreement with the trustee even if there is no such agreement in the trust instrument.

Controlled corporation. A corporation is a controlled corporation if at any time after the transfer of property and during the 3-year period ending on the date of death, the decedent-

1) Directly or indirectly owned or
2) Had the right, either alone or with another person, to vote stock having at least 20% of the total combined voting power of all classes of stock.

In determining whether the corporation is a controlled corporation, the decedent is considered to own stock under the following rules.

1) *Members of the family A* decedent is considered as having owned the stock held directly or indirectly by or for:
    a) *A* spouse (other than one legally separated from the person under a decree of divorce or separate maintenance), or
    b) *A* child, grandchild, or parent. A legally adopted child is treated as a child of the individual by blood.
2) *Partnerships and estates.* Stock owned, directly or indirectly, by or for a partnership or estate is considered as having been owned by its partners or beneficiaries in proportion to their interest in the partnership or the estate.

3) *Trusts.* Stock owned, directly or indirectly, by or for a trust is considered as having been owned by the beneficiaries in proportion to their actuarial interest. (Stock owned by a tax-exempt qualified employee benefit plan trust is not included.) Stock owned, directly or indirectly, by or for any part of a trust of which a person was considered the owner or substantial owner is considered as having been owned by that person.
4) *Corporations.* If 50% or more in value of corporation stock was owned, directly or indirectly, by or for any person, that person is considered as having been the owner of any stock held (either directly or indirectly) by or for the corporation in the proportion that the value of the stock the person owned bears to the value of all the stock in the corporation.
5) *Options.* If the decedent had an option to acquire stock, the stock is considered as having been owned by the decedent. An option to acquire that option and each one of a series of those options is considered an option to acquire the stock.

Transfers Taking Effect at Death

The gross estate includes the value of property interests transferred by the decedent after September 7, 1916, if all the following conditions exist:

1) The beneficiaries could have possessed or enjoyed the transferred property through ownership of it, only by surviving the decedent,
2) The decedent kept a reversionary interest in the property, and
3) The value of the reversionary interest immediately before death was more than 5% of the value of the entire property.

However, the gross estate does not include the value of a transferred interest if the transfer was made for its full worth in money, or something else of equal value.

The first condition is met if the only way any beneficiary can get possession or enjoyment of the property through ownership of it is by surviving the decedent.

Example- Paul Birch transferred property in trust with the income payable to his wife for life. At her death, the remainder interest passes to their surviving child, or if there is no surviving child, to Paul or his estate. Since each beneficiary can possess or enjoy the property without surviving Paul, no part of the property is includible in his gross estate when he dies as a transfer taking effect at death, regardless of the value of his reversionary interest.

The second condition is met if the decedent kept a reversionary interest in the property transferred. *Reversionary Interest* includes a possibility that the transferred property may return to the decedent or to the decedent's estate and a possibility that the property may become subject to a power of disposition by the decedent. The term generally refers to any right under which the transferred property will or may be returned to the grantor. It does not matter if the right arises by the express terms of the instrument of transfer or by operation of law. However, if the transfer was made before October 8, 1949, and if the right to the return of the property does not arise because of the express terms of the instrument of transfer, the value of the property transferred is not includible in the gross estate as a transfer taking effect at death regardless of the value of the reversionary interest. The possibility of receiving income only from the transferred property after the death of another person is not a reversionary interest within the meaning of that term. The term *reversionary Interest* does not include the possibility that the decedent during his or her lifetime might have gotten back an interest in the transferred property by inheritance through the estate of another person.

Example- Kevin Spruce transferred property in trust with the income payable to his wife for life and the remainder payable to himself or, if he was not living at his wife's death, to their child or the child's estate. By the terms of the trust, Kevin kept a reversionary interest because he kept the right to have the property returned to him if he survived his wife. He had this right up to the moment preceding death.

The third condition for includibility is met if the value of the reversionary interest, as of the moment preceding death, is more than 5% of the value of the property transferred.

Death benefit under employment contract
An employment contract may provide that the employer will pay a death benefit during the term of the contract to the employee's spouse or to the employee's estate if the spouse dies first. This is a transfer that takes effect at death. The employee retained a reversionary interest40in the death benefit. If the value of the reversionary interest in the death benefit at the moment before death was more than 5% of the payment, the value of the death benefit is included in the employee's gross estate.

Example. John Elm entered into an employment contract with Maple Corporation. The employment contract provides that Maple Corporation will pay a stated death benefit to John's wife if John is an employee of the corporation at his death. If John's wife dies before him, the contract allows the benefit to be paid to his estate. After John's death, the death benefit was paid to his wife under the terms of the contract. The value of John's reversionary interest in the death benefit payment was more than 5% of the value of the payment at the moment before death. Because the interest meets all three conditions described in this section, the value of the death benefit is includible in John's estate as a transfer taking effect at death.

Transfer of reversionary interest
Generally, the decedent's gross estate will include the value of the property transferred that meets all three conditions. However, if more than 3 years before death the decedent transferred the reversionary interest, the value of the property is not includible in the gross estate. Conversely if the transfer of the reversionary interest occurs within the 3-year period before death, the value of the property is includible in the gross estate, whether or not a gift tax return was required to be filed.

Revocable Transfers
The gross estate includes the value of property interests transferred by a decedent that were subject to an exercisable power of the decedent. This does not apply to the extent the transfer was made for its full worth in money or something of equal value. If the enjoyment of the interest transferred was subject to any power of the decedent to change or end the transfer on the date of death, the value of that property interest is included in the gross estate. The same result occurs if the power was given up by the decedent within 3 years of the date of death. A decedent's power to change the beneficiaries or to hasten or increase any beneficiary's enjoyment of the property are examples of this. The decedent, either alone or with others, must have held this power at the time of death or within 3 years of the date of death. However, if the use of the power was limited by a condition beyond the decedent's control, and that condition did not occur before death, the property is not included in the gross estate as a revocable transfer.

Use of the power- The capacity in which a decedent could use the power has no bearing. If the decedent gave property in trust and was the trustee with the power to revoke the trust, the property would be included in his or her gross estate. If the decedent named another person trustee but kept the power to later appoint himself or herself trustee with power to revoke, the property also would be included in the gross estate. A similar result occurs if the decedent reserved the power to remove the trustee at will and appoint another trustee of an irrevocable trust for any transfer or addition to the trust after October 28, 1979. If, however, the power to change or end was held at all times solely by a person other than the decedent and the decedent reserved *no* right to assume these powers, the gross estate does not include the value of this property. Property interests generally are included in the gross estate even though the power to change or end them could be used by the decedent only along with others, regardless of their capacity or interests.

There are *two exceptions;*

- If the transfer was made before June 2, 1924, and the power can be used only with a person having a substantial adverse interest, the value included in the gross estate will not include the value of that other person's interest.
- Property is not included in the gross estate regardless of when it was transferred, if the decedent's power could be used only with the consent of all parties having an interest in the property, and if the power added nothing to the rights of the parties under local law.

The power may arise from the express provision of the transfer, by operation of law, or by an unrelated action at a later date. It is not necessary that the decedent kept the power on the date of the transfer (except for transfers occurring before June 23, 1936) as long as the decedent had the power at the date of death or within 3 years before death. Only the part of the transferred property that is subject to the decedent's power, as described above, is included in the gross estate.

Transfer of power- If the decedent transferred the power within 3 years of death, the value of the property interest transferred that was subject to the power is includible in the gross estate whether or not a gift tax return was required to be filed.

Transfers Before Death

The value of property transferred by a person before death is generally not included in the gross estate with the following exception:

1) Transfers with retained life estate,
2) Transfers taking effect at death,
3) Revocable transfers, and
4) Transfers of life insurance.

Also, if the decedent within 3 years of death transferred the retained interest, the reversionary interest, or the power relating to the above transfers, the value of the property is included in the gross estate. These transfers are included in the gross estate whether or not a gift tax return was required to be filed. Each of these transfers is discussed under its own heading.

Life insurance- If a decedent made a completed gift of a life insurance policy on his or her life within three years of death, the proceeds of the life insurance policy are included in the gross estate of the decedent. Therefore, if the decedent assigned all rights under the insurance policy to another person more than three years before death, the proceeds are not included in the gross estate. If the first assignment (made more than three years before death) of a group term life insurance policy is voided because of a change in the employer's insurance company and the new policy is assigned within three years of death, the proceeds are not included in the gross estate.

A gift of an insurance policy is considered to be made within three years of death if the decedent each year repurchases a policy that expires at the end of the policy year and reassigns it. In this case, the repurchase and reassignment constitutes a new transfer. However, the proceeds are not included in the gross estate if there is an option for an automatic renewal of a group term life insurance policy upon payment of the premium and if the policy was assigned more than three years before death.

Gift taxes- The gross estate also includes the amount of any gift tax paid by the decedent or the estate on any gift made by the decedent or the decedent's spouse during the 3-year period ending on the date of the decedent's death. Transfers made by the decedent within 3 years of death are used in certain computations that relate to:

- Distributions in redemption of stock to pay death taxes,
- Special-use valuation of certain farm, etc., real property, and
- Estate tax liens.

In addition, the estate may qualify to make installment payments of the estate tax only if the 35% of adjusted gross estate requirement is met by both including and excluding in the gross estate any transfers made within three years of death. See *Installment Payments,* discussed earlier under *The Estate* Tax *Return.* The other computations for which transfers within 3 years of death must be taken into account are discussed later.

For these computations, the following transfers will not be included:

- Any bona fide sale for an adequate and full consideration in money or money's worth
- Any gift (other than a life insurance policy) made during a calendar year if the decedent was not required to file a gift tax return for the gifts to that donee (recipient). This exception does not apply to transfers that must be included in the gross estate whether or not a gift tax return was required to be filed. Gifts to a spouse that qualified for the marital deduction and that are made within 3 years of death are included in the gross estate for purposes of these computations even though no gift tax return was required to be filed.

Form 706. The value of any transfer included in the gross estate, and any gift taxes paid within the three-year period before death, are listed on Schedule G, Form 706.

Annuities

The gross estate includes the value of an annuity or other payment under a contract or agreement that a beneficiary will receive because he or she survives the decedent. The value included is based on contributions made by the decedent or the decedent's employer under a plan entered into after March 3, 1931. A pure annuity contract that provides periodic payments to a person for life and ceases at the person's death is not included in the gross estate. Only certain annuities that continue to provide payments to surviving beneficiaries after the decedent dies are included in the gross estate. The inclusion of the proceeds of a life insurance contract on the decedent's life is determined under special rules discussed later in *Proceeds of Life Insurance.*

Annuity or other payment- The term annuity or other payment refers to one or more payments extending over any period of time. The payments do not have to be made in equal amounts or at regular intervals. Contracts or agreements include any arrangement, understanding, or plan such as a plan related to the decedent's employment.

A surviving spouse may be eligible to receive social security benefits if the decedent had been subject to the taxes imposed by the Federal Insurance Contributions Act or the Self-Employment Contributions Act. These benefits are not paid because of a contract or agreement. Therefore the value of monthly benefits payable to a surviving spouse under the *Social Security Act is* not includible in the decedent's gross estate as an annuity or other payment, or as property in which the decedent had an interest at the time of death. This rule also applies to the social security equivalent portion of tier 1 monthly payments receivable by the surviving beneficiaries under the Railroad Retirement Act.

Death benefits payable under the *Public Safety Officer's Benefit Act,* which provides for the payment of benefits to survivors of local, state, and federal public safety officers who died in the performance of duty, are not includible in the gross estates of such decedents because they are not paid under any form of contract or agreement. The annuity or other payment receivable by any beneficiary is included in the gross estate if *either* of the following conditions is met;

1) The annuity or other payment was payable to the decedent, either alone or in conjunction with another person or persons,
   a) For the decedent's life, or
   b) For any period that can be determined only with reference to the decedent's death (see *Transfers with retained Life* Estate), or
   c) For any period that does not in fact end before the decedent's death; or
2) The decedent must have possessed, for any period described in (1) the right to receive such an annuity or other payment, either alone or with another person or persons.

An annuity or other payment that is not includible in the decedent's or the survivor's gross estate as an annuity may still be includible under some other applicable provision of law. For example, survivor annuity payments that remain payable at a survivor's death under a qualified noncontributory plan are includible in the survivor's gross estate if the survivor had the unrestricted power to select the beneficiary of the remaining payments. See *Powers of Appointment,* discussed later. An annuity or other payment was payable to a decedent if, at the time of death, the decedent was in fact receiving an annuity or other payment, with or without an enforceable right to have the payments continued. The decedent had the ***right to receive*** an annuity or other payment if, immediately before death, the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of death, the decedent had a present right to receive payments.

Amount included in gross estate- If the decedent contributed only part of the purchase price of the contract or agreement, the gross estate includes only that part of the value at the decedent's death of the annuity or other payment receivable by the beneficiary that the decedent's contribution to the purchase price bears to the total purchase price. Contributions made by the decedent's employer (or former employer) to the purchase price of the contract or agreement are considered made by the decedent if the contributions are made because of the decedent's employment.

Example. Assume at death the value of an annuity payable to a beneficiary is $20,000. Before death, the decedent was receiving payments under the annuity contract. The annuity contract cost $25,000, of which the decedent had paid $15,000. The remaining cost was paid by the decedent's spouse. The value included in the decedent's gross estate is $12,000 ([$15,000/$25,000] X $20,000). If the annuity was part of a retirement plan and the decedent's employer rather than the spouse had paid the remaining cost, $20,000 ([$25,000/$25,000] X $20,000) would be included in the decedent's gross estate.

Annuities Under Approved Plans
If a decedent retired after 1984, the value of any annuity or other benefit payable to a survivor is included in the decedent's gross estate. The amount included is based on contributions made by the decedent or decedent's employer as explained in the example above. For the estates of decedents retiring before 1985 and dying either before 1985 and or after 1984, the following provisions apply if the decedent:

1) Was a participant in any plan,
2) Was in pay status on December 31,1984, and
3) Had irrevocably elected the form of the benefit before July 18, 1984.

If the decedent separated from service before January 1, 1985 and had elected a form of benefit before July 8, 1984, the decedent may be treated as meeting the pay status and irrevocable election requirements if he or she meets all other requirements and did not change the form of the benefit before death. If the decedent died after 1984 and did not meet these requirements, the previous discussion for including annuities in the gross estate will apply to the estate of the decedent.

Joint Interests
The gross estate includes the value of property held jointly at the time of death by the decedent and anyone who has the right of survivorship. However, that part of the property acquired by a person other than the decedent for adequate and full consideration in money or money's worth, or by bequest or gift from a third party, is not included in the decedent's gross estate. As the executor of the estate, the executor must prove that the other person (joint owner) acquired his or her interest for consideration or by bequest or gift. Consideration given by a surviving joint owner does not include money or property that was acquired from the decedent for less than a full and adequate consideration in money or money's worth. This general rule applies to all joint interests unless the interests are *qualified joint interests,* discussed later. If the owners of property in joint tenancy were jointly and severally liable on a mortgage on that property, and if at the death of a joint tenant the mortgage is outstanding, the surviving joint tenant's total contribution to the purchase is the sum of that survivor's actual payments for the purchase, later mortgage payments, and one-half of the mortgage indebtedness that remained outstanding at death.

Uniform Simultaneous Death Act- Certain states have adopted the Uniform Simultaneous Death Act to provide for the devolution of property when individuals die at the same time. The Act provides that for property held jointly by the decedents, one-half of the property is to be distributed as if one person had survived the other and one-half as if the other had survived. Therefore, one-half of the value of the property is includible in the gross estate of each decedent. However, if one decedent had contributed the entire consideration for the property held jointly, the full value of the property is included in that decedent's estate and one-half of the value of the property is included in the other decedent's estate.

Qualified Joint Interests- The gross estate includes one-half of the value of a qualified joint interest, no matter how much each spouse provided toward the purchase price.

The term *qualified joint interest* means any interest in property held by the decedent and the decedent's spouse as:

1) Tenants by the entirety
2) Joint tenants with right of survivorship, but only if the spouses are the only joint tenants.

If the interest in property is a qualified joint interest, one-half of the value will be included in the gross estate of the spouse who dies first. This rule applies even if the surviving spouse furnished the total consideration for the property. This qualified joint interest rule does not apply if the surviving spouse of the decedent is not a citizen of the United States.

Form 706- Jointly owned property is listed on Schedule E, Form 706. Real property that the decedent held as a tenant in common is listed on Schedule A, Form 706.

Powers of Appointment
The gross estate includes the value of property interests over which the decedent had a *general power of appointment* at death. The existence of the power does not depend on the capacity of the decedent to exercise the power. Included is the value of property interests over which the decedent exercised or released the power during lifetime if the exercise or release was:

1) With a retained life interest in the property appointed (as described in *Transfers with Retained Life Estate*), or
2) With a retained reversionary interest in the property appointed (as described in *Transfers Taking Effect at Death),* or
3) With a retained power to alter, amend, revoke, or terminate the appointment (as described in *Revocable Transfers)*

There are different rules for including property subject to a general power of appointment if the power was created before October 22, 1942. These are discussed later.

Power of appointment- A power of appointment determines who will own or enjoy the property subject to the power and when they will own or enjoy it. The power must be created by someone other than the decedent. It does not include a power created or held on property transferred by the decedent. It does not matter whether a power is actually called a power of appointment in a legal document. It also does not matter if the term is used in local property law. What matters is that the power exists in substance and effect. Thus, if the property laws of a state give the wife a power of testamentary disposition over property to which she does not have a vested title, she is considered to have a power of appointment for federal estate tax purposes.

Some powers do not in themselves constitute a power of appointment. For example, a power to amend only administrative provisions of a trust that cannot substantially affect the beneficial enjoyment of the trust property or income is not a power of appointment. A power to manage, invest or control assets or to allocate receipts and disbursements, when exercised only in a fiduciary capacity is not a power of appointment.

General power of appointment- A general power of appointment is one in which decedents could have appointed the property subject to the power to themselves, their creditors, their estates, or the creditors of their estates. It includes the unlimited power to use income or corpus or both for the decedent's benefit. Thus, if a decedent received the power to appoint the corpus of a trust to any of six persons not including the decedent, but also received the power to invade the corpus for any reason for the decedent's own benefit, the decedent would have a general power of appointment. However, a power of the decedent to consume or invade for the decedent's own benefit *limited by an ascertainable standard* relating to health, education, support or maintenance is *not* considered a general power of appointment. A power to use property for the *comfort, welfare, or happiness* of the decedent is *not* an ascertainable standard and therefore is a general power of appointment.

Example. Michael Elm, the decedent, was given the power to appoint the corpus of a trust. He could appoint to any of six persons not including himself, and he could also invade the corpus for his own reasonable support, education, and medical expenses. He would not be considered to have a general power of appointment.

A power of appointment is not a general power if, by its terms, it is either exercisable only in favor of one or more designated persons other than the decedent, the decedent's creditors, the decedent's estate, or creditors of the decedent's estate, or is expressly not exercisable in favor of the decedent the decedent's creditors, the decedent's estate or the creditors of the decedent's estate.

Joint powers- The decedent is not considered to have had a general power of appointment if the power could be exercised only with the consent or together with the creator of the power, or a person having a substantial adverse interest in the property subject to the power. A trustee administering a trust as a fiduciary does not have an adverse interest in the trust.

Right under the Uniform Gifts to Minors Act. If under the Uniform Gift to Minors Act (or the Uniform Transfers to Minors Act) the decedent-parent had a right to petition a court to order the custodian of the property transferred under the Act by a person other than the decedent, to apply the property for the child's benefit, the right to petition the court does not constitute a general power of appointment. The value of the custodial property is not includible in the decedent-parent's gross estate.

Exercised or released- Property interests subject to a general power of appointment are includible in the gross estate if a decedent held that power at death. They are also includible if the decedent had previously exercised or released the power in such a way that, if it had been a transfer of the decedent's own property, it would have been included in the gross estate as a transfer with a retained life estate, a transfer taking effect at death, or a revocable transfer.

Example. If the decedent had been given a general power of appointment over a farm and had exercised the power in favor of his son but had also retained the use of the farm himself for life, the value of the farm would be included in his gross estate.

Property subject to the power is not included in a gross estate if the decedent released the power completely and if the decedent held no interest in or control over the property. If the failure to exercise a general power of appointment results in a *lapse* of the power, the lapse is treated as a release only to the extent that the value of the property that could have been appointed by the exercise of the lapsed power is more than the greater of either $5,000 or 5% of the total value, at the time of the lapse, of the assets, or proceeds, out of which the exercise of the lapsed power could have been satisfied. In contrast to a release, if a decedent had disclaimed or renounced a general power of appointment, the property is not included in the gross estate. A disclaimer is a complete and unqualified *refusal to accept* the power of appointment. There can be no disclaimer of a power after it has once been accepted, and the disclaimer must be a qualified disclaimer, as discussed in the Gift Tax chapter.

The surviving spouse's nonexercise of the right to take a statutory share in place of the share provided in the decedent spouse's will is a complete disclaimer of that right by operation of law.

Form 706 Property subject to a general power of appointment that is includible in the gross estate is listed on Schedule H, Form 706.

Proceeds of Life Insurance

The gross estate includes the proceeds of life insurance *on the decedent's life* if:

1) The proceeds are receivable by the estate, or
2) The proceeds are receivable by another for the benefit of the estate, or
3) The proceeds are not receivable by or for the benefit of the estate and the decedent possessed *Incidents of ownership* in the policy.

Life insurance on the life of another, owned by the decedent at the decedent's death, is included in the gross estate as *property owned at death,* as discussed earlier in *Property Owned by the* Decedent In this case the amount includible is the replacement value of the policy. When the replacement value cannot be readily determined, the value of the policy may be approximated by adding the interpolated terminal reserve at the date of death and a proportionate share of the last premium paid.

The term *life Insurance* means all kinds of life insurance including:

1) Whole life policies,
2) Term insurance,
3) Group life insurance,
4) Double indemnity, travel, and accident insurance,
5) Endowment contracts (before being paid up), and
6) Death benefits paid by fraternal beneficial societies operating under the lodge system.

The term "life insurance," however, does not include:

1) Refunds of premiums in case of suicide, and
2) No-risk, single-premium policies combining annuities and life insurance.

If proceeds of life insurance are not includible in the gross estate under the provisions discussed in this section, they might still be includible under another provision.

Receivable by or for estate- The gross estate includes proceeds of insurance on the life of the decedent receivable by the executor or payable to the decedent's estate. The estate does not have to be specifically named as the beneficiary. If the proceeds of a policy are receivable by a beneficiary, other than the executor or the estate, and are subject to a legal obligation on the beneficiary to pay taxes, debts, or other charges enforceable against the estate, the proceeds required for payment of these obligations are includible in the decedent's gross estate to the extent of the beneficiary's obligation.

Incidents of ownership- Proceeds of insurance on the life of a decedent, not receivable by or for the benefit of the estate, are includible if the decedent held at death any of the incidents of ownership in the policy, exercisable either alone or together with any other person. This applies even if the decedent was acting as a trustee. If a policy is included in an estate because a decedent held an incident of ownership over it, it does not matter that the decedent did not initially take out the policy or that the decedent was physically unable to exercise control over the policy at the time of death. The term *Incidents of ownership* does not mean only the ownership of the policy in a technical legal sense. Here, the term refers to the right of the insured or the insured's estate to the economic benefits of the policy. It includes the power to change beneficiaries, to revoke an assignment, to obtain a loan against the surrender value, to pledge the policy for a loan, or to surrender or cancel the policy. Rights that are not considered to be incidents of ownership include the right to receive dividends and the right to veto the sale by a trustee of an irrevocable funded insurance trust.

Example. Bob Gray purchased an insurance policy on his life and named his wife as beneficiary. Bob transferred complete ownership of the policy to his wife and she added their children as beneficiaries. Bob's wife died and in her will, Bob was named executor of her estate and the trustee of a residuary trust established for the children. The insurance policy on Bob's life was included in her residuary estate.

As trustee, Bob was granted absolute discretion to distribute the current income to the beneficiaries or accumulate the income and add it to the corpus. Bob also was empowered in the management and investment of the trust property to do anything with the property as if it were his own. Under the terms of the policy, the owner could elect to have the proceeds made payable according to various plans, use the loan value to pay the premiums, borrow on the policy, assign or pledge the policy, and elect to receive the annual dividends. Under the terms of the will, Bob could exercise these rights, but not for his own benefit. Bob paid the premiums on the policy out of other trust property. Bob died 4 years after his wife. The proceeds of the policy are not included in his gross estate since he did not possess incidents of ownership in the policy. Bob's power over the policy on his life was held in a fiduciary capacity and was not exercisable for his personal benefit. He did not transfer property to the trust and did not receive his powers as fiduciary as part of a prearranged plan.

Partnerships- The proceeds of a life insurance policy that is owned by a partnership on the life of a partner are not includible in the insured partner's gross estate if the proceeds are payable to or for the benefit of the partnership. However, this only applies if the partner, in his or her individual capacity had no incidents of ownership in the policy. If the proceeds are payable other than to or for the benefit of the partnership, the proceeds are includible in the insured partner's gross estate. In this situation, the incidents of ownership in the policy held by the partnership are effectively held by the partners as individuals. Therefore, the insured partner possesses incidents of ownership that are exercisable with the other partners.

Group life insurance- The gross estate includes a group life insurance policy taken out by an employer on the decedent's life if the decedent owned the right to change the beneficiaries, the right to terminate the policy, or the right to prevent cancellation by purchasing the policy. In addition, a decedent's right to select a settlement option for the proceeds is generally an incident of ownership. The power to terminate a policy solely by ending employment is not an incident of ownership and the value of the proceeds is not included in the gross estate. Further, if the employee had the right to convert a group policy into an individual insurance policy at the end of employment and could transfer this right, the proceeds of the policy are not included in the gross estate if the decedent irrevocably transferred the policy to another and retained the conversion privilege. In this case, the conversion privilege is not an incident of ownership. A partnership's power to surrender or cancel its group term life insurance policy is not attributable to any of the partners. A partner who transferred all rights and interest in the partnership's group term life insurance policy more than 3 years before death does not have any incidents of ownership at the date of death. Therefore, the proceeds received under that policy are not includible in the decedent's gross estate.

Reversionary Interest- An incident of ownership includes a reversionary interest in the policy or its proceeds, but only if the value of the reversionary interest immediately before the death of the decedent was more than 5% of the value of the policy. This interest may arise by the specific terms of the policy or by operation of law. For this purpose, the term *reversionary interest* includes two possibilities:

1) That the policy or its proceeds may return to the decedent or the decedent's estate
2) That the policy or its proceeds may become subject to a power of disposition by the decedent.

Insurance proceeds paid to a divorced spouse- The gross estate includes life insurance proceeds paid directly to a decedent's former spouse if, under a decree of divorce, the decedent was required to name the divorced spouse as beneficiary of certain life insurance policies on the decedent's life and was required to maintain the policies until the former spouse's death or remarriage (at which time the proceeds would become payable to the decedent or the decedent's estate). However, a deduction is allowed from the gross estate for the obligation to pay the proceeds to the former spouse as an indebtedness of the estate.

Example. Under the terms of a divorce decree by a court with power under local law to decree a settlement of all marital property rights, John Black was required to name his former spouse as beneficiary of certain life insurance policies on his life. John was required to keep the policies in full force and effect until his death. If John's former wife remarries or dies before John dies, the policy proceeds would return to John or his estate, or they would be subject to a power of disposition. Thus, before death John held a reversionary interest that was more than 5% of the value of the policies. After John's death, the proceeds were paid directly to John's former spouse and never became part of the probate estate. Since before death John held a reversionary interest of more than 5% of the value of the policies, the interest was an incident of ownership in the policies, and the value of the proceeds is includible in John's gross estate. The estate, however, may deduct the amount of the proceeds paid to John's former spouse. The requirement to pay the proceeds to John's former spouse is an indebtedness against the property included in John's estate.

The terms *Reversionary Interest* and *Incidents of Ownership* do not apply to a policy or its proceeds that the decedent might inherit through the estate of another person or as a surviving spouse under a statutory right of election or similar right.

Transfers before death. If the decedent made a completed gift of a life insurance policy and all incidents of ownership in the policy more than 3 years before death, the value of the policy is not included in the decedent's gross estate. If the gift was made within 3 years before the date of death, see *Transfers Before Death,* discussed earlier.

Form 706- The proceeds of life insurance on the decedent's life includible in the gross estate should be listed on Schedule D, Form 706. A copy of Form 712, *Life Insurance Statement,* prepared by the insurance company, should accompany the return for each policy on the decedent's life whether or not the executor includes it in the gross estate.

Qualified Terminable Interest Property

The executor of an estate of a person who died after 1981 may have elected the marital deduction for certain qualified terminable interest property that passed to the surviving spouse. If a gift of terminable interest property was made between spouses after 1981, the donor may have elected the marital deduction for that property if it qualified. To qualify, under either situation, the spouse who received the property must have a qualifying income interest for life in that property.

If the spouse who received the property dies, the value of any property in which the spouse had a qualifying income interest for life and for which a marital deduction was allowed, under either election, will be included in his or her gross estate. However, if all or part of the property had been disposed of before death, it will not be included in the gross estate. Property included in a decedent's (i.e., the deceased surviving spouse of the transferor spouse) gross estate under this provision is treated as property passing from the decedent. Therefore, it may qualify as a charitable deduction, or as a marital deduction, from the decedent's gross estate.

Estate taxes recovered- If the gross estate includes the value of this marital deduction property, the estate may recover the estate tax on that property from whoever receives the property. See *Reimbursement of Estate Taxes,* discussed later.

Form 706- This property is listed on Schedule F, Form 706.

Valuation

Generally, the value of the decedent's property interest for estate tax purposes is its fair market value at the date of death or at the alternate valuation date. (See *Alternate Valuation,* discussed later.) Real property used in farming or other closely held businesses may be eligible for a reduced valuation for estate tax purposes if the executor elects it. See *Special-Use Valuation* for a discussion of this valuation.

Valuation understatement- A valuation understatement occurs if the value of any property claimed on the estate tax return is 50% or less of the amount determined to be the correct valuation. If there is an underpayment of the estate tax because of this understatement, an addition to tax of up to 20% of the underpayment may be assessed. The addition to tax will not apply if the underpayment is less than $5,000. The Internal Revenue Service may waive all or part of this addition to tax if it can be shown that there was a reasonable basis for the valuation claimed and that it was made in good faith. In addition, the penalty increases to 40% of the underpayment attributable to a gross valuation misstatement. There is a gross valuation misstatement if the value of any property claimed on an estate tax return is 25% or less of the amount determined to be correct.

Special rules- There are special rules for determining the fair market value of some kinds of property, such as stocks and bonds, shares of mutual funds, common trust funds, interests in a business, and life insurance. These rules are generally the same as those for the determination of fair market value for federal gift tax purposes and are discussed in detail in *Valuation,* under *Gift tax.*

Flower bonds- So-called "flower bonds" are marketable United States Treasury bonds that can be redeemed by an executor at par value plus accrued interest to pay federal estate taxes. These bonds are included in the gross estate at par value, even if the market value is less than par. If the market value is greater than par, they are included in the gross estate at the mean between the highest and lowest quoted selling prices. The gross estate will include the par value of flower bonds that could have been applied toward a part of the estate tax even if they are not used to pay the estate tax and are sold on the market at less than par value. Bonds in excess of the amount that may be applied are included in the gross estate at their market value.

The value of all annuities life estates, terms for years, remainders, or reversions other than those described below, is the present value on the applicable valuation date.

An annuity payable under a combination annuity and life insurance policy on a decedent's life that had no insurance element at the time of death is treated as a contract for the payment of an annuity.

An insurance policy on a decedent's life that is includible in the gross estate, as described earlier in *Proceeds of Life Insurance,* has a value equal to the proceeds payable by the policy.

Alternate Valuation

The executor may elect to use the alternate valuation method. Under this method, property included in the decedent's gross estate is valued as of a date other than that of death. This election does not change the rule that the gross estate includes property that the decedent owned or had an interest in on the date of death. The following provisions apply to the election of the alternate valuation method;

1) The election must be made on the first estate tax return filed for the estate. The return does not have to be filed on time for the election to apply. However, the election must be made on a return filed within 1 year of the due date (including extensions) for filing the return. The election cannot be changed.
2) The election may be made only if it will decrease the value of the gross estate and the sum of the estate tax and the generation skipping transfer tax (reduced by any allowable credits).

The election is effective only if a return is required to be filed. The election applies to all of the property in the estate. It cannot be used for only part of the property. However, the executor may elect alternate valuation and also elect special-use valuation for qualified real property (discussed later). Under the alternate valuation method, any deduction is allowed only to the extent it is not otherwise allowed in determining the value of the gross estate. In addition, if a charitable deduction is expressed as a percentage of the gross estate, the alternate value of the gross estate would be used in computing the charitable deduction.

Alternate valuation rules

If one elects the alternate valuation method, property in the estate is valued according to the following rules:

1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of.
2) Any property not disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death.
3) Any property, interest, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death. However, this is adjusted for any difference in value not due to mere lapse of time as of 6 months after the decedent's death, or, if earlier, as of the date of its disposition.

Properties, interests, or estates that are *affected by mere lapse of time* include patents, estates for the lives of persons other than the decedent, remainders, and reversions. This term does not apply to obligations for the payment of money, whether or not interest bearing, the value of which changes with the passing of time. The following are examples of rule 3.

Example Al Brown has a life estate in certain property, that is, the right to receive the income from the property as long as he lives. Al's brother Bob has a remainder interest in fee in the same property; that is, Bob or his estate will receive the property after Al's death. Bob died when Al was 31 years old, calculated to his nearest birthday. On the date of Bob's death the fair market value of the property was $250,000. The value of the remainder interest in this property is includible in Bob's gross estate. The actuarial value of the estate's remainder interest in this property is computed by using the factor taken from the applicable federal rate tables. (Assume the factor is .03610). If the executor does not elect the alternate valuation date, the value of the remainder interest in the property for estate tax purposes is $9,025 ($250,000 X .03610). If the executor elects the alternate valuation date and if me property declined $10,000 in value because of economic conditions, the value of the remainder interest (assuming an interest rate of 10.6%) would be $8,664 ($240,000 x .03610). This would apply even if Al were 32 years old on the alternate valuation date.

Note. If the alternate valuation method is used, the values of life estates, remainders, and similar interests are figured by using the ages of the recipients on the date of the decedent's death and the value of the property on the alternate valuation date.

Mutual fund capital gain dividends- When a capital gain dividend is declared and paid by a regulated investment company on its stock between the date of the decedent's death and the alternate valuation date, it is not includible in computing the value of the decedent's gross estate on the alternate valuation date. This rule applies if the value of the shares of the stock on the alternate valuation date reasonably *represents* the same included properly of the gross estate as existed at the date of death.

Special-Use Valuation

The executor of an estate may elect to value qualified real property that is included in the decedent's estate and that is devoted to farming, or is used in a closely held business, on the basis of its actual use for these purposes, rather than its fair market value determined on any other basis. Property passing in trust and property owned indirectly through a corporation or partnership qualify for this special-use valuation.

The decedent must have been a citizen or resident of the United States at the time of death and the property must be located in the United States. The election does not have to cover all qualified real property included in the estate.

Limitation- The total decrease in the value of qualified real property for which this election applies cannot be more than $750,000 for the estate of a person who dies after 1982.

Community property rules- If the decedent and the decedent's spouse at any time held qualified real property as community property, the special-use valuation rules apply as if the property were not community property. A decedent's community property interest is treated as if owned by the decedent as an individual. The decedent's community property interest is to be treated in the same manner as a comparable common law interest. For example, if the decedent held the qualified real property as a tenant in common, 1/2 of the total value would be includible in the gross estate regardless of the decedent's contribution. The full amount of the limitation applies to the decedent's qualified community property interest whether or not the decedent contributed to the purchase of the property.

