2011

Fundamentals of Wealth Transfer Tax Planning

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THE FUNDAMENTALS OF WEALTH TRANSFER TAX PLANNING: 2011 AND BEYOND†

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I. INTRODUCTION

In December of 2010, Congress revived the temporarily defunct federal estate tax and the generation-skipping transfer (GST) tax, ushering in a new era of federal wealth transfer taxation.[1] The tax act in question, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (The Tax Relief Act of 2010) was late in arriving, but, as will be described, it carried quite a wallop. The estate and the GST taxes had expired the previous January, making 2010 the year to die among the elderly rich. The reenactment of a revised version of the estate tax and of the GST tax makes the present moment a propitious time to publish this article summarizing the operation of the federal wealth transfer taxes and describing the basic tax planning techniques for wealth transmission. An earlier version of this article was published fifteen years ago.[2] Like that earlier version, this article is designed to bring the general practitioner into the wealth transfer tax

1. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §§ 301–304, 124 Stat. 3296, 3300–3306.

2. John A. Miller & Jeffrey A. Maine, *Fundamentals of Estate Tax Planning*, 32 IDAHO L. REV. 197 (1996).

planning picture and to provide references to more detailed treatments of particular topics within that broad field.

The story behind the brief repeal of two of the three federal wealth transfer taxes[3] is a tale worth telling in some detail. However, this is not the place. Suffice it to say that in 2001 Congress, under the direction of the Bush administration, passed changes to the estate tax and the GST tax that were designed to lead to their repeal on January 1, 2010.[4] Nearly everyone expected that Congress would revisit those taxes before their scheduled date of repeal because the repeal provision was itself slated to sunset one year later.[5] However, for various reasons, or for no reason at all, Congress failed to act and the temporary repeal of the estate tax and the GST tax came to fruition. This meant that had Congress taken no action in year 2010, on January 1, 2011, those two transfer taxes would have sprung back to life in the form in which they existed in 2001. Instead, Congress did act, if belatedly, and in doing so revived the estate tax and the GST tax in a manner that is considerably friendlier toward the wealthy than the version that would have come into being on January 1, 2011, had Congress stood mute. Those taxpayer-friendly changes primarily concern the unified credit,[6] which was increased to protect estates as great as $5,000,000, and the tax rate structure,[7] which now provides for a maximum rate of 35% for estates that exceed that amount. Certain added complexities in the unified credit will be addressed in due course.[8] Consistent with the topsy-turvy way in which this area of law has evolved, the current state of the law is only temporary because the changes made in The Tax Relief Act of 2010 are slated to sunset at the end of year 2012.[9] It is vitally important to keep this sunset date in mind as one plans any large estate.

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3. The federal gift tax was left in place with some slight modifications. *See* 26 U.S.C. §§ 2501–2524 (2002). Hereinafter, Title 26 of the United States Code will be cited as the Internal Revenue Code, I.R.C.

4. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub.L. No. 107-16, 115 Stat. 38 [hereinafter EGTRRA].

5. *Id.* at § 901. The sunset of EGTRRA would have brought back the wealth transfer taxes under the terms of the law as it existed in 2001.

6. *See* I.R.C. § 2010. All references and citations to sections in this article are to sections of the Internal Revenue Code of 1986, as amended (the Code). Similarly, citations to treasury regulations are to treasury regulations under the Code. In essence the Unified Credit was amended to shield individual estates of up to $5,000,000 from estate tax and from GST tax. *Id.* Without the enactment of The Tax Relief Act of 2010 the shielded amount would have been $1,000,000. The credit is addressed *infra* Part II.A.4.a.

7. *See* I.R.C. § 2001(c). For 2011 and 2012 the maximum estate tax rate is 35%, as compared with a maximum rate of 55% that would have applied had Congress taken no action.

8. *See infra* Part II.A.4.a.