General Requirements- The property must have been *qualified* real *property* used for a qualified use by the decedent or a member of the decedent's family or, the date of the decedent's death, and:

1) At least 50% of the *adjusted* value of the gross estate must consist of the adjusted value of real or personal property that was being used as a farm or in a closely held business and that was acquired from, or passed from, the decedent to a qualified heir of the decedent,
2) At least 25% of the adjusted value of the gross estate must consist of the adjusted value of qualified farm or closely held business real property,
3) The decedent or a member of the decedent's family must have owned the qualifying real property and must have used it for a qualified use for periods totaling at least 5 years out of the 8-year period ending on the date of the decedent's death (but see post-death *qualified* use rules), and
4) There must have been material *participation* in the operation of the farm or closely held business by the decedent or by a member of the decedent's family for periods totaling at least 5 years out of the 8-year period ending on the date of the decedent's death.

Adjusted value- For purposes of (1) and (2), the adjusted value is the value of property determined without regard to its special-use value. The value is reduced for unpaid mortgages on the property or any indebtedness against the property, if the full value of the decedent's interest in the property (not reduced by such mortgage or indebtedness) is included in the value of the gross estate. In addition, the adjusted value of the qualified real and personal property used in *different businesses* may be combined to meet the 50% and 25% tests.

A decedent's estate takes into consideration property transferred by the decedent within 3 years of death for purposes of determining if the estate qualifies for special-use valuation. If this property continued to be used until the decedent's death, it may be used to meet the 50% requirement of (1).

Qualified Real Property- For real property to qualify for this special-use valuation, a *qualified heir* must receive or acquire it from the decedent. It does not matter whether the real property is owned by the decedent directly or indirectly, through ownership of an interest in a corporation, a partnership, or a trust. If the ownership is indirect, the decedent's interest in the business must qualify under the requirements as discussed in this section, and:

1) If the indirect ownership is through a corporation-
   a) At least 20% of the value of the corporation's voting stock must be included in the gross estate, or
   b) The corporation must have had no more than 15 shareholders; or
2) If the indirect ownership is through a partnership-
   a) At least 20% of the partnership's total capital interest must be included in the gross estate, or
   b) The partnership must have had no more than 15 partners; and therefore qualify as an interest in a closely held business on the date of the decedent's death and for a period of time that equals (when combined with periods of direct ownership) at least 5 of the 8 years preceding death. All specially valued property must be used in a trade or business.

When directly owned real property is leased by a decedent to a separate closely held business, it is considered to be qualified real property if the separate business qualifies as a closely held business with respect to the decedent, as discussed above on the date of death and for a period of time that equals (when combined with periods during which the property was operated as a proprietorship) at least 5 of the 8 years preceding death. For example, real property owned by the decedent is eligible for the special-use valuation when it is leased to a farming corporation or partnership owned and operated entirely by the decedent and fewer than 15 members of the decedent's family.

For the special-use valuation, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities. It does not apply to passive investment activities or the mere passive rental of property to a party other than a member of the decedent's family. The decedent or a member of the decedent's family must own an equity interest in the farm operation. No trade or business is present in the case of activities not engaged in for profit.

Structures and other real property Improvements- Qualified real property includes residential buildings and other structures and real property improvements regularly occupied or used by the owner or lessee of real property (or by employees of the owner or lessee) to operate the farm or business. A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even when a family member and not the decedent was the person materially participating in the operation of the farm. Qualified real property also includes roads, buildings, and other structures, and improvements functionally related to the qualified use. However, elements of value, such as mineral rights and hunting rights that are not related to the farm or business use are not eligible for special-use valuation.

Property acquired from the decedent- Property is considered to have been acquired from, or to have passed from, the decedent if one of the following applies:

a. The property is so considered under section 1014(b) of the Code (relating to basis of property acquired from a decedent).
b. The property is acquired by any person from the estate.
c. The property is acquired by any person from a trust; to the extent the property is includible in the gross estate.

Qualified heir- A person is a qualified heir of property if he or she is a member of the decedent's family and acquired or received the property from the decedent. If a qualified heir disposes of any interest in qualified real property to any member of his or her family, that person will then be treated as the qualified heir with respect to the interest.

Member of the *family.* The term "member of the family" includes only:

1) An ancestor (parent, grandparent, etc.) of the individual,
2) The spouse of the individual,
3) A lineal descendant (child, stepchild, grandchild, etc.) of the individual, the individual's spouse, or a parent of the individual, or
4) The spouse, widow, or widower of any lineal descendant described above.

A legally adopted child of an individual is treated as a child of that individual by blood.

Discretionary trust- Property transferred to a discretionary trust is eligible for the special-use valuation if all the potential beneficiaries of the trust are qualified heirs and the other requirements discussed in this section are met.

Qualified use- The term "qualified use" means the *use* of property as a farm for farming purposes or the use of property in a trade or business other than farming. For purposes of determining whether property is eligible for the election, the mere passive rental of property to a party other than a member of the decedent's family does not qualify. Thus, the surviving spouse is not treated as failing to use property in a qualified use solely because the spouse rents the property to a member of the spouse's family on a net cash basis. If the decedent's trade or business leases the property and conducts farming or other business activities on the property, the real property may qualify for the special-use valuation. A net lease to any party other than an entity that is the decedent's trade or business is not a qualified use. For purposes of determining whether property is used in a qualified use after the decedent's death, see *post death qualified use rules,* for additional restrictions for qualified heirs.

In general, **farms** include stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, and greenhouses or other similar structures used primarily for raising agricultural or horticultural commodities. Farms also include orchards and woodlands. The term "farming purposes" means:

1) Cultivating the soil or raising or harvesting any agricultural or horticultural commodity on a farm including raising, shearing, feeding, caring for, training, and managing animals,
2) Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated, and
3) Planting, cultivating, caring for, or cutting trees or preparing (other than milling) trees for market.

Real property that is used in a trade or business other than farming may also qualify if the property was used in a trade or business in which the decedent or a member of the decedent's family materially participated before the decedent's death. This is true even if the party carrying on the business was not the decedent or a member of the family. However, the decedent or a member of the family must have personally and materially participated in the operation of the business and the decedent must have owned an interest in the business.

Period property must be owned- To be valued in this manner, the real property must be actually owned by any combination of the decedent, members of the decedent's family, and qualified closely held businesses for periods totaling at least 5 years of the 8-year period ending on the date of the decedent's death.

If property is transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death it is considered to be continuously owned to the extent of the decedent's equity interest in the corporation or partnership. But this applies only if the transfer meets the requirements of a nontaxable transfer to a corporation controlled by the transferor (section 351), or of the nonrecognition of gain or loss on a contribution to a partnership (section 721), and the decedent's interest in the corporation or partnership meets the requirements for indirectly held property as discussed at the beginning of *Qualified* Real/ *property*

Property transferred to a trust is also considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements for indirect ownership of property through a corporation (discussed earlier) would be satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. The executor may not count any periods following the transfer during which the interest in a corporation, partnership, or trust does not meet the indirect ownership requirements.

Replacement property. The period of the decedent or family member's ownership, qualified use, or material participation (discussed next) with respect to replaced property is treated as the period of ownership, qualified use, or material participation with respect to the qualified replacement property. This applies only to that part of the fair market value of the qualified replacement property (at the date of acquisition) that does not exceed the fair market value of the replaced property (at date of disposition).

Property is *qualified replacement properly* if it is acquired in a like-kind exchange or is acquired because of an involuntary conversion. This includes only property that is used for the same qualified use as that of the replaced property before the exchange. *Replaced property is* the property transferred in a like-kind exchange or involuntarily converted.

Example. Karen Ash had owned two tracts of land that were qualified real property. She acquired tract A in 2002 and tract B in 2011. Both tracts were condemned for public use in 2014. Karen received $100,000 for tract A and $50,000 for tract B. She used the total proceeds to purchase tract C, a single tract of land, as qualified replacement property.

To determine Karen's period of ownership for tract C, allocate the condemnation proceeds received for each tract to the total purchase price of the replacement property. The proceeds from tract A ($100,000) equals two-thirds of the total purchase price ($150,000). Therefore, two-thirds of tract C is considered replacement property of tract A. Karen is considered to have owned two-thirds of tract C since 2002. Under this method one-third of tract C is considered replacement property of tract B. Therefore, one-third of tract C is considered owned since 2011.

If Karen dies in 2015, she would meet the ownership requirements for special-use valuation for only two-thirds of tract C. The same apportionment method applies in determining whether the material participation and qualified use requirements are met.

Material Participation

For the special-use valuation rules to apply, the deceased owner or a member of the owner's family or both must materially participate in the operation of the farm or other business. Whether the required material participation occurs is a factual determination. The types of activities and financial risks that will support such a finding vary with the type of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not material participation. Neither is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

Period of material participation- The required participation must last:

1) 1) For periods totaling at least 5 years during the 8 years immediately before the date of death, and
2) For periods totaling at least 5 years during any 8-year period ending after the date of the decedent's death, but within the recapture period. (Recapture periods are discussed later and depend on the year of death.)

To determine whether the material participation requirement is satisfied, make no exception for periods during which the decedent's estate holds the real property. Additionally, if two or more family members materially participate at the same time during a period totaling a year, that will not result in the year being counted as 2 or more years for purposes of satisfying the above requirements. If a qualified heir dies before the required period has passed, any material participation requirement ends for that heir's portion of the property provided the heir received a separate, joint, or other undivided property interest from the decedent. If qualified heirs receive successive interests in specially valued property (for example, life estate and remainder interests) from the decedent, the material participation requirement does not end for any part of the property until the death of the last qualified heir (or, if earlier, the expiration of the recapture period). The requirements fully apply to an heir's estate if the heir's executor made an election for the same property.

In determining whether the required participation has occurred, disregard brief periods (30 days or less) during which there was no material participation. But the executor may disregard them only if these periods were both preceded and followed by substantial periods (more than 120 days) in which there was uninterrupted material participation. See *Required activities for material participation,* discussed later, which provides a special rule for periods when little or no activity is necessary to fully manage a farm.

Retired or disabled- If, on the date of death, the time period for material participation could not be met because the decedent had retired or was disabled, a substitute period may apply. This substitute period applies only if the decedent was retired on social security or was disabled for a continuous period ending with death. The time period for material participation for these decedents is a period totaling at least 5 years out of the 8-year period ending on the earlier of (1) the date that person began receiving social security benefits, or (2) the date that person became disabled. A person is disabled if the person is mentally or physically unable to materially participate in the operation of the farm or other business.

Required activities for material participation- To constitute material participation, the actual employment of the decedent or a member of the decedent's family must be substantially full-time. This means 35 hours a week or more or enough time to personally fully manage the farm or business in which the real property is used. For many farming operations that require only seasonal activity, material participation exists as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons. In the absence of this direct involvement in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this discussion and subject the person to self-employment tax.

If participants are self-employed with respect to the farm or other trade or business, their income from the farm or other business must be earned income for purposes of the tax on self-employment income before they are considered to be materially participating. Payment of the self-employment tax does not in itself indicate material participation. If no self-employment taxes have been paid, however, no material participation is considered to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason why no tax was paid. In addition, all self-employment taxes (including interest and penalties) determined to be due must be paid, if they can be assessed at the time of the determination. Generally, this means that any self-employment tax due for the previous 3 years must be paid.

In determining whether the material participation requirement is satisfied, the activities of each participant are considered separately from the activities of all other participants. At any given time the activities of at least one participant must be material. If the involvement is less than full-time, it must be according to an arrangement. The arrangement must provide for actual participation in the production or management of production in which the land is used by any nonfamily member, trust, or business entity in farming or another business. The arrangement may be oral or written, but must be in an arrangement that can be proven. Activities not called for by the arrangement will not support a finding of material participation. Activities of any agent or employee other than a family member may not be considered in determining if material participation exists. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

No one factor brings about the existence of material participation, but physical work and participation in management decisions are the principal factors to be considered.

The decedent or family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent or family member must participate in making a substantial number of these decisions.

The family participant should regularly look at the production activities on the land. The decedent or family member should have also advanced funds and taken on financial responsibility for a substantial part of the expense involved in the operation of the farm or other business in which the real property is used. An important factor in material participation in the case of a farm is whether the owner or other family members furnish a substantial part of the machinery, implements, and livestock used in the production activities.

A factor in material participation when the trade or business is a farm, hotel, or apartment building is whether the participating decedent or heir maintains his or her principal place of residence on the premises. Material participation by the decedent or family members may exist even when a professional farm manager is used. However, the decedent or family member must materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

Special rules for corporations, partnerships, and trusts- If property is indirectly owned, an arrangement must exist calling for material participation in the business by the decedent owner or a family member. In addition, full-time involvement must be under an arrangement between the entity and the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are performed may constitute the necessary arrangement for material participation.

If the property is owned by a trust, the arrangement will generally be found in one or more of the following situations;

1) The arrangement may result from appointment as a trustee.
2) The arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring material participation in its activities.
3) The arrangement may result because the participants enter into a contract with the trustees to manage or take part in managing the real property for the trust.
4) If the trust agreement expressly grants the management rights to the beneficial owner, the grant is sufficient to constitute the required arrangement.

The same participation standards apply for property that is owned by a qualified closely held business as for property that is directly owned. In the case of a corporation, partnership, or trust in which the decedent or family members are employees and thus not subject to self-employment tax, they are viewed as if they were self-employed. Their activities must be of the nature that would subject them to self-employment taxes. When the property is owned by a corporation, partnership, or trust, participation in the management and operation of the real property itself as a component of a closely held business is the determinative factor. If a person nominally holds a position as a corporate officer or director and receives a salary or is merely listed as a partner and shares in the profits and losses that alone does not support a finding of material participation. This applies even if the partner pays self-employment taxes on the distributive share of partnership earnings. Further, it applies for corporate directors in states where the board of directors does not need to be an active functioning entity or needs to act only informally. However, corporate offices held by an owner are factors considered in judging the degree of participation.

When real property is directly owned and leased to a corporation or partnership in which the decedent owns an interest that qualifies as an interest in a trade or business, the presence of material participation is determined by looking at the activities the participant takes part in regarding the property. During any periods when qualified real property is held by an estate, material participation is to be determined as if the property were owned by a trust.

Active management- The active management of a farm or other business by an eligible qualified heir, or a fiduciary of certain eligible qualified heirs, is treated as material participation by that eligible qualified heir in the operation of the farm or business. The term "active management" means the making of the management decisions of a business (other than the daily operating decisions). This is a finding of fact, and the requirements can be met even if the income from the farm or other business is not subject to self-employment tax. Active management, for farming purposes, includes the inspection of growing crops, review and approval of annual crop plans before planting, approval of large expenditures in advance, and making a large number of management decisions. Typical management decisions are deciding what crops to plant, where and when to market crops and other business products, how to finance operations, and what capital expenditures to make. An *eligible qualified heir is* a qualified heir (discussed earlier) who is:

1) The surviving spouse, or
2) Under age 21, or
3) Disabled, or
4) A student.

An eligible qualified heir under requirement (2), (3), or (4) will be considered to materially participate by engaging in active management only during the period that he or she meets those requirements. Active management by a fiduciary of an eligible qualified heir will be treated as material participation only if the heir is under 21 or disabled.

Surviving spouse- A surviving spouse who received qualified real property from a spouse who died is considered to have materially participated if the surviving spouse was engaged in the active management of the farm or other business. If the surviving spouse dies within B years of the first spouse's death, the period of material participation by the first spouse is added to the period of active management by the surviving spouse to determine if the surviving spouse's estate qualifies for special-use valuation.

The property must have been eligible for special-use valuation in the first spouse's estate. The surviving spouse's estate may elect special-use valuation even if that valuation was not used by the estate of the first spouse who died.

Special-Use Valuation Methods
The discussion that follows explains the methods an executor may elect for special-use valuations for qualified real property. An executor may change the special-use valuation method used after the federal estate tax return has been filed and the election for special-use valuation has been made.

Method for valuing term real property.. Generally, the special-use value of property that is used for farming purposes is determined as follows;

1) Subtract the average annual state and local real estate taxes on actual tracts of comparable real property from the average annual gross cash rental (or net share rental, if applicable) for that same comparable property, and
2) Divide the result in (1) by the average annual effective interest rate charged under the Farm Credit Bank System.

The computation of each average annual amount is based on the 5 most recent calendar years ending before the date of the decedent's death. The average annual effective interest rate to be used for estates of decedents is announced periodically in a news release and published in the Internal Revenue Bulletin as a Revenue Ruling.

This method cannot be used if it is established that there is no comparable property from which the average annual gross cash rental (or net share rental) can be determined or if the executor elects to use the method discussed later for valuing a real property interest in a closely held business.

Gross cash rental- Generally, gross cash rental is the total amount of cash received in a calendar year for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued. This amount is not reduced by the amount of any expenses or liabilities associated with the farm operation or the lease. (A definition of comparable proper(y and rules for property on which buildings or other improvements are located and on farms including multiple property types are given later in this section.)

For this method, the executor may use only rentals from tracts of comparable farm property that are rented solely for an amount of cash that is not based on production. The rentals considered must result from an arm's-length transaction (defined later). The executor may not use as accurate measures of cash rental value any rentals received under leases that provide for payment only in cash if the lessor (or a member of the lessor's family who is other than a lessee) is involved in the management or operation of the farm and the involvement amounts to material participation. This applies whether the lessor's involvement is contemplated or actually occurs. In general, therefore, rentals for any property that qualifies for special-use valuation cannot be used to compute gross cash rentals because the total amount received by the lessor does not reflect the true cash rental value of the real property.

Identification- Under this method, the executor must identify to the Internal Revenue Service the actual comparable property and cash rentals from that property. If this is not done but the special-use valuation has been elected, all specially valued real property must be valued under the rules discussed later for valuing property in a closely held business.

Arm's-length transaction- Under this method only cash rentals from a lease entered into in an arm's-length transaction are acceptable. For these purposes, arm's-length transactions do not include lands leased from the federal government or any state or local government for less than the amount that would be demanded by a private individual leasing for profit. They also do not include leases between family members, as defined earlier, that do not provide a return on the property to the same extent as that received under leases between unrelated parties in the locality.

Rents paid in kind and appraisals- Under this method, the executor may not use rents that are paid wholly or partly in kind (such as crop shares) to determine the value of real property. The executor also may not use appraisals or other statements regarding rental value or area wide averages of rentals (such as those compiled by the U.S. Department of Agriculture), because they are not true measures of the actual cash rental value of comparable property in the same locality as the specially valued property.

Five-year period Comparable real property rented solely for cash must be identified for each of the 5 calendar years preceding the year of the decedent's death. Rentals from the same tract of comparable property need not be used for each of these 5 years, however, if an actual tract of property meeting the requirements for this method is identified for each year.

Rents that Include use of equipment- In general, no adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property when its use is included under a lease for comparable real property. However, an adjustment is made if the lease specifies the amount of the total rental attributable to the personal property.

State and local real estate taxes- For purposes of the farm valuation formula, state and local taxes are taxes that are assessed by a state or local government and that are allowable as itemized deductions. However, a person may use in the valuation formula only those taxes on the comparable real property from which cash rentals are determined.

Comparable real property- Comparable real property must be situated in the same locality as the specially valued property. This is not solely a matter of mileage or political division. Instead, it is determined according to generally accepted real property valuation rules. The determination of properties that are comparable is a factual one. It is based on numerous factors, no one of which is determinative. It is often necessary, therefore, to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, rental property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases of multiple uses or land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all the properties must be combined. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. In the case of specially valued farmland used along with a grazing permit on nearby federal lands, comparable property is a parcel of farmland similar to that owned by the decedent that is used along with a second parcel similar to that used under the decedent's federal permit and that is rented as a combined unit to a third party.

All factors generally considered in real estate valuation are considered in determining comparability. The following list contains some of the factors considered in determining comparability:

1) Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index,
2) Whether the crops grown would deplete the soil in a similar manner,
3) Types of soil conservation techniques that have been practiced on the two properties,

4) Whether the two properties are subject to flooding,
5) Slope of the land,
6) For livestock operations, the carrying capacity of the land,
7) For timbered land, whether the timber is comparable to that on the subject property,
8) Whether the property as a whole is unified or segmented; if segmented, the availability of the means necessary for movement among the different sections,
9) Number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management, use, and value of the property, and
10) Availability and type of transportation facilities in terms of costs and of proximity of the properties to local markets.

Effective Interest rate- Generally, the annual effective interest rate on new loans under the Farm Credit Bank system loans is the average billing rate charged as adjusted on new agricultural loans to farmers and ranchers in the district in which the real property to be valued is located.

Net share rental- One may use the average annual net share rental from comparable land only if there is no comparable land from which average annual gross cash rental can be determined. If there are cash rentals from comparable land, the executor must use the cash rental method. The requirements in the earlier discussion of the cash rental method apply to the share rental method. For this purpose, net share rental means the gross value of the produce received by the lessor of the comparable land on which the produce grows minus the cash operating expenses (other than real estate taxes) of growing the produce that, under the lease, are paid by the lessor.

The term *produce* means crops or other products, such as cattle. The production of the produce must be the business purpose of the farming operation. The *gross value of the produce is* generally the gross amount received in the disposition of the produce if it is disposed of in an arm's-length transaction within the period established by the Department of Agriculture for its price support program. This is currently the 5-month period immediately after the date the lessor received (or constructively received) the produce. If there is no arm's-length transaction within this period, the value will be the weighted average price for which the produce sold on the national or regional commodities market closest to the farm property. The price will be determined as of the date the lessor received (or constructively received) the produce. If the lessor received only the proceeds (or an agreed set value) of his or her part of the farm's production, the share rental is determined under these rules as if the lessor had received his or her share of the produce.

Qualified woodlands- *The executor* may elect to treat trees (standing timber) growing on a qualified woodland as an interest in real property rather than as a crop. Therefore, the executor may specially value the timber as part of the qualified real property on which it is located. The election is made on the estate tax return and cannot be changed. A "qualified woodland" is any real property that is used in timber operations and that is an identifiable area of land. The term *timber operations* means planting, cultivating, caring for, or cutting trees, or preparing (other than milling) trees for market. An identifiable area is an acre or other area of land for which records are normally maintained for the timber operation.

The executor may use the cash rental method or if there is no comparable land to determine the cash rental, the share rental method to value the timber. The rentals must be on similar timber located on comparable land on which both the timber and land are rented for timber growing purposes. Other leases on the comparable property are not used in determining the value of qualified woodlands. If there are no comparable rentals on land and timber in the locality of the property to be valued, use the method for valuing a closely held business to determine the value of the timber and land. To make the election, the executor must attach to the estate tax return a special notice of election that:

1) Contains the decedent's name and taxpayer identification number as they appear on the estate tax return,
2) Identifies the election as a section 2032A(e)(13) election,
3) Specifies the property for which the election is made, and
4) Provides all information necessary to show that the executor is entitled to make the election.

If the Internal Revenue Service later asks the executor to furnish additional information, it must be furnished within 60 days after it is requested. The statement containing the: requested information should also contain the information in (1), (2), and (3) above. If the executor does not provide the additional information within 60 days after it is requested, the election may be held invalid.

Method of valuing a real property interest in a closely held business. This method is used to determine the special-use valuation for qualifying real property used in a trade or business other than farming. The executor may also use this method for qualifying farm property if there is no comparable land from which cash rentals or share rentals can be determined, or if one elects to use this method for farm property.

Under this method, the value of real property is determined by applying the following factors:

1) The capitalization of income that the property can be expected to yield for farming or for closely held business purposes over a reasonable period of time with prudent management and traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors.
2) The capitalization of the fair rental value of the land for farming or for closely held business purposes.
3) The assessed land values in a state that provides a differential or use value assessment law for farmland or closely held business.
4) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price.
5) Any other factor that fairly values the farm or closely held business value of the property.

Dispositions and Failures to Use for Qualified Use

Some or all of the estate tax benefits obtained through reduced valuation may be recaptured under some circumstances. This would happen if within the recapture period after the death of the decedent but before the death of the qualified heir, the qualified heir disposes of the property to nonfamily members or the property ceases to be used for farming or other closely held business purposes.

The amount of the tax benefit potentially subject to recapture (additional estate tax) is the lesser of the following:

1) The excess of the estate tax liability that would have been incurred if the special-use valuation had not been used *over* the estate tax liability based on the special-use valuation, or

2) The excess of the amount realized on the property (or the fair market value of the property in any case other than a sale or exchange at arm's length) *over the* value of the property determined under this method of valuation.

Recapture period- The recapture period for the estate of a decedent who dies after 1981 is 10 years. If the decedent died before 1982, the recapture period is 15 years. Liability for additional estate tax. If any additional estate tax is due, the qualified heir must file Form 706-A, United *States Additional/ Estate Tax Return,* within 6 months after the taxable disposition or the end of the qualified use, unless the Service has granted an extension of time. Interest on the additional estate tax will be assessed only for the period from the due date (6 months after the disposition or the end of qualified use) until the tax is paid.

A qualified heir is personally liable for the additional estate tax to the extent of the heir's interest in the qualified real property. However, the heir will not be liable if a bond is furnished that meets certain requirements.

Bond requirements- A qualified heir may apply in writing to the Internal Revenue Service for a determination of the maximum additional estate tax that may be imposed on the heir's interest in the qualified real property. The Service will notify the heir as soon as possible of the maximum amount of the tax liability. The Service will send the notice within one year of the date the application is made. By furnishing a bond for the maximum amount of the tax and for the period required, the heir will be discharged from personal liability. The qualified heir is entitled to a receipt or writing that acknowledges the discharge from personal liability.

Involuntary conversions- The additional estate tax does not apply to an involuntary conversion, such as a condemnation, if the cost of qualified replacement property equals or exceeds the amount realized on the conversion. When involuntarily converted property is only partially replaced, determine the additional estate tax liability by reducing the amount of tax that would have been imposed by an amount that bears the same ratio to the tax as the cost of the qualified replacement property bears to the amount realized on the conversion. Any additional estate tax that is imposed on the involuntary conversion is treated as a tax imposed on a partial disposition. Form 706-A should be filed whether or not any additional estate tax is due. See the Form 706-A instructions for the lines to be completed.

In determining the imposition of and the amount of the additional estate tax (and the special lien, described later), any qualified replacement property must be treated just as if it were a portion of the interest in the qualified real property that was involuntarily converted. However, the recapture period described earlier is extended by any period during which the qualified heir was allowed to replace the qualified real property. However, this extension does not include the 2 --year period generally allowed for replacement of involuntarily converted property.

In determining whether property has ceased to be used for a qualified use, do not consider periods after the involuntary conversion and before the acquisition of the qualified replacement property. Material participation with respect to the converted property is treated as material participation with respect to the qualified replacement property.

Like-kind exchanges- The additional estate tax does not apply to a like-kind exchange. This is an exchange of an interest in qualified real property solely for an interest in qualified exchange property. However, the tax will apply if other property is also received in the exchange. The full additional estate tax on the interest exchanged is reduced by a percentage. Determine the percentage by dividing the fair market value of the qualified exchange property by the fair market value of the qualified real property exchanged. Fair market value is determined at the time of the exchange. Any additional estate tax on the exchange is treated as a tax on a partial disposition of qualified real property. The term *qualified exchange* properly means real property that will be used for the same qualified use as was applied to the property for which it was exchanged. Any interest in qualified exchange property is treated just as if it were an interest in the qualified real property that was exchanged. Material participation with respect to the exchanged property is treated as material participating with respect to the qualified exchange property.

Disposition of timber- If the election had been made to treat standing timber as an interest in real property (discussed earlier), a disposition of part of that interest in qualified real property occurs if a qualified heir severs or otherwise disposes of the standing timber on the qualified woodland during the recapture period. The disposition of a right to sever is treated as a disposition of the standing timber. The additional estate tax on this disposition is the amount equal to the lesser of:

1) The amount realized on the disposition (or, if other than a sale or exchange at arm's length, the fair market value of the part of the interest disposed of), or
2) The amount of additional estate tax that would have been imposed if the entire interest of the qualified heir in the qualified woodland had been disposed of, minus any additional estate tax imposed on all earlier transactions involving that woodland.

Property ceases to be used for a qualified use if it is no longer used as a farm or in a closely held business. It also ceases if no material participation exists for periods of time totaling more than 3 years in any 8-year period that ends after the decedent's death but before the death of the qualified heir. Generally, if the qualified heir dies without having disposed of the property but having retained its qualified use, the potential liability for the additional estate tax ceases. In order to meet the qualified use requirement after the decedent's death, the qualified heir must continuously use the specially valued property in its qualified use during the entire recapture period. A qualified heir is regarded as using the specially valued property in its qualified use only if the qualified heir has a financial stake in the operation of the farm or other business by

1) operating the farm or other business for his or her own benefit, or
2) in the case of a farm or like property, renting it out to someone else under a crop share lease or similar lease in which the qualified heir has equity in the use of the specially valued property.

A qualified heir is not regarded as using the specially valued property in the qualified use if the qualified heir (other than the decedent's spouse) leases the property to anyone on a cash-lease basis. However, under a special rule that applies only for surviving spouses, if the surviving spouse of a decedent is the qualified heir of farm property that was specially valued in the decedent's gross estate, the surviving spouse's cash rental of the property to a member of the surviving spouse's family is not treated as a cessation of the surviving spouse's qualified use of the property. Thus, a qualified heir (other than the spouse under the limited exception) who cash leases specially valued property triggers an imposition of the additional estate tax.

The additional estate tax does not apply to the failure by the qualified heir to use the property before the commencement date. The commencement date is the date on which the heir begins to use the qualified real property. However, for this exception, the commencement date must be within 2 years after the decedent's death. If the commencement date is within 2 years of the decedent's death, the recapture period is extended by the period after the decedent's death and before the commencement date.

Lien- A special lien in favor of the United States apaches to the property for which an election to use the special-use valuation has been made. The lien equals the adjusted tax difference attributable to the interest in the property. In an involuntary conversion, the lien attaches to the qualified replacement property and in a like-kind exchange it attaches to the qualified exchange property. The lien continues until:

1) The liability for the additional estate tax has been satisfied, or
2) The liability has become unenforceable because of the lapse of time, or
3) It is established to the satisfaction of the Internal Revenue Service that no further tax liability may arise.

Security may be furnished to substitute for this lien. The Service may issue a certificate of discharge of any or all property subject to the lien after receiving a bond or other security. The Service may also issue a certificate of subordination of this special lien if it is determined that the interests of the United States are protected adequately after the subordination.

Election of Special Valuation

An individual makes the election to use the special-use valuation on the estate tax return. Check the "Yes" box under the *Elections* by *the Executor* section of the return and complete Schedule A-1 (Form 706). An individual must also attach the agreement and notice of election as described later. The election must be made on the first estate tax return filed by the estate. The return does not have to be filed on time for the election to apply. The election to use special-use valuation cannot be changed. One may choose an election for less than all qualified real property. An election need not include all real property included in an estate that is eligible for special-use valuation. For example, some acreage contained in a farm may be valued at its fair market value if the heirs plan to sell that land, while other acreage may be valued at its special-use value.

If qualified heirs receive joint or undivided interests (for example, interests as joint tenants or tenants in common) in the same property, an election for one heir's joint or undivided interest does not have to include any other heir's interest in the same property.

When successive interests in specially valued property are created, remainder interests may be treated as being received by qualified heirs. They are treated in this way only if the remainder interests are not contingent upon surviving a non-family member or are not subject to divestment in favor of a nonfamily member.

Agreement to special-use valuation- Generally, an agreement must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of death. For a qualified heir, the agreement must express consent to personal liability for additional estate tax in the event of certain early dispositions of the property or early cessation of the qualified use. For parties other than qualified heirs with interests in the property, the agreement must express consent to collection of any additional estate tax imposed. The agreement must be in a form that is binding on all parties having an interest in the property. It must give the name and address of an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service on matters arising under the agreement to the special valuation.

The Internal Revenue Service will contact the designated agent on all matters relating to continued qualification of the specially valued real property and on all matters relating to the special lien. The agent is the attorney-in-fact for the parties with interests in the specially valued real property and must furnish the Service with any requested information. The agent must also notify the Service of any disposition or cessation of qualified use of any part of the property.

An <u>interest in property</u> is an interest that, as of the date of the decedent's death, can be asserted under local law so as to affect the disposition of the specially valued property by the estate. Any person, who at the death of the decedent has any interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Examples of holders of an interest in property are: owners of remainder and executory interests, holders of general or special powers of appointment; beneficiaries of a gift over in default of exercise of any power; co-tenants; joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued; and trustees and beneficiaries of trusts holding any interest in the property.

Persons who are not considered to have an interest in property include an heir who has the power under local law to challenge (caveat) a will and thus affect disposition of the property or an estate's creditors merely because of their status as creditors. In some cases, a representative may sign the agreement for the person with an interest in property. The representative must be authorized under local law to bind the person in such an agreement. The person with the interest must want the representative to act for him or her or must be unable to enter a binding agreement because he or she is too young, is incompetent, or dies before the election is exercised. Proof of the power to act must be attached to the agreement. A sample form of the agreement to special valuation follows;

AGREEMENT TO SPECIAL VALUATION UNDER SECTION 2032A

Estate of ________________________________
Date of Death: _____________
Decedent's Social Security Number: ____________
We _______, _________, ________, being all of the qualified heirs and, _______, _______, _______, _______, other parties having interests in the property that is qualified real property and that is valued under section 2032A of the Internal Revenue Code, do hereby approve of the election being made by ____________, Executor/Administrator of the Estate of ______________, pursuant to section 2032A, to value said property on the basis of the qualified use to which the property is devoted and do hereby enter into this agreement pursuant to section 2032A(d).

The undersigned agree and consent to the application of subsection (c) of section 2032A of the Code with respect to all the property described on line 2 of Part 2 of Schedule A-1 of Form 706, attached to this agreement.

More specifically, the undersigned qualified heirs expressly agree and consent to personal liability under subsection (c) of 2032A for the additional tax imposed by that subsection with respect to their respective interests in the above-described property in the event of certain early dispositions of the property or early cessation of the qualified use of the property. It is understood that if a qualified heir disposes of any interest in qualified real property to any member of his or her family, such member shall thereafter be treated as the qualified heir with respect to such interest.

The undersigned interested parties who are not qualified heirs consent to the collection of any additional estate and generation-skipping transfer (GST) taxes imposed under section 2032A(c) of the Code from the specially valued property.

If there is a disposition (other than to a member of his or her family) of any interest that passes or has passed to him or her or if there is a cessation of the qualified use of any specially valued property that passes or passed to him or her, each of the undersigned heirs agrees to file a Form 706-A, United States Additional Estate Tax Return, and pay any additional estate and GST taxes due within six months of the disposition or cessation.

It is understood by all interested parties that this agreement is a condition precedent to the election of special-use valuation under section 2032A of the Code and must be executed by every interested party even though that person may not have received the estate (or GST) tax benefits or be in possession of such property.

Each of the undersigned understands that by making this election, a lien will be created and recorded pursuant to section 6324B of the Code on the property referred to in this agreement for the adjusted tax difference with respect to the estate as defined in section 2032A(c)(2)(C).

As the interested parties, the undersigned designate the following individual as their agent for all dealings with the Service concerning the continued qualification of the specially valued property under section 2032A of the Code and on all issues regarding the special lien under section 6324B. The agent is authorized to act for the parties in all dealings with the Internal Revenue Service on matters affecting the qualified real property described earlier. This authority includes the following:

To receive confidential information on all matters relating to continued qualification under section 2032A of the specially valued real property and on all matters relating to the special lien arising under section 6324B.
To furnish the Service with any requested information concerning the property.
To notify the Service of any disposition or cessation of qualified use of any part of the property.
To receive, but not to endorse and collect, checks in payment of any refund of Internal Revenue taxes, penalties, or interest.
To execute waivers (including offers of waivers) of restrictions on assessment or collection of deficiencies in tax and waivers of notice of disallowance of a claim for credit or refund.
To execute closing agreements under section 7121.
Other acts (specify) ________________________

By signing this agreement, the agent agrees to provide the Service with any requested information concerning this property and to notify the Service of any disposition or cessation of the qualified use of any part of the property.

Name of Agent _____________________
Signature ______________________
Address ______________________

The property to which this agreement relates is listed in Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and in the Notice of Election along with its fair market value according to section 2031 of the Code and its special-use value according to section 2032A. The name, address, social security number, and interest (including the value) of each of the undersigned in this property are as set forth in the attached Notice of Election.
IN WITNESS WHEREOF the undersigned have hereunto set their hands at ___________, this ___________, day of _________, 200__.

Signature(s) of Qualified Heir(s): ______________________

Signature(s) of Other Interested Parties: ____________________

Notice of election- The notice must contain the following information:

1) The decedent's name and taxpayer identification number as they appear on the estate tax return,
2) The relevant qualified use,
3) The items of real property shown on the estate tax return to be specially valued under the election (identified by schedule and item number),
4) The fair market value of the property to be specially valued and the property's value based on its qualified use (both values determined without reduction for unpaid mortgages, etc.),
5) The adjusted value of all real property (after reduction for unpaid mortgages, etc.) that is used in a qualified use and that passes to a qualified heir, and the adjusted value of all real property to be specially valued,
6) The items of personal property shown on the estate tax return that pass from a decedent to a qualified heir and that are used in a qualified use (identified by schedule and item number), and the total value of the personal property (reduced by unpaid mortgages, etc.),
7) The adjusted value of the gross estate (gross estate minus any unpaid mortgages, etc.),
8) The method used for determining the special value based on use,
9) Copies of written appraisals of the fair market value of the real property,
10) A statement that the decedent or a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death,
11) Any periods during the 8 years preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business,
12) Affidavits describing the activities constituting material participation and the identity of the material participant or participants, and
13) A legal description of the specially valued property.

Modification of election or agreement- If the following applies;

1) The notice of election or agreement, as filed, does not contain all required information, or
2) The agreement, as filed, does not include the signature of any person required to enter into the agreement,

a person will have a reasonable period of time (not exceeding 90 days) after notification of these failures to provide the information or agreements. This period to modify the election will only be allowed if an individual made the election on time and substantially complied with the requirements for filing the election.

One has not substantially complied with the requirements, if they only check the applicable box on the estate tax return. Both a notice of election and an agreement that substantially comply with the requirements must be included with the estate tax return. The types of information that may be supplied after the initial filing are social security numbers and addresses of qualified heirs, written appraisals that had been obtained prior to filing the return, legal description of property, and the designation of an agent.

Protective election- The estate may make a protective election to specially value qualified real property. The availability of special-use valuation under this protective election depends upon the values finally determined (or agreed to following examination of a return) that meet the requirements of the special-use election. To make a protective election, check "Yes" under the *Elections* by the *Executor,* section and complete Schedule A-1 according to its instructions for "Protective Election."

If they make a protective election, one should complete this Form 706 by valuing all property at its fair market value. Do not use special-use valuation. Usually, this will result in higher estate and GST tax liabilities than will be ultimately determined if special-use valuation is allowed. <u>The protective election does not extend the time to pay the taxes shown on the return.</u> If one wishes to extend the time to pay the taxes, they should file Form 4768 in adequate time before the return due date.

If it is found that the estate qualifies for special-use valuation based on the values as finally determined (or agreed to following examination of the return), one must file a supplemental Form 706 (with a complete section 2032A election) within 60 days after the date of this determination. Complete the supplemental return using special-use values under the rules of section 2032A, and complete Schedule A-1 and attach *all* of the required statements. The amended return is to be filed with the Service office where the original return was filed.

Chapter 4 Taxable Estate

The *taxable estate is* the gross estate minus:

1) Administration and funeral expenses,
2) Claims against the estate,
3) Any outstanding obligation to which the property is subject, if the value of the property is included in the gross estate and is undiminished by the outstanding indebtedness,
4) Casualty and theft losses,
5) Marital deduction,
6) Charitable deduction, and
7) Deduction for proceeds from certain sales of employer securities.

Expenses, Claims, and Obligations

A deduction is allowed for amounts payable out of *property subject to claims* (generally, the probate assets) for:

1) Funeral expenses,
2) Administration expenses incurred in administering property subject to claims,
3) Claims against the estate, and
4) Unpaid mortgages and other charges (indebtedness) against property if the value of the property is included in the gross estate without reduction for the mortgage or other indebtedness. This deduction includes the interest accrued to the date of decedent's death.

Limitation- The amount of the deduction is the amount paid for these expenses that is allowable under the local law governing the administration of the decedent's estate. The total deduction, however, is limited to:

1) The value of property subject to claims included in the decedent's gross estate, plus
2) The amount paid out of property included in the gross estate but not subject to claims. This amount must actually be paid within the time allowed for the filing of the estate tax return.

The applicable local law under which the estate is being administered determines which property is subject to claims and which property is not subject to claims. If under local law a particular property interest included in the decedent's gross estate would bear the burden for the payment of the expenses, then the property is considered *property subject to claims* For this purpose, the value of this property is reduced by the amount of any deduction allowed for a casualty or theft loss to the property during the settlement of the estate.

Example. The only items in the gross estate were a bank deposit of $50,000 and jointly owned real estate, valued at $750,000 at decedent's death. The bank account was subject to claims, but the real estate, under local law, was not. Funeral expenses amounted to $10,000 and the debts of the decedent totaled $45,000, both of which were allowable under local law. If the executor paid the funeral expenses and $25,000 of the debts out of the bank account, the estate could claim $35,000 in deductions. If, in addition, the surviving spouse paid the remaining $20,000 of debts *before* the executor filed the return, the estate could claim a $55,000 deduction.

If the surviving spouse paid the remaining $20,000 in debts *after* the time required to file the return, the estate could claim only $35,000 in deductions. If, on the other hand, the executor paid only $20,000 out of the bank account for the funeral expenses and debts, and the surviving spouse paid $20,000 *before* filing the return and the remaining $15,000 *after* the time required to file, the estate would be entitled to the full $55,000 deduction. This is because the allowable deduction is the amount that is *payable* out of property subject to claims and is actually paid ($55,000) from any source in the gross estate, but limited to the value of:

1) The property subject to claims ($50,000) *plus*
2) The amount actually paid out of property not subject to claims before the return is filed ($20,000).

Since the amount actually paid ($55,000) is within the limitation ($70,000), the full $55,000 may be deducted.

Property not subject to claims- A deduction is also allowed for the expense of administering proper(y that is not subject to claims (generally, nonprobate assets included in the gross estate), if:

1) The expense is paid before the expiration of the period of limitation for assessing the federal estate tax (generally, 3 years after filing), and
2) The expense is allowable by the law governing the administration of the decedent's estate as if the property were subject to claims.

Estimated amount-If at the time of filing the estate tax return, the exact amount of a deductible item is not known, one may enter an estimated amount for that item on the return if the estimated amount can be determined with reasonable certainty and it can be shown that the item will be paid.

Administration Expenses

These expenses include commissions as the executor, fees of attorneys for the estate, and miscellaneous expenses. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of beneficiaries (heirs, legatees, or devisees) are not deductible. An attorney's fee incurred by a beneficiary that is not essential to the proper settlement of the estate is not deductible as an administration expense, even if it is approved by a probate court as an expense payable or reimbursable by the estate.

If the estate includes property located in a foreign country and if administration expenses are incurred on that property, one must determine the United States dollar value for those expenses. For this purpose, use the foreign exchange rate in effect on the date that the payments are made.

Miscellaneous expenses- These expenses include court costs, accountants' fees, appraisers' fees, and other expenses necessary for preserving and distributing the estate. They include the cost of storing or maintaining property of the estate for a reasonable period of time before the property is distributed. They do not include the cost of additions or improvements to the property. Excise taxes incurred in distributing property in kind are deductible administration expenses.

Selling expenses- If property has to be sold to pay the decedent's debts, administration expenses, or taxes or to maintain the estate or make a distribution, the expenses of the sale are deductible. These expenses include brokerage fees, excise taxes on the sale, and other expenses of the sale. Underwriting fees that were necessary to sell a large block of stock are deductible as administration expenses.

Interest expenses- Interest expenses incurred after the decedent's death are generally allowed as a deduction if they are reasonable and necessary to the administration of the estate. The interest must be allowable under local law. The interest that accrues after death on federal and state *Income tax* deficiencies while an executor contests the imposition of the taxes is deductible as an administration expense.

Interest on a loan incurred to pay *estate taxes* is deductible as an administration expense when it accrues. A deduction is not allowed for estimated amounts that will accrue if repayment of the loan could be accelerated. Interest incurred as the result of a federal *estate tax or gift tax* deficiency is a deductible administration expense.

If the executor elects *installment payments* for the estate tax, they may deduct the interest payable on those installments. One may not deduct an estimate of the amount of interest payable, because they may have to accelerate the payment of the tax. Therefore, this interest expense is deductible only when the interest accrues. Installment payments are discussed under *The Estate Tax Return.* Interest incurred as the result of a *late payment* of the federal estate tax, a state death tax, or a foreign death tax is deductible as an administration expense. However, any *penalty* for failure to pay or failure to file is not deductible as an administration expense even if it is allowable under local law.

Interest accrued on obligation of decedent- An administration expense is not allowed for interest that is payable after a decedent's death and that is attributable to an installment obligation incurred by the decedent. If the decedent had lived, he or she would have been liable for the interest as well as the principal. Since the interest is not actually and necessarily incurred in the administration of the decedent's estate, it is not allowable as an administration expense.

Funeral Expenses

These expenses are allowed as a deduction from the gross estate if they are actually paid, are allowable out of property subject to claims under local law, and satisfy the limitation (discussed earlier) for the total amount of expenses allowed for the items discussed in this section. Deductible expenses may include the cost of a tombstone, monument, mausoleum, or a burial lot, either for the decedent or the decedent's family, and a reasonable expenditure for its future care if allowable by the local law. The cost of transportation of the person bringing the body to the place of burial is deductible. Funeral expenses are allowable only as deductions in computing the estate tax.

The estate is allowed a deduction if it is primarily liable under local law for the decedent's funeral expenses and last illness expenses. (Last illness expenses are deductible as a claim against the estate.) However, under local law, the husband may be primarily liable for the funeral and last illness expenses of his deceased wife. In this case the estate would be allowed a deduction for these expenses only if the wife's will directs that these expenses be paid out of her estate.

Claims Against the Estate

Amounts that may be deducted as claims against a decedent's estate are only for enforceable personal obligations of the decedent at the time of death and interest on those obligations that had accrued at the time of death. It does not matter whether the obligations had matured. Only interest accrued up to the date of death is deductible even though the executor elects the alternate valuation date.

Medical expenses of the decedent are deductible as a claim against the estate. (See *Medical expenses,* later.) Deductions for claims founded upon promises or agreements are limited to the extent that the liabilities were contracted in good faith and for adequate and full consideration in money or money's worth. However, a pledge or subscription in favor of a public, charitable, religious, or educational organization is deductible to the extent that it would have constituted an allowable deduction if it had been a bequest. No deduction is allowed for a claim against the estate by a remainderman relating to any qualified terminable interest property included in the gross estate.

If the estate has to pay a claim in a foreign currency, the executor must determine the United States dollar value for that claim. For this purpose, use the foreign exchange rate in effect on the date of death (or alternate valuation date). However, if events that occur after death must be considered in valuing the claim, you must use the foreign exchange rate in effect on the date of payment.

A transfer of property that satisfies the requirements that exempt certain property settlements between spouses from the gift tax is considered to be made for adequate and full consideration in money or money's worth. The obligation to transfer the property to the former spouse would qualify as a claim against the estate. See *Certain Property Settlements* under *Gift Tax.*

Taxes- Taxes that are deductible as claims against the estate include property taxes accrued before the decedent's death, unpaid income taxes on income received by the decedent during life, and unpaid gift taxes on gifts made by the decedent during life. Unpaid state gift taxes are deductible even if, when they are paid, they are credited against a state inheritance tax. Any self-employment taxes paid by the executor to meet the material participation requirements for special-use valuation are deductible as a claim against the estate. Taxes that are not deductible include income taxes on income received after the decedent's death, property taxes not enforceable before death, or any estate, succession, legacy, or inheritance taxes.

State or foreign death tax deduction- If a state or a foreign country imposes a death tax on a transfer made by a decedent for charitable purposes, the estate may elect to take a deduction for the payment of this tax rather than the state or foreign death tax credit. The deduction is allowed only if the decrease in the federal estate tax due to the allowance of the deduction only benefits the charity, or if the federal estate tax is apportioned among all beneficiaries of property included in the estate. When the deduction is claimed, the credit for state death taxes or foreign death taxes, whichever is applicable, is reduced to reflect that a portion of the tax is used as a deduction rather than as a credit. These credits are discussed later.

Other Indebtedness

This includes any unpaid mortgages and other indebtedness against property included in the estate. It also includes any interest that had accrued on these obligations to the date of the decedent's death. If the estate is liable for the payment of the obligation, the executor must include the full value of the property in the gross estate and deduct the amount of the outstanding indebtedness. Special-use valuation of property will not affect the deductible amount of any outstanding indebtedness on that property.

If the estate is not liable for the obligation, include only the value of the property minus the obligation in the gross estate. However, if a decedent had made a transfer before death that must be included in the gross estate, the value of the property that is included in the decedent's gross estate is not reduced by the amount of any mortgage that the donee (recipient) obtains on the property. This is so because the mortgage did not benefit the decedent and applies even if the decedent was guarantor of the loan with a right of reimbursement, unless the donee becomes insolvent. If the mortgage is on jointly held property, only that part of the mortgage for which the decedent was liable and for which the estate must pay is deductible.

Insurance proceeds paid to divorced spouse- Generally, the decedent's estate includes life insurance proceeds paid directly to a divorced spouse if under the divorce decree the decedent was required to name the former spouse as beneficiary of a life insurance policy and was obligated to keep the policies in force until the former spouse's death or remarriage (at which time the proceeds become payable to the decedent or the decedent's estate. See *Proceeds of Life Insurance.)*

The payment of the insurance proceeds to the former spouse satisfies an indebtedness created in settlement of the decedent's marital obligations. Thus, since the insurance proceeds are includible in the decedent's gross estate at full value (because of a reversionary interest in the proceeds), the obligation to pay the decedent's former spouse is an indebtedness against property included in the gross estate. Therefore, the proceeds of the life insurance policy may be deducted from the gross estate of the decedent.

Income Tax vs. Estate Tax Deduction

The executor may not use amounts allowable as administration expenses or losses (discussed later) during administration of the estate as deductions in computing the taxable income of the estate for income tax purposes unless they waive the deduction for estate tax purposes. The total deductions or the total amount of any deduction does not have to be treated in the same way. One deduction, or a portion of a deduction, may be allowed for income tax purposes if the waiver is filed and another deduction or portion may be allowed for estate tax purposes.

File the waiver with the income tax return in the year the expenses are claimed on the return for income tax purposes. This waiver is irrevocable. Taxes, interest, and business expenses accrued at the date of the decedent's death are deductible as claims against the estate on the estate tax return and also as deductions in respect of the decedent on the income tax return of the estate or a beneficiary who received the property subject to these expenses. If these expenses were not accrued at the date of the decedent's death, they are administration expenses and are deductible only on the estate tax return unless a waiver is filed. See Publication 559, *Survivors, Executors, and Administrators,* for a discussion of income and deductions in respect of a decedent.

Medical expenses- If medical expenses are deducted only on the estate tax return, they are fully deductible as claims against the estate. If expenses for the decedent's medical care are paid within one year after date of death, they are treated as being paid in the tax year in which they were incurred. In this case, if a waiver is filed, the expenses may be deducted on the decedent's income tax return for the year incurred. The deduction may be claimed only to the extent that the decedent's total medical deduction exceeds the percentage limitation for the year incurred. If part of the medical expenses are deducted on the decedent's income tax return and part deducted on the estate tax return, the part deducted on the estate tax return may not include the amount that is not deductible for income tax purposes because of the percentage limitation.

Example. The decedent incurred $20,000 in medical expenses in 2011. These were the only medical expenses incurred during the year. The decedent's income tax return for 2011 showed an adjusted gross income of $100,000. The decedent died in 2011. You, as the executor of the decedent's estate, paid the $20,000 in medical expenses within one year of the decedent's death. You elected to deduct $5,000 as a claim against the estate. You file an amended income tax return for 2011 and attach the necessary waiver indicating that $15,000 had not been and would not be deducted for estate tax purposes. Only $7,500 ($15,000 - $7,500 (7.5% x$100,000)) is deductible on the decedent's income tax return for 2011. If you had deducted all the medical expenses as claims against the estate, $20,000 would be deductible for estate tax purposes.

Selling expenses- These expenses cannot be used to offset the sales price of property in determining gain or loss if they have been deducted for estate tax purposes as an administration expense.

Alimony payments- The commuted value of alimony payments to be made by the estate is deductible as a claim against the estate if the court that issued the divorce decree had the power to settle all property rights. The alimony payments made by the fiduciary during administration are deductible for income tax purposes. If the court did not have jurisdiction to settle all property rights, the value of the alimony payments would be deductible only to the extent that they do not exceed the reasonable value of the support rights of the ex-spouse.

Form 706- If these deductions are used to determine the taxable estate, list them on the following schedules;

- Funeral expenses and expenses incurred in administering property subject to claims are listed on Schedule J, Form 706.
- Claims against the estate and other indebtedness (mortgages, etc.) are listed on Schedule K, Form 706.
- Expenses incurred in administering property not subject to claims are listed on Schedule L, Form 706.

Casualty or Theft Losses

Deductions are allowed for losses incurred during the settlement of the estate arising from theft or casualties, such as storms or fires. But they are allowed only to the extent that the losses are not compensated for by insurance or in another manner. The executor may waive the right to claim a loss for estate tax purposes if they want to claim the loss in computing the taxable income of the estate for income tax purposes.

Form 706- The net losses allowable for estate tax purposes are listed on Schedule L, Form 706.

Marital Deduction

The marital deduction is a deduction from the gross estate of the value of property that is included in the gross estate but that passes, or has passed, to the surviving spouse.

Property interests passing to the surviving spouse include any interest taken:

1) As the decedent's legatee, devisee, heir, or donee,
2) As the decedent's surviving tenant by the entirety or joint tenant with right of survivorship,
3) As an appointee under the decedent's exercise of a power or as the taker in default if the decedent does not exercise a power, or
4) As the beneficiary of insurance upon the decedent's life.

Interests passing to the surviving spouse include dower (or curtesy) interests or the statutory interest in place of dower or curtesy, if elected. They also include an interest that, under community property laws, the surviving spouse had merely an expectant interest in before the decedent's death. In order for property passing from a decedent to a surviving spouse to qualify for the marital deduction, the spouse must survive the decedent and be married to the decedent at the time of death. The marital deduction is not allowable for transferred property if the decedent was not married to the transferee at the time of death even though the transferee was the decedent's spouse at the time of the transfer.

The parties are considered to have been married at the time of the decedent's death in spite of a prior ex parse divorce, if the divorce had been overturned by a court having personal jurisdiction over the spouses. No marital deduction is allowed if the surviving spouse disclaims a property interest; it is considered as passing to the person entitled to receive that interest as a result of the disclaimer. However, if the surviving spouse receives an interest in property as a result of a qualified disclaimer by another person, that interest is considered as passing directly from the decedent to the surviving spouse and may qualify for the marital deduction. (See *Qualified Disclaimers,* in the Gift Tax chapter.)

Federal estate taxes or other death taxes that are paid out of the surviving spouse's share of the gross estate are not included in the value of property interests passing to the surviving spouse. If a property interest that passes to a surviving spouse is subject to a mortgage or other encumbrance, or if an obligation is imposed upon the surviving spouse in connection with the passing of a property interest, the value of the interest must be reduced by the amount of the mortgage or other encumbrance. However, if the will or local law requires the executor to discharge the mortgage or other encumbrance out of other assets of the estate, or to reimburse the surviving spouse, the payment or reimbursement constitutes an additional interest passing to the surviving spouse.

A property interest passes to a surviving spouse when a will requires an executor to satisfy a debt of the surviving spouse for which the decedent had no liability. The amount of the bequest to satisfy the debt qualifies for the marital deduction. Whenever a surviving spouse receives a bequest with a condition that he or she relinquishes certain other property, the value of the conditional bequest is the amount by which it exceeds the value of the relinquished property.

Nondeductible interests- Certain interests that pass to the surviving spouse do not qualify for the marital deduction. These nondeductible interests include:

1) A property interest that is not included in the decedent's gross estate.
2) A property interest that is transferred to the spouse to satisfy a claim against the estate. Similarly, if the surviving spouse is the executor of the estate and receives commissions deducted as an administration expense, no marital deduction is allowed for the commissions. (See the earlier discussion of administration expenses, etc.)
3) A property interest on which a deductible loss occurred during settlement of the estate. No marital deduction is allowed for this property to the extent of the deductible loss. (See *Casualty or Theft Losses,* discussed earlier.)
4) A property interest that is a *terminable interest* However, there are exceptions to this nondeductible interest.

Terminable Interests

Certain interests in property passing from a decedent to a surviving spouse are referred to as *Terminable Interests.* Such interests may terminate or fail after the passage of time, or upon the occurrence or nonoccurrence of some contingency. Examples are life estates, annuities, estates for terms of years, and patents. Generally, the value of a terminable interest is nondeductible if:

1) Another interest in the same property passed from the decedent to some other person for less than adequate and full consideration in money or money's worth, and
2) Because it passed, the other person or that person's heirs may enjoy part of the property after the termination of the surviving spouse's interest.

Example A decedent devises real property to the spouse for life with remainder to his children. The life interest that passed to the spouse is a terminable interest since it will terminate at the spouse's death, and the children will thereafter possess or enjoy the property.

Alternate valuation date- An interest in property passing from the decedent to the surviving spouse and another person does not qualify for the marital deduction even though the other person's contingent interest will be extinguished before the alternate valuation date elected by the executor of the decedent's estate.

Other nondeductible terminable Interests- A property interest may be a nondeductible terminable interest even if it does not meet the above conditions. No marital deduction is allowed for a property interest that the executor must convert into a terminable interest for the surviving spouse. For example, a bequest of money is a nondeductible interest if the executor must use the money to purchase an annuity for the surviving spouse. A property interest that may be satisfied out of a group of assets that includes a nondeductible interest will not qualify for the marital deduction to the extent of the value of the nondeductible interest. For example, suppose a surviving spouse is to receive one-third of the estate after all expenses are paid. The value of this bequest is $150,000. The estate includes a property interest that would be a nondeductible terminable interest if it passes to the surviving spouse. This interest is included in the gross estate at a value of $120,000. The executor has the right to satisfy the bequest by transferring this entire property interest to the surviving spouse. Therefore, the bequest is a nondeductible interest to the extent of $120,000. If only one-third of that interest can be used to satisfy the bequest, $40,000 is a nondeductible interest.

Exceptions- There are, however, exceptions to the terminable interest rule. A property interest passing from the decedent to the surviving spouse is not treated as a nondeductible terminable interest if:

1) It is a right to income for life with a power of appointment meeting the requirements discussed later,
2) It consists of life insurance or annuity payments held by the insurer with a power of appointment in the spouse, meeting the requirements discussed later,
3) It is conditioned on the spouse's surviving for a limited period, in the manner described later,
4) It is qualified terminable interest property, meeting the requirements discussed later, or
5) It is an interest in a qualified charitable remainder trust of which the spouse is the only non-charitable beneficiary, as discussed later.

Income interest with power of appointment- A property interest passing from the decedent to a surviving spouse is considered a deductible interest if it satisfies the following five conditions:

1) The surviving spouse is entitled to all or a specific part of the income from the entire interest or a specific part of it for life,
2) The income is payable annually or more frequently,
3) The surviving spouse has the power to appoint the entire interest or the specific portion to the surviving spouse or to his or her estate,
4) The surviving spouse must be able to exercise the power alone and in all events (although it may be limited to exercise either during life or by will), and
5) The interest is not subject to a power in any other person to appoint any part of the interest to anyone other than the surviving spouse.

If either the right to income or the power of appointment passing to the surviving spouse pertains only to a specific portion of a property interest passing from the decedent, the marital deduction is allowed only to the extent that the rights in the surviving spouse meet all of these five conditions. In determining whether a surviving spouse is entitled to receive all the income from a specific portion of an interest, it is not necessary that the surviving spouse receive a fractional or percentile share of all the income from the entire interest. When a surviving spouse is entitled to receive a specified sum of income per year, the capital amount that would produce such a specified sum will be considered the specific portion from which the surviving spouse is entitled to receive the income.

Life Insurance with power of appointment- A property interest consisting of the proceeds of a life insurance, endowment, or annuity contract that are held by an insurer and that pass from the decedent to the surviving spouse is considered a deductible interest if:

1) The surviving spouse is entitled to receive the proceeds in installments, or is entitled to interest on them, with all amounts payable during the surviving spouse's life and only to the surviving spouse,
2) The installment or interest payments are payable annually, or more frequently, beginning not later than 13 months after the decedent's death,
3) The surviving spouse has the power to appoint any amounts payable under the contract to the surviving spouse or to his or her estate,
4) The surviving spouse must be able to exercise the power alone and in all events (although it may be limited to exercise either during life or by will), and
5) The amount payable under the contract is not subject to a power in any other person to appoint any part of the amount to anyone other than the surviving spouse.

If these five conditions are met only for a specific portion of the proceeds, the rules for a partial interest in property are applicable in determining the extent of the allowable deduction.

Survival for limited period requirement- If a property interest passed from a decedent to a surviving spouse, subject to a provision that it was to pass to some other person if either the spouse dies within 6 months after the decedent's death or the decedent and the spouse should die as a result of a common disaster, the property interest is deductible if the spouse survived beyond the stated period or if the decedent and the spouse did not die as the result of a common disaster.

Qualified terminable interest property- Generally, a marital deduction is not allowed for a life estate that passes from a decedent to a surviving spouse, because the surviving spouse's interest terminates when he or she dies. However, an individual may elect the marital deduction for all or part of this interest if it meets the requirements of qualified terminable interest property. Make the election on the estate tax return. The election cannot be changed.

The term "qualified terminable interest property" (QTIP) means property that passes from the decedent and in which the surviving spouse has a *qualifying income interest for life.*

Property includes an interest in property. A specific portion of property is treated as separate property. The surviving spouse has a qualifying income interest for life if:

1) The surviving spouse is entitled to all the income from the property, or has a usufruct interest for life in the property,
2) The income is payable annually or more frequently, and
3) No person (including the surviving spouse) has the power to appoint any part of the property to anyone other than the surviving spouse.

An annuity is treated as an income interest that may be a qualifying income interest for life (regardless of whether the property from which the annuity is payable can be separately identified). Income interests granted for a term of years or life estates subject to termination if certain events occur (for example, if the surviving spouse remarries) do not qualify for this election. If any person, including the surviving spouse, can appoint any pad of the property subject to the qualifying income interest to someone other than the surviving spouse, the interest does not qualify. However, a power that can be exercised only at or after the death of the surviving spouse does not disqualify the interest for purposes of making this election.

If the interest meets the requirement for QTIP treatment and the executor makes a valid election in accordance with the requirements of Form 706 and instructions to treat the property as qualified terminable interest property, the entire property subject to the interest is treated as passing only to the surviving spouse. No one other than the surviving spouse is treated as having received any pan of the property. In the case of a survivor annuity that is includible in the decedent's estate under section 2039, where only the surviving spouse has the right to receive payments before the death of the surviving spouse, the surviving spouse's interest in the annuity is treated as a qualifying income interest for life and the executor is treated as having made a QTIP election for the annuity unless the executor otherwise elects on the Form 706.

If the surviving spouse transfers all or part of the qualifying income interest, the transfer is subject to the gift tax. (See *Qualified Terminable Interest Property* in the *Gift Tax* chapter.) If the surviving spouse did not dispose of the property, his or her gross estate will include the value of the property. (See *Qualified Terminable Interest Property* discussed earlier under *Gross Estate.)*

Charitable remainder trusts- If the surviving spouse is the only non-charitable beneficiary of a qualified charitable remainder trust, the marital deduction is allowed for any interest in the trust that passes to the surviving spouse. A *noncharitable beneficiary* means any beneficiary of the trust other than an organization for which a charitable contribution deduction is allowed. A ***qualified charitable remainder trust*** *is* a charitable remainder annuity trust or a charitable remainder unitrust. These trusts are discussed later under *Charitable Deduction*

Limitation on Marital Deduction

The amount of the marital deduction is the value of a qualifying property passing to the surviving spouse. One does not have to make any adjustments for gifts made to the spouse or for community property included in the gross estate. The maximum formula is expressed as follows;

1) The property passes under a will executed before September 12, 1981, or a trust created before that date, that contains a maximum marital deduction formula,
2) The formula was not amended after September 12, 1981, and before the death of the decedent to refer specifically to the unlimited marital deduction, and
3) The state does not enact a law applicable to the estate that construes the formula as referring to the unlimited marital deduction; the unlimited marital deduction will not apply.

In that event, the maximum marital deduction for property passing from a decedent to the surviving spouse will be the *greater* of:

1) $250,000, or
2) 50% of the value of the decedent's adjusted gross estate.

The deduction is limited to the actual value of the interest that passes, or has passed, from the decedent to the surviving spouse.

Restriction on Deduction for Alien Spouses
In the case of those who die after November 10 1988, the marital deduction is not available for property passing to a surviving spouse who is an alien (either a resident alien or a non-resident alien) unless the property passes to the spouse in a qualified domestic trust (QDOT) or is placed in a QDOT before the date on which the decedent's estate tax return is filed. In order to qualify as a QDOT, a trust must meet the requirements of either a life estate with power of appointment discussed above or an estate trust. An estate trust is one in which;

1) The income is payable to the spouse for life and upon death is distributable to the spouse's estate,
2) The spouse is entitled to the income for a term of years following which the corpus is to be paid to the spouse or the spouse's estate, or
3) The trust income is to be accumulated for a term of years or for the spouse's life and the augmented funds paid to the spouse or the spouse's estate.

In addition, the trust instrument of the QDOT must require that at least one trustee be a citizen of the United States or a domestic corporation. No distribution, other than a distribution of income, may be made from the trust unless a U.S. trustee has the right to withhold the federal estate tax imposed on QDOT distributions discussed below. The trust must meet the requirements of regulations to insure the collection of this tax. The personal representative must elect on the federal estate tax return to treat the trust as a QDOT. An estate tax is imposed on a QDOT in three situations:

1) When any distribution is made from a QDOT before the death of the surviving spouse (other than a distribution of income or a distribution of principal on account of hardship),
2) On the value of all property in the trust if the trust ceases to meet the QDOT requirements, and
3) On the value of property remaining in the QDOT on the death of the surviving spouse.

If a surviving spouse becomes a United States citizen before the date on which the decedent's estate tax return is filed, the unlimited marital deduction is allowable under the rules applicable to citizen spouses and there is no requirement that the property be placed in a QDOT.

Deduction Reduced by Death Taxes
If death taxes must be paid out of the property passing to a surviving spouse, the marital deduction is reduced by the amount used to pay the taxes. The marital deduction is likewise reduced if the executor has the discretionary power to pay any death taxes from the marital interest, regardless of whether the executor uses that discretion. The marital deduction is limited to the value of property that could not have been allocated for the payment of death taxes. The payment of death taxes from a deductible interest causes a situation known as an ***interrelated computation*** of the federal estate tax. This computation is beyond the scope of this book. Anyone considering such an arrangement should seek appropriate legal or tax counsel on the matter.

Form 706- Property interests that otherwise qualify for a marital deduction (and are not includible as QTIP property) are to be listed on Schedule M, Form 706. Property interests for which a QTIP election is being made must be listed on Schedule M. See the instructions to the form for additional information.

Charitable Deduction
A deduction is allowed for the value of property in the decedent's gross estate that the decedent transferred during life or by will to or for the use of any of the following:

1) The United States, a state, a political subdivision of a state, or the District of Columbia, for exclusively public purposes,
2) Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment, unless the organization is a qualified amateur sports organization) and the prevention of cruelty to children or animals, as long as no part of the net earnings benefits any private individual and no substantial activity is undertaken to carry on propaganda, or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office,
3) A trustee or a fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, and no substantial activity is undertaken to carry on propaganda or otherwise attempt to influence legislation, or participate in any political campaign on behalf of any candidate for public office,
4) Any veterans organization incorporated by an Act of Congress or any of its departments, local chapters, or posts, for which none of the net earnings benefits any private individual, or
5) A foreign government or its political subdivision when the use of such property is limited exclusively to charitable purposes.

Note. For purposes of 1) above, certain Indian tribal governments are treated as states and therefore, transfers to these tribal governments qualify as deductible charitable contributions. See Revenue Procedure 83-87 for a list of qualifying Indian tribal governments.

For purposes of 2) above, educational purposes includes the providing of care of children away from their homes if substantially all the care provided enables individuals (the parents) to be gainfully employed, and the services are available to the general public.

Transfers subject to a condition or power- If a transfer to a qualified charity depends on some act or occurrence, a deduction is allowable only if it is virtually certain that the transfer will become effective. If the donee or the trustee has the power to divert any part of the property or fund for a use or purpose that is not deductible, only the portion of the property or fund not subject to this power is deductible.

Disclaimers- The charitable deduction is allowed for amounts that are transferred to charitable organizations as a result of either a qualified disclaimer or the complete termination of a power to consume, invade, or appropriate property for the benefit of an individual. It does not matter whether termination occurs because of the death of the individual or in any other way. The termination must occur within the period of time (including extensions) for filing the decedent's estate tax return and before the power has been exercised. See *Qualified Disclaimers,* in the Gift Tax chapter.

Payment of death taxes- The deduction is limited to the amount actually available for charitable uses. Thus, if under the terms of a will or the provisions of local law, the federal estate tax or any other death tax is payable in whole or in part out of property that is transferred as a charitable deduction, the deduction is the amount of the transferred property reduced by these taxes. If the executor elected to make installment payments of the estate tax, they must reduce the charitable deduction by an estimate of the maximum amount of interest that will be payable on the deferred taxes if the interest is payable out of property transferred to charity. It does not matter if the interest deduction is taken on the estate tax return or on the estate's income tax return. The payment of death taxes from a deductible interest causes a situation known as an *interrelated computation* of the federal estate tax. This computation is beyond the scope of this book. Anyone considering such an arrangement should seek appropriate legal or tax counsel on the matter.

Powers of appointment- The charitable deduction is allowed for property passing to charity by the exercise, release, or lapse of a power of appointment, if the property is included in the decedent's gross estate.

Partial interests- Sometimes an interest in property passes from the decedent for charitable purposes and another interest (other than an interest that is extinguished upon the decedent's death) in the same property passes from the decedent for private purposes for less than an adequate and full consideration in money or money's worth. When this occurs, a deduction is allowed for the value of the interest that passes for charitable purposes only under certain conditions. These are described later under *Partial interests* in the *Gift Tax* section. If at the date of a decedent's death, a transfer for private purposes depends on the performance of some act or the happening of some precedent event in order to be effective, the interest is considered to pass for a private purpose unless the possibility of the occurrence of the act or event is so remote as to be negligible.

State or foreign death taxes- For treatment of state or foreign death taxes imposed on a transfer to a charity; see the discussion under *Administration Expenses, Funeral Expenses, Claims, and Obligations,* and *Credit for State Death Taxes.*

Form 706- Charitable transfers are listed on Schedule O, Form 706.

Prior law allowed a deduction from the gross estate of 50% of the proceeds from the sale of employer securities to employee stock ownership plans (ESOP's), including tax-credit ESOP's, or to eligible worker-owned cooperatives (EWOC's). The deduction was limited to 50% of the taxable estate (figured without regard to the estate tax deduction for sales of stock to ESOP's) and could not reduce the estate tax before credits by more than $750,000.

Estate Tax Computation

The taxable estate is the *total gross estate* minus:

1) Administration and funeral expenses,
2) Claims against the estate and obligations,
3) Casualty and theft losses,
4) Marital deduction, and
5) Charitable deduction.