9. For a summary of this and other wealth transfer tax provisions of the 2010 act, see Gerald W. Paulukonis, *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010—An Analysis* § 1.03 (MB) (available on Lexis); CCH, 2010 TAX

As the title of this article implies, the reader should be aware that, generally speaking, we have not concerned ourselves with year 2010. Still we wish to point out that The Tax Relief Act of 2010 provides for retroactive effect to January 1, 2010, for its estate tax provisions *on an elect out basis.*[10] Why, you might wonder, would one choose to be subject to the estate tax? The primary answer lies in the adjusted basis rules. The repeal of the estate tax also brought the repeal of § 1014, which granted a date of death fair market value basis to most property subject to the estate tax. Instead, for year 2010, § 1022 provided for a carryover basis for estates in excess of $1.3 million.[11] The estates most likely to elect to retroactively apply current law are those that would benefit from the basis step-up rules of re-enacted § 1014 while still being sheltered from any significant transfer tax liability by the increased unified credit.[12] Be advised that there are other transitional issues raised by The Tax Relief Act of 2010 that we do not address here.[13]

With that brief précis, let's begin our analysis of wealth transfer tax planning. Estate planning is the process by which individuals make effective disposition of their property according to their personal objectives. It is a complex subject because it draws upon a diverse body of law. Estate planning takes into account the law of wills, trusts and estates, property, and insurance. If a corporation or partnership is involved, the substantive law in these areas must be considered as well. An important consideration is the desire to minimize taxes, which reduce the net amount of property available for disposition to family members. The estate planner generally must ascertain a client's wishes

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LEGISLATION: TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010, RIC MODERNIZATION ACT OF 2010 AND OTHER RECENT TAX ACTS: LAW, EXPLANATION AND ANALYSIS (2010) [hereinafter CCH 2010 ANALYSIS].

10. The Tax Relief Act of 2010, *supra* note 1, § 301(c).

11. I.R.C. § 1022(a), (b). Section 1022 established a modified carryover basis regime with respect to inherited property. Under this provision, as an initial matter, property acquired from a decedent took a basis in the hands of its new owner equal to the lesser of the decedent's basis or fair market value. *Id.* § 1022(a)(2). But this initial basis could be stepped up by as much as $3,000,000 for bequests to the decedent's spouse and by $1,300,000 for bequests to others. *Id.* § 1022(c), (b). These basis increases could not increase the basis of the property above its fair market value on the decedent's date of death. *Id.* § 1022(d)(2). For lower and middle class taxpayers the overall income tax effect of section 1022 is not substantively different than the treatment the taxpayer would receive under section 1014. For wealthier taxpayers, however, the effect is dramatically different. The reader should note that we are simplifying here since year 2010 is not the focus of this article. For more detailed treatment of section 1022, see KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶ 4.01A (2010 Cumulative Supp.); JOHN R. PRICE & SAMUEL A. DONALDSON, PRICE ON CONTEMPORARY ESTATE PLANNING § 2.15 (2011 ed.); RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 8.10 (8th ed. 2002 & Cumulative Supp.).

12. *See* CCH 2010 ANALYSIS, *supra* note 9, ¶¶ 705, 740.

13. For discussion of some of those issues, see Paulukonis, *supra* note 9, § 1.03; CCH 2010 ANALYSIS, *supra* note 9, ¶ 705.

with respect to taxes,[14] prepare a tax estimate of the client's existing estate plan,[15] and determine the tax costs of alternative plans under consideration. In addition to understanding aspects of the federal income tax pertinent to estate planning, an estate planner must understand the three federal transfer taxes: the estate tax, the gift tax, and the GST tax. These wealth transfer taxes are excise taxes on the privilege of transferring property from one person to another. This article discusses basic aspects of all three transfer taxes, with particular emphasis on the estate tax. This article then outlines fundamental estate planning techniques in light of the impact of these taxes. In addition, references are provided in the footnotes to more detailed treatments of the planning techniques described here.[16]

II. THE WEALTH TRANSFER TAXES

A. The Estate Tax

The estate tax is an excise tax levied on the privilege of transferring property at death.[17] It generally is measured by the size of the estate and employs a "graduated" rate table found in § 2001(c) of the Code.[18] The estate tax is computed by determining the "taxable estate."[19]

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14. In the initial stages of estate planning, the attorney must ascertain the client's objectives with respect to tax savings in addition to determining the client's wishes with respect to non-tax considerations. An estate plan that minimizes overall taxes is not morally or legally objectionable, but sometimes other considerations may override.

15. A client with a simple will already has an estate plan—the will. A client without an existing will also has an estate plan—the state's intestacy statutes. *See, e.g.*, IDAHO CODE ANN. §§ 15-2-101 to -114 (2010).

16. In that spirit we note that a few of our favorite secondary reference sources for the topics addressed in this article are JOHN R. PRICE & SAMUEL A. DONALDSON, PRICE ON CONTEMPORARY ESTATE PLANNING (2011 ed., 2010); RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION (8th ed. 2002 & Supp.); William P. Streng, *Estate Planning*, Tax Mgmt. (BNA) No. 800-2d (2006); and KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION (2003 & Supp.). We generally start with the BNA Tax Management Portfolios when we are seeking detailed treatment of a specific area of tax planning. Other useful resources include DAVID WESTFALL & GEORGE P. MAIR, ESTATE PLANNING LAW AND TAXATION (4th ed. 2010) (updated annually); and JEROME A. MANNING ET AL., MANNING ON ESTATE PLANNING (6th ed. 2009). A shorter treatment with some basic forms is RAY D. MADOFF ET AL, PRACTICAL GUIDE TO ESTATE PLANNING (2009). Many fine books have been written on estate planning over the years, but the shelf life of a transfer tax planning book is brief. The ones we list here have a history of being kept reliably up to date. A further resource is the University of Miami Heckerling Institute on Estate Planning. The proceedings of this high level continuing education program are published annually.

17. An excise tax is imposed on an event or transaction (e.g., the transfer of property at death), and is to be contrasted with a direct tax which is imposed on property or a person.

18. I.R.C. § 2001(c). While the tax has the appearance of being graduated, it currently operates as a 35% flat rate tax because of the size of the unified credit exclusion amount in section 2010(c) ($5,000,000). This rate structure is slated to sunset on December

The taxable estate is determined by deducting from the value of the "gross estate" certain deductions allowed by the Code.[20] The initial concern, then, is to define what constitutes the "gross estate." The gross estate concept is a slippery one, much less intuitive than the concept of "gross income" for federal income tax purposes.[21] The gross estate consists not only of property actually owned by a decedent at death that passes to someone else either by will or intestacy (e.g., what one normally thinks of as the probate estate under state law). It also consists of, among other things, certain life insurance, jointly owned property, and property that was given away by the decedent before death but treated as if owned by the decedent until death and passing then.[22] These latter items are commonly referred to as the "artificial gross estate." The starting point for determining what is encompassed by the term "gross estate" is § 2031 of the Code. Section 2031 refers to other sections of the Code for those items of property included in the gross estate.[23] Section 2031 also describes the method of valuing property included in the gross estate and the appropriate time to value such property.

1. Valuation of Gross Estate

In general, the value of property included in a decedent's gross estate is its fair market value at the time of the decedent's death.[24] Fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[25] There are exceptions to the time (date of death valua-

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31, 2012. If it is permitted to do so, the maximum rate under the estate tax will jump to 55% and the unified credit exclusion amount will fall to $1,000,000. If those two things happen, the tax truly will be graduated once again.

19. *Id.* § 2001(a) ("A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.").

20. *Id.* § 2051.