There is one *Unified Rate Schedule* that applies to both estate and gift taxes. The schedule is used to determine the tentative tax on the taxable amount (taxable estate or taxable gift). The Unified Rate Schedule can be found at the end of the Gift Tax chapter.

The *gross estate tax* before the allowance of any credit is an amount equal to:

1) A tentative tax on the sum of-
    a) The amount of the taxable estate, and
    b) The amount of the *adjusted taxable gifts;*
    c) Minus
2) The total amount of *tax payable* for gifts made after 1976.

The *adjusted taxable gifts* include only the value of the taxable gifts that were made by the decedent after 1976 and that are *not includible* in the decedent's gross estate. Generally, transfers before death are not included in a decedent's gross estate and, therefore, are considered adjusted taxable gifts for purposes of determining the tentative tax. However, certain transfers are included in the gross estate and would not be included in adjusted taxable gifts. See *Transfers Before Death,* discussed earlier.

The estate tax reduction for taxes payable on gifts made after 1976 is based on the rate schedule in effect at the time of death. For example, in 1980 Joan Green made a gift that was taxed at the maximum rate (70%). If Joan dies in 1992, the estate tax reduction for the gift tax payable on the 1980 gift is based on the 1992 rate schedule, which has a maximum rate of 55%.

Adjustment for gift tax paid by spouse- If one-half of a gift made by a decedent is considered made by the decedent's spouse, and if the amount of the gift is includible in the decedent's gross estate, any tax payable by the spouse is treated as a tax payable on a gift made by the decedent. It therefore is included as an offset against the tentative estate tax.

Split gifts made before death by spouse- A gift is not included in computing the adjusted taxable gifts of a decedent if:

1) The decedent's spouse was the donor of a gift (one-half of which was considered as made by the decedent), and
2) The amount of the gift was included in the gross estate of the decedent's spouse as a *transfer before death*

Also, the total tax payable for gifts made after 1976 is reduced by the amount of gift tax payable that was treated as a tax payable for the gift made by the decedent's spouse.

U.S. military personnel- A special exemption applies to U.S. military personnel who die as a result of service in a combat zone. The decedent must have been a U.S. citizen or resident and must have died during active service. Death must have been caused by wounds, injury, or disease suffered in a combat zone, in the line of duty, or by reason of a hazard to which the individual was subjected in the course of such service.

Terrorist acts- Under the Terrorism Tax Relief Act of 2001, the federal income tax liability of those killed in terrorist attacks is forgiven for certain tax years. The Act also exempts form federal income tax certain disaster, disability, death payments and debt cancellation for terrorist attacks. For tax years ending after September 10, 2001, tax liability is forgiven for an individual who dies from wounds or injury incurred while a U.S. employee in a terroristic or military action regardless of where the action occurred.

If any of the tax-forgiveness situations applies to a prior year tax, any tax paid for which the period for filing a claim has not ended will be credited or refunded. If any tax is still due, it will be canceled. The normal period for filing a claim for credit or refund is three years after the return was filed or two years after the tax was paid, whichever is later.

Estate tax recovery- The estate may recover any estate tax that is attributable to qualified terminable interest property included in the gross estate. The taxes may be recovered from the person or persons receiving the property. See *Qualified* Ter*minable Interest Property* discussed earlier under *Gross Estate,* and *Reimbursement of Estate Tax* discussed later under *Miscellaneous Provisions.*

Addition to Estate Tax

For estates of those who die after 1986, the estate tax is increased by 15% of the decedent's excess retirement accumulation. The excess retirement accumulation subject to the 15% tax is the excess (if any) of:

1) The value of the decedent's interest in all qualified employer and individual retirement plans as of the date of death or, if applicable at the alternate valuation date, *over*
2) The present value (as of the date of death or, if applicable, at the alternate valuation date) of a hypothetical life annuity.

The value of the decedent's interest is determined in a manner consistent with the valuation of these interests for purposes of determining the decedent's gross estate. The value is figured without regard to the spouse's community property interest in the decedent's accumulation.

A ***qualified employer plan*** is any pension, profit-sharing, stock bonus, or annuity plan that is a qualified plan under the internal Revenue Code. Plans under which certain exempt organizations and educational organizations purchase tax sheltered annuity contracts for their employees are also qualified employer plans.

A *hypothetical life annuity* is a single life annuity contract with equal annual payments for the life of an individual whose age is the same as the decedent's as of the date of the decedent's death. The amount of each annual payment is equal to the greater of $150,000 (unindexed) or $112,500 (as indexed until the date of death). The $112,500 is indexed for inflation in the same way as the dollar limit on annual benefits under a defined benefit pension plan. If the decedent elected, or the personal representative elects, the special grandfather rule (discussed below), the amount of each annual payment is $112,500 (indexed until the date of death).

Special grandfather rule- If the decedent elected during his or her lifetime the special grandfather rule, the part of the excess accumulation that is related to the decedent's accrued benefits on August 1, 1986, may be excluded from this estate tax. However, this rule applies only if the present value of the accrued benefit as of August 1, 1986, is at least $562,500. This election must have been made by the due date, including extensions, for filing the decedent's 1988 income tax return. If this grandfather rule applies, the decedent's excess accumulation is the excess of:

1) the value of the decedent's interest in all qualified plans, *over*
2) the greater of;
   a) the decedent's remaining unrecovered grandfather amount as of the date of the decedent's death, or
   b) an amount equal to the present value of a hypothetical life annuity (defined earlier).

Credits, deduction, etc.- No credits, deductions or exclusions that apply for estate tax purposes are allowed to offset the tax. For example, the unified credit (applicable credit amount) and credits for state death taxes and gift taxes are not allowed.

Form 706- The executor of the estate of a decedent who has an excess accumulation must complete Schedule S and file it with the estate tax return of the decedent.

Note. Executors who may not otherwise be required to file an estate tax return for a decedent (for example, if the gross estate is less than the exclusion amount ($5.43 million in 2015)) may have to file and pay the 15% additional tax if the estate has an excess retirement accumulation.

Credits Against the Tax

The following credits are deducted from the gross estate tax to determine the *net* estate tax payable:

1) Unified credit (applicable credit amount),
2) Credit for state death taxes,
3) Credit for gift taxes,
4) Credit for tax on prior transfers, and
5) Credit for foreign death taxes.

➊ Unified Credit

The amount of the unified credit (applicable credit amount) for the last several years.

Years	Unified Credit
2009-2010	$1,455,800
2011	$1,730.800
2012	$1,772,800

2013	$2,045,800
2014	$2,081,800
2015	$2,117,800
2016	$2,125,800
2017	$2,141,800

State Estate Taxes

The EGTRRA extended the Section 2018 deduction of state death taxes through 2010, but the old state death tax credit returned in 2013. Given the increased federal exemption in 2011 and 2012, states were inspired to enact or reenact decoupled state estate taxes applying, at least, to those two years. In Illinois, for example, the decoupled state estate tax ended for deaths after Dec. 31, 2009, and, thereafter, the state estate tax equals the credit for state tax allowable under IRC Section 2011 (pick-up tax only). Because it is tied to the federal estate tax, there was no Illinois state estate tax for 2010. Programs that compute the state estate tax required revisions for 2010 and later years with the postponement of the state death tax credit calculation to 2013.

Maximum Credit for State Death Taxes
(Based on federal adjusted taxable estate)

Adjusted taxable estate equal to or more than- (1)	Adjusted taxable estate less than- (2)	Credit on amount in column (1) (3)	Rates of credit on excess over amt in column (1) (4)
0	$40,000	0	None
$40,000	90,000	0	0.8
90,000	140,000	$400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5,6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000	....	1,082,800	16.0

❷ **Credit for State Death Taxes**; As mentioned above, a credit is allowed for any estate, inheritance, legacy, or succession tax *actually paid* to any state, as a result of any property included in the gross estate of the decedent. The payment of these taxes in property other than cash constitutes taxes actually paid for this purpose

The allowable credit is computed using the *adjusted taxable estate,* rather than the taxable estate. The *adjusted taxable estate is* the taxable estate reduced by $60,000. The credit for state death taxes may not be more than the amount of the gross estate tax reduced by the unified credit (applicable credit amount).

<u>Deduction</u>: If a state imposes a death tax on a *charitable* transfer and a deduction is claimed for the tax, the credit for state death taxes is limited to the lower of:

1) The amount of state death taxes paid minus those imposed on a charitable transfer for which a deduction was claimed,

2) The maximum credit allowable to the decedent's estate using the table for credit for state death taxes, or

3) All the state death taxes minus those imposed <u>on the charitable transfer</u> / All state death taxes X The maximum credit computed without the deduction for state death taxes

Limitation period- The credit applies only to taxes that actually were paid and for which the credit was claimed within 4 years after filing the estate tax return. The executor must submit proof that the taxes have been paid. Any inheritance tax considered paid by a credit of state gift tax paid at any time is not allowable as a credit. If a timely petition for a redetermination of a tax deficiency has been filed with the Tax Court, the credit may be claimed within the 4-year period or 60 days after the Tax Court decision becomes final, whichever is later. If an extension of time for paying the estate tax or a deficiency has been granted the credit may be claimed by the end of the 4-year period or the expiration of the extended time for payment, whichever is later. In addition, this rule applies if the estate also elects to pay state death taxes in annual installments over a period longer than four years from the date of the filing of the federal estate tax return.

If a timely claim for refund of or credit for an overpayment of tax has been filed, the claim for the credit for state death taxes may be filed by the later of:

1) The expiration of the normal 4-year period, or
2) 60 days from the date of a notice of the disallowance of any part of the claim for credit or refund, or
3) 60 days from the date a decision of any court of competent jurisdiction becomes final.

Refunds of estate tax based on the allowance of the state death tax credit are made without interest.

❸ Credit for Gift Taxes

No credit is allowed for any gift tax paid on gifts made after 1976.

Gift made before 1977- Credit is allowed against the estate tax for the federal gift tax paid on a gift made by a decedent, if the property is included in the gross estate. The credit is allowable even if the gift tax is paid after the decedent's death and the amount of the gift tax is deducted from the gross estate as a debt of the decedent. The credit is allowed only when the gift tax has been paid on the transfer of nonprobate assets and double taxation would result.

Limitation- The credit is limited to the lesser of:

1) The gift tax paid on the gift that is included in the gross estate, or
2) The amount of estate tax attributable to the inclusion of the gift in the decedent's gross estate.

Limitation 1. If the gift included in the gross estate was the only one made in a given calendar quarter (or calendar year, it made before 1971), the amount of the limitation is the gift tax paid for that quarter (or year). If the included gift is only one of several made in a given calendar quarter (or year, if pre-1971), the amount under this limitation is a fraction of the gift tax paid for that quarter (or year). The numerator of the fraction is the amount of the included gift reduced by any portion excluded or deducted; and the denominator is the total taxable gifts increased by the specific exemption allowed. The values used are those determined for purposes of the gift tax.

Example. A gift included in the gross estate was valued at $63,000 for gift tax purposes and that an exclusion of $3,000 was applicable, the total amount of taxable gifts was $210,000 after deduction of a specific exemption of $30,000; and the gift tax paid was $40,275. The amount under *limitation*:

$$\frac{\$63,000 - \$3,000}{\$210,000 - \$30.000} \times \$40,275 = \$10.068.75$$

Limitation 2 The amount under this limitation is a fraction of the gross estate tax reduced by any credit for state death taxes and the unified credit (applicable credit amount). The numerator is the value of the gift, and the denominator is the value of the entire gross estate minus any amount allowed as charitable and marital deductions. For this purpose, the *value of the gift is* the value included in the gross estate, or the value for purposes of the gift tax, whichever is lower, reduced by all or a portion of any annual exclusion allowed for gift tax purposes and by any amount allowed as charitable and marital deductions. If the gift tax value is lower than the estate tax value, it is reduced by the amount of the entire annual exclusion. If the estate tax value is lower, it is reduced by only a portion of the annual exclusion that is computed by multiplying the estate tax value of the gift by a fraction. The numerator is the annual exclusion, and the denominator is the gift tax value.

Example. A gift by the decedent, valued at $30,000 for gift tax purposes, is included in his gross estate at a value of $27,000 and an exclusion of $3,000 had been allowed. The value of the gift for this purpose would be:

$$\$27,000 - \left[\frac{\$3,000}{\$30,000} \times \$27,000\right] = \$24,300$$

If a charitable or marital deduction were allowed the estate in this example, the amount of the gift also would have to be reduced by a proportionate part of any such deduction.

❹ Credit for Tax on Prior Transfers

Credit is allowed against the gross estate tax for federal estate taxes paid on the transfer of property to the decedent from a transferor who died within 10 years before or 2 years after the decedent's death. For this purpose, property means any beneficial interest in property. This includes a general power of appointment. Examples of this type of property include annuities, life estates, remainders, and other future interests. The transferred property does not have to be identified in the decedent's estate. It does not have to exist at the time of death. What matters is that the transfer of the property to the decedent was subject to federal estate tax in the estate of the transferor and that the transferor died within the prescribed period of time.

Limitation- The credit is limited to the smaller of the following amounts:

1) The amount of the federal estate tax attributable to the transferred property in the transferor's estate, or
2) The amount of the federal estate tax attributable to the transferred property in the decedent's estate.

Percentage allowable- If the transferor died within 2 years before or 2 years after the decedent's death, the credit is the smaller of limitation (1) or (2). If the transferor died more than 2 years before the decedent, the credit is a percentage of the smaller of either limitation (1) or (2) as follows:

1) 80%, if the transferor died within the 3rd or 4th year before the decedent's death,
2) 60%, if within the 5th or 6th year,
3) 40%, if within the 7th or 8th year, and
4) 20%, if within the 9th or 10th year.

Limitation 1. The first limitation is a fraction of the transferor's adjusted federal estate tax. The numerator is the value of the transferred property, and the denominator is the transferor's adjusted taxable estate.

The transferor's *adjusted federal estate tax is* the amount of federal estate tax paid on the transferor's estate, plus any credit allowed that estate for gift tax and any credit allowed that estate for tax on prior transfers. However, the credit for tax on prior transfers is added only if the transferor acquired property from a person who died within 10 years before the death of the decedent.

If the federal estate tax of the transferor is being paid in installments, only the amount of the installments actually paid is used in computing the credit for tax on prior transfers for the estate of the transferee. As the transferor's estate makes the installment payments, the first limitation and the amount of the credit increase. The executor of the transferee's estate must file a protective claim for refund for the entire amount of credit that may be due because of later installment payments. The protective claim must be perfected by filing a claim for refund for the additional credit allowable upon the payment of each installment of the transferor's estate tax. Use Form 843, *Claim for Refund and Request for Abatement,* to file a claim for refund.

The transferor's *adjusted taxable estate is* the amount of the transferor's taxable estate decreased by the amount of any death taxes paid with respect to the gross estate (and increased by the amount of the exemption, $60,000, allowed in computing the taxable estate if the transferor died before 1977). The *death taxes,* for this purpose, are the federal estate tax plus the net amount of all other estate, inheritance, legacy, succession, or similar taxes imposed by and paid to any taxing authority, whether within the United States or not.

Limitation 2. The second limitation is the excess of:

1) The net estate tax payable on the decedent's estate, determined without regard to the *credit for tax on prior* transfers, and without regard to any credit for foreign death taxes claimed under the provisions of a death tax convention, over
2) The net estate tax determined in a similar manner, but computed after subtracting from the decedent's gross estate the value of the property transferred.

For purposes of determining the reduced gross estate, any charitable deduction allowable to the decedent's estate is reduced by an amount having the same ratio to that charitable deduction as the value of the transferred property has to the value of the decedent's adjusted gross estate. If a marital deduction is allowable, it is limited to the value of the property passing to the spouse. However, if the unlimited marital deduction does not apply to the estate, the deduction cannot be more than 50% of the reduced adjusted gross estate or $250,000, whichever is greater, for the purpose of computing the net estate tax.

Property transferred- The value of the transferred property is the value used to determine the transferor's federal estate tax liability, reduced by the following:

1) The amount of any death taxes payable out of the transferred property or paid by the decedent in connection with it,
2) The amount of any encumbrance on the property or obligation imposed by the transferor upon the property and incurred by the decedent with respect to it, and
3) The amount of any marital deduction allowed the transferor's estate if the decedent was the transferor's spouse at the time of the transferor's death.

Certain real property- If the gross estate of the transferor included real property, such as a farm or other closely held business, for which the special-use valuation election was made, discussed earlier, and if the additional estate tax is imposed on the transferor's estate within 2 years of the decedent's death because the property was disposed of or ceased to be used for a qualified use, the additional tax is treated as a federal estate tax payable on the transfer of the decedent's estate. Further, the value of this property and the amount of the transferor's taxable estate is determined as if the special valuation had not been elected.

Form 706- The credit for tax on prior transfers is figured on Schedule O, Form 706.

❺ Credit for Foreign Death Taxes
Credit is allowed against the gross estate tax for any estate, inheritance, legacy, or succession taxes actually paid by the decedent's estate to any foreign country. The term *foreign country* includes possessions or political subdivisions of foreign states and possessions of the United States. The credit is allowed for death taxes paid with respect to property:

1) Situated within the foreign country to which the tax is paid, and
2) Included in the decedent's gross estate.

No credit is allowed for such taxes paid for the estate of a person other than the decedent. No credit is allowed for interest or penalties relating to foreign death taxes. The credit is allowable to the estate of a decedent who, at the time of death, was a citizen of the United States. It also is allowable to the estate of a decedent who was a resident but not a citizen of the United States at the time of death. However, it is not allowed if a proclamation issued by the President of the United States denies the foreign death tax credit to citizens of the foreign country of which the decedent was a citizen. No credit is allowable to the estate of a decedent who was neither a citizen nor resident of the United States at the time of death.

The same principles apply for determining whether a particular property included in a decedent's gross estate is situated in the foreign country imposing the tax as for determining whether similar property of a nonresident non-citizen decedent is situated within the United States for federal estate tax purposes. (See *Location of Property* under Estates *of Nonresident Non-citizens.)* If the tax is imposed by a political subdivision of a foreign country, the tax credit may be allowed even though the property involved is situated in a political subdivision different from the one imposing the tax.

Limitation- The credit is limited to the lesser of the following:

1) The amount of the foreign death tax attributable to the property situated in the country imposing the tax and included in the decedent's gross estate for federal estate tax purposes, or
2) The amount of the federal estate tax attributable to particular property situated in a foreign country, subject to death tax in that country, and included in the decedent's gross estate for federal estate tax purposes.

Exchange rate- When computing the credit, convert death taxes paid to the foreign country into U.S. dollars by using the rate of exchange in effect at the time each payment of foreign tax is made.

<u>*Limitation 1*</u>*.* The first limitation is a fraction of the tax imposed by the foreign country, without allowance of any credit for U.S. estate tax. The numerator is the value of the property situated in the foreign country subjected to the foreign tax and included in the decedent's gross estate for federal estate tax purposes. The denominator is the value of all the property subjected to

the foreign tax. The values used in this computation are those used by the foreign jurisdiction in imposing its tax. If a foreign country imposes more than one kind of death tax or imposes tax at different rates upon the several shares of an estate, or if a foreign country and its political subdivision or possession each imposes a death tax, make separate computations and add the results to determine the first limitation.

<u>*Limitation 2*</u> The second limitation is a fraction of the gross federal estate tax reduced by the unified credit (applicable credit amount), any credit for state death taxes, and any credit for gift tax. The numerator is the adjusted value of the property situated in the foreign country, subjected to the foreign death tax, and included in the gross estate. The denominator is the value of the entire gross estate, reduced by the total amount allowed as a charitable deduction and as a marital deduction. The values used in this computation are those determined for purposes of the federal estate tax. The *adjusted value of the property situated in the foreign country is* the value of the property in the foreign country that meets the requirements for credit, reduced by the amount of any allowable charitable and marital deductions attributable to the property.

The credit is authorized either by statute or by treaty. If a credit is authorized by a treaty, whichever of the following is the most beneficial to the estate is allowed:

a. the credit computed under the treaty
b. the credit computed under the statute, or
c. the credit computed under the treaty, plus the credit computed under the statute for death taxes paid to the treaty country that are not creditable under the treaty.

The credit is authorized for all death taxes imposed in the foreign country. If a credit for death taxes paid in more than one foreign country is allowable, a separate computation of the credit must be made for each foreign country (see below). The question of whether particular property is situated in the foreign country imposing the tax is determined by the same principles that would apply in determining whether similar property of a nonresident (not a U.S. citizen) is situated within the United States for purposes of the Federal estate tax.

Death tax conventions and the credit- In addition to the credit for foreign death taxes under the provisions of federal estate tax law, similar credits are allowed under death tax conventions with a number of foreign countries, discussed later.

If credit is allowable either under the provisions of law or under the provisions of a convention, the credit that is allowed is the one most beneficial to the estate. If property of the estate is subjected to tax by a country with which the United States has a convention, and also by a political subdivision or possession of that country, the estate is allowed the most beneficial of the following:

1) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as provided for by the convention,
2) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as determined under the provisions of law, or
3) A credit for that amount of the combined death taxes paid to the foreign country and its political subdivisions or possessions as allowed under the convention, and a further credit, determined in the regular manner, for the death taxes paid to each political subdivision or possession to the extent the death taxes are not covered by the convention.

Taxes imposed by two foreign countries- Sometimes a credit is allowable for tax paid to more than one foreign country. The credit may be determined under the provisions of law or under a convention. In these cases, the credits are combined and the total amount is credited against the federal estate tax. The amount allowable is limited, however, to the amount of the federal estate tax attributable to the property involved, determined according to the rules for computing the second limitation.

<u>Note</u>; If the foreign death taxes that are paid on charitable transfers are deducted rather than credited, the value of that property is *excluded* in computing the limitations.

Credit for death taxes on remainders- If the election is made to postpone paying any portion of the federal estate tax attributable to a remainder or reversionary interest in property, the credit may be taken against that portion of the federal estate tax for foreign death taxes attributable to the reversionary or remainder interest. This applies if the foreign death taxes are paid and claimed as a credit anytime before the expiration of the time for payment.

Limitation period- The credit for foreign death taxes is limited to those taxes that actually were paid and for which a credit was claimed within the later of the 4 years after the filing of the estate tax return, or before the date of expiration of any extension of time for paying the federal estate tax, or 60 days after a final decision of the Tax Court on a timely filed petition for a redetermination of a deficiency.

Form 706-The credit for foreign death taxes is figured on Schedule P, Form 706. Form 706CE, *Certificate of Payment of Foreign Death Tax,* must be attached to the Form 706.

Recovery of Taxes Claimed as Credits
If any amount of taxes claimed as a credit for state death taxes or for foreign death taxes is refunded, the executor or any other person recovering the taxes must notify the Internal Revenue Service office where the estate tax return was filed within 30 days of its receipt. The Internal Revenue Service will redetermine the federal estate tax. No interest is assessed on any amount of tax due because of a refund of foreign taxes paid, except to the extent the foreign country paid interest on the refund. The person who receives the refund must pay any federal estate tax found to be due as a result of the refund. This applies even if the refund is received after the expiration of the period of limitations. The notice must include the following:

1) The name of the decedent,
2) The date of death,
3) The property with respect to which the refund was made,
4) The amount of the refund, not including interest,
5) The date of the refund, and
6) The name and address of the person receiving the refund.

If the refund is of foreign taxes, the notice must contain a statement showing the amount of any interest paid by the foreign country on the refund.

Examples of Estate Tax Computation
Joe Jones died on April 1, 2011. He was a widower. The gross estate amounted to $5,450,000 plus the proceeds of a $50,000 life insurance policy that he gave away in 1999. As part of Jones' estate, $100,000 went to Jones' favorite charity, Charity A (a qualified §501(c)(3) organization). The estate also incurred $50,000 in administrative expenses. Finally, he made $200,000 in post '76 taxable gifts during his life, including the life insurance.

Gross Estate:		$5,500,000	
Includes $50,000 gift (life insurance) in gross estate			
Deductions:			
Charity	$100,000		
Expenses	50,000		
Total Deductions:		(150,000)	
Taxable Estate:		$5,350,000	
Adjusted Prior Taxable Gifts: (Excludes $50,000 gift above)		$150,000	
Tentative Tax Base:		$5,500,000	
Tentative Tax:		$ 1,905,800	
Tax on Prior Gifts $150,000 + 50,000 = $200,000 in gifts			
Tax on $200,000 = $ 54,800			
Unified Credit for Gift Tax ($ 1,730,800)			
Net Tax on Prior Gifts:	-0-		
Gross Estate Tax:		$ 1,905,800	
Unified Credit for Estate Tax (2011):		($ 1,730,800)	
Net Estate Tax:		$ 175,000	

Notes:
Gross Estate includes a prior taxable gift included under §2035
Adjusted prior taxable gifts includes all post '76 gifts by decedent, excluding those gifts included in gross estate
Prior taxable gifts include all post '76 taxable gifts made by decedent.
Unified credit appears twice, once for gift taxes and again for estate taxes.
Form 706 filed by executor and due 9 months after death. Mailed to Service Center for decedent's last address.

Example 2- Ms. Smith died in 2011. Her estate size is $6,000,000 and she was a spinster. This estate pays state estate taxes. Funeral expenses and administrative cost are 2%, debts are $250,000 and there are no claims against the estate. Charitable deductions are $50,000. Adjustable post-'76 taxable gifts are $100,000 on which no gift taxes have been paid.

Gross Estate		$6,000,000
MINUS		
Funeral and administrative Costs (estimated as 2% of gross estate)	$20,000	
Debts of the decedent	250,000	
Claims Against Estate		($270,000)
Adjusted Gross Estate		$5,730,000
MINUS		
Charitable Deductions	$50,000	
Subtotal all deductions		($50,000)

Taxable Estate		$5,680,000
ADD Adjustable Taxable Gifts (Post 1976 lifetime taxable transfers not included in gross estate)		$100,000
YIELDS Tentative Tax Base		$5,780,000
TAX	$2,003,800	
MINUS Gift taxes paid on post-1976 taxable gifts	0	
YIELDS Estate Tax Before Credits	$2,003,800	
MINUS Unified Credit $1,730,800 State Death Tax Credit 30,800		
Subtotal Credits	($1,761,600)	
YIELDS		
Net Federal Estate Tax Payable	$242,200	

Miscellaneous Provisions
This section discusses the duties of the executor of an estate. It includes information on paying the estate tax and determining the basis of inherited property in the hands of the beneficiaries.

Executors and Administrators
Generally, an *executor* (or executrix) is named in a decedent's will to administer the estate and distribute properties as the decedent has directed. An ***administrator*** (or administratrix) is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. In general, an executor and an administrator perform the same duties and have the same responsibilities.

If there is no executor or administrator appointed, qualified, and acting within the United States, the term executor includes anyone in actual or constructive possession of any property of the decedent. It includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding securities of the decedent as collateral; and the debtors of the decedent who are in this country.

Duties- The primary duties of the executor or administrator are to collect all the assets of the decedent, to pay the creditors, and to distribute the remaining assets to the beneficiaries. The executor is responsible for filing the estate tax return (and any income tax returns) when due and for paying the taxes determined, up to the date of discharge from duties. Additionally, the executor must keep records and supplemental data supporting the estate tax return. The prescribed forms must be used in filing the estate tax return.

If the estate of a decedent is insufficient to pay all the decedent's debts, the debts due the United States must be paid first. The decedent's federal income tax liabilities at the time of death, the estate's income tax liability, and the estate tax liability are debts due the United States. The executor of an insolvent estate is personally responsible for any tax liability of the decedent or of the estate if he or she had notice of the tax obligations or had failed to exercise due care in determining if these obligations existed before distributing the estate's assets and before being discharged from duties. The extent of such personal responsibility is the amount of any other payments made before paying the debts due the United States. The tax liabilities need not be formally assessed for the executor to be liable if he or she was aware or should have been aware of their existence.

Notice concerning fiduciary relationship- If an individual is appointed to act in any fiduciary capacity (as administrator, executor, or an ancillary representative) for another, that person must file a written notice with the Internal Revenue Service. They may use Form *56, Notice Concerning Fiduciary Relationship,* for this purpose. File the written notice (or Form *56)* with the Internal Revenue office where the returns are filed for the person or estate for whom the executor are acting. The executor should file this notice when all of the necessary information is available. It allows the Internal Revenue Service to mail to that person the tax notices concerning the person or estate being represented. The notice remains in effect until the executor notifies the appropriate Internal Revenue Service office that the relationship to the estate has terminated.

When someone is relieved of their responsibilities as executor, they must inform the Internal Revenue Service office with which Form *56* was filed that the estate has either been terminated or that a successor has been appointed. If the estate is terminated, one must furnish satisfactory evidence of that fact. Use Form *56* for the termination notice by checking the applicable box on the form and attaching the required evidence. If another has been appointed as successor executor, the name and address of the successor should be given.

Discharge from personal liability- The executor may request a release from personal liability. The request must specifically refer to section 2204 of the Code, or directly ask for a discharge from personal liability within 9 months. The executor can do this by applying in writing to the Internal Revenue Service Center for a determination of the federal estate tax and a discharge from personal liability. Within 9 months after receiving the application, the Service Center will notify that person of the estate tax liability. If they apply before filing the return, the Service will notify the executor within 9 months after the return is filed. After this amount is paid (or this amount minus any amount for which payment has been extended) and a bond furnished (if requested by the Service Center), the executor will be discharged from personal liability for any deficiency in taxes later found to be due. If a notice is not received in the following 9-month period, and the tax shown on the return has been paid, the executor is discharged from personal liability. In either case, the discharge is only for personal liability as the executor. The executor is still liable for the payment of the federal estate tax in a fiduciary capacity out of assets included in the gross estate still in his/her possession. A personal bond must be furnished if the time for paying any amount of the federal estate tax has been extended. One may use the notice received from the Internal Revenue Service and proof of payment, such as canceled checks or receipts, to establish that personal liability for the estate tax has been satisfied.

Relief from personal liability for reliance on gift tax returns- If the executor relies in good faith on gift tax returns furnished by the Internal Revenue Service for determining adjusted taxable gifts made after 1976, then they are discharged from personal liability for any estate tax deficiency attributable to *adjusted taxable gifts* that are:

1) Made more than 3 years before the decedent's death, and
2) Not shown on the gift tax returns.

Fiduciary other than executor- If the decedent was not a nonresident, a fiduciary other than the executor can apply for a discharge from personal liability. As a fiduciary, the executor should apply in writing to the Service Center for a determination of the amount of estate tax for which they may be personally liable, and for a discharge from this liability. That person will be notified after the executor is discharged or after *6* months from the making of the application, whichever is later, of the amount of any tax for which they may be liable. After paying this amount (other than the amount for which an extension of time to pay the tax has been granted) and upon furnishing a bond (if required), that person will be discharged from personal liability for any estate tax later found to be due. This does not preclude, however, the assessment and collection of any deficiency in estate tax from the fiduciary out of the assets still possessed by the fiduciary.

Estate Tax Lien

Generally, no tax may be assessed later than 3 years after the estate tax return is filed or is due, whichever is later. The period of assessment is 6 years if 25% or more of the value of the gross estate is not reported on the return. The period of assessment of taxes is 4 years for recipients of property included in the gross estate.

A tax lien attaches to all property included in the gross estate (except property used to pay certain administration expenses and claims) to cover the assessment. The lien is considered to attach at the decedent's date of death. It will not lapse until 10 years after that date unless the tax is fully paid or becomes unenforceable because of lapse of time. If the estate tax is not paid when due, all persons receiving this property are personally liable for the tax to the extent of the value of the property on the date of the decedent's death.

This general estate tax lien does not attach to any property that is subject to a special lien. A special lien attaches to property for which the special-use valuation method is used (discussed earlier under *Special-Use Valuation),* or for which the estate tax is paid in installments, discussed next. A federal tax lien generally takes priority over certain interests in property held by purchasers, holders of a security interest, mechanics lienors and judgment lien creditors, but only if notice of the tax lien is appropriately filed. However, the estate tax lien does not have to be filed. The above mentioned parties are protected from the estate tax lien in certain situations.

Special Lien

In place of the executor's personal bond, one may elect a special lien in favor of the United States. The special lien will also discharge an individual from being personally liable for the payment of deferred estate tax. A person can do this if they elected to pay the estate tax attributable to a closely held business (including a farm) in installments. This election was discussed earlier in *Installment Payments,* under *Paying the Tax.*

This lien is considered a bond for purposes of determining the executor's release from personal liability. If the special lien election is made, one may not substitute a bond in place of the special lien. If a personal bond has been supplied, however, a person may substitute a lien under these rules for any part or all of the personal bond. This can be done by filing a proper notice of election and agreement.

Amount of lien- The unpaid portion of the deferred amount plus any unpaid interest additional amount, addition to tax, assessable penalty, and other costs attributable to the deferred amount will be the amount of the lien on the lien property.

Lien property- The special lien attaches to the estate's section 6166 lien property. This property consists of those interests in real and personal property designated in the lien agreement, as discussed later. An interest in property may be designated only to the extent the interest can be expected to survive the deferral period (the period for payment of the tax). Property designated does not have to be property that was included in the decedent's estate. The fair market value of the property required by the Internal Revenue Service to be designated as section 6166 lien property cannot be more than the sum of the deferred amount and the required interest amount. The parties to the lien agreement may voluntarily designate property having a fair market value in excess of that sum.

The *deferred amount is* the total amount of estate tax that is to be paid in installments determined as of the due date (without extensions) for payment of the estate tax. The ***required interest amount*** *is* the total amount of interest payable over the first 4 years of the deferral period. The interest rate in effect on the due date and the IRS-established interest rate on installment payments are used in computing the required interest amount.

The value of this lien property is its fair market value determined as of the due date (without extensions) for payment of the estate tax, reduced by other prior encumbrances, such as mortgages. If a special-use valuation is selected, the liens required by that provision also reduce the value of the property.

Additional property may have to be added to the agreement if at any time the value of the section 6166 lien property is less than the sum of the unpaid portion of the deferred amount and the required interest amount. If additional property or other security is not furnished within 90 days after notice and demand by the Internal Revenue Service, the failure is an event that will accelerate the payment of the tax installments.

Effect of lien- For this property, the special lien replaces the regular estate tax lien. This lien and notice of the lien must be filed by the Internal Revenue Service to be valid as against any purchaser holder of a security interest, mechanic's lien, or judgment lien creditor. However, unlike regular tax liens, the special lien does not have to be refiled every 6 years. This lien arises when the executor is~ discharged from liability or, if earlier, when the notice of lien is filed. It continues until liability for the deferred amount of taxes is satisfied or becomes unenforceable by reason of lapse of time.

Even if the notice of the lien has been filed, the lien does not supersede:

1) Certain real property tax and special assessment liens,
2) Mechanic's liens for repairs or improvements to real property, or
3) Financing agreements securing loans for construction or improvement of real property raising or harvesting of farm crops, or raising livestock or other animals, whether these security interests came into existence before or after the filing of the tax lien.

If the Internal Revenue Service files a notice that payment of the deferred amount has been accelerated, the tax liens take priority over subsequent mechanic's liens or real property construction or improvement financing agreements. But they do not take priority over real property tax or special assessment liens.

Election of lien- One may elect this lien by applying to the Internal Revenue Service office where the estate tax return was filed. Apply at any time before paying the full amount of estate tax and interest due. The application is a notice of election requesting the special lien. It must be accompanied by the agreement to lien.

Agreement to lien- Generally, a special lien arises only when everyone signs a consent agreement who has an interest in the property designated as property to which the lien apaches. The property does not have to be property included in the decedent's estate. The agreement is attached to the notice in which the special lien is elected. It must be in a form that is binding on all parties who have any interest in the property. It must contain the following information:

1) The decedent's name and taxpayer identification number as they appear on the estate tax return,
2) The amount of the lien,
3) The fair market value of the lien property as of the date of the decedent's death and the date of the special lien election,
4) The amount, as of the date of the decedent's death and the date of the election, of all encumbrances on the property, including mortgages and other liens in favor of the United States,
5) A clear description of the lien property and for property other than land, a statement of its estimated remaining useful life, and
6) The designation of an agent (including the agent's address) for the estate's beneficiaries and consenting parties to the lien for all dealings with the Internal Revenue Service on matters regarding the lien and the election to pay the tax in installments.