21. *See id.* § 61(a) (defining gross income as "all income from whatever source derived" and enumerating more than a dozen classes of income items); *see also* Comm'r v. Glenshaw Glass, 348 U.S. 426 (1955). Of course there is much about the concept of gross income that many people would find counter-intuitive. Consider, for example, some of the time value of money rules.

22. *See infra* Part II.A.2.b.

23. I.R.C. § 2031(a) (referring to part III of subchapter A of chapter 11 of subtitle B of the Internal Revenue Code; part III includes §§ 2031 through 2046).

24. *Id.* § 2031; Treas. Reg. § 20.2031-1(b) (as amended in 1965).

25. Treas. Reg. § 20.2031-1(b). The regulations continue:

> The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Id.

tion) and the method (fair market value) of valuing property included in a decedent's gross estate. Section 2032 provides that the executor may elect to value property included in the decedent's gross estate as of the date six months after the date of the decedent's death.[26] This is commonly referred to as the alternate valuation date or method. Under the alternate valuation method, if property is distributed, sold, exchanged, or otherwise disposed of within six months of the decedent's date of death, the property included in the gross estate is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of.[27] The alternate valuation date is not automatic but may be used only if the executor makes a timely election on the estate tax return, filed within nine months of the decedent's death.[28] If the election is made, the alternate valuation date applies to all property included in the decedent's gross estate.[29] A § 2032 election may not be made unless the election decreases both the gross estate and the estate and generation-skipping transfer taxes applicable to the decedent.[30] An exception also exists for the method used in valuing certain property included in the decedent's gross estate.

Under § 2032A, an executor may make a special election concerning the valuation of "qualified real property" used as a farm or used in a trade or business.[31] If the executor makes the special election, the property will be valued on the basis of its actual use, rather than on its fair market value determined on the basis of highest and best use.[32] In no event, however, can the aggregate decrease in value of qualified real property using the special valuation method exceed $750,000 as adjust-

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26. I.R.C. § 2032.

27. *Id.* § 2032(a)(1).

28. *Id.* § 2032(d); Treas. Reg. § 20.2032-1(b)(2) (as amended in 2009). See *infra* Part II.A.5 for the estate tax filing requirements.

29. Treas. Reg. § 20.2032-1(b)(2). The alternative valuation method cannot apply only to a portion of the property included in the decedent's gross estate.

30. I.R.C. § 2032(c). The purpose of this provision becomes apparent when one considers the implications of § 1014 of the Code. Assume that the value of a decedent's gross estate at the date of death was $2,000,000 and that the aggregate value of the property six months later was $3,000,000. Although no estate tax would be due using either valuation date (because of the unified credit), the executor would prefer to elect to value the gross estate under the alternate valuation method ($3,000,000). Such election would entitle the recipients of the property to receive a stepped-up basis in the property under § 1014(a)(2) of $3,000,000, rather than $2,000,000. Congress has prevented this with § 2032(c).

31. *See id.* § 2032A(b) (defining "qualified real property").

32. Treas. Reg. § 20.2032A-3(a) (1980). See *supra* note 25 and accompanying text for a definition of "fair market value."

ed for inflation since 1997.[33] Several requirements must be met before the special valuation rules of § 2032A will apply.[34]

2. Property Included in Gross Estate

As noted earlier, § 2031 refers to §§ 2031 through 2046 of the Code for a description of those items of property included in a decedent's gross estate. In general, these sections include in the gross estate several categories of property: (1) property owned by the decedent at death,[35] (2) certain property transferred by the decedent within three years of death,[36] (3) property that was transferred before the decedent's death but over which the transferor retained some right of enjoyment,[37] (4) property transfers conditioned upon survival of the decedent,[38] (5) revocably transferred property,[39] (6) certain annuities,[40] (7) jointly held property,[41] (8) property subject to a general power of appointment,[42] (9) certain life insurance proceeds,[43] and (10) qualifying terminable interest property.[44] These items are addressed in order below.

a. Property Owned at Death

Section 2033 of the Code states the most obvious category of property included in a decedent's gross estate: "all property to the extent of the interest therein of the decedent at the time of his death."[45] This section, which includes any interest the decedent has in property at the time of his death, is concerned principally with interests in property passing through the decedent's probate estate.[46] Although it would be simpler to think in terms of "property" owned by the decedent at death,

33. I.R.C. § 2032A(a)(2). For year 2011 the aggregate decrease is $1,020,000. Rev. Proc. 2010-40, 2010-46 I.R.B. 663.

34. For an extensive, practical analysis of § 2032A, see Steven E. Zumbach et al., *Section 2032A—Special Use Valuation*, Tax Mgmt. (BNA) No. 833-2d (2003); L. Paul Hood, *Valuation: General and Real Estate*, Tax Mgmt. (BNA) No. 830-2d (2003); Alex E. Snyder, Note, *Saving the Family Farm Through Federal Tax Policy: Easier Said than Done*, 62 WASH. & LEE L. REV. 729, 751 (2005). Snyder's student note discusses the uses of § 2032A special-use valuation to benefit small family farmers. *See also* PRICE & DONALDSON, *supra* note 11, § 12.19; STEPHENS ET AL., *supra* note 11, ¶ 4.04.

35. I.R.C. § 2033.

36. *Id.* § 2035.

37. *Id.* § 2036.

38. *Id.* § 2037.

39. *Id.* § 2038.

40. *Id* § 2039.

41. *Id.* § 2040.

42. *Id.* § 2041.

43. *Id.* § 2042.

44. *Id.* § 2044.

45. *Id.* § 2033.

46. *See id.*

emphasis should be on the decedent's "interest" in property.[47] The term "interest" in property refers to a beneficial interest in property.[48] Accordingly, property over which the decedent had mere legal title (e.g., decedent was a trustee over property) is not included. In addition, interests that are terminable at the decedent's death, such as life interests measured by the decedent's life or contingent remainders that terminate at death, are not included under § 2033.[49]

The term "interest" in property is a broader concept than just property. If a decedent owned a partial interest in a piece of property, it is that partial interest which is included. For example, rights to income that has accrued prior to the decedent's death, such as interest, rents, or share of partnership profits, are includible under § 2033.[50] An interest in property held by the decedent as a tenant in common and an interest in community property are also included.[51] In determining whether a decedent possessed an "interest" in property, one must turn to state law.[52] Federal authorities generally are not bound to follow lower state court decisions that have adjudicated property rights or characterized property interests.[53] Federal courts, however, will give finality to a decision of the state's highest court on a state law issue.[54] If there is no decision by the state's highest court, federal authorities can supply what they de-

47. See Smith v. Shaughnessy, 318 U.S. 176 (1943), which is helpful in getting one to think in terms of "interest in property" and not just property.

48. Treas. Reg. § 20.2033-1(a) (as amended in 1963) ("The gross estate of a decedent . . . includes under section 2033 the value of *all* property, whether real or personal, tangible *or intangible*, and wherever situated, beneficially owned by the decedent at the time of his death.") (emphasis added).

49. I.R.C. § 2033.

50. *See, e.g.*, Treas. Reg. § 20.2033-1(b) (noting further that "dividends which are payable to the decedent or his estate by reason of the fact that on or before the date of the decedent's death he was a stockholder of record (but which have not been collected at death) constitute a part of the gross estate").

51. Under community property principles, spouses have equal interests in community property. Because a decedent possessed a one-half, undivided interest in community property, one half of the value of community property is included in his gross estate under § 2033. The surviving spouse's one-half interest in the community property is not included, however, as the decedent did not possess at his death an interest in it. It should be noted that the surviving spouse's community property interest is nevertheless accorded a basis adjustment on the decedent's death under § 1014(b)(6). *See* I.R.C. § 1014(b)(6). The § 1014(b)(6) basis rule is an oddity because normally the only property which gets the fair market value basis step-up is property which is included in the gross estate. It may be explained partially by the fact that property which is left to a spouse in a common law state gets the basis step-up, but is ultimately excluded from the decedent's taxable estate via the marital deduction. The marital deduction is discussed more fully *infra* Parts II.A.3.c, III.B.