An interest in property is any interest that as of the date of the election can be asserted under local law so as to affect the disposition of any property designated in the required agreement. Any person in being at the date of the election who has any such interest in the property must enter into the agreement. This applies whether the interest is present or future, vested or contingent. These people may be owners of remainder and executory interests, holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants, holders of other undivided interests when the decedent held a joint or undivided interest in the property, and trustees of trusts holding any interest in the property.

An heir is not considered a person with an interest in property just because he or she has the power under the local law to challenge (caveat) a will and thus affect disposition of the property. Similarly, creditors of an estate are not persons with an interest in property just because they are creditors.

In some cases a representative may sign the agreement for the person with an interest in properly. The representative must be authorized under local law to bind the person in such an agreement. The person must want the representative to sign or be unable to enter a binding contract because he or she is too young or is incompetent.

Partial substitution of bond for lien- If the amount of unpaid estate tax plus interest exceeds the value of property listed in the agreement, the Internal Revenue Service may make the release from personal liability conditional. The release would depend upon the executor's submitting an agreement listing additional property or furnishing an acceptable bond in the amount of the excess.

Stock Redemptions to Pay Estate Taxes

If stock that is included in a decedent's gross estate is redeemed, the distribution is exempt from dividend treatment under certain circumstances. The distribution in redemption of the stock is treated as an exchange and will result in capital gain if the stock was held as a capital asset at the time of the exchange. The amount that qualifies for exchange treatment is limited to the sum of:

1) The estate, inheritance, legacy, and succession taxes (including any interest collected as part of these taxes) imposed because of a decedent's death, and
2) The amount of funeral and administration expenses allowable as deductions to the estate.

Exchange treatment is available only if the value of all of the stock in the redeeming corporation that is included in a decedent's gross estate is more than 35% of the excess of the gross estate over the sum of allowable deductions for funeral and administrative expenses, claims against the estate, debts, and losses.

Stock of two or more corporations may be treated as the stock of a single corporation in applying the 35% test. However, stock of a corporation can be combined with the stock of another corporation only if 20% or more in value of the outstanding stock of each corporation is included in the gross estate. In applying the 20% test, a surviving spouse's interest in stock held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as included in the decedent's gross estate.

Note- Different percentages and rules relating to the surviving spouse's interest apply to estates of decedents who died before 1982. To qualify for exchange treatment, the distribution in redemption of the stock must be made after the death of the decedent and within 40 days after the period of limitation on the assessment of the federal estate tax (three years after the return is filed). Since an estate tax return must be filed within nine months after the decedent's death and a return filed before the last day for filing is treated as having been filed on the last day, the actual distribution period is approximately four years.

Also, if the estate tax is being paid in installments, under section 6166 of the Code (election to pay estate tax in installments to the extent it is attributable to an interest in a closely held business), a distribution before the due date of the last installment will qualify. However, a distribution more than 4 years after the decedent's death will qualify for treatment only to the extent of either:

1) The amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or
2) The total of these amounts that are paid within one year after the distribution, whichever is less.

Although the redeemed stock must be included in the gross estate of the decedent, the stock need not be owned by the decedent's estate in order to qualify for exchange treatment. Thus, a qualifying redemption may be made of stock included in the gross estate because it was property over which the decedent had a general power of appointment, which the decedent has previously transferred subject to retained dispositive powers, or which was held by the decedent as a joint tenant. Exchange treatment will apply to the distribution only to the extent that the interest of a shareholder is reduced directly or through a binding obligation to contribute toward the payment of the estate's death taxes on funeral and administrative expenses.

Transfers before death- Exchange treatment is not available for stock that was transferred by the decedent within three years of death. Exchange treatment is only available for stock that is included in the decedent's gross estate for purposes of determining the amount of federal estate tax liability. Although the stock is included in the decedent's gross estate for purposes of the 35% requirement, it is not included for purposes of determining the amount of federal estate tax liability.

Example 1. Two years before death, the decedent transferred all of his interest in ABC Corporation stock to his daughter, the sole beneficiary of his estate. A gift tax return was required to be filed for the gift of stock. The daughter redeemed 100 shares of the stock for an amount that equaled the death taxes on the estate. The value of the stock equaled 40% of the excess of the gross estate over the sum of the allowable deductions for funeral and administrative expenses, claims against the estate, debts, and losses. The stock is included in the decedent's gross estate only for the purpose of determining whether the estate meets the percentage requirements to qualify for exchange treatment. Because the stock was not included in the decedent's gross estate for purposes of determining the amount of federal estate tax liability, the distribution in redemption of the stock does not qualify for exchange treatment.

Example 2 The facts are the same as in Example 1, except that the decedent had retained ownership of 100 shares of ABC Corporation stock, which was included in his gross estate. This stock was redeemed for an amount equal to the death taxes on the estate.

The value of the redeemed stock equaled 15% of the excess of the gross estate over the sum of the allowable deductions for funeral and administrative expenses, claims against the estate, debts, and losses. The combined value of the stock transferred to the daughter and the stock retained by the estate equaled 40% of the excess of the gross estate over the sum of the allowable deductions for funeral and administrative expenses, claims against the estate, debts, and losses.

The stock transferred to the daughter is included in the gross estate for the purpose of determining the percentage requirements. Therefore, the estate meets the percentage requirements for exchange treatment. Because the redeemed stock was included in the decedent's gross estate for purposes of determining the amount of federal estate tax liability, the distribution in redemption of the stock qualifies for exchange treatment.

Reimbursement of Estate Tax

If the decedent died without a will, or if the will did not specify the bequests to use to satisfy the federal estate tax, state law will determine which assets included in the gross estate are liable. However, if the assets designated by state law are insufficient to pay the estate tax, the federal government may collect the taxes out of any assets included in the gross estate. The beneficiaries of these assets are liable to the extent of the value of the assets received, valued on the decedent's date of death. In such a case, a beneficiary may demand a reimbursement out of any part of the estate still undistributed or a just and equitable contribution by other beneficiaries.

Liability of life Insurance beneficiary- One may recover for the benefit of the estate a proportionate share of the federal estate tax from a beneficiary of life insurance proceeds on the life of the decedent included in the gross estate, unless the decedent's will directs otherwise. However, if the surviving spouse is the beneficiary of the life insurance proceeds, only the amount in excess of the marital deduction may be recovered.

Liability of recipient of property over which decedent had power of appointment- One may recover for the benefit of the estate a proportionate share of the federal estate tax from a person who receives property that was subject to a general power of appointment and that was included in the decedent's gross estate, unless the decedent's will directs otherwise. If the surviving spouse is that person, only amounts in excess of the marital deduction reduced by life insurance proceeds for which the marital deduction was allowed may be recovered.

Liability of recipient of qualified terminable interest property- A person may recover for the benefit of the estate the taxes on qualified terminable interest property included in the estate. The taxes may be recovered from the recipients of that property, unless the decedent's will directs otherwise. The estate tax on that property is the excess of the total estate tax paid over the total estate tax that would have been paid if the value of that property was not included in the gross estate. Any penalties and interest on the excess taxes may also be recovered. See *Qualified Terminable Interest Property* discussed earlier under *Gross Estate.*

Liability of recipient where decedent retained an Interest- Unless otherwise directed in a decedent's will, the executor may also recover from the recipient a portion of the taxes attributable to the inclusion in the estate of property in which the decedent retained an interest for life.

Assumption of Estate Tax Liability
The provision for assuming certain estate tax liability has been repealed for the estates of persons who die after July 12, 1989. Before the repeal, if certain requirements were satisfied, the executor of a decedent's estate was relieved of liability for the payment of the portion of the estate tax liability that an employee stock ownership (ESOP) or eligible worker-owned cooperative (EWOC) was required to pay when the ESOP or EWOC acquired qualified employer securities from the decedent.

Basis-Property Acquired from a Decedent
Generally, the basis of property in the hands of a person who acquired it from a decedent (or to whom the property passed from a decedent) is the value used for estate tax purposes. The property could have been valued in the following ways:
The fair market value at the date of the decedent's death,
The fair market value determined on the alternate valuation date (discussed earlier), if so elected by the executor, or
The special-use valuation for real property used in farming or other closely held business (discussed earlier), if so elected.

The basis in certain appreciated property that a beneficiary acquires may be the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies only if the beneficiary or the beneficiary's spouse had given the decedent the appreciated property as a gift during the one-year period ending on the date of death. Appreciated property is any property whose fair market value on the day it was given to the decedent is more than its adjusted basis.

If the special-use valuation (item (3) above) was used for property that a beneficiary received from an estate of a person who died after 1981, the beneficiary's basis in the property can be increased if it becomes subject to the additional estate tax, as discussed earlier under *Dispositions and Failures to Use for Qualified Use.* To qualify for the increase, the beneficiary must make an irrevocable election and pay the interest on the additional estate tax figured for the period from the date 9 months after the decedent's death until the due date for paying the additional estate tax. If these requirements are met, the beneficiary's basis is increased to the fair market value of the property on the date of the decedent's death or the alternate valuation date.

Internal Revenue Service Explanation of Valuation

The Internal Revenue Service may value any item of property for the purposes of the estate, gift, or generation-skipping transfer tax. If so, the executor or donor may request that the Internal Revenue Service furnish a written statement explaining the valuation, including a copy of any expert appraisal made for the Service. The request must be filed within the period of limitations for filing a claim for refund. This is usually 3 years from the date the return is filed. The request is filed with the district director's office that has jurisdiction over the return.

Chapter 5 Gift Tax

The federal gift tax is imposed on the gratuitous transfer of property. The person making the gift (the donor) must generally pay the *tax.* If the donor does not pay the gift *tax,* the person receiving the gift (the donee) may have to pay the tax. Whether a person is subject to a gift tax may depend on whether the person is a citizen or resident of the United States.

Citizens or residents of the United States- Federal gift tax applies to all transfers by gift of properly, wherever situated, by U.S. citizens or residents. The term *United States* includes only the 50 states and the District of Columbia. It does not include U.S. possessions or territories. A person acquires a domicile by living in a place, even for a brief period of time, with no definite present intention of leaving permanently. A gift by a corporation is considered a gift by its individual stockholders. A gift to a corporation generally is considered a gift to its individual stockholders. However, in certain cases, a gift made to a charitable, public, political, or similar organization may be considered a gift to the organization.

Nonresident non-citizen- For an individual who is neither a citizen nor a resident of the United States, the federal gift tax applies only to gifts of property situated within the United States. If an individual is a resident of a U.S. possession at the time of the gift and is a U.S. citizen only because of birth, residence, or citizenship in that possession, he or she is considered a nonresident non-citizen for gift tax purposes. A gift of intangible personal property is not subject to federal gift tax if it is made by a nonresident non-citizen, except in the case of certain expatriate U.S. citizens. (See *Gifts by Nonresident Non-citizens.)*

The Gift Tax Return

The 2001 Tax Act did not increase the $10,000 annual gift tax exclusion. The $10,000 annual gift tax exclusion is subject to an inflation adjustment for gifts made after 2001, and the gift tax exclusion is $15,000 for the year 2018. In 2018, the applicable credit amount for gift tax and estate tax purposes gave an effective exemption of $5.49 million.
Keep in mind that the tax applies when gifts are made to individuals- grandchildren, for example. It does not apply to charitable gifts, which are tax-deductible.

The scheduled changes:

Year	**Gift-tax exemption**	**Gift-tax minimum rate**
2012	**$5.12 million**	**35%**
2013	**$5.25 million**	**55%**
2014	**$5.34 million**	**35%**
2015	**$5.43 million**	**40%**
2016	**$5.45 million**	**40%**
2017	**$5.49 million**	**40%**

The gift tax exemption is shown in the chart above for 2012 and later years, the $1 million lifetime gift exemption has been changed. The $1 million gift exemption did not increase after 2003 when the estate tax exemption increased. The maximum gift tax rate was reduced along with the maximum estate tax rate.

Federal Gift and Estate Tax Rates 2016 and 2017

Taxable Gift or Estate		Tentative Tax	
From	To	Tax	Rate on Excess
$ 0	$ 10,000	$ 0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000 and over		345,800	40%

Filing the return. If the donor makes a transfer by gift during a calendar year, file Form 709, *United States Gift (and Generation-Skipping Transfer) Tax* Return, for that year. However, one does not have to file a return for:

1) A transfer of a present interest that is not more than the annual exclusion ($14,000),
2) A qualified transfer for educational or medical expenses, or
3) A transfer to that qualifies for the unlimited marital deduction.

These items are discussed later under *Taxable Gifts.* Form 709 is filed annually. A person must file it by April 15 of the year after the year one makes the gift, unless that person receives an extension of time for filing the return. If the donor of the gift dies during the year in which the gift was made, the gift tax return is due not later than the earlier of the due date (including extensions) for the donor's estate tax return or April 15. Therefore, the gift tax return may be due before April 15. If no estate tax return is required to be filed, the gift tax return is due by April 15, unless an extension of time to file has been granted. The executor of the donor's estate must file the gift tax return.

Other documents- A person must submit certain documents with the return. Submit copies of instruments executed for transfers of property, statements by insurance companies on Form 712, *Life Insurance Statement,* for every insurance policy listed on the return, and copies of appraisals of real property. If someone lists shares of stock in closely held corporations on the return, attach the documents used to value the shares, such as balance sheets, profit and loss statements for each of the 5 years preceding the valuation date, and statements of dividends paid during that period.

Penalties are provided for willful failure to file a return on time and for willful attempt to evade or defeat payment of the tax. Form *709-A, United States Short Form Gift Tax Return,* may be filed if certain requirements are met and the donor and spouse consent to ***gift splitting.*** See *Gift Splitting* discussed later.

Who may file- One may use Form 709-A if **all** of the following requirements are met:

1) The individual is a U.S. citizen or resident, and was married during the entire calendar year to one individual who is a U.S. citizen or resident. Both spouses must have been alive at the end of the calendar year.

2) The only gifts, other than qualified transfers (discussed under *Taxable* Gifts), to a third party, consisted entirely of present interests in tangible personal property, cash, U.S. savings bonds, or stocks and bonds listed on a stock exchange.
3) The total gifts (other than qualified transfers) to each third-party donee total not more than $20,000 for the calendar year.
4) They did not make any gifts of terminable interests to their spouse during the calendar year.
5) The spouse did not make any gifts during the calendar year to any of the donees listed on this form, did not make gifts of terminable interests to the subject spouse, did not make gifts (other than qualified transfers) of over $14,000 to any other donee and did not make any gifts of a future interest.
6) The donor and spouse agree to split all of the gifts either of them made during the calendar year.
7) The individual did not file a Form 709 for this calendar year.

File Form 709-A by April 15 of the calendar year following the year the individual made the nontaxable split gifts, unless an extension of time to file has been granted.

Extension of time to file- An extension of time to file a gift tax return (up to 6 months) may be requested from the District Director or Service Center for the donor's area. The reason for the delay must be fully explained. An extension of time to file does not extend the time to pay the tax. No form is provided for this request. An extension of time to file an income tax return for any tax year that is a calendar year automatically extends the time for filing the annual gift tax return for that calendar year until the due date of the income tax return.

Paying the tax- The tax shown on the gift tax return must be paid by the person required to file the return at the time and place fixed for filing. At the request of the donor, a reasonable extension of time, up to 6 months, may be granted by the Service Center for the payment of the tax shown on the return. The extension may exceed 6 months if the donor is abroad. For a deficiency, an extension of time for up to 18 months may be granted. In an exceptional situation another 12 months may be granted.

Interest- must be paid on any amount of tax that is not paid by the last date prescribed for the payment of the tax. The last date for payment is the due date determined without regard to any extensions of time to pay.

Penalty- The law provides for penalties for both late filing of returns and late payment of tax unless the taxpayer has reasonable cause. There are also penalties for valuation understatements that cause an underpayment of the tax, willful failure to file a return on time, and willful attempt to evade or defeat payment of tax. The late filing penalty will not be imposed if the taxpayer can show that the failure to file a timely return is due to reasonable cause. Those filing late (after the due date, including extensions) should attach an explanation to the return to show reasonable cause. A valuation understatement occurs when the reported value of property entered on Form 709 is 50% or less of the actual value of the property.

Gifts in General

The gift tax applies to a transfer by gift of real or personal property. The property may be tangible or intangible. The gift may be direct, indirect, or given in trust. In other words, all transactions in which property or property interests are transferred to another without adequate consideration constitute gifts subject to gift tax. However, transfers of money or other property to a qualified political organization (including a newsletter fund) for use by the organization are not subject to gift tax.

The tax may apply to transfers made for valuable consideration if the value of the property transferred is more than the consideration received. In that case, the tax is imposed only on the value of the excess. However, if a bona fide transfer, sale, or exchange is made at arm's length in the ordinary course of business, the transaction will be considered a transfer for adequate consideration and not subject to gift tax.

Below-market loans have gift tax consequences. The right to use money is the property right being transferred and, if no interest or a low rate of interest is charged, the transfer is for less than adequate consideration. The gift is the reasonable value of the use of the money lent. See *below market loans* and *Interest-free demand loans before* 1984 under *Valuation.*

A consideration that is not reducible to a value in money or money's worth, such as love and affection, or a promise of marriage, must be considered totally gratuitous. The giving up (or promise to give up) of dower or curtesy, or of other marital rights in a spouse's property or estate, is not considered to any extent a consideration "in money or money's worth." If property is transferred in exchange for the release of these rights, the property is a gift for gift tax purposes. However, see Certain *Property Settlements,* for an explanation of transfers of property in the event of an actual divorce and a written agreement.

If a gift is made on the express or implied condition that the donee pay the gift tax, the payment of this tax is deducted from the value of the gift made as partial consideration for the gift. It should be noted that such an agreement does not release the donor from the principal liability of paying the gift tax if, in fact, the tax is not paid. The payment of gift taxes by a donee causes an interrelated computation known as a *net gift computation.* This computation is beyond the scope of this book. Anyone considering such an arrangement should seek appropriate legal or tax counsel on the matter.

<u>Note</u>. If the donee pays the gift tax, the donor realizes taxable income to the extent the gift taxes paid by the donee exceed the donor's adjusted basis in the property. There are many ways to make a gift. The following are examples of some transfers that come within the scope of the gift tax law.

Example 1. Bob Green creates a trust under the terms of which his child is to receive income for life and his grandchild the remainder at the child's death. Gifts of the income to the child and of the remainder to the grandchild result from the transaction.

Example 2. Jack White, with his own funds, creates a joint bank account for himself and his brother, Tom. There is a gift when Tom draws money out of the account for his own benefit. If both had contributed money to the account, there would be a gift by one to the other only to the extent that the amount withdrawn by the other person exceeds his own contribution.

Certain types of transfers are subject to special tax rules. They are discussed later in *Particular Types of Gifts.*

Completed gift

The gift tax is not imposed on the receipt of gift property, but rather upon the donor's act of making a completed gift. A gift is complete if a donor has *parted with dominion and control* over the transferred property or property interest, leaving the donor without the power to change its disposition, whether for the benefit of the donor or for the benefit of others. A promise to make a gift becomes taxable in the year the obligation becomes binding and not when the discharging payments are made. As a result, if one promises to transfer property in the future, the gift becomes taxable as of the first date on which it is possible to determine that the transfer must be made and that it will be of a determinable amount.

Example 1. If you create a trust under the terms of which you can revoke the transfer and revest title in the donor's name, the transfer is an incomplete gift. The same would be true if you reserved the power to alter the instrument, enabling you to name new beneficiaries or change the interests of the beneficiaries. The gift would, in either case, become complete at such time as you renounce the power, or the right to exercise it ceases, because of some event or contingency or the fulfillment of some condition other than the donor's death. The gift would be considered complete if the powers could be exercised only with the consent of a person having a substantial adverse interest.

Example 2 William Cedar creates a trust giving income for life to his wife and providing that, at her death, the corpus will be distributed to their son, Jack. William reserves the right to revoke the transfer but only with the consent of Jack, in which event the corpus would revert to William. The gift is considered complete in its entirety, because Jack has a substantial adverse interest in the property.

Example 3. If Susan Gray delivers a properly endorsed stock certificate to George Black or to George's agent, the gift is completed, for gift tax purposes, on the date of delivery. If Susan delivers the certificate to her bank or broker as her agent, or to the issuing corporation or its transfer agent, for transfer to George's name, the gift is completed on the date the stock is transferred on the corporation's books.

Particular Types of Gifts

There are some kinds of gifts for which special gift tax rules apply.

Powers of Appointment- The exercise or complete release of a general power of appointment is treated as a gift unless the exercise or release was for adequate consideration. There are different rules for powers of appointment created before October 22, 1942. They are discussed later. A power of appointment is a power to determine who will own or enjoy the property subject to the power. It must be created by someone other than the possessor (holder) of the power. It does not include a power retained by the holder on property he or she transfers. The term includes all powers that are, in substance and effect, powers of appointment regardless of what they are called and regardless of local property law.

Some powers are not powers of appointment. A power to amend only administrative provisions of a trust that do not substantially affect the beneficial enjoyment of the trust property or income would not be considered a power of appointment. A power to manage, invest, or control assets, or to allocate receipts and disbursements, when exercised only in a fiduciary capacity, would not be considered a power of appointment.

General powers of appointment- Consist of those in which the holders of the powers can appoint the property subject to the power to themselves, their creditors, their estates, or the creditors of their estates. They include the unlimited power to consume, invade, or appropriate either income or corpus, or both, for the benefit of the holder of the power.

Powers of appointment are not general powers if, by their terms they are exercisable only for the benefit of one or more persons or classes other than the holders, their creditors, their estates, or the creditors of their estates, or expressly are not exercisable in favor of the holders, their creditors, their estates, or the creditors of their estates.

An individual, who has a lifetime income interest in a trust as well as a nongeneral power to appoint the underlying property to another, has two separate rights. If the individual exercises the power during life, a taxable gift results, because by exercising that power he or she also gives up the income interest. The value of the gift is the amount of the income interest subject to the individual's power at the time of the transfer. The release of the power itself does not result in a taxable gift. A power limited by an ascertainable standard relating to the holder's health, education, support, or maintenance, is not a general power of appointment. However, a power to use property for the holder's comfort, welfare, or happiness is not considered an ascertainable standard.

Joint powers. If a power of appointment can be exercised by the holder, but only with the consent of the creator of the power, or a person having a substantial adverse interest in the property subject to the power, the holder is not considered to have a general power of appointment. For this purpose a trustee administering a trust in a fiduciary capacity does not, by that fact alone, have an adverse interest in the trust.

Exercise or release. If the holder of a general power of appointment exercises or releases the power, he or she will have made a gift. A release of a power need not be formal in character.

Lapses. The failure to exercise a general power of appointment within a specified time, so that the power lapses, constitutes a release of the power. However, the lapse is treated as a release only to the extent that the value of the property that could have been appointed by the exercise of the lapsed power exceeds the greater of either $5,000, or 5% of the total value of the property out of which the appointment could have been satisfied.

For lapses of multiple noncumulative powers in the same trust, the holder of the powers of appointment is entitled to only one $5,000 exemption per calendar year and the 5% limitation is figured using the total value of the assets out of which the exercise of the powers could have been satisfied. This also applies in the case of the lapsed powers over multiple trusts.

Disclaimer. A qualified disclaimer or renunciation of a general power of appointment is not considered a release of the power and does not result in a gift. A disclaimer is a complete refusal to accept the power of appointment. There can be no disclaimer of a power after it has been accepted.

If the power was created in the person disclaiming before January 1, 1977, the disclaimer must meet the requirements of local law. A disclaimer of a power of appointment, created after 1976, must meet the requirements for a qualified disclaimer. See *Qualified Disclaimers* discussed below.

Power created before October 22, 1942. A gift results if a general power of appointment created before October 22, 1942, is exercised. The release or lapse of such a power does not result in a gift. Also, a power created before October 22, 1942, that is only exercisable by the holder together with another person, regardless of adverse interest, is not treated as a general power of appointment.

Time of creation of power. A power of appointment created by will generally is considered as created on the date of the creator's death. However, a power of appointment created by a will executed before October 22, 1942, is considered as created before that date if the creator died before July 1, 1949, without having republished the will after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. This power is not considered created at some future date just because it can be revoked, or cannot be exercised immediately, or its holder's identity cannot be ascertained until after the date document takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first.

Qualified Disclaimers
For the purpose of the estate, gift, and generation skipping transfer taxes, if a person makes a qualified disclaimer with respect to any interest in property, the property will be treated as if it had never been transferred to that person. Accordingly, the disclaimant is not regarded as making a gift to the person who receives the property because of the qualified disclaimer.

Requirements. To be a qualified disclaimer, a refusal to accept an interest in property must meet the following conditions:

1) The refusal must be in writing,
2) The refusal must be received by the transferor of the interest, the legal representative of the transferor, the holder of the legal title to the property to which the interest relates or the person in possession of the property within 9 months after the later of-
    a) The day on which the transfer creating the interest is made, or
    b) The day on which the disclaimant reaches age 21,
3) The disclaimant must not have accepted the interest or any of its benefits,
4) As a result of the refusal, the interest must pass without any direction from the disclaimant to either-
    a) The spouse of the decedent, or
    b) A person other than the disclaimant, and
5) The refusal must be irrevocable and unqualified.

The 9-month period- The 9-month period for making a disclaimer generally is determined for each taxable transfer. For lifetime transfers, the period begins on the date the transfer is a completed transfer for gift tax purposes. For a transfer by will, it begins on the date of the decedent's death.

For a general power of appointment, the person who would be the holder of the power has 9 months after the creation of the power to disclaim; the person to whom property passes by reason of the exercise or lapse of a general power may disclaim within a 9-month period after the exercise or lapse. When a lifetime transfer is included in the transferor's gross estate because the transferor retained an interest in the property, the person who received the interests in the property during the lifetime of the grantor and a person who would receive an interest in the property on or after the grantor's death has 9 months after the taxable transfer in which to disclaim. A qualified disclaimer may be made for an undivided portion of an interest. A power with respect to property is treated as an interest in that property.

Certain transfers treated as disclaimers- If someone receives an interest in property because of a transfer made after *1981,* transfer of that interest may be treated as a qualified disclaimer. To qualify, one must make a written transfer of the entire interest in the property. The transfer must be received within the 9-month period after the later of the date on which the transfer creating the interest was made, or the day on which they attain age 21. The individual must not have accepted the interest or any of its benefits. The interest must be transferred to a person or persons who would have received the property had they made a qualified disclaimer as discussed above. The donor's direction of the transfer to these persons is not considered to be acceptance of the property. The persons who may receive the interest are determined by local law. However, the transfer does not have to satisfy the local disclaimer statutes.

Certain Property Settlements- Transfers of property or property interests made under the terms of a written agreement between spouses in settlement of their marital or property rights are considered to be for adequate consideration in money or money's worth and, therefore, are exempt from the gift tax (whether or not the agreement is approved by a divorce decree), if the spouses get a final decree of divorce within the 3-year period beginning on the date 1 year before the agreement was entered into. Therefore, the divorce can occur up to 1 year before, or 2 years after, the date the agreement was entered into, and the transfer would be exempt from the gift tax. Transfers to provide a reasonable allowance for the support of minor children (including legally adopted children) of a marriage are not subject to the gift tax if made under an agreement that satisfies these requirements.

If a husband and wife have a written property settlement, and a final decree of divorce is not granted by the due date for filing a gift tax return for the calendar year in which the settlement agreement becomes effective, the transferor must show the transfer on a gift tax return for that calendar year. Attach a copy of the settlement agreement to the return. Send a certified copy of the final divorce decree to the Internal Revenue Service office where the gift tax return was filed not later than 60 days after the divorce is granted. Until the Service receives evidence that the final decree of divorce has been granted (but no more than 2 years from the effective date of the settlement) the transfer will tentatively be treated as made for an adequate consideration in money or money's worth.

Support rights- A release of support rights constitutes a consideration in money or money's worth. However, a transfer in settlement of dower or curtesy inheritance rights is not reducible to money and results in a gift. Therefore, the transfer of property under a property settlement agreement incident to a legal separation results in a gift *only* to the extent that the value of the transferred property is more than the value of any support rights surrendered. Voluntary increases in support payments after a final decree of divorce are subject to the gift tax if, under state laws, the court has no authority to modify the decree as it pertains to the payments. The value of the gift is the amount by which each payment exceeds the amount specified in the original written agreement between the spouses.

The facts in the following example are applied in three situations to illustrate the gift tax consequences of an individual's transfer of property to a trust, under an agreement in contemplation of divorce and in exchange for the spouse's surrender of support rights.

Example. John and Mary Brown entered into a written agreement in contemplation of a divorce. Except as specified in each situation, the agreement contained a provision that, in exchange for Mary's surrender of the right to support, John would transfer $100,000 to a trust upon the issuance of a divorce decree. At the time of the agreement, John and Mary had two adult children. The divorce occurred more than 2 years after the agreement was signed, and the divorce decree was issued by a court that had no power to alter or invalidate the agreement.

Situation 1. Under the terms of the trust, the income is payable to Mary for life, and at Mary's death the principal is payable to the children of John and Mary. Since their children are adults, John and Mary have no legal obligation to support them. When John made the transfer to the trust, the present value of Mary's right of support was $50,000. The present value of the right to trust income for Mary's life is $60,000 as of the transfer date. The present value of the remainder is $40,000.

Gift tax consequences. Since the value of the trust income interest transferred by John is more than the value of the support rights surrendered by Mary, John's gifts for federal gift tax purposes are:

1) $10,000 to Mary (the excess of the value of Mary's income interest ($60,000) over her support rights ($50,000)), and
2) $40,000 to John and Mary's children (the full value of the remainder interest).

Situation 2 Under the terms of the trust, one-third of the trust income is payable to one of John and Mary's children, and two-thirds of the income is payable to Mary. At Mary's death, all income payments stop and the trust principal is paid to both children. John and Mary have no legal obligation to support their adult children. The present value of the one child's right to trust income is $20 000 and the present value of Mary's right is $40 000. The present value of Mary's right of support is $50,000. The present value of the remainder is $40,000.

In the settlement agreement, John agreed to provide one child with the one-third income interest after Mary bargained for an income interest of less value than she might otherwise have demanded, in view of her support rights, to secure the income payments for their child.

Gift tax consequences. Mary bargained for a reduced income interest to secure an income interest in the trust for the child. Therefore, the excess ($10,000) of the value of Mary's support rights ($50,000) over Mary's income interest ($40 000) is excludable from the value of the child's income interest ($20,000) as consideration in money or money's worth. The amount of John's gift to the child is the excess of the income interest transferred to the child over the value of the consideration received by John, or $10,000.

Since Mary transferred the excess value ($10,000) of her support rights to secure the income interest to the child, Mary has made a taxable gift to the child of $10,000.

The gift tax is also applicable to the full value of the remainder interest ($40,000) transferred by John to children.

Situation 3. Under the terms of the trust, the income is payable to Mary for life and at Mary's death the trust terminates, and the remaining trust principal is payable to John's brother, Fred. The present value of Mary's income interest is $60,000. The present value of the remainder interest is $40,000. The value of Mary's surrendered right to support is $70,000.

Mary neither suggested nor was concerned with naming the person who would receive the remainder of the trust principal after her death. Mary's main concern was to avoid any litigation or other delays; thus, she settled for a monthly payment that was smaller than the amount she would have received if she had demanded and been paid the full value of the support she was entitled to.

Gift tax consequences. The transfer of the income interest to Mary was adequately met by valuable consideration; thus, no gift was paid to Mary. However, the amount of the gift of the remainder interest from John to his brother Fred is its full present value of $40,000 on the date of the gift.

Although John obtained a release by Mary of support rights that was more than the income interest transferred to her, the excess value was not paid to secure the transfer of the remaining interest to Fred. Therefore, no amount is excludable as consideration in money or money's worth from the value of the remainder interest transferred by John to his brother.

However, the value of the support rights ($70,000) Mary surrendered exceeded the income interest ($60,000) transferred to Mary by $10,000. Her motives for releasing the excess value of the support rights (to avoid litigation and delay) are not consideration for purposes of the gift tax. Therefore, Mary has made a taxable gift to John of $10,000.

Survivor Annuities
A gift generally results when an employee who has an unqualified right to an annuity elects to receive a lesser amount so that at the employee's death a survivor annuity will be paid to the employee's designated beneficiary. The gift is made in the calendar year in which the employee gives up the power to deprive the beneficiary of the survivor annuity by making the election irrevocable.

Waiver of pension rights. If a spouse consents to an election to waive a qualified joint and survivor annuity or preretirement survivor annuity, or the rights to these benefits, before the death of the participant spouse, the waiver is not treated as a transfer of property by gift.

Qualified Terminable Interest Property
A spouse may elect the marital deduction for a transfer of certain qualified terminable interest property. One also may receive qualified terminable interest property from the spouse's estate. Qualified terminable interest property is property in which a person has received a qualifying income interest for life. (See *Marital Deduction* under *Taxable Gifts,* or *Marital deduction* in the Estate Tax Summary chapter.)

If someone disposes of all or part of a qualifying income interest for life in any qualified terminable interest property for which the spouse or the spouse's estate has been allowed a marital deduction, they have made a transfer of all interest in the property other than the qualifying income interest, that is subject to the gift tax. Disposition can be by sale gift, or otherwise. The amount of the gift is the entire value of the property less any amounts received on disposition. If the person did not dispose of any part of this property during their life, the value of the property is included in the gross estate. (Sea *Qualified Terminable Interest* Property in the Estate Tax Summary chapter.)

Gift tax recovered. If someone pays a gift tax because of a transfer of qualified terminable interest property, they may recover the gift tax on the property from whoever receives the property. The gift tax on this property is the excess of the total gift tax paid over the total gift tax that would have been paid if the value of the property had not been included in taxable gifts. They may also recover any penalties and interest on the excess taxes.

Before 1982- These provisions apply only after 1981. The spouse could not elect qualified terminable interest treatment before 1982.

Valuation
The value of a gift is the *fair market value* of the property on the date the gift is made. There is no alternate valuation date for the federal gift tax as there is for the federal estate tax. The *fair market value* is the price at which the property would change hands between a willing buyer

and a willing seller, when neither one is under any compulsion to buy or to sell, and when both have reasonable knowledge of all relevant facts. Fair market value is not determined by a forced sale price or by the sale price of the item in a market other than that in which that item is most commonly sold to the public.

In the case of an item that is generally sold at retail, the fair market value is the price at which the item or a comparable item would be sold.

Example. Automobiles are usually retailed so the fair market value would be the retail value. The price a used car dealer would pay may not be used. If tangible personal property is sold through classified advertising in a newspaper, and if this is a common way of selling this kind of property, the selling price will be considered the retail sales price of the item at the time of the sale. This also applies to property sold at a public auction. This retail sales price also will be considered the retail sales price of the item on the date of the gift if the sale is made within a reasonable period following the gift and there is no substantial change in market conditions or other circumstances affecting the value of similar items between the time of the sale and the date of the gift.

Gift tax paid by donee- If a gift is made on the express or implied condition that the donee pays the gift tax, the amount of this tax may be deducted from the value of the gift made as partial consideration for the gift. This kind of agreement does not release the donor from the principal liability of paying the gift tax, if in fact the tax is not paid. The donor's available unified credit (applicable credit amount) must be used to reduce the tax liability of the donee. The value of the gift is reduced only by the amount of tax liability assumed by the donee.

When a gift is made jointly (split) by a husband and wife who are in different gift tax brackets with the condition that the gift tax is to be paid by the donee or out of the properly itself, a special formula is used to compute the gift tax that is deducted in order to value the gift. The payment of gift taxes by a donee causes an *interrelated computation* known as a net gift computation. This computation is beyond the scope of this book. Anyone contemplating such a transaction should seek qualified legal and tax advice.

The following rules govern the valuation of particular types of property.