52. State law creates legal interests, whereas federal law designates what interests are taxed. *See* Morgan v. Comm'r, 309 U.S. 78, 80 (1940); Burnet v. Harmel, 287 U.S. 103, 110 (1932). Accordingly, estate tax references to property rights are to interests established by state law.

53. Comm'r v. Estate of Bosch, 387 U.S. 456 (1967).

54. *Id.*

termine to be state law after giving "proper regard" to relevant lower state court rulings.[55]

Section 2033 provides a broad category of items included in a decedent's gross estate: property to the extent of any interest held by a decedent. It is a simple category and includes what is often referred to as the "actual" gross estate of the decedent.[56] The other categories of items included in a decedent's gross estate include property not actually owned by a decedent at death, but which is nevertheless treated as being owned by the decedent at death. Such property constitutes what is often known as the artificial gross estate. These categories are addressed in the remainder of this section.

b. Property Transferred Near Death

Under § 2035, a decedent's gross estate includes the value of certain property transferred by the decedent within three years before his death, except to the extent that the transfer was for full and adequate consideration in money or money's worth.[57] Not all property transferred by the decedent within three years of death is drawn back into the gross estate. Rather, only certain property interests transferred by the decedent will result in inclusion under § 2035. These include interests in property that would be included in the decedent's gross estate under §§ 2036, 2037, 2038, or 2042 of the Code had the near-death transfer not occurred. These sections are addressed later in this article.[58]

55. *Id.* For example, if lower state courts disagree as to a decedent's relationship to property, and the state's highest court has not spoken on the issue, federal authorities must give only proper regard to the lower state court decisions in determining what the state law is.

56. Other than disputes as to the proper regard given state court decisions interpreting taxpayers' state law relationships to property, few disputes exist as to what items are included in a decedent's gross estate under § 2033.

57. Section 2035 provides, in pertinent part:

> (a) Inclusion of certain property in gross estate. --If--(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death, the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

I.R.C. § 2035(a). Bona fide purchases are excepted from subsection (a). *Id.* §§ 2035(d), 2043(a). There have been a number of amendments to § 2035 over the years. Section 2035 is no longer as necessary as it once was due to the adoption of the unified estate and gift tax rates in 1976. Nevertheless, it continues to close some important loopholes in the transfer taxes.

58. As will be discussed below, transfers under §§ 2036–2038 and 2042 are inherently testamentary, even if made prior to death. See *infra* Part II.A.2.c, for a discussion of §

Generally, § 2036 includes in a decedent's gross estate the value of any interest transferred by the decedent if the decedent retained beneficial enjoyment (e.g., right to income of the transferred property) over the transferred property.[59] Section 2037 includes in a decedent's gross estate the value of any interest transferred by the decedent if possession or enjoyment of the property could only be obtained by surviving the decedent and the decedent retained a significant reversionary interest in the property.[60] Section 2038 includes in a decedent's gross estate the value of any interest transferred by the decedent if enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power held by the decedent to alter, amend, revoke, or terminate the transfer.[61] Section 2042 includes in a decedent's gross estate the proceeds of insurance on the decedent's life in certain circumstances.[62]

Whether § 2035 mandates inclusion in a decedent's gross estate requires an answer to the following question: but for the transfer by the decedent within three years of death, would there have been inclusion in the decedent's gross estate under §§ 2036, 2037, 2038, or 2042?[63] If the answer is "yes," § 2035 applies. Consider that question in the following scenario: D transferred property to his daughter, but retained an income interest in the property for D's life. If D died retaining the life estate (which links him to the remainder), § 2036 would include the value of the remainder in his gross estate. What happens if D gives away the life estate within three years of his death? There would be no inclusion in D's gross estate under § 2036 as D retained no income interest and nothing linked him to the remainder. Nevertheless, § 2035 would apply to include the value of the remainder in D's gross estate. But for the transfer of the life estate, there would have been inclusion of the remainder under § 2036.