Unimproved Real Property
Unimproved real property is defined as land without significant buildings, structures, or any other improvements that contribute to its value. Generally, the best indication of the value of unimproved real property is the price paid for the properly in an arm's-length transaction on or before the valuation date. If the property has not recently been the subject of an arm's-length transaction, the best method of estimating value is by using the market data or comparable sales approach. This approach uses arm's-length sales of properties that are as similar as possible to the property being valued.

Comparable Sales- In the comparable sales method, a comparison is made between the property and other similar properties that have been sold. After the sales prices are adjusted for differences in date of sale, size, condition, and location, they reflect the estimated fair market value of the properly to be valued. With the comparable sales method, consider the following factors when inspecting the potential comparable property and the property to be valued:

1) Location, configuration, restrictions on use or zoning,
2) Accessibility and road frontage, available utilities and water rights,

3) Riparian rights, existing easements, rights of way, leases, etc.,
4) Soil characteristics, vegetative cover, status of mineral rights, and
5) Other factors affecting value.

In addition, take note of the names of the buyer and seller, the deed book and page number, the date of sale, sale price, property description, amount and terms of mortgages, property surveys, the assessed value, tax rate, and the assessor's appraised fair market value of the comparable properties.

The potential comparable sale price must be adjusted to account for differences between the sale property and the property to be valued. Since differences of opinions may arise as to the degree of comparability and the amount of the adjustment considered necessary for comparison purposes, document each item of adjustment. Only comparable sales having the least adjustments in terms of items and/or total dollar adjustments should be considered as comparable to the property to be valued. The appraiser should then conclude that two or three adjusted sales furnish the most reliable estimate of fair market value of the property being valued.

Stocks and Bonds
The value of stocks and bonds is their fair market value per unit (share or bond) on the date of the gift. If there is a market for stocks and bonds on a stock exchange, in an over-the-counter market, or otherwise, the fair market value per unit is the mean (midpoint) between the highest and lowest quoted selling prices on the date of the gift.

If there were no sales on the date of the gift but there were sales on dates within a reasonable period before and after the date of the gift, the fair market value is determined in the following way: take a weighted average of the mean between the highest and lowest sales prices on the nearest date before the date of the gift, and the mean between the highest and lowest sales prices on the nearest date after the date of the gift. The average must be weighted *inversely* by the respective numbers of trading days between the selling dates and the date of the gift.

Example The nearest transactions took place 2 trading days before the date of the gift at a mean selling price of $10 and 3 trading days after the date of the gift at a mean selling price of $15. The price of $12 is the fair market value, obtained by the following computation:

$$\frac{(3\times\$10)+(2\times\$15)}{5}=\$12$$

If no sales occurred within a reasonable period before and after the date of the gift, the fair market! value may be determined by taking the mean between the bona fide bid and asked prices on the date of the gift, or if none, by taking a weighted average of the means between the bona fide bid ~ and asked prices on the nearest trading date before, and the nearest trading date after, the date of the gift. Both of these dates must be within a reasonable period. If the highest and lowest selling prices on the I date of the gifts are not available for bonds for which there is a market on a stock exchange, but the closing selling prices are available on the date of the gift and the trading day before the date of the gift, then the fair market value of the bond is the mean between the quoted closing selling price on the date of the gift and the quoted closing selling price on the trading day before the date of the gift.

If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be used to value the stocks and bonds if the records are available in a generally available listing or publication of general circulation. If these records are not available and the stocks and bonds are in a composite listing of combined exchanges that is generally available, then use the records of the combined exchanges. If no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the date of the gift, but are available on a date within a reasonable period after that date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices on that date may be taken as the fair market value.

Prices unavailable- If selling prices or bid and | asked prices are not available under the preceding conditions, or if securities of a closely held corporation are involved, determine the fair market value by taking the following factors into consideration: I

1) In the case of bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors, and
2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the *other relevant factors* are the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry, the degree of control represented by the block of stock to be valued, and the value of securities of other corporations engaged in the same or similar lines of business that are listed on a stock exchange. For preferred stock, the most important factors are its yield, dividend coverage and protection of its liquidation preference.

Stock selling ex-dividend- If a dividend was declared before the date of the gift and was payable after that date, and if the stock was selling ex-dividend on the date of the gift, determine the fair market value of the stock by adding the amount of the dividend to the ax-dividend quotation. If the decedent died on a weekend and the stock began selling ax-dividend on the following trading day, determine the weighted average by adding the value of the dividend to the mean of the ex-dividend quotations.

Restricted securities- Some securities cannot be immediately resold by the holder because they are restricted from resale under federal securities laws. The securities are sometimes called "restricted securities," "unregistered securities," "investment letter stock," or "private placement stock." See Revenue Ruling 77-287, 1977-2 C.B.319, for guidelines on the valuation of these securities.

Common Trust Funds

For common trust funds, the property to be valued is the participating interest in the fund. A bank administering a common trust fund must value the assets of the fund at least quarterly. If the valuation date for gift tax purposes is not the same as the bank valuation date, the individual must determine the fair market value using the same weighted average method as is used for stocks and bonds. The average must be weighted inversely by the respective number of days between the scheduled bank valuation dates and the date of the gifts.

Example. The scheduled bank valuation date occurred 25 days before the date of the gift and resulted in a value of $100 per unit. The next scheduled bank valuation date occurred 66 days after the date of the gift and resulted in a value of $105 per unit. The fair market value on the date of the gift is $101.37, computed as follows:

$$\frac{(25\times\$105)+(66\times\$100)}{91}=\$101.37$$

Shares in Mutual Funds
The fair market value of a share in an open-end investment company (commonly known as a mutual fund) is the redemption price (bid price). If there is no public redemption price quoted by the company for the date of the gifts, the fair market value of the mutual fund share is the last public redemption price quoted by the company for the first day before the date of the gift for which there is a quotation.

Interest in Business
The fair market value of an interest in a business is the net amount that a willing purchaser would pay for the interest to a willing seller, when neither is under any compulsion to buy or sell and both have reasonable knowledge of relevant facts. This applies both for sole proprietorships and for partnerships. The net value is determined on the basis of all relevant factors, including:

1) A fair appraisal of all the assets of the business,
2) The demonstrated earning capacity of the business, and
3) Other applicable factors used in considering the value of corporate stock.

Special attention should be given to determining an adequate value of the goodwill of the business. Include complete financial and other data supporting this valuation with the return.

Annuities, Life Estates, Terms for Years, Remainders, and Reversions
The value of all annuities, life estates, terms for years, remainders, or reversions is generally the present value on the date of the gift. However, the value of an annuity, or of a life insurance policy issued by a company regularly engaged in the selling of such contracts, is the amount that the issuing company would charge for a comparable contract on the date of the decedent's death.

The value of these kinds of property is their present value, except in the case of annuities under contracts issued by companies regularly engaged in their sale. To determine present value, the taxpayer must know the applicable interest rate and use actuarial tables.

Interest rate. The applicable interest rate varies. It is announced monthly in a news release and published in the Internal Revenue Bulletin as a Revenue Ruling. The interest rate to use is under the heading "Rate Under Section 7520" for a given month and year. This is available at the IRS website.

Actuarial tables. Refer to actuarial tables to determine a qualified interest in the form of an annuity, any interest for life or a term of years, or any remainder interest to a charitable organization.

Use the valuation tables set forth in IRS Publications 1457 (Alpha Volume) and 1458 (Beta Volume). Both of these publications provide tables containing actuarial factors to be used in determining the present value of an annuity, an interest for life or for a term of years, or a remainder or reversionary interest. For qualified charitable transfers, a person can use the factor for the month in which he or she made the contribution or for either of the 2 months preceding that month.

Publication 1457 also contains actuarial factors for computing the value of a remainder interest in a charitable remainder annuity trust and a pooled income fund. Publication 1458 contains the factors for valuing the remainder interest in a charitable remainder unitrust. Tables containing actuarial factors for transfers to pooled income funds may also be found in Income Tax Regulation 1.642(c)-6(e)(5), transfers to charitable remainder unitrusts in Regulation 1.664(e)(6), and other transfers in Regulation 20.2031-7(d)(6).

Below-market loans- A below-market loan is (1) a demand loan on which the interest is payable at a rate less than the applicable federal rate, or (2) a term loan in which the amount loaned (amount received by the borrower) exceeds the present value of all payments due under the loan.

These provisions apply to term loans made after June 6, 1984, and demand loans outstanding after June 6, 1984. Any loan renegotiated, extended, or revised after June 6, 1984, is treated as a loan made after that date.

If an individual has made a below-market loan that is a *gift loan,* that person may be subject to the gift tax. In addition, there are additional Internal Revenue Code regulations for the income tax consequences of below market loans that are beyond the scope of this text. *A gift loan* means any below-market loan where the foregone interest is in the nature of a gift. A loan between unrelated persons can qualify as a gift loan.

Foregone Interest- This means, for any period during which the loan is outstanding, the excess of (1) the amount of interest that would have been payable for the period if interest accrued at the applicable federal rate and were payable annually on the last day of the calendar year, over (2) any interest payable on the loan properly allocable to that period.

If the gift loan is a below-market demand loan, the foregone interest is treated as transferred (as a gift) by the lender to the borrower. Any foregone interest attributable to periods during any calendar year is treated as transferred on the last day of that calendar year.

If the gift loan is a below-market term loan, the lender is treated as having transferred (as a gift) on the date the loan was made an amount equal to the excess of the amount loaned, over the present value of all payments that are required to be made under the terms of the loan. Present value is determined on the date of the loan by using a discount rate equal to the applicable federal rate.

Applicable federal rate- For demand loans, the applicable federal rate is the federal short-term rate in effect for the period for which the amount of foregone interest is being determined, compounded semiannually. The applicable federal rate for a semiannual period (January 1 through June 30 or July 1 through December 31) is the short-term rate that is in effect for the first month of that semiannual period (i.e., January or July). In the case of a below-market demand loan of a fixed principal amount that remains outstanding for an entire calendar year, the "blended annual rate" may be used to compute foregone interest. For term loans, the applicable federal rate is the federal short-term, mid-term, or long-term rate, based on the term of the loan, in effect on the day the loan was made, compounded semiannually. These federal rates are published monthly. Equivalent rates based on compounding periods other than semiannual compounding are also published to facilitate the application of section 7872 of the Code to loans other than those involving semiannual payments or compounding. For periods before January 1, 1985, the applicable federal rate for both types of loans is 10%.

Exception- These provisions do not apply to gift loans directly between individuals for any day on which the total outstanding amount of loans between these individuals is not more than $10,000. This exception does not apply to any gift loan directly attributable to the purchase or carrying of income-producing assets.

Valuation understatement- A valuation understatement occurs if the value of any property claimed on the gift tax return is 65% or less of the amount determined to be the correct valuation. If there is an underpayment of the gift tax because of this understatement, an addition to tax of up to 30% of the underpayment may be assessed. The addition to tax will not apply if the underpayment is less than $1,000. The Internal Revenue Service may waive all or part of this addition to tax if it can be shown that there was a reasonable basis for the valuation claimed and that it was made in good faith.

Gift by Husband or Wife to Third Party-Gift Splitting

A gift made by a person to someone other than a spouse may be considered as made one-half by each spouse. This is known as g/R *spiriting* and both spouses must consent to its use. Generally, if a gift is split, a lower gift tax rate bracket applies to the total taxable gift. In addition, the annual exclusion and the unified credit (applicable credit amount) allowable to each spouse applies to the gift.

To split the gift the spouses must be legally married to each other at the time of the gift. If they are divorced during the year, they still may split the gift so long as neither marries anyone else during that year. In addition, both must be citizens or residents of the United States on the date of the gift and one spouse may not create a general power of appointment in the other spouse over the property transferred. If the spouses consent to gift splitting, all gifts made during the year that qualify must be split.

Consent- If a gift is to be split, both spouses must indicate their consent on the gift tax return. If both spouses file gift tax returns within the time for signifying consent, it is sufficient if:

1) The consent of the husband is signified on the wife's return and the consent of the wife on the husband's return,
2) The consent of each spouse is signified on his or her own return, or
3) The consent of both spouses is signified on one of the returns.

If only one spouse has made gifts during the year and the spouses consent to split the gift, the other spouse is not required to file a gift tax return provided that:

1) The total value of gifts made to any one donee is not more than $20,000, and
2) The property transferred is not a gift of a future interest.

If the spouses consent to split a gift of a future interest, both spouses must file gift tax returns regardless of the value of the gift. See Future *interests,* discussed later, under *Annual Exclusion.* The consent to split gifts cannot be made after a gift tax return has been filed and the due date for filing the return has passed. The consent may be revoked, but not after April 15 of the year following the year of the gift. The consent to split gifts can be made on either Form 709 or, if certain requirements are met, on Form 70~A. See *The Gift Tax Return* for these requirements.

Taxable Gifts

Determine the amount of the taxable gifts by subtracting from the total gifts for the year the annual exclusion, the charitable deduction, and the marital deduction. Total gifts for the year do not include a qualified transfer.

Qualified transfer- A qualified transfer is any amount paid for an individual:
1) 1) To an educational organization as tuition for the individual's education or training, or,
2) To any person for medical care provided to the individual.

The exclusion for a qualified transfer is in addition to the annual exclusion. Therefore, if only part of a payment was a qualified transfer, the other part could qualify for the annual exclusion. A qualified transfer is allowed without regard to the relationship between the donor and the donee.

An educational organization is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on. The educational organization may be domestic or foreign. The individual may be a full- or part-time student. The payment must be made directly to the organization. The qualified transfer is limited to direct tuition costs. It does not apply to books, supplies, dormitory fees, etc. The payment for medical care must be made directly to the person or organization providing the medical services. Reimbursement to the individual for expenses he or she paid and amounts reimbursed by insurance do not qualify.

Annual Exclusion

Generally, the first $14,000 (for 16-17) of gifts made to any one person during the calendar year (except gifts of future interests in property) is excluded in determining the total amount of gifts for the calendar year. This annual exclusion is applied to all gifts of a present interest made during the calendar year. For a gift in trust, each beneficiary of the trust is treated as a separate person for purposes of the annual exclusion. However, the exclusion is not available for gifts of a future interest, such as a remainder interest in a trust. The entire value of such a gift must be included in the total amount of gifts for the calendar year in which the gift was made. The annual exclusion allows spouses who consent to split their gifts to transfer up to $28,000 (for 2016-17) to any one person during any calendar year without any gift tax liability if the gift qualifies as a present interest.

Future interests- This is a legal term that includes reversions, remainders, and other interests or estates that are to commence in use, possession, or enjoyment at some future date. On the other hand, an unrestricted right to the immediate use, possession, or enjoyment of property or the income from the property is a present interest in property.

Example. Fred Jones created a trust under the terms of which his son was to receive for life the entire income from the property, with the remainder going to Fred's grandson at the death of his son. There is a gift of a present interest to the son and of a future interest to the grandson. However, if Fred directed the trustees to pursue an investment policy that results in future increases in the value of the trust, rather than current income, his son would not have a present interest, and the annual exclusion would not be allowed for Fred's gift to his son.

Proof of gift value- The donor who claims the annual exclusion has the burden of proving the value of the amount of the gift that is claimed to be a present interest. Generally, the annual exclusion is not allowable unless:
1) The number of eventual donees can be determined, or
2) The interest of each beneficiary can be valued.

The allowance of the exclusion is determined by the facts in each case.

Gift to corporation- A gift to a corporation is a gift of a future interest to its stockholders, and does not qualify for the annual exclusion. If the donor's spouse is a shareholder, such a gift qualifies for the marital deduction in proportion to the interest of the donor's spouse in the corporation.

Transfers for the benefit of a minor- A transfer for the benefit of a person who has not reached age 21 on the date of the gift is considered a gift of a present interest even though the minor is not given the unrestricted right to the immediate use, possession, or enjoyment of the property or the income from it if certain conditions are met.

Conditions- A gift to a minor is considered a present interest and qualifies for the annual exclusion if the following conditions are met:

1) Both the property and its income may be expended by, or for the benefit of, the minor before the minor reaches age 21,
2) Any part of the property or its income not disposed of by the minor's 21st birthday must pass to the minor at that time, and
3) If the minor dies before the age of 21, the property and its income will be payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

Loan of artwork- Any loan of a qualified work of art to a charitable organization (501 (c)(3) organization) is not treated as a transfer subject to the gift tax. A qualified work of art is any archeological, historic, or creative tangible personal property. A loan of a painting to a museum would not be a transfer subject to the gift.

Charitable Deduction

An individual may deduct from the total amount of gifts they made during the calendar year all gifts (included in that total) that were made to or for the use of:

1) The United States, a state, a political subdivision of a state, or the District of Columbia, for exclusively public purposes,
2) Any corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art. Organizations that foster national or international amateur sports competition, but only if none of their activities involve providing athletic facilities or equipment, unless they are qualified amateur sports organizations, and organizations for the prevention of cruelty to children or animals are included. These organizations qualify as long as no part of their net earnings benefits any private individual and no substantial activity is undertaken to carry on propaganda, or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office,
3) A fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes including the encouragement of art, and the prevention of cruelty to children or animals, or
4) Any war veterans' organization organized in the United States or any of its auxiliary departments or local chapter or posts, as long as no part of the net earnings benefits any private individual.

<u>Note</u>. For purposes of 1) above, certain Indian tribal governments are treated as states and, as such, gifts to these tribal governments qualify for deductible charitable contributions. See Revenue Procedure 83-87 for a list of qualifying Indian tribal governments. For purposes of 2) above, educational purposes includes the providing of care of children away from their homes if substantially all the care provided enables individuals (the parents) to be gainfully employed, and the services are available to the general public.

Transfer subject to a condition or power- If, at the date of the gift, a transfer to a qualified charity is contingent upon some act or occurrence, a deduction is allowable only if it is virtually certain that the transfer will become effective and the contingency can be ignored. If the donee or the trustee has the power to divert any part of the property or fund for a use or purpose that is not deductible, only the part of the property or fund not subject to this power is deductible.

Payments in compromise- If a charitable organization assigns or surrenders a part of a transfer to it under a compromise agreement to settle a controversy, the amount surrendered or compromised is not deductible as a transfer to that charitable organization.

Work of art- If one makes a qualified contribution of a copyrightable work of art; the work of art and its copyright are treated as separate properties. Therefore, they are allowed a charitable deduction, for gift tax purposes, for the transfer to a qualified organization of a work of art, even if the subject individual does not transfer the copyright to the charity. One is not allowed a charitable deduction for income tax purposes for a contribution of a split interest in a copyrightable work of art.

Partial interests- If a person transfers an interest in property for both charitable and noncharitable purposes, a charitable deduction is allowed for the interest passing to the charity only if the transfer is one of the following:

1) *An undivided portion of the entire interest.* If they transferred for a charitable purpose an undivided interest, *not in trust,* of the entire interest in property, the value of the interest is a deductible charitable contribution. An undivided portion of the entire interest in property must consist of a fraction or a percentage of each interest or right they own in the property, and it must extend over the entire term of the individual's interest in that property or in other property into which the donated property is converted.
2) *Remainder interest in a personal residence.* If an individual transferred for a charitable purpose the remainder interest, *not in trust,* in his/her personal residence, the value of the interest is a deductible charitable contribution.
3) *Remainder interest in a farm.* If someone transferred the remainder interest, *not in trust,* in a farm to a qualified charity, the value of that interest is deductible.
4) *Qualified conservation contribution* If they transfer a qualified real property interest to a qualified organization exclusively for conservation purposes, the value of that interest is deductible.
5) *Remainder Interests charitable remainder trusts, and pooled-income funds.* A charitable deduction is allowed for the transfer of a remainder interest for a charitable purpose in certain cases. The charitable remainder must be in a trust. The trust must be in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled-income fund.
    - *A charitable remainder annuity trust is* a trust from which a specified amount is paid at least annually to one or more persons who were living at the time the trust was created. The amount must be at least *5%* of the initial fair market value *of* the property placed in trust. At the death *of* the last noncharitable beneficiary or at the

end of a term of up to 20 years, the remainder interest must be paid to or held for the benefit of a qualified charitable organization.

- Generally, a *charitable remainder unitrust* is a trust from which a fixed percentage of the net fair market value of its assets, valued annually, is paid at least annually to one or more persons who are living at the time of the creation of the trust. The percentage must be at least *5%.* At the death of the beneficiaries or at the end of a term of up to 20 years, the remainder interest is paid to or held for the benefit of a qualified charitable organization.
- The possibility that federal or state death taxes will be paid out of trust assets will disqualify a trust from being a charitable remainder trust, if the trust was created after October 3, 1982.
- *A pooled-income trust* is a trust maintained by a charity to which donors transfer property and contribute the remainder interest in the property to charity. The grantor either keeps an income interest for life for their part of the trust property or create an income interest in that property for the life of one or more beneficiaries who are living at the time of the transfer.
- Any other form of charitable remainder interest trust will not qualify for the charitable deduction.

6) *Guaranteed annuity Interests and unitrust Interests.* If an individual transfers *a lead Interest,* whether or not in trust, to a charity and the remainder to a noncharitable entity, the charitable deduction is allowed only if the lead interest is in the form of a guaranteed annuity interest or a unitrust interest.
   - The term *guaranteed* annuity interest *is* the right, under the instrument of transfer, to receive a determinable amount for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of the gift. The annuity may also qualify if the instrument of transfer provides for a term of years or a period of lives plus a term of years. The amount must be paid at least annually.
   - For example, the annuity may be paid for the life of an individual plus a term of years. An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of the gift.
   - A guaranteed annuity interest, not in trust, will be considered a guaranteed annuity interest only if it is paid by an insurance company or by an organization regularly engaged in issuing annuity contracts.
   - The term *unitrust interest* means the right, given in the instrument of transfer, to receive payment at least annually of a fixed percentage of the net fair market value, determined annually, of the property that funds the unitrust.
   - A unitrust interest, not in trust, will be considered a unitrust interest only if it is paid by an insurance company or by an organization regularly engaged in issuing interests otherwise meeting the requirements of a unitrust interest.

Partial Interests, valuation- The amount of the deduction in the case of a partial interest (including a remainder interest) is the value of the interest on the date of the gift. The value of an annuity, life estate, term for years, remainder, reversion, or unitrust interest is its present value. If the valuation of the interest depends on the continuation or termination of more than one life, or upon a term certain concurrent with one or more lives, a special factor must be used. See the discussion of annuities, etc. under *Valuation* earlier.

If a person needs a special factor for an actual transaction, that person may request the factor from the Commissioner of Internal Revenue.

If one makes a qualified conservation contribution, see Publication 561, *Determining the Value* of *Donated Property,* and Publication 526, for information on valuing the contribution.

Marital Deduction

One may deduct from the total amount of gifts made during the calendar year the value of gifts made to their spouse. The amount of the marital deduction is unlimited. Some gifts are not deductible. See *Nondeductible interests,* below. To qualify for the marital deduction, the following conditions must be met at the time the gift is made.

1) The *spouses* must be married. A gift to a person who later becomes the spouse after the gift has been made does not qualify for the marital deduction.
2) The spouse making the gift does not have to be a U.S. citizen or resident. The spouse receiving the gift must be a U.S. citizen.

Nondeductible Interests- Not all interests qualify for the marital deduction. Nondeductible interests include amounts not included in total gifts for the calendar year and property interests transferred to a spouse that are *terminable interests.*

Terminable Interests- For purposes of the marital deduction, there is a distinction between "property" and an "interest in property." "Property" refers to the underlying property in which various interests exist. Each of the interests in property is not considered "property". A *terminable Interest /n property is* an interest that will end or fail after a period of time or when some contingency occurs or fails to occur. Examples of terminable interests are life estates, annuities, estates for a term of years, and patents.

As they relate to the marital deduction, terminable interests fall into three categories:

1) Terminable interests that qualify for the marital deduction without the need for an election. (These terminable interests are discussed below under *Exceptions.)*
2) Terminable interests that do not qualify for the marital deduction unless the donor makes an election to treat the interest as qualified terminable interest property. See *qualified terminable interest property* below.
3) Terminable interests that cannot qualify for the marital deduction.

Generally, terminable interests in these three categories have the following characteristics:

1) The donor has-
   a) Transferred an interest in the same property for less than adequate consideration to someone other than his or her spouse, or
   b) Retained an interest in the same property, or
   c) Retained a power to appoint an interest in the same property, <u>and</u>
2) Because of this transfer or retention, the other donee, the donor, or the person to whom an interest may be appointed, may possess or use any part of the property after the spouse's interest ends or fails.

Example. If Charles gave his wife a patent that has a useful life of 10 years, he has given her a terminable interest. But, since no one will enjoy the use of the patent after her interest ends, Charles is entitled to a marital deduction. However if Charles gives his wife only the first 5 years of the patent and gives his son the last 5 years, he will not be entitled to a marital deduction.

Exceptions- There are exceptions to the terminable interest rule. A terminable interest qualifies for the marital deduction if the transfer qualifies as one of the following exceptions.

Joint Interests. If there is a transfer a property interest to a U.S. citizen spouse and the couple are the only joint tenants or are tenants by the entirety, they are not considered to have retained an interest in the property. The marital deduction is allowed even if the donor may receive the property because the other spouse dies or the tenancy is severed.

Life estate with power of appointment. If a person makes a transfer that meets all of the following conditions, they are considered to have made a transfer to their spouse that qualifies for the marital deduction. The transferor is not considered to have retained an interest or transferred an interest to someone other than the spouse. The transfer to the spouse will qualify if:

1) The spouse is entitled for life to all the income from the entire interest,
2) The spouse must receive the income annually or at more frequent intervals,
3) The spouse must have the power, exercisable in his or her favor or for his or her estate, to appoint the entire interest,
4) The spouse must be able to exercise the power alone and (whether exercisable by will or during life) in all events, and
5) The spouse must have the only power to appoint any part of the interest in the property to another person.

If either the right to income or the power of appointment given to the spouse pertains only to a specific portion of a property interest, the marital deduction is allowed only to the extent that the rights of the spouse meet all of the five conditions. For example, if the spouse is to receive all the income from the entire interest, but only has a power to appoint one-half of the entire interest, then only one-half qualifies for the marital deduction.

A *partial interest* in property is treated as a specific portion of an entire interest only if the rights of the spouse to the income and to the power constitute a fractional or percentile share of the entire property interest. This means that the interest or share will reflect any increase or decrease in the value of the entire property interest. Thus, if the right of the spouse to income and the power are for a specified percentage of the property, the interest is a specific portion. If, however, the spouse is entitled to receive a specified sum of income annually, the capital amount that would produce such a sum will be considered the specific portion from which the surviving spouse is entitled to receive the income.

Qualified terminable interest property. If a donor gives their spouse a life interest in property, the gift generally is a terminable interest and does not qualify for the marital deduction. However, the individual may elect to treat the life interest as a qualified terminable interest for which the marital deduction is allowed. Make the election on the gift tax return for the calendar year in which they transferred the interest. One must make the election on or before the due date, including extensions, for filing the return. The subject taxpayer cannot change this election. For this purpose, property includes an interest in property. A specific portion of property is treated as separate property.

A person can make the election for any property that they transfer and in which the spouse has a qualifying income interest for life. This qualified terminable interest property is treated as transferred to the spouse and qualifies for the marital deduction. The individual is not considered to have retained any part of the property or transferred any part to any person other than the spouse. The spouse has a ***qualifying income interest for life*** if:

1) The spouse is entitled to all the income from the property for life, or has a usufruct interest for life in the property,
2) The income is payable annually or at more frequent intervals, and
3) No person has the power to appoint any pan of the property to any person other than the spouse.

An income interest granted for a term of years or a life estate that will end if a specified event occurs does not qualify. No person, including the spouse, can appoint any part of the property during the spouse's life. A power that can be exercised only at or after the spouse's death is allowable. A trustee may invade the corpus of a trust for the benefit of the spouse. Generally, a lifetime annuity interest is treated as a qualifying income interest for life.

Special rules apply to the disposition of all or part of the qualifying income interest by the spouse. See *Qualified Terminable Interest Property* discussed earlier under *Gifts in General.* See also *Qualified Terminable Interest Property* in the *Estate Tax* section.

Any interest that an individual retained in the qualified terminable interest property is not includable in their gross estate. If an individual transfers their interest in that property, the transfer will not be subject to the gift tax. However, these rules will not apply if the spouse has disposed of any part of the qualifying income interest or if the property was included in the spouse's gross estate. A transfer to a spouse of an interest in a joint and survivor annuity in which only the spouses have the right to receive any payments prior to the death of the survivor qualifies for the gift tax marital deduction.

For transfers made after December 31, 1981, a transfer of a survivor annuity interest will not qualify for the marital deduction if the donor elects out of qualified terminable interest property treatment.

Charitable remainder trust- If an individual creates a charitable remainder annuity trust or a charitable remainder unitrust in which the only noncharitable beneficiaries are the individual and his/her spouse, they can claim a marital deduction for the interest in the trust that is transferred to the spouse. A *noncharitable beneficiary is* any beneficiary of the trust other than an organization for which a charitable contribution is allowed.

Gift Tax Computation

Taxable gifts are the total gifts reduced by the annual exclusion, the charitable deduction, and the marital deduction.

The gift tax before any credits is the excess of:

1) A tentative tax on the sum of-
   a) The taxable gifts for the calendar year, and
   b) The taxable gifts for all preceding calendar periods, <u>Over</u>
2) A tentative tax on the total taxable gifts for an preceding calendar periods.

Taxable gifts for all *preceding calendar periods* means all taxable gifts made after June 6, 1932. The taxable gifts for these periods are determined under the gift tax provisions that applied when the gift was made. The amount of the annual exclusion allowed in the preceding periods is not included in taxable gifts. However, the specific (lifetime) exemption is limited to $30,000 for gifts made before 1977.

Unified credit (applicable credit amount)
Gift taxes were not eliminated from the 2001 Tax Act. However, the Act allows larger gifts and lower tax rates. The exclusion was $14,000 (for 2016-17) per year. No gift tax is due below this amount).

When the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (Public Law 111-312) was signed into law December 17, 2010, it made a number of important estate and gift tax changes including:

1. it reunified the Federal estate tax exemption and the lifetime gift tax exemption [P.L.111-312 §302(b)(1)];
2. it raised this exemption to $5m [P.L. 111-312 §302(a)(1) amending IRC §2010(c)]; and
3. it indexed this amount for inflation [P.L. 111-312 §302(a)(1) & §302(a) adding IRC §2010(c)(3)(B)].

This may be the first time that the unified credit was ever indexed.
In Rev. Proc. 2011-52 (November 7, 2011; IRB 2011-45), §3.29, the IRS announced that the basic exclusion amount against estate tax under §2010 for an estate of any decedent dying during calendar year 2012(and by extension, the unified credit against gift tax under §2505) is $5,120,000. With the American Taxpayer Relief Act of 2012, or ATRA, which was passed Jan. 1, 2013, the estate tax was made a permanent part of the tax code and the exemption amount automatically indexed for inflation. The amount of unified credit for the past several years is summarized here:

Years	Unified Credit
2009-2010	$1,455,800
2011	$1,730.800
2012	$1,772,800
2013	$2,045,800

Years	Unified Credit
2014	$2,081,800
2015	$2,117,800
2016	$2,125,800
2017	$2,141,800

Limit- The amount of unified credit (applicable credit amount) a person may claim may not exceed the amount of the tax for the calendar year.

Applying the Unified Credit to Gift Tax
After it has been determined which of the gifts are taxable, one must figure the amount of gift tax on the total taxable gifts and apply the unified credit for the year.

Example. In 2014, you give your niece, Mary, a cash gift of $8,000. It is your only gift to her this year. You pay the $15,000 college tuition of your friend, David. You give your 25-year-old daughter, Lisa, $25,000. You also give your 27-year-old son, Ken, $25,000. Before 2014, you had never given a taxable gift. You apply the exceptions to the gift tax and the unified credit as follows:

1) Apply the educational exclusion. Payment of tuition expenses is not subject to the gift tax. Therefore, the gift to David is not a taxable gift.
2) Apply the annual exclusion. The first $14,000 you give someone during 2014 is not a taxable gift. Therefore, your $8,000 gift to Mary, the first $14,000 of your gift to Lisa, and the first $14,000 of your gift to Ken are not taxable gifts.
3) Apply the unified credit. The gift tax on $22,000 ($11,000 remaining from your gift to Lisa plus $11,000 remaining from your gift to Ken) is $4,240. You subtract the $4,240 from your

unified credit of $2,081,800 for 2014. The unified credit that you can use against the gift tax in a later year is $2,077,560.

In this example, the donor does not have to pay any gift tax for 2014. However, he or she does have to file Form 709.

Filing a Gift Tax Return

Generally, a person must file a gift tax return on Form 709 if any of the following apply;

- He or she gave gifts that are more than the annual exclusion for the year to someone (other than to their spouse).
- An individual and spouse are splitting a gift (they may be able to use Form 709-A).
- He or she gave someone (other than their spouse) a gift that the recipient cannot actually possess, enjoy, or receive income from until some time in the future.
- A person gave his or her spouse an interest in property that will be ended by some future event.

A taxpayer does not have to file a gift tax return to report gifts to (or for the use of) political organizations and gifts made by paying someone's tuition or medical expenses. An individual also does not need to report the following deductible gifts made to charities.

- His or her entire interest in property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use.
- A qualified conservation contribution that is a restriction (granted forever) on the use of real property.

If an insurance professional knows somebody who needs to file a gift tax return, he or she should get Form 709 and its instructions or Form 709-A.

Gift Splitting

If either of the spouses is a nonresident non-citizen, they may not elect to split the gift made by one spouse to a third party.

Recipient's Basis in Gifts

To figure the recipient's basis in gift property, the donor's adjusted basis in the property, its fair market value at the time of the gift, and the gift tax paid on the gift must be known.

Fair market value less than donor's adjusted basis- If the fair market value of the property at the time of the gift was less than the donor's adjusted basis just before the gift was made, the recipient's basis for depreciation, depletion, or amortization and for gain on its sale or other disposition, is the donor's adjusted basis. The recipient's basis for figuring a loss is the fair market value of the property at the time of the gift. However, if the donor's adjusted basis is used for determining a gain and a loss is computed, and then the lower fair market value basis is used for determining a loss and a gain is computed, there is neither a gain nor a loss.

Example. You received a gift of income-producing property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift was $9,000. If you sell the property for $9,500, you have neither gain nor loss. There is no gain because the basis for determining gain is $10,000, there is no loss because the basis for determining loss is $9,000.

Fair market value more than donor's adjusted basis- If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift was made, the recipient's basis for depreciation, depletion, or amortization, and for gain or loss on its sale or other disposition, is the donor's adjusted basis at the time of the gift, increased by the gift tax paid on the gift. This basis, however, cannot be more than the fair market value of the property at the time of the gift.

Gift tax paid on the gift- For gifts made after 1976, the recipient's basis (donor's adjusted basis) is increased by the gift tax paid that is attributable to the net appreciation in value of the gift. This is determined by multiplying the total gift tax paid on the gift by a fraction. The numerator of the fraction is the net appreciation in value of the gift and the denominator is the amount of the gift. The net appreciation in value of the gift is the fair market value of the gift minus the donor's adjusted basis.

Gift made before 1977- If the recipient received property by gift before 1977, the basis in the property (donor's adjusted basis) is increased (but not above fair market value at the time of the gift) by the total gift tax paid on the gift.

Gift made before 1921- If the property was received by gift before 1921, the recipient's basis for depreciation and for gain or loss on the sale or other disposition of the property is its fair market value at the time of the gift.

Generation-Skipping Transfer Tax

The federal generation skipping transfer tax is a system meant to fill what was once a gap between the federal estate tax and the federal gift tax, which were meant to levy tax on substantial wealth transferred between generations. By the normal order of things, this meant that the estate tax would apply to each generation. For example, Father, by will, gives Son $6,000,000; at his death, the Son gives the $6,000,000 to Grandson (his son). The tax collector would assess tax when Father transferred the money to Son, and again when Son transferred the money to Grandson.)

Before the enactment of the GST tax, extremely wealthy individuals (usually those having a net worth of several million dollars) would sometime set up a bequest like this: During his lifetime, or in his will, Mr. Madeogold gives his *grandchild* $10,000,000. Although this bequest would be subject to the federal estate or gift tax, the grandfather has managed to get the money to the grandchild without the extra round of taxes that would have been collected had the money first been given to his daughter, Ima, and then transferred by her to her child.

Generation-Skipping Transfers

A generation-skipping transfer includes: 1) a taxable termination, 2) a taxable distribution, and 3) a direct skip. Taxable distributions and taxable terminations involve transfers from, or terminations of interests in, trusts. The term trust includes any arrangement (other than an estate) which although not a trust, has substantially the same effect as a trust. Examples of these arrangements include life estates and remainders, estates for years, and insurance and annuity contracts. For these purposes, the term trustee means the person in actual or constructive possession of the property subject to such arrangement.

The IRC provides several exemptions and exclusions for the GST tax. Unlike the estate and gift taxes, the GST tax does not use the unified credit. Instead, a $5,340,000 GST exemption is allowed to each individual for generation-skipping transfers during life or at death. The GST exemption is equal to the estate tax unified credit amount, with both indexed for inflation. The GST exemption may be allocated by the transferor or the executor to any generation-skipping transfer. The allocation is irrevocable once made. Unless a contrary election is made, all or any portion of the exclusion not previously allocated is deemed allocated to a lifetime direct skip to the extent necessary to make the inclusion ratio for the transfer zero. 26 U.S.C. §2632. The exemption is doubled for married individuals who elect to treat the transfers as made one-half by each spouse. An indirect skip property transfer automatically triggers the GST exemption.

The basic Estate Tax is designed to tax assets when they are passed from one generation to another, such as a parent to a child. The generation-skipping tax ("GST" in estate-planning jargon) on the other hand, is designed to impose tax on those who the Government has figured are attempting to circumvent the Government's expectation that it will collect more Estate Tax sooner rather than later, and by-pass the usual "leave it directly to your children", and, instead, leave the inheritance to someone in the next generation - hence "the skip". A simple example is that of a grandparent leaving money to a grandchild where the grandchild's parent is still alive, leaving out the middle generation. But GST can also apply in non-family situations -- GST may be due if a beneficiary of a gift or estate is 37.5 years younger than the donor or deceased.)

Gifts given outright that qualify for the $14,000 Gift Tax exclusion are shielded from the GST as are education and medical expenses.

Direct Skip

A direct skip is an outright transfer to or a transfer in trust for the benefit of a skip person. A direct skip is a transfer of an interest in property that is a taxable gift or is includible in the estate of the transferor. An example is a gift from a grandparent to his grandchild or to a trust for his or her grandchild's benefit.

Election- An election may be made to treat certain transfers in trust for the benefit of the transferor's grandchildren as direct skips. The transfer must have been qualified as a direct skip except that the trust instrument provides that if the grandchild dies before vesting of the transferred interest, the interest is transferred to the grandchild's heir (rather than to the grandchild's estate).

Skip person- A skip person is:

1) a person two or more generations below that of the transferor! Or
2) a trust
   a) if all interests in the trust are held by skip persons, or
   b) if no person holds an interest in the trust, and future distributions or terminations can be made from the trust only to skip persons.

Determining Which Transfers Are Direct Skips

Effective dates. The rules below apply only for the purpose of determining if a transfer is a direct skip that should be reported on Schedule R or R-1 of Form 706.
In general. The GST tax is effective for the estates of decedents dying after October 22, 1986.

Irrevocable trusts. The GST tax will not apply to any transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer was not made out of corpus added to the trust after September 25, 1985. An addition to the corpus after that date will cause a proportionate part of future income and appreciation to be subject to the GST tax. For more information, see IRS Regulations section 26.2601-1(b)(1)(ii).

Mental disability. If, on October 22, 1986, the decedent was under a mental disability to change the disposition of his or her property and did not regain the competence to dispose of property before death, the GST tax will not apply to any property included in the gross estate (other than property transferred on behalf of the decedent during life and after October 21, 1986). The GST tax will also not apply to any transfer under a trust to the extent that the trust consists of property included in the gross estate (other than property transferred on behalf of the decedent during life and after October 21, 1986).

The term "mental disability" means the decedent's mental incompetence to execute an instrument governing the disposition of his or her property, whether or not there has been an adjudication of incompetence and whether or not there has been an appointment of any other person charged with the care of the person or property of the transferor. If the decedent had been adjudged mentally incompetent, a copy of the judgment or decree must be filed with the return.

If the decedent had not been adjudged mentally incompetent, the executor must file with the return a certification from a qualified physician stating that in his opinion the decedent had been mentally incompetent at all times on and after October 22, 1986, and that the decedent had not regained the competence to modify or revoke the terms of the trust or will prior to his death or a statement as to why no such certification may be obtained from a physician.

Direct skip. The GST tax reported on Form 706 and Schedule R-1 (Form 706) is imposed only on direct skips. For purposes of Form 706, a direct skip is a transfer that is:
1. Subject to the estate tax,
2. Of an interest in property, and
3. To a skip person.

All three requirements must be met before the transfer is subject to the GST tax. A transfer is subject to the estate tax if it is required to be listed on any of Schedules A through I of Form 706. To determine if a transfer is of an interest in property and to a skip person, one must first determine if the transferee is a natural person or a trust as defined below.

Trust. For purposes of the GST tax, a trust includes not only an explicit trust (as defined in **Special rule for trusts other than explicit trusts**), but also any other arrangement (other than an estate) which, although not explicitly a trust, has substantially the same effect as a trust. For example, a trust includes life estates with remainders, terms for years, and insurance and annuity contracts. Substantially separate and independent shares of different beneficiaries in a trust are treated as separate trusts.

Interest in property. If a transfer is made to a natural person, it is always considered a transfer of an interest in property for purposes of the GST tax. If a transfer is made to a trust, a person will have an interest in the property transferred to the trust if that person either has a present right to receive income or corpus from the trust (such as an income interest for life) or is a permissible current recipient of income or corpus from the trust (e.g., may receive income or corpus at the discretion of the trustee).

Skip person. A transferee who is a natural person is a skip person if that transferee is assigned to a generation that is two or more generations below the generation assignment of the decedent. See **Determining the generation of a transferee**, below. A transferee who is a trust is a skip person if all the interests in the property (as defined above) transferred to the trust are held by skip persons. Thus, whenever a non-skip person has an interest in a trust, the trust will not be a skip person even though a skip person also has an interest in the trust.

A trust will also be a skip person if there are no interests in the property transferred to the trust held by any person, and future distributions or terminations from the trust can be made only to skip persons.

Non-skip person. A non-skip person is any transferee who is not a skip person. Determining the generation of a transferee. Generally, a generation is determined along family lines as follows:

1. Where the beneficiary is a lineal descendant of a grandparent of the decedent (e.g., the decedent's cousin, niece, nephew, etc.), the number of generations between the decedent and the beneficiary is determined by subtracting the number of generations between the grandparent and the decedent from the number of generations between the grandparent and the beneficiary.
2. Where the beneficiary is a lineal descendant of a grandparent of a spouse (or former spouse) of the decedent, the number of generations between the decedent and the beneficiary is determined by subtracting the number of generations between the grandparent and the spouse (or former spouse) from the number of generations between the grandparent and the beneficiary.
3. A person who at any time was married to a person described in 1 or 2 above is assigned to the generation of that person. A person who at any time was married to the decedent is assigned to the decedent's generation.
4. A relationship by adoption or half-blood is treated as a relationship by whole-blood.
5. A person who is not assigned to a generation according to 1, 2, 3, or 4 above is assigned to a generation based on his or her birth date, as follows:
   a. A person who was born not more than 12½ years after the decedent is in the decedent's generation.
   b. A person born more than 12½ years, but not more than 37½ years, after the decedent is in the first generation younger than the decedent.

A similar rule applies for a new generation every 25 years. If more than one of the rules for assigning generations applies to a transferee, that transferee is generally assigned to the youngest of the generations that would apply. If an estate, trust, partnership, corporation, or other entity (other than certain charitable organizations and trusts described in sections 511(a)(2) and 511(b)(2)) is a transferee, then each person who indirectly receives the property interests through the entity is treated as a transferee and is assigned to a generation as explained in the above rules. However, this look-through rule does not apply for the purpose of determining whether a transfer to a trust is a direct skip.

Generation assignment where intervening parent is dead*.* A special rule may apply in the case of the death of a parent of the transferee. For terminations, distributions, and transfers after December 31, 1997, the existing rule that applied to grandchildren of the decedent has been extended to apply to other lineal descendants. If property is transferred to an individual who is a descendant of a parent of the transferor, and that individual's parent (who is a lineal descendant of the parent of the transferor) is dead at the time the transfer is subject to gift or estate tax, then for purposes of generation assignment, the individual is treated as if he or she is a member of the generation that is one generation below the lower of:

- .the transferor's generation, or

- .the generation assignment of the youngest living ancestor of the individual, who is also a descendant of the parent of the transferor.

The same rules apply to the generation assignment of any descendant of the individual. This rule **does not** apply to a transfer to an individual who is not a lineal descendant of the transferor if the transferor has any living lineal descendants. If any transfer of property to a trust would have been a direct skip except for this generation assignment rule, then the rule also applies to transfers from the trust attributable to such property.

Charitable organizations. Charitable organizations and trusts described in sections 511(a)(2) and 511(b)(2) are assigned to the decedent's generation. Transfers to such organizations are therefore not subject to the GST tax.

Charitable remainder trusts. Transfers to or in the form of charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds are not considered made to skip persons and, therefore, are not direct skips even if all of the life beneficiaries are skip persons.

Examples. The rules above can be illustrated by the following examples:
Example 1. Under the will, the decedent's house is transferred to the decedent's daughter for her life with the remainder passing to her children. This transfer is made to a "trust" even though there is no explicit trust instrument. The interest in the property transferred (the present right to use the house) is transferred to a non-skip person (the decedent's daughter). Therefore, the trust is not a skip person because there is an interest in the transferred-In property that is held by a non-skip person. The transfer is not a direct skip.

Example 2. The will bequeaths $100,000 to the decedent's grandchild. This transfer is a direct skip that is not made in trust and should be shown on Schedule R.

Example 3. The will establishes a trust that is required to accumulate income for 10 years and then pay its income to the decedent's grandchildren for the rest of their lives and, upon their deaths, distribute the corpus to the decedent's great-grandchildren. Because the trust has no current beneficiaries, there are no present interests in the property transferred to the trust. All of the persons to whom the trust can make future distributions (including distributions upon the termination of interests in property held in trust) are skip persons (i.e., the decedent's grandchildren and great-grandchildren). Therefore, the trust itself is a skip person and the transfer should be shown on Schedule R.

Example 4. The will establishes a trust that is to pay all of its income to the decedent's grandchildren for 10 years. At the end of 10 years, the corpus is to be distributed to the decedent's children. Skip persons hold all of the present interests in this trust. Therefore, the trust is a skip person and this transfer should be shown on Schedule R. The taxpayer should show the estate tax value of all the property transferred to the trust even though the trust has some ultimate beneficiaries who are non-skip persons.

Special rule for trusts other than explicit trusts. An explicit trust is a trust as defined in Regulations section 3017701-4(a) as "an arrangement created by a will or by an inter-vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts." Direct skips from explicit trusts are required to be reported on Schedule R-1 regardless of their size unless the executor is also a trustee (see below).

Direct skips from trusts that are trusts for GST tax purposes but are not explicit trusts are to be shown on Schedule R-1 only if the total of all tentative maximum direct skips from the entity is $250,000 or more. If this total is less than $250,000, the skips should be shown on Schedule R. For purposes of the $250,000 limit, "tentative maximum direct skips" is the amount which should be entered on line 5 of Schedule R-1 if one were to file that schedule.

A liquidating trust (such as a bankruptcy trust) under Regulations section 301.7701-4(d) is not treated as an explicit trust for the purposes of this special rule.

If the proceeds of a life insurance policy are includible in the gross estate and are payable to a beneficiary who is a skip person, the transfer is a direct skip from a trust that is not an explicit trust. It should be reported on Schedule R-1 if the total of all the tentative maximum direct skips from the company is $250,000 or more. Otherwise, it should be reported on Schedule R.

Similarly, if an annuity is includible on Schedule I and its survivor benefits are payable to a beneficiary who is a skip person, then the estate tax value of the annuity should be reported as a direct skip on Schedule R-1 if the total tentative maximum direct skips from the entity paying the annuity is $250,000 or more.

Executor as trustee. If any of the executors of the decedent's estate are trustees of the trust, then all direct skips with respect to that trust must be shown on Schedule R and not on Schedule R-1 even if they would otherwise have been required to be shown on Schedule R-1. This rule applies even if the trust has other trustees who are not executors of the decedent's estate.

Valuation

Generally, property is valued as of the time of the generation-skipping transfer. The value of the transferred property is reduced by the amount of any consideration provided by the transferee.

Direct skips- Direct skip property that is included in the transferor's gross estate is valued the same as for estate tax valuation purposes. If the estate elects the alternate or special-use valuation, the value will be used to compute the GST tax liability.

Taxable terminations- If taxable terminations occur at the same time as, and as a result of, an individual's death, an election may be made to value all the property included in the termination using the alternate valuation method.

QTIP trusts- If the value of qualified terminable interest property (QTIP) is included in the gross estate of a spouse under section 2044, and if the spouse is the transferor of the property, the value of the property for GST tax purposes is its value for estate purposes. For additional information, see *Qualified Terminable Interest Property* in the *Estate Tax* section.

For more information, see the discussions under *Valuation* in both the *Estate Tax* and *Gift Tax* sections of this chapter.

Miscellaneous Provisions

Estate and gift tax rules The Code provisions on procedures and administration, including penalties, that apply to estate and gift taxation have been made applicable to the generation-skipping transfer tax. Estate tax rules apply where the transfer occurs as a result of death; gift tax rules apply to inter vivos transfers.

Disclaimers
A disclaimer that results in property passing to a person at least 2 generations below that of the original transferor results in the GST tax being imposed. For more information, see *Qualified Disclaimers* in the Gift Tax Chapter.

Income Tax
If income distributions are subject to the GST tax, the recipient of this income is allowed an income tax deduction for the GST tax imposed on this distribution.

Redemptions of Stock to Pay Tax
If corporate stock is the subject of a generation skipping transfer at the same time as, or as a result of, the transferor's death, and a redemption of this stock occurs to pay generation-skipping transfer tax, then:

1) The stock is deemed to be included in the gross estate of the transferor,
2) The estate, inheritance, legacy, and succession taxes, (including any interest collected as part of such taxes) that are imposed because of the generation-skipping transfer are treated as being imposed because of the transferor's death and, for purposes of redemptions to pay death taxes, the GST tax is treated as an estate tax,
3) The distribution period begins on the date of the generation-skipping transfer, and
4) The relationship between the corporate stock and the decedent's estate is measured with reference solely to the amount of the generation-skipping transfer.

Redemptions to pay death taxes are discussed in *Stock Redemptions to Pay Estate Taxes,* under *Estate Tax.*

Basis Adjustment
If property is transferred to any person in a generation-skipping transfer, the basis of the transferred property in the transferee's hands is increased (not above the fair market value of the property) by an amount equal to the portion of the generation skipping tax that is attributable to the excess of the fair market value of the transferred property over its adjusted basis immediately before the transfer.

If at the same time as, or as a result of, the death of a transferor, property is transferred to any person in a generation-skipping transfer, the basis of the transferred property is adjusted in a manner similar to that required for property acquired from a decedent. See *Basis-Property Acquired from a Decedent,* under *Estate Tax.*

Treatment of GST tax
In the case of a taxable gift that is a direct skip, the amount of the gift must be increased by the amount of the GST tax imposed on the transfer with respect to the gift.

Installment Payments
The special rules under which estate tax attributable to interests in certain closely held businesses may be paid in installments also apply to direct skips occurring as a result of death. See the discussion under *Installment Payments* in the *Estate Tax* section for more information.

Special Valuation Rules
Unique gift tax valuation rules apply when a transfer of an interest in a corporation or partnership is made to a member of the transferor's family and the transferor or applicable family member thereafter holds an applicable retained interest. Special rules are also provided for valuing applicable retained interests held by a transferor or an applicable family member of a transferor. An applicable retained interest is any interest that confers a discretionary liquidation, put, call or conversion right, or a distribution right in a family-controlled entity. A retained put, call or conversion right, a right to compel liquidation, or a similar right (an "extraordinary payment right") is valued at zero. A distribution right (other than a qualified payment right) in a controlled entity is also valued at zero. Other rights (including qualified payment rights) are valued as if the rights valued at zero did not exist. Certain rights, such as a right to receive a mandatory payment that is fixed as to time and amount, are neither an extraordinary payment right nor a distribution right.

If a qualified payment right (generally a right to a fixed-rate cumulative dividend payable on a periodic basis or the partnership equivalent) is held in conjunction with an extraordinary payment right (such as the right to compel liquidation), the rights are valued on the assumption that each right will be exercised in a manner that results in the lowest total value for all the rights (the "lower of" rule). Except for the "lower of" rule, qualified payment rights are valued under current law without regard to the special valuation rules.

Subtraction method- The amount of an individual's gift is determined using a four-step subtraction method of valuation.

1) Determine the fair market value of all family held equity interests in the entity as if the interests were held by one individual.
2) Reduce the amount from item 1 above by the fair market value of all family-held senior equity interests and applicable retained interests held by the transferor and applicable family members.
3) Allocate the value remaining among the transferred interests and other family-held subordinate equity interests.
4) Adjust the amount allocated to the transferred interests for minority or similar discounts, retained interests, and consideration received.

Minimum value rule- The minimum value rule provides a floor on the value of junior equity. The value of the junior equity must not be less than 10 percent of the sum of total equity in the entity plus debt owing to the transferor and applicable family members. Indebtedness incurred for current operating expenses is not indebtedness for this purpose.

Elections- An individual may elect to treat a payment that is not a qualified payment as a qualified payment. If such an election is made, the value of the right under the election cannot exceed the fair market value of that right determined without regard to the election. Taxpayers may also make "partial" elections or they may elect out of qualified payment treatment. Absent an election out, applicable family members who hold qualified payment rights would be subject to the valuation rules even though they made no transfer, and were not aware that a transfer had been made. To avoid this result, an applicable family member is deemed not to have elected to treat payments as qualified payments unless a statement signed by the individual is attached to the transferor's gift tax return affirmatively electing to treat the payments as qualified payments.

Control- For corporations, control means the holding of at least 50 percent (by vote or value) of the stock. Similarly, for partnerships, control means the holding of at least 50 percent of the capital or profit's interest (or a general partner interest in a limited partnership).

Transfers- A contribution to capital or a recapitalization, redemption, or other change in capital structure is treated as a transfer if the transferor or an applicable family member receives an applicable retained interest as a result of the transaction. Similar transactions are treated as transfers if the transferor or an applicable family member otherwise holds an applicable retained interest after the transaction and, as a result of the transaction, either the individual receives additional property or the value of the applicable retained interest already held by that individual increases.

Exceptions- The new rules do not apply if there are market quotations readily available for the retained or transferred interests. Moreover, the special rules do not apply to a transfer of an interest of the same class as the retained interest (i.e., a single class of stock in a corporation) or if the retained interest is of a class that is proportionally the same as that of the transferred interest. A transfer of a "vertical slice" of an interest in the entity is also excluded.

Indirect ownership- Stock or partnership interests held through corporations, partnerships, trusts or other entities are attributed to individuals.

Transfers In trust- Special valuation rules are also provided for determining the amount of a gift on the transfer of an interest in trust to a family member of the transferor. The amount of the gift is the value of the transferred property less the value of any interest retained by the transferor or an applicable family member. All retained interests other than qualified interests are valued at zero.

Qualified Interest. A qualified interest is a qualified annuity interest, a qualified unitrust interest, or a noncontingent remainder interest. In defining qualified annuity and unitrust interests, the rules governing charitable lead annuity and unitrust interests apply.

Transfer. Transfers of property in which there are one or more term interests are treated as transfers in trust. A joint purchase by members of the same family is treated as an acquisition of the entire property by the term holder followed by a transfer of the remainder interest. The term "transfer in trust" includes transfers to a new or existing trust as well as a beneficiary's transfer of an interest in an existing trust. Neither a qualified disclaimer nor the exercise of a limited power of appointment is treated as a transfer.

Retained. An interest is treated as "retained" by the transferor or an applicable family member only if it is held by the same individual both before and after the transfer. Thus, an individual will not pay gift tax on more than the full value of the property even if one of the interests is transferred to an applicable family member.

Exclusions. An exception is provided for transfers of an interest in trust to a family member if the remainder interest in the trust qualifies for the gift tax charitable deduction.

Personal residence trusts. A transfer of an interest in trust is not subject to the special valuation rule if the only property held in the trust is a personal residence of the term holder. The requirements of a qualified personal residence trust include limitations on other assets that the trust can hold, rules concerning the sale of the residence by the trust, a prohibition on commutation of the term holder's interest, and a prohibition against distribution of assets by the trust to persons other than the term holder. A personal residence means the principal residence and one other residence of the term holder.

Exception for term interests in certain tangible property. If the failure of the holder of a term interest in tangible property to exercise his rights would not increase the value of the property that passes to the remainderman, the value of the term interest is the amount an unrelated party would pay for the interest. For example, this rule could apply to valuable art work and undeveloped real property. This rule applies to term interests in tangible property other than property for which a depreciation or depletion deduction would be allowable if the property were used in a trade or business or held for the production of income.

Right or restriction- The value of property is determined without regard to any option, agreement, or other right to acquire or use the property at a price less than fair market value and without regard to any restriction on the right to sell or use such property ("right or restriction"). This general rule does not apply to any right or restriction that:

1) Is a bona fide business arrangement,
2) Is not a device to transfer the property to members of the transferor's family for less than full and adequate consideration in money or money's worth, and
3) Is an arrangement comparable to similar arrangements entered into by persons in arm's length transactions

Chapter 6 Final Reckoning Dealing With the IRS

First Thing to Do

One of the first things a person should do, as soon as the court has approved their appointment as the executor, is to obtain an employer identification number. Next, the individual should notify the Internal Revenue Service center where the tax returns of the estate will be filed that they have been appointed as executor. The individual should use Form 56, *Notice Concerning Fiduciary Relationship*

Termination of Estate

The termination of an estate generally is marked by the end of the period of administration and by the distribution of the assets to the beneficiaries under the terms of the will or under the laws of succession of the state if there is no will. These beneficiaries may or may not be the same persons as the beneficiaries of the estate's income.

Period of Administration

The period of administration is the time actually required by the personal representative to assemble all of the decedent's assets, pay all the expenses and obligations, and distribute the assets to the beneficiaries. This may be longer or shorter than the time provided by local law for the administration of estates.

Ends-it-all: assets distributed- If all assets are distributed except for a reasonable amount set aside, in good faith, for the payment of unascertained or contingent liabilities and expenses (but not including a claim by a beneficiary, as a beneficiary) the estate will be considered terminated.

Ends if period unreasonably long. If settlement is prolonged unreasonably, the estate will be treated as terminated for federal income tax purposes. From that point on, the gross income, deductions, and credits of the estate are considered those of the person or persons succeeding to the property of the estate.

Comprehensive Example

The following is an example of a typical situation. All figures on the filled-in forms have been rounded to the nearest whole dollar.

On April 9, 2017, your father, John R. Smith, died at the age of 72. He had not resided in a community property state. His will named you to serve as his executor (personal representative). Except for specific bequests to your mother, Mary, of your parents' home and your father's automobile and a bequest of $5,000 to his church, your father's will named your mother and his brother as beneficiaries.

After the court has approved your appointment as the executor, you should obtain an employer identification number for the estate. (See *Duties* under *Personal Representatives,* earlier.) Next, you use Form 56 to notify the Internal Revenue Service that you have been appointed executor of your father's estate.

Assets of the estate. Your father had the following assets when he died.

- His checking account balance was $2,550 and his savings account balance was $53,650.
- Your father inherited his home from his parents on March 5, 1980. At that time it was worth $42,000, but was appraised at the time of your father's death at $150,000. The home was free of existing debts (or mortgages) at the time of his death.
- Your father owned 500 shares of ABC Company stock that cost $10.20 a share in 1984. The stock had a mean selling price (midpoint between highest and lowest selling price) of $25 a share on the day he died. He also owned 500 shares of XYZ Company stock that cost $30 a share in 1989. The stock had a mean selling price on the date of death of $22.
- The appraiser valued your father's automobile at $6,300 and the household effects at $18,500.
- Your father's employer sent a check to your mother for $11,082 ($12,000 − $918 for social security and Medicare taxes), representing unpaid salary and payment for accrued vacation time. The statement that came with the check indicated that no amount was withheld for income tax. The check was made out to the estate, so your mother gave you the check.
- The Easy Life Insurance Company gave your mother a check for $275,000 because she was the beneficiary of his life insurance policy.
- Your father was the owner of several series EE U.S. savings bonds on which he named your mother as co-owner. Your father purchased the bonds during the past several years. The cost of these bonds totaled $2,500. After referring to the appropriate table of redemption values (see *U.S. savings bonds acquired from decedent,* earlier), you determine that interest of $840 had accrued on the bonds at the date of your father's death. You must include the redemption value of these bonds at date of death, $3,340, in your father's gross estate.
- On July 1, 1996, your parents purchased a house for $90,000. They have held the property for rental purposes continuously since its purchase. Your mother paid one-third of the purchase price, or $30,000, and your father paid $60,000. They owned the property, however, as joint tenants with right of survivorship. An appraiser valued the property at $120,000. You include $60,000, one-half the value, in your father's gross estate because your parents owned the property as joint tenants with right of survivorship and they were the only joint tenants.

Your mother also gave you a Form W-2, Wage and Tax Statement, that your father's employer had sent. In examining it, you discover that your father had been paid $11,000 in salary between January 1, 2017, and April 9, 2017 (the date he died). The Form W-2 showed $11,000 in box 1 and $23,000 ($11,000 + $12,000) in boxes 3 and 5. The Form W-2 indicated $845 as federal income tax withheld in box 2. The estate received a Form 1099-MISC from the employer showing $12,000 in box 3. The estate received a Form 1099-INT for your father showing he was paid $1,900 interest on his savings account at the First S&L of Juneville in 2017, before he died.

Final Return for Decedent

From the papers in your father's files, you determine that the $11,000 paid to him by his employer (as shown on the Form W-2), rental income, and interest are the only items of income he received between January 1 and the date of his death. You will have to file an income tax return for him for the period during which he lived. (You determine that he timely filed his 2016 income tax return before he died.) The final return is not due until April 17, 2018, the same date it would have been due had your father lived during all of 2017.

The check representing unpaid salary and earned but unused vacation time was not paid to your father before he died, so the $12,000 is not reported as income on his final return. It is reported on the income tax return for the estate (Form 1041) for 2017. The only taxable income to be reported for your father will be the $11,000 salary (as shown on the Form W-2), the $1,900 interest, and his portion of the rental income that he received in 2017.

Your father was a cash basis taxpayer and did not report the interest accrued on the series EE U.S. savings bonds on prior tax returns that he filed jointly with your mother. As the personal representative of your father's estate, you choose to report the interest earned on these bonds before your father's death ($840) on the final income tax return.

The rental property was leased the entire year of 2017 for $1,000 per month. Under local law, your parents (as joint tenants) each had a half interest in the income from the property. Your father's will, however, stipulates that the entire rental income is to be paid directly to your mother. None of the rental income will be reported on the income tax return for the estate. Instead, your mother will report all the rental income and expenses on Form 1040. Checking the records and prior tax returns of your parents, you find that they previously elected to use the alternative depreciation system (ADS) with the mid-month convention. Under ADS, the rental house is depreciated using the straight-line method over a 40-year recovery period. They allocated $15,000 of the cost to the land (which is never depreciable) and $75,000 to the rental house. Salvage value was disregarded for the depreciation computation. Before 2017, $23,359 had been allowed as depreciation.

Deductions. During the year, you received a bill from the hospital for $945 and bills from your father's doctors totaling $685. You paid these bills as they were presented. In addition, you find other bills from his doctors totaling $302 that your father paid in 2017 and receipts for prescribed drugs he purchased totaling $724. The funeral home presented you a bill for $6,890 for the expenses of your father's funeral, which you paid.

The medical expenses you paid from the estate's funds ($945 and $685) were for your father's care and were paid within 1 year after his death. They will not be used to figure the taxable estate so you can treat them as having been paid by your father when he received the medical services. See *Medical Expenses* under *Final Income Tax Return for Decedent-Form 1041,* earlier. However, you cannot deduct the funeral expenses either on your father's final return or on the estate's income tax return. They are deductible only on the federal estate tax return (Form 706).

In addition, after going over other receipts and canceled checks for the tax year with your mother, you determine that the following items are deductible on your parents' 2017 income tax return.

Health insurance	$4,250
State income tax paid	1,391
Real estate tax on home	3,100
Contributions to church	3,830

Rental expenses included real estate taxes of $700 and mortgage interest of $410. In addition, insurance premiums of $260 and painting and repair expenses for $350 were paid. These rental expenses totaled $1,720 and are reflected on Schedule E (Form 1040).

Your mother and father owned the property as joint tenants with right of survivorship and they were the only joint tenants, so her basis in this property upon your father's death is $93,047. This is figured by adding the $60,000 value of the half interest included in your father's gross estate to your mother's $45,000 share of the cost basis and subtracting your mother's $11,953 share of depreciation (including 2017 depreciation for the period before your father's death), as explained next.

For 2017, you must make the following computations to figure the depreciation deduction.

1. For the period before your father's death, depreciate the property using the same method, basis, and life used by your parents in previous years. They used the mid-month convention, so the amount deductible for three and a half months is $547. (This brings the total depreciation to $23,906 ($23,359 + $547) at the time of your father's death.)
2. For the period after your father's death, you must make two computations.
    a. Your mother's cost basis ($45,000) minus one-half of the amount allocated to the land ($7,500) is her depreciable basis ($37,500) for half of the property. She continues to use the same life and depreciation method as was originally used for the property. The amount deductible for the remaining eight and a half months is $664.
    b. The other half of the property must be depreciated using a depreciation method that is acceptable for property placed in service in 2017. You chose to use ADS with the mid-month convention. The value included in the estate ($60,000) less the value allocable to the land ($10,000) is the depreciable basis ($50,000) for this half of the property. The amount deductible for this half of the property is $886 ($50,000 × .01771). See chapter 4 and *Table A-13* in IRS Publication 946.

Show the total of the amounts in (1) and (2)(a), above, on line 17 of Form 4562, Depreciation and Amortization. Show the amount in (2)(b) on line 20c. The total depreciation deduction allowed for the year is $2,097.

Filing status. After December 31, 2017, when your mother determines the amount of her income, you and your mother must decide whether you will file a joint return or separate returns for your parents for 2017. Your mother has rental income and $400 of interest income from her savings account at the Mayflower Bank of Juneville, so it appears to be to her advantage to file a joint return.

Income:		
Salary (per Form W-2)	$11,000	
Interest income	3,140	
Net rental income	8,183	
Adjusted gross income		$22,323
Minus: Itemized deductions		(13,553)
Balance		$8,770
Minus: Exemptions (2)		(7,900)
Taxable income		$870
Income tax from tax table		$86
Minus: Tax withheld		(845)
Refund of taxes		**$759**

Tax computation. The illustrations of Form 1040 and related schedules appear near the end of this publication. These illustrations are based on information in this example. The tax refund is $1,194. The computation is as follows:

Income Tax Return of an Estate-Form 1041

These illustrations are based on the information that follows.

2017 income tax return. Having determined the tax liability for your father's final return, you now figure the estate's taxable income. You decide to use the calendar year and the cash method of accounting to report the estate's income. This return also is due by April 17, 2018.

In addition to the amount you received from your father's employer for unpaid salary and for vacation pay ($12,000) entered on line 8 (Form 1041), you received a dividend check from the XYZ Company on June 16, 2017. The check was for $750 and you enter it on line 2a (Form 1041). The amount is a qualified dividend and you show the allocation to the beneficiaries and the estate on line 2b. The amount allocated to the beneficiary ($179) is based on the distributable dividend income before any deductions. The estate received a Form 1099-INT showing $2,250 interest paid by the bank on the savings account in 2017 after your father died. Show this amount on line 1 (Form 1041).

Deductions. In November 2017, you received a bill for the real estate taxes on your parents' home. The bill was for $2,250, which you paid. Include real estate taxes on line 11 (Form 1041).

You paid $1,325 for attorney's fees in connection with administration of the estate. This is an expense of administration and is deducted on line 14 (Form 1041). You must, however, file with the return a statement in duplicate that such expense has not been claimed as a deduction from the gross estate for figuring the federal estate tax on Form 706, and that all rights to claim that deduction on Form 706 are waived.

Distributions. You made a distribution of $2,000 to your father's brother, James. The distribution was made from current income of the estate under the terms of the will.
The income distribution deduction ($2,000) is figured on Schedule B of Form 1041 and deducted on line 18 (Form 1041).
You characterized the $2,000 that is included in income and reported it on Schedule K-1 (Form 1041) as follows:

Step 1 Allocation Income & Deductions

Type of Income	Amount	Deductions	Distributable Net Income
Interest (15%)	$ 2,250	(586)	$ 1,714
Dividends (5%)	750	(179)	571
Other Income (80%)	12,000	(2,860)	9,140
Total	**$15,000**	**(3,575)**	**$11,425**

Step 2 Allocation of Distribution (Schedule K-1)

Line 1 – Interest	
$2,000 × (1,864 ÷ 12,425)	$300
Line 2b – Total dividends	
$2,000 × (621 ÷ 12,425)	100
Line 5 – Other income	
$2,000 × (9,940 ÷12,425)	1,600
Total Distribution	**$2,000**

The estate took an income distribution deduction, so you must prepare Schedule I (Form 1041), Alternative Minimum Tax, regardless of whether the estate is liable for the alternative minimum tax.
The other distribution you made out of the assets of the estate in 2017 was the transfer of the automobile to your mother on July 1. This is included in the bequest of property, so it is not taken into account in computing the distributions of income to the beneficiary. The life insurance proceeds of $275,000 paid directly to your mother by the insurance company are not an asset of the estate.

Tax computation. The taxable income of the estate for 2017 is $8,825, figured as follows:

Gross income:		
Income in respect of a decedent		$12,000
Dividends		750
Interest		2,250
		$15,000
Minus: Deductions and income distribution		
Real estate taxes	$2,250	
Attorney's fee	1,325	
Exemption	600	
Distribution	2,000	6,175
Taxable income		**$8,825**

The estate had had taxable income of $8,825 which included $571 of qualified dividends for the year, which leaves the estate with a tax due of $1,981 for 2017.
Note. For purpose of this example, we have illustrated the filled-in worksheet. You would not file the worksheet with the return. You would keep the worksheet for your records.

2018 income tax return for estate. On January 6, 2018, you receive a dividend check from the XYZ Company for $500. You also have interest posted to the savings account in January totaling $350. On January 28, 2018, you make a final accounting to the court and obtain permission to close the estate. In the accounting, you list $1,650 as the balance of the expense of administering the estate.

You advise the court that you plan to pay $5,000 to Hometown Church under the provisions of the will, and that you will distribute the balance of the property to your mother, the remaining beneficiary.

Gross income. After making the distributions already described, you can wind up the affairs of the estate. The gross income of the estate for 2018 is more than $600, so you must file a final income tax return, Form 1041, for 2018 (not shown). The estate's gross income for 2018 is $850 (dividends $500 and interest $350).

Deductions. After making the following computations, you determine that none of the distributions made to your mother must be included in her taxable income for 2018.

Gross income for 2018:	
Dividends	$500
Interest	350
	$850
Less deductions:	
Administration expense	$1,650
Loss	**($800)**

Note that because the contribution of $5,000 to Hometown Church was not required under the terms of the will to be paid out of the gross income of the estate, it is not deductible and was not included in the computation.