Application of § 2035 can be considered under another scenario. Assume D owns an insurance policy on his life, the proceeds of which are payable to a designated beneficiary. If D died owning the policy, § 2042 would require inclusion of the proceeds of the policy in his gross estate. What happens if within three years of D's death, D conveyed the policy to his brother to avoid inclusion under § 2042? Upon D's death, would the proceeds be included in his gross estate? The answer is yes, under § 2035. But for the transfer of the insurance policy, there would have been

2036; see *infra* Part II.A.2.d, for a discussion of § 2037; see *infra* Part II.A.2.e, for a discussion of § 2038; and see *infra* Part II.A.2.i, for a discussion of § 2042.

59. I.R.C. § 2036. See *infra* Part II.A.2.c, for a discussion of § 2036.

60. I.R.C. § 2037. See *infra* Part II.A.2.d, for a discussion of § 2037.

61. I.R.C. § 2038. See *infra* Part II.A.2.e, for a discussion of § 2038.

62. I.R.C. § 2042. See *infra* Part II.A.2.i, for a discussion of § 2042.

63. I.R.C. § 2035(a).

inclusion of the proceeds under § 2042, one of the four enumerated provisions listed in § 2035.[64]

As can be seen, § 2035 closes some important loopholes in the transfer taxes. It is triggered in those situations when the disparity between what the "gift tax" taxes and what the "estate tax" would tax is too great for Congress to accept.[65] This can be seen in the two scenarios discussed above. In the first scenario, D gifted the life estate to avoid inclusion under § 2036. The value of the gift for gift tax purposes is the actuarially-determined value of the life estate gifted.[66] This is a much lower figure than the value that would be used for estate tax purposes had the life interest not been transferred—the full value of the remainder interest. In the second scenario, D gifted the life insurance policy to avoid inclusion under § 2042. The value of the gift for gift tax purposes is the replacement cost of the policy.[67] This is a much lower figure than the value that would have been used for estate tax purposes had the insurance policy not been transferred—the face value of the policy or the proceeds of insurance. Hence, § 2035 thwarts artificial, tax-free reduction of a decedent's estate. Such disparity in value is not seen with respect to certain near-death transfers. For instance, if D gifted cash to his children within three years of his death, the value of the cash for gift tax purposes would be the same as the value of the cash for estate tax purposes had he not made the transfers. Accordingly, § 2035 would not apply in this last instance.

Section 2035 also draws into the gross estate any gift tax paid by the decedent within three years of death.[68] This aspect of § 2035 is entirely independent of the aspect of § 2035 discussed above.[69]

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64. *Id.* Note that the operation of § 2035 is different in one important respect as between its effect on transfers to which §§ 2036 through 2038 would have applied, and transfers to which § 2042 would have applied. That difference is with respect to the property drawn back into the gross estate. With respect to life insurance (I.R.C. § 2042), it is the property transferred within three years of death that is drawn back into the gross estate. With respect to the others, it is not the property transferred within three years of death which is drawn back into the gross estate, but rather the interest in property on which §§ 2036 through 2038 operated which is drawn back into the gross estate (e.g., in the case of § 2036, it is the remainder and not the life estate which is drawn back).

65. In other words, it includes near-death gifts, such as life insurance, that substantially appreciate in value between the time of the transfer (value for gift tax purposes) and the transferor's death (value for estate tax purposes).

66. *See* Treas. Reg. § 20.2031-7 (retroactively effective May 1, 2009).

67. Treas. Reg. § 25.2512-6(a) (as amended in 1974).

68. I.R.C. § 2035(b) ("The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 [gift tax] by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death.").