The estate had no distributable net income in 2018, so none of the distributions made to your mother have to be included in her gross income. Furthermore, because the estate in the year of termination had deductions in excess of its gross income, the excess of $800 will be allowed as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit to your mother on her individual return for the year 2018, if she itemizes deductions.

Chapter 7 Ethics and the Professional

For a society to function, rules are necessary. Without rules and enforcement, there can only be anarchy. Ideally, the values basic to a civilized society are handed down to individuals through customs. These are rules of behavior that over generations have been found to help make it possible for people to live together peacefully. Observing these rules is largely a result of family training and peer pressure.

Ethics and the Law

There are always individuals who through ignorance, lack of training, or sheer perversity will not follow the rules. Penalties for rule-breakers make up the basic legal system of a society, backing up customs with force. Every civilized society is founded on law, and none has ever survived without it.

Ethics goes further than law in determining everyday behavior. Law cannot cover every aspect of human relationships. Personal ethics, or individual morality, has been called "what one does when nobody is looking." Law, on the other hand, sets standards for behavior in situations involving other people, and backs those standards with the power invested in law enforcement.

The subject of ethics has been prevalent in the insurance industry since the early days of insurance. In Europe, regulation was found to be a means of enforced ethics within the industry.

Rise of Regulation

In America, the original pattern of expansion filled legitimate needs. The insurance industry, as well as of other forms of business, grew eventually into a relentless drive for more and more success.

The results of this uncontrolled expansion and unethical practices brought on a demand for regulation. In the insurance business, state laws and licensing practices gradually developed to set required standards for companies and agents.

At the beginning of the 19th century there were only five million people in the United States, 90 percent of them farmers. There were only six cities in the country with a population of more than 8,000.

The growing cities produced an increasingly complex society in 19th century America. Individuals working for wages in a cash economy could no longer live the self-sufficient lives of their rural ancestors. In this setting, insurance rapidly became a recognized necessity for the protection of families and property.

Early insurance companies had waited for customers to come to them. As time went on and more insurers competed for business. It became the practice to advertise and send out agents in an aggressive effort at expansion. Many of these agents had little training or understanding of the principles involved in the policies they were selling.

Insurance stock companies were organized to take advantage of the growing market, and unregulated expansion continued. From 1830 to 1850, insurance in force increased by more than 3,000 per cent. After the Civil War, the growth rate of the industry was even faster. The amount of insurance in force increased at 50 per cent a year, reaching a total of two billion dollars by the end of the 1860s.

The Civil War brought unprecedented demand for manufactured goods. After the war American enterprise continued at a fast pace. New industries sprang up. Railroads crossed the continent. Cables crossed the oceans. Coal, copper, iron mines fed the factories. America was on its way to becoming the industrial colossus of the world.

Standards Decline

In the excitement, attitudes changed. Business and political life were no longer governed by the ethical standards once taken for granted. Tax and other scandals rocked Washington during the Grant administration. Business was drawn into wildcat schemes, stock-watering, and embezzlement.

Insurance executives and agents concentrated on achieving personal power and prestige through business success. There were exaggerated advertising claims, carelessly written risks, and recklessly raised commissions.

Ethics Made Into Laws

The Massachusetts legislature in 1858 was the first to pass a law making a version of Wright's legal reserve principle a requirement for insurers. A state insurance department was created to enforce the new law and Elizur Wright became its head.

As the western part of the country was settled, the insurance industry again expanded its horizons. New companies grew up to offer insurance in the growing western cities as transportation and manufacturing facilities followed the trails blazed by the pioneers.

People moved about more, and travel restrictions were removed from insurance policies. Prudential pioneered insurance for low-income groups and it became widely accepted. By the end of the 19th century, the total of insurance in force in the United States had risen to seven and a half billion dollars.
Rapid growth again led to difficulties. Since insurance companies were the custodians of much of the nation's wealth, attention focused on them as a new "muckraking" phase of attacks on questionable business practices began shortly after the turn of the century. There was a renewed public demand for investigation of the insurance industry.

The Armstrong Investigating Committee in 1905, with Charles Evans Hughes as its chief counsel, turned its attention to insurance practices in New York. Its recommendations, backed by responsible insurance companies, resulted in the adoption of the New York Insurance Code in 1906. State supervision of insurance practices was tightened by this code, and eventually public confidence in the insurance industry was restored. Throughout the 20th century insurance regulation has grown.

The National Association of Insurance Commissioners (NAIC), a group made up of insurance officials from all states, has drafted model legislation which has been widely adopted by state legislatures.

The unfair trade practices act recommended by the NAIC defines unfair claims settlements, false advertising, defamation, and unfair discrimination and prohibits all these practices. This NAIC model has been adopted by nearly every state.

The resulting laws give state insurance commissioners the power to investigate when such practices are suspected and to levy fines and suspend or revoke licenses when violations are found. Marketing and disclosure standards for life insurance agents also are recommended by the NAIC. These make deceptive practices designed to mislead clients not only unethical but also illegal.

Any statement misrepresenting the benefits or coverage offered by a policy is a deceptive practice which can lead to the loss of an agent's license. Implying that future dividends provided by a participating policy will be enough to take care of premium payments would be such a misrepresentation. So would an implication that future policy dividends are guaranteed.

To tell a prospect that certain benefits in a policy being offered cannot be found in any other policy, or that an offer must be taken at once or the opportunity will be lost, would be considered unacceptable tactics. Any misleading use of figures as to cost comparisons or other significant policy features would come under the guidelines. So would statements defamatory to competing agents or insurers.

Legitimate agents recognize such actions as unethical.
They also have been made illegal in states that have adopted the NAIC recommendations. There are other prohibitions, such as offering a rebate to make a sale, or persuading a client to drop a policy just for the sake of selling a replacement that will be discussed later in detail.

While an ethical agent would not knowingly violate these guidelines, it is necessary for any insurance professional to be aware of the particular legal provisions in effect in the state with jurisdiction. The laws are to be followed first, supplemented by one's own ethical standards.

Licensing
Insurers must be licensed by a state to issue policies there. A state's guarantee fund usually covers only insurers authorized to do business in that state. An agent representing an unauthorized company may be held personally liable for losses on a contract placed with an unauthorized insurer. The agent needs to be sure the company being represented is authorized to do business in that state.

It is also important for both the agent and the company office to be aware that laws can change. Actions of the state legislature and regulations issued by the state insurance commission both can vary with time and the pressure of public opinion.

Court decisions in insurance cases can make a change in liability affecting those in the industry. The legal system in this country is not static, but fluid. Company officials need to keep abreast of such developments and let their agents in the field know about them.

Court Decisions
Suits to recover damages in cases of disputes over insurance coverage are increasingly frequent. The growing tendency to consider insurance practitioners as professional people carries with it increased legal responsibility.

Court decisions in many cases do not take into account any responsibility on the part of the insurance purchaser to be aware of policy provisions, even of easy-to-read policies. The outcome in many liability suits has made the agent or insurance company responsible for providing adequate coverage.

In a Louisiana case a plaintiff, the operator of a Laundromat in a leased building, asked his insurance agent to get as much property damage liability for him as possible. The agent told him $100,000 was the maximum coverage obtainable, and the plaintiff told the agent to get that amount. Through an error, the policy was written for only $10,000. A boiler explosion caused $18,500 in damages at the Laundromat, and the plaintiff sued to recover the $8,500 that was not covered by the $10,000 policy.

The court appeared to place no responsibility on the owner for reading the policy, the declarations page, or the bill for the premium on the $10,000 coverage. The decision was that the insured was justified in believing that the agent had obtained the limit of liability they had discussed. The resulting point of case law is that an insurance provider cannot count on having any responsibility placed on the insured to analyze the coverage provided.

The issue of professional responsibility on the part of insurance agents and agencies is playing an increasingly important part in court cases. In a Georgia decision involving business interruption policies, an insurance agency had been provided with a client's books to use in determining what coverage limit was needed. The agency used the gross profits figure rather than gross earnings to determine the coverage needs, leaving the client underinsured.

Professional Responsibility

The plaintiff's argument in the court case was that the insurance agency had held itself out as an expert in the field with the needed qualifications to examine the books and determine coverage limits. The agency agreement with the client was to maintain adequate business interruption insurance based on yearly audits, and this agreement, the court held, was violated.

Such court decisions set the precedent of requiring a high standard of competence on the part of insurance professionals. Both agents and agencies need to be aware of this situation.

In addition to staying well informed and exercising due care, the responsible insurance practitioner can have professional representation available for claims protection by carrying Errors and Omissions (E & O) insurance. The E & O carrier will investigate claims situations and provide legal representation if necessary.

In the case of claims, the insurance professional needs to be prepared to deal with the claimant in a calm and competent way without overstepping limits on giving legal advice or otherwise prejudicing the case. Quick adjustment and settlement procedures are desirable in case of claims to uphold the reputation of the insurance provider, but it is important to have all the facts at hand before action is taken.

In dealing with a claimant, the insurance provider needs to remember not to give advice or promise to get the claim paid. It is also important, however, not to deny a claim without positive knowledge that it is invalid. Also, a claim should never be paid without certain authority. Any of these actions can create legal liability.

It is helpful in avoiding legal difficulties for the agent to maintain friendly relations with clients and establish a reputation for being trustworthy over the long term. A personal relationship of trust and confidence between agent and client may help avoid lawsuits and make settlements easier.

Ethics Commissions

In addition to court cases, changes in the law can be brought about by an increasingly important agent, the ethics commission. Under pressure from activists, consumer protection groups and others, Ethics Commissions have been set up in state and national legislative bodies as well as in local government agencies.

Ethics Commissions tend to focus on lobbying, gifts to officials, conflicts of interest, and election procedures. They also, however, can consider other areas of public concern and produce legislation in response to consumer complaints.

An ethics commission can hold public hearings. It can determine what legislation needs to be passed in order to prevent abuses. It can investigate whether behavior of a public official has violated existing laws.

Congressional committees in both the Senate and the House have been conducting investigations into insurance cases with a view to possible federal legislation supplementing state level regulation of the industry. A Senate committee probe has centered on offshore insurers and reinsurers which are not subject to state regulation.

One reinsurer listed as its primary assets $22 million in "treasury bills" claimed to have been issued by a Texas Indian tribe. Senate investigators believed this group to be fictitious. One of the tribe officials known as "Wise Otter" was thought to be a British subject.

The House investigation that followed the failures of large domestic insurance companies has focused on the possibility of setting up a federal support mechanism similar to the banking industry's Federal Deposit Insurance Corporation in order to protect policy holders beyond state agencies' limits.
It is important for insurance professionals to keep abreast of such legal developments affecting the industry and its traditional standards.

SEC Requirements
Financial planning, a relatively new field for insurance providers, requires some specialized knowledge relating to securities and investment regulations. The Securities and Exchange Commission through the Investment Advisers Act sets high ethical standards for professional providers of investment advice.

Any transaction or business practice intended to deceive a client or prospective client is strictly forbidden under the act. The agent acting as a securities representative is legally required to act with due diligence, meaning that documented financial information must be furnished on companies whose stocks or bonds are being sold.

Guidelines
In contrast to due diligence for securities salesmen, the standard established in court cases for agents only involved in selling insurance is due care. The client is given financial information on request, but the state insurance department is the agency responsible for requiring reports from companies authorized to do business in that state. The agent's legal obligation is to sell policies of insurance companies licensed in that state and not to sell policies of companies the agent knows to be insolvent.

Claims Defense
An agency can establish a back-up line of defense against claims arising from insurance company insolvency. This can be done by showing proof that the agency has maintained a system for tracking financial conditions in the industry through figures from the various reporting agencies and by other means available.

It is important for the insurance agent to know the specific do's and do not's that constitute ethical behavior. Specifics that will be discussed are advertising, commissions (rebates), agent conduct, clients' files, illustrations and underwriting.

Agent Compliance

Advertising
When the agent advertises, he/she is making the product known to the public at large. There are many different ways to advertise. The following are the major methods, of advertising.

- Printed and/or published materials.
- Newspaper, radio, television, computers, billboards.
- Ads, circulars, leaflets, descriptive literature.
- Business cards, business brochures, prepared sales talks.
- Telephone solicitations.
- Any material used to sell, modify, update or retain a policy of insurance.

Agents wishing to advertise must obtain approval from their respective insurance company. All advertisements for life, accident, and health insurance must include and identify the insurance company the agent represents.

Advertisement that would not require prior insurance company approval would be one in which the only information given is the agent's name, address, telephone number, and description of the services being offered. Agency history and a simple statement of products offered, such as life, health, and/or annuities would also apply. There must be no reference made to specific policies, benefits or cost.

Requirements

The agent must do the following in all advertising:

- Make clear that insurance is the subject of the solicitation; clearly identify the type of insurance being sold, and the full name of the insurer.
- Include all limitations and exclusions affecting the payment of benefits or cost of a policy, as well as disclose any charges or penalties, such as administrative fees, and surrender charges contained in a life or annuity policy, or withdrawals made during the duration of the contract years.
- If a policy offers optional benefits or riders, disclose that each optional benefit or rider is available for an additional cost.
- For a life insurance policy with accelerated death benefits, clearly disclose the conditions, care or confinement which will initiate any acceleration of payment of the death benefit and/or other values under the life policy.
- If a policy includes a payment endorsement, disclose that fact.

Proscriptions

The agent MUST NOT do the following in any advertising:

- Be deceptive or misleading by overall impression or explicit information.
- Refer to considerations paid on an individual policy or annuity, including policy fees.
- Use terms such as "Financial Planner", "Investment Advisor", "Financial Consultant", or "Financial Services" in such a way as to imply the engagement in an advisory

business in which compensation is unrelated to insurance sales, unless this is actually the case.

- Use a service mark, trade name or group designation without disclosing the name of the actual insurer, if specific coverages, benefits or costs are described.
- Make unfair or incomplete comparisons of policies.
- Disparage competitors, their products, their policies, their services, business or marketing methods.
- Make untrue or misleading statements with respect to another company's insured assets, financial standing or relative position in the insurance business.
- Imply group coverage, certificate or enrollment when the policy offered is actually an individual policy.
- State that the policy is a limited offer and the applicants will receive advantages by accepting the offer, and that such advantages will not be available at a later date, if this is not the fact.
- Advertise a free gift, bonus, or anything of value outside of -the policy contract, which is an inducement to buy and considered rebating.
- Advertise for life, health, accident or annuities, use the existence of the GUARANTEE ASSOCIATION as an inducement to buy.
- Use misleading words or symbols or imply the material is being sent by a government entity.
- Use the phrase "low cost" without providing disclosures and the caveats associated with the particular plan.

Advertising can be one of the best career enhancing tools, when utilized effectively, legally and ethically.

Commissions

Commissions are the direct result of work performed by the agent with a new or existing policy owner. The agent's compensation is paid direct from the respective insurance company for the type of product and services recommended and are willing to provide. In addition to the initial commission, most insurance companies provide "renewal commissions", as an inducement to continue servicing the existing policy owners.

The Concept

This concept, initiated many decades ago, was intended to accomplish two primary objectives:

1. Compensate the agent for future servicing needs the policy owner will require -- such as beneficiary changes, bank draft changes, endorsements, etc.
2. Provide the agent with an opportunity to perform periodic reevaluations of the policy owners' needs, thereby resulting in additional sales opportunities.

The agent, as a licensed insurance person, shall not directly or indirectly rebate or attempt to rebate all or any part of a commission for insurance. Rebating is illegal in most states, and is strictly prohibited. It can be punishable by fine, cancellation of contract with insurance company, and loss of license, or a combination of all three. Rebating can be described as offering any type of inducement other than what is contained in the policy itself, in exchange for purchase of insurance. Examples include, but are not limited to the following:

- Any verbal or written agreement for the agent to pay any part of a policy owner's premium.
- Any payment, allowance, or gifts of any kind offered or given as an inducement to

purchase insurance.

- Any paid employment or contract for services.
- Returning any part of the premium to the policy owner.
- Offering any special advantage regarding the dividend, interest, or other policy benefits to the policy owner which are not specified in the policy.
- Offering to buy, sell, or give any type of security (stocks, bonds, etc.) or property, or any dividends or income from securities or property, to the policy owners' benefit.
- Giving anything of value to the policy owner in return for buying an insurance product.

Rebating

Rebating, or the attempt to rebate, is an offense not only under the Code of Ethics, but also under state insurance laws. There may be borderline situations in which it is difficult to determine whether rebating has taken place.

Borderline Situations

It is fairly common practice, as an example, for an insurance agent to entertain policy owners or prospective purchasers with a meal and perhaps give a nominal or token gift such as a policy wallet. Such things are considered to be normal business practice, and not in the nature of a rebate. However, should the agent contemplate anything more than such token gestures of appreciation, then the greatest caution and good judgment must be exercised. Excessive benefits or gifts conferred upon policy owners or prospective purchasers, will at the very least be considered in bad taste, and at the worst, depending on all the circumstances, may expose the licensee to a charge of rebating. In no circumstances should a gift of anything of value be given as an inducement to purchase insurance.

The rules for rebating do not apply to splitting of business with another licensed insurance agent. Joint case work is very common throughout the industry, and splitting of commissions is normal business practice. This practice does not apply to equity and variable life products, since they are sold under the rules and guidelines of the Securities Exchange Commission.

Agent's Conduct

As an insurance professional, the agent becomes part of the insurance industry's public relations arm. The agent meets the public every day, and the manner and conduct exhibited leaves a lasting impression with everyone with whom that agent had contact.

A big part of professionalism is the attitude toward competition; therefore, agents should avoid criticizing other agents. Such activity is detrimental to everyone in the business. Any criticism of another company's policies should be avoided. An incomplete comparison is not only misleading and harmful to the public, it can also result in license revocation for the guilty party. Respect for competitors helps to keep policy owners satisfied.

The agent is under an obligation to make accurate and complete disclosure of all information which policy owners or prospective purchasers should have, in order for them to make a decision in their best interest.

Representing the Insurance Product

The agent is called upon daily to make many statements and representations, oral and written, upon which policy owners and prospects are entitled to rely. Such statements and representations must not only be accurate, but must also be sufficiently complete to prevent any wrong or misleading conclusions from being made by policy owners or prospects. It is just as wrong for a life underwriter to omit giving essential information, such as, failing to correct a mistaken impression which is known to exist, as it is to give inaccurate or misleading information. Representing insurance products as exclusively "retirement plans", "college education plans" or "savings plans", without noting that the life insurance is primary and the cash value features are secondary, can result in serious charges of misrepresentation of insurance products. Use of the word "deposit" versus "premium" can have a like effect.

Deceptive Practices

As they pertain to the insurance industry deceptive practices have countless examples, a few of which are:

- Passing off the agent's own goods or services as someone else's.
- Misrepresenting the benefits, uses, or characteristics of the product.
- Making disparaging remarks pertaining to someone else's products, services, company, by making false or misleading representations.
- Advertising the product or rates while intending not to sell them as advertised.
- Misrepresenting the agent's authority as a sales person, representative, or agent to negotiate the final terms of the contract with the policy owner.
- Offering, in connection with an insurance purchase, participation in a "multi-level distributorship" under which payments are conditioned on the recruitment of additional sales people rather than the proceeds from the product sales.
- Using the terms "corporation" or "incorporated" or their abbreviations in the name of an unincorporated business.
- Failing to disclose information during a transaction with the intent of inducing a prospect or policy owner to do something he or she would not do otherwise.
- The law allows courts to award an insured triple damages, court costs, and attorney fees, for deceptive insurance trade practices.
- Insurance is not only a complex product, it is an extremely complex industry. The insurance agent must be very careful not to mislead the consumer regarding any aspect of an insurance transaction.
- Misrepresentations can be in the form of an oral or written statement, advertisement in any media, use of a business logo or advertising slogan, or anything else that communicates a false or misleading idea. A few examples of misrepresentation include:
- False or misleading statements about a particular policy.
- False or misleading statements about the financial condition of a respective insurance company.
- Telling a prospect or policy owner that dividends or current assumption mortality charges are guaranteed.
- Identifying a term life policy by a name that implies cash value accumulation, or vice versa.
- Indicating that premiums on a policy are payable for a shorter time period, when the premiums may be payable for life.
- Indicating that the agent represents several insurance companies, when in fact the agent represents only one.

A high degree of ethical representation is good solid business. The agent's insurance career can provide financial gain and personal growth. Practicing as an ethical professional will bring both. The agent's actions will gain the respect of the policy owners as well as that of the insurance carriers. The agent's reputation will be significantly enhanced, and people in the community will want to do business with that agent.

Documenting Clients' Files

Documenting the client files involves keeping track of the actions taken in dealing with the policy owner. A properly documented file should contain complete and accurate answers to all pertinent questions. This allows the agent to properly assess the need for insurance and substantiates the reason for the sale.

Paper Trail

After the fact-finding meeting, the agent should send a discovery agreement to the prospective policy owner summarizing the initial meeting and outlining the agent's understanding of the policy owner's short-term and long-term financial goals. This document should also contain information about the policy owner's salary and expenses, and the amount of money in savings accounts and investments. It should also reiterate the amount of insurance in force and the amount of money the policy owner would be able to allocate for insurance premiums. In addition to this, the discovery agreement should thank the policy owner for the chance to work with them, and confirm the date of the agent's next meeting.

The agent should always keep on file a proper ledger illustration. This should be an approved insurance company ledger, a sales proposal/idea that contains the following elements:

1. Insurance company name.
2. A full dividend/interest rate crediting disclaimer.
3. A clear description of the product.
4. The agent's name and illustration date.
5. Guaranteed values.
6. A page containing full explanation of any assumptions or special instructions.

Data Note and Log

Effective case notes should also be kept in the policy owner's file. These should list the date and time of contact with the policy owner and concise summaries of all interactions. It is also recommended that the agent document the level of service provided to the policy owner.

An effective log of all telephone calls should be kept, listing the date, time, reason, and follow-up action of all telephone conversations with the policy owner. The agent should also note all unsuccessful calls to the policy owner in order to verify the attempts to provide proper service, thus, once again, documenting the level of service provided.

A delivery letter should be sent to each policy owner with a copy kept in their file. This letter would reinforce the information already discussed, such as the reason for purchasing the insurance, and the type of plan as well as the face amount of coverage. The agent should reiterate the amount and duration of premium payments, as well as the premium payment method. The agent should also restate the impact on policy values as it relates to borrowing, partial surrenders, advanced premiums, interest requirements, dividend usage, and if appropriate, interest or dividend crediting performance.

Many companies provide a delivery receipt with the policy that must be signed by the policy owner upon delivery. If the company does not, it is recommended that the agent prepare such a document to be signed upon delivery to the policy owners. It should list the date the policy was received by the agent, the policy number, and the insurance company's name. It should also contain the owner's signature and the date they signed for delivery of the policy. All of this should be kept in the policy owner's file.

Illustrations

Illustrations have been used extensively in the insurance industry for several decades to help secure sales. In the past, they were obtained from the respective insurance company, and were fairly bland and standardized for many years. They were straight forward and represented a close approximation of actual future performance.

Changes Cause Problems

Beginning in the early 1980's, a radical change began, primarily due to three events occurring simultaneously:

1. A significant reduction in mortality charges, due to advancement in medical technology.
2. Significant advancement in electronic technology -- also known as low cost personal computers.
3. A significant economic change resulting in double-digit market interest rates.

These three events, coupled with consumer demand, helped produce a product called Universal Life -- an unbundled, interest sensitive, whole life policy with a high degree of flexibility.

Insurance was viewed more as an investment product consisting of "mortality" and "side funds". Illustrations began to change and use historically high double-digit interest rates as the basis for projected values. As interest rates began to fall in the late 80's, projected values did not hold up to reality. Many policy owners received notices that premiums would have to be increased or death benefits reduced to keep policies in force. Policy owners became angry, and many accused agents and companies of unethical behavior.

It cannot be overemphasized that illustrations are mere projections based on current interest rates, current mortality charges and other expenses. These conditions are not contractual obligations. Agents who have competed on the basis of high interest returns will produce projections that are unrealistic. This blatant misuse of illustrations has led to policy owner confusion and dissatisfaction. Agents, companies, and the insurance industry have suffered tarnished reputations.

The results have been fierce disciplinary actions backed by a series of heavy fines on some insurance companies by state regulators. Some examples of illustration abuse are as follows:

- Falling prey to the allure of high interest returns.
- Use of "assumed" interest rates in competitive situations.
- The sales technique of "Vanishing Premiums".
- Heavy emphasis on accumulated values verses death benefits.
- Poor emphasis of contractual guaranteed values and the potential problems that could exist in the future.

Remember, the policy owner does not necessarily see the illustrations as hypothetical. Policy owner dissatisfaction has resulted in increased demands by state regulators for heavy regulations regarding illustrations. Some insurance departments are considering the elimination of current assumptions, and only allowing illustrations based on guaranteed values. The parameters of an illustration under these proposals would be strictly monitored. They have also suggested that disclosure of past performance will be all that is permissible.

Understanding the Hypothetical

Many companies provide guidelines regarding interest rates to be used in product illustrations. The agent is advised to stay within the company guidelines to avoid policy owner dissatisfaction. Policy owners should be aware that current illustrations are a snap shot of how a policy might work if the current rates remained unchanged. To help with this awareness, illustrations should have three distinct columns:

1. Guaranteed Values.
2. Current Return Values.
3. Current Return Minus 1%.

This type of diligence will reward the agent with greater policy owner understanding of how interest rates and dividend scales can affect cash values and premiums.

Illustrations are rarely valid for policy comparisons. They are designed to show how a particular product of a particular company works. There are too many inconsistent variables from one company to another to allow for valid comparison. Policy selection should be made on knowledge of the product and analysis of assumptions underlying each policy. Policy provisions, company financial condition, and quality of service are valid considerations. Illustrations only, can be a dangerous criterion for policy selection without additional considerations.

Transparency and Self-Policing

The vanishing premium concept has been particularly damaging to the public perception of insurance industry ethics. This concept is based on the premise that premiums may be discontinued after a certain number of years through the use of cash value or dividends. It was used as a marketing tool extensively in the 1980's. Projections of vanishing premiums (typically in six to eight years) were based on high interest rates in effect at that time. Many policy owners did not understand that a continuation of high interest rate was necessary to fulfill illustrated projections. When interest rates fell, policy owners charged that no one explained the fact that the illustrated "vanish" was not guaranteed. This disappointment can be avoided with proper disclosure of illustrated concepts and the effect of changing interest rates. Good ethics and business practice dictates that illustrations show both guaranteed and non-guaranteed values with the difference clearly explained to the policy owner. Any illustrations showing non-guaranteed values may be incorrect after the first year. The agent should be thoroughly informed about "assumptions" and "hypothetical" and the effect of fluctuating interest rates and mortality charges. This additional risk should be communicated to the policy owner in written as well as verbal form.

There are many types of new generation policies which require due care and full disclosure. These include Blended Policies (permanent and term), Adjustable Policies, First-to-Die Policies, and Second-to-Die Policies. When two or more lives are insured under the same contract, particular care should be taken to explain to the policy owners that the death benefit is paid on the death of only one of the insureds.

Falling interest can create a climate where actual performance falls short of illustrated projections. Very often, policy owners do not understand the difference between hypothetical projections and contractual guarantees. This can lead to policy owner dissatisfaction, complaints and potential litigation. Increased policy owner complaints lead to adverse insurance department rulings, state regulations, fines and lawsuits against companies and agents. This affects the public perception of ethical conduct of the entire insurance industry. The solution lies in ethical business practices, particularly concerning policy owner understanding of illustrations. Self-policing through education, discretion and common sense will lead to field practices of a high ethical standard. It is important to remember that the policy owner will retain that information they see as most beneficial. As a professional community, our watch words are, tell the policy owner the truth.

Replacement of a contract of life insurance means any transaction which includes a:

- Rescinded, lapsed or surrendered policy.
- Charge to paid-up insurance, continued as extended term insurance or placed under automatic premium loan.
- Change in any manner to effect a reduction of benefits.
- Change so that cash values in excess of 50% are released.
- Policy subjected to substantial borrowing of cash value, but does not include the purchase of an additional life insurance contract.

The agent should not, when it could be detrimental to the interest of the policy owner, replace an existing contract of life, health, disability and annuity contracts with a new insurance contract. Every reasonable effort should be made to maintain the existing contract in force.

Where it appears that, due to a change in circumstances, an existing contract of insurance should be amended or changed; the agent should ensure that the policy owner is fully informed of any values, credits, or privileges in the existing contract which can be transferred to an amended or changed contract of insurance.

Service

One study indicated that the average insured purchases insurance seven times during their lifetime - from six different agents. Is part of the reason because of poor or lackluster service?

The insurance industry employs and contracts nearly two million people. It is quite evident that insurance is an intricate and essential service in our society. It is a field upon which our society depends more and more for financial protection. Life and health insurance purchases continue to increase each year. Property and casualty insurance is a part of every mortgage contract, auto ownership, and business coverage. Life insurance in force at the end of 1993 was nearly $11 trillion. On a daily basis a large group of people will die, enter retirement, experience a cash emergency, or have a physical asset damaged or destroyed. This is the real world- it affects everyone! These are critical times. The agent's insurance company, the agent, and the policy sold, stand between the client and financial disaster.

Value Added

The insurance agent must be the "value added" benefit for the insured as well as the insurance company. In the decade of high tech mega information highway, the agent has to be the interpreting guide and the analyst for the general public to solve financial problems with an insurance purchase. The agent must also become the motivator, leading a prospect to action.

People like to do business with people they trust. Trust is built on ethical behavior. When potential prospects and existing policy owners find an agent with high ethical standards, they tend to do more business with the agent -- therefore becoming a client. In perhaps no other industry is the element of trust more important.

Charging fees for service is common practice in most occupational groups; however, Texas has an exception for insurance agents. Group I licensed agents are not allowed to charge fees for service unless they are properly licensed as a Certified Insurance Counselor (CIC). Property and casualty licensed agents are also allowed to charge fees for certain services.

Service Essentials

The service to a policy owner/client is not only qualitative, but also quantitative. Periodic contact is essential, but can take various forms:

- Daily phone contact with the same policy owner would not only be extremely expensive and cumbersome, but also non productive and obnoxious. Most policy owners tend to accept three to six months intervals as a good basis for agent contact. This could be in the form of telephone calls, letters, informative announcements, as well as birthday and Christmas cards. Many agents use Thanksgiving cards as an alternative to the more commonplace Christmas card mailing.
- Annual reviews are extremely important with many policy owners, simply because their needs change. This is particularly obvious with business clients.
- It is definitely recommended that the agent staff her/his office with people able to handle day to day service needs, such as change of beneficiary designations, bank draft changes, policy amendments or endorsements, etc. If the agent elects to refer all of these tasks to the respective insurance company home office, it would significantly reduce the "value added" benefit that serve the policy owner. It would also enhance the likelihood of future replacement from another insurance agent -- who specializes in service.

Generally speaking, policy owners want convenience and immediate response. An agent, who refers policy owner service duties directly to the insurance company, is missing tremendous future sales opportunities, alienating themselves from building the trusted relationship necessary to maintain a strong business practice, and presenting themselves in less than an exemplary fashion.

Underwriting

Perhaps no other area pertaining to compliance and ethics deserves as much attention as agent underwriting. When any type of claim occurs, the insurance application becomes the basis for a claim dispute, denial or acceptance. An agent, who compromises part of the underwriting process with false or misleading information, as it pertains to the prospective insured, is creating potential wealth for litigating attorneys.

Part of the Contract

The agent must always remember that an underwritten application becomes part of any insurance contract. It is critical that all questions be answered completely and honestly. Too often it is tempting for an agent to "trim" ten or twenty pounds off a rather overweight insured or help them grow one or two inches, in order to assure a standard issue from the respective insurance company. Asking a potential policy owner to discard a lit cigarette during the application process may create non-smoker discounts, but in all likelihood would initiate a claim denial. Insurance companies have challenged fraudulent non-smoker rated policies through the court system, and won. It is also naive for the agent to believe that a two-year incontestability clause will exempt him/her or the insured from blatant, fraudulent underwriting. Insurance companies may pay a claim, but they can and do pursue legal action against the insured's estate.

The agent should make every effort to provide the insurance company with all accurate information pertaining to the prospective insured. Cover letters should be submitted with the application to provide details of unusual or extensive medical history or information; unusual business uses of insurance; foreign travel and residence; unusual financial situations; unusual beneficiary and ownership arrangements to clarify the insurable interest; unusual occupational duties; and any case discussions with an underwriter prior to the application submission.

Many insurance agents order medical examinations, attending physician statements, and financial information through third party sources, and upon receipt forwards these items to the insurance company. This is not an illegal practice, but it may be against the company's practice. Since underwriting information is highly confidential, both the originals and photocopies of financial statements, attending physician statements, hospital abstracts and other confidential records that have been obtained by agency personnel require safeguarding.

Protect Confidentiality

To comply with state and federal privacy laws and to control and protect confidential information provided to the company by applicants, guidelines need to be followed to insure the strictest handling of these documents. Examples to follow are:

- Access to files containing confidential material must be restricted to employees who have legitimate "need to know" in order to perform their assigned duties.
- Confidential information stored in personal files, should be retained only as long as there is legitimate need.
- Some companies absolutely forbid the acquisition and retention of medical examinations, attending physician statements, hospital abstracts or other medical histories.
- It is up to the agent to know what the insurance company's practices are.

Since the application is such an integral part of the insurance contract, care should be utilized in presenting all information to the insurance company in a professional manner. One of the most consistent complaints with insurance company underwriters is illegible applications. Not only does this impair the underwriting process, but it could be grounds for significant dispute during the processing of a claim.

Generally, changes or alterations to the application must be initialed by the insured/applicant. This is specifically important in changes in plan, face amount, owner, beneficiary, medical or financial representations and dates. Some companies are more lenient and allow amendment signatures at the contract delivery.

Agents need to document 2nd residence; unusual financial situations; unusual beneficiary and ownership arrangements to clarify the insurable interest; unusual occupational duties; and any case discussions with an underwriter prior to the application submission. Many insurance agents order medical examinations, attending physician statements, and financial information through third party sources and upon receipt forwards these items to the insurance company. This is not an illegal practice, but it may be against the insurance company's practice. Since underwriting information is highly confidential, both the originals and photocopies of financial statements, attending physician statements, hospital abstracts and other confidential records that have been obtained by agency personnel require safe guarding.

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The National Association of Insurance Commissioners has a Model Privacy Act that requires any applicant/insured to be notified of any adverse action taken in regard to their application. This Act allows an insured the right to know the details of the personal information about themselves in the company files, and has the right to request an insurance company to amend, delete, and correct such information.

Litmus Test

Labeling a decision as an "ethical decision" may disguise the fact that almost every decision holds some ethical issue or impact. Perhaps a better approach would be to develop an ability to judge the ethical implications. What role do ethics play in this decision? How does one recognize an ethical situation or problem? What are the warning signs that this may be a tougher decision with deeper issues and wider impact? Here are some guidelines. Not all apply every time, but they should raise understanding and improve the decision-making process.

Do I put a monetary value on this decision? Would I make this decision differently if cost were not a factor? Am I putting a monetary value on my ethics?

Do words such as right, fairness, truth, perception, values, or principles appear in my reasoning when I am making my decision?

- Do I feel as if I need to search through a standard policies and procedures or contact a legal representative for help with my decision?
- Do questions of fair treatment arise?
- Do my personal goals or values conflict with my professional ones?
- Could this decision generate strong feelings or other controversy?
- What does my heart tell me? Do I ponder this decision on the way home?
- Do I offer myself excuses such as everybody does it, or no one will find out, or I did it for "The Company"?
- Does this decision really need to be made by someone else? Did I inherit it because someone else doesn't want to make it?
- How am I going to feel tomorrow if I do this?

If an individual faces a tough decision and feels as if some guidance is needed, sometimes there is no place else to turn. One must have an internal compass, a value system for guidance. That is why an ethical standard is important for everyone in the insurance industry.