69. Although difficult to see at this point, the function of § 2035(b) is to equalize the effect of giving during life and giving at death.

c. Property Transferred Before Death But Over Which the Decedent Retained Some Right of Enjoyment

Section 2036 includes in a decedent's gross estate the value of any interest in property transferred by the decedent over which the decedent retained economic benefit for a certain prescribed period.[70] Specifically, there are two elements that must be met before inclusion is required. First, the decedent must retain a prescribed interest.[71] This includes either (1) possession or enjoyment of, or the right to the income from, the property transferred,[72] or (2) "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."[73] Second, the decedent must retain that prescribed interest for a prescribed period.[74] This includes either (1) the decedent's life,[75] (2) any period not ascertainable without reference to the decedent's death,[76] or (3) any period which does not in fact end before the decedent's death.[77] In addition, § 2036 applies only

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70. *Id.* § 2036. Section 2036 provides, in part:

> (a) GENERAL RULE.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death--(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

I.R.C. § 2036(a).

71. *Id.* § 2036(a)(1).

72. *Id.* For example, Grantor transfers stock to a trust retaining for his life the right to all trust income to be paid annually. Section 2036(a)(1) would require the trust corpus to be included in Grantor's gross estate. If the retained income interest were applied toward the discharge of a legal obligation of the decedent (e.g., support of a dependent child during the decedent's life time), or otherwise for his pecuniary benefit, the result would be the same. Treas. Reg. § 20.2036-1(b)(2) (as amended in 2008).

73. I.R.C. § 2036(a)(2). Such right includes "a reserved power to designate the person or persons to receive the income from the transferred property, or to possess or enjoy nonincome-producing property, during the decedent's life . . . ." Treas. Reg. 20.2036-1(b)(3). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. *Cf.* I.R.C. § 2038.

74. *Id.* § 2036(a).

75. *Id.*

76. *Id.* For example, Grantor transfers property to a trust, providing that all trust income is to be paid to Grantor annually for his life, but no trust income shall be paid to Grantor during the quarter preceding his death. Grantor has retained a prescribed interest (income interest) for a prescribed period (a period not ascertainable without reference to his death).

77. *Id.* For example, Grantor transfers property to a trust and provides that all trust income is to be paid to Grantor for ten years, when the trust is to terminate and the

when a life estate or similar interest is "retained," but not when there has been an acquisition or reacquisition of such an interest.[78]

The amount to be included in a decedent's gross estate under § 2036 is the value of the entire property transferred.[79] If a decedent retained an interest or right in only a portion of the property transferred, the amount to be included in his or her gross estate is only a corresponding proportion of the value of the property.[80]

Section 2036 attacks a simple mechanism for avoiding estate tax while reaping most of the benefits of enjoyment of property during life. Consider if there were no § 2036. A grantor could place property in trust and retain a steady flow of income for her life, after which the property would pass from the trust to a designated beneficiary. There would be no inclusion under § 2033[81] because the grantor had no interest in property at the moment of death taking into account the fact of death. Without § 2036, the grantor could have avoided tax while in effect owning the property till death and disposing of it at death. There may have been gift taxes payable on the transfer of the remainder; however, the remainder would have had a low present value at the time of the transfer if the grantor was fairly young.[82] With § 2036, the date of death fair market value of the remainder interest is included in the grantor's gross estate. We will have more to say about § 2036 when we consider the use of family limited partnerships as wealth transfer vehicles.

d. Transfers Taking Effect at Death

Section 2037 includes in a decedent's gross estate the value of any interest in property transferred by the decedent if (1) possession or enjoyment of the property could have been obtained only by surviving the decedent, and (2) the decedent retained a reversionary interest in the property which, immediately before the decedent's death, exceeded five percent of the value of such property.[83] The term "reversionary interest"

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corpus distributed to Daughter or Daughter's estate. If Grantor dies before the expiration of the ten-year period, § 2036(a) causes the property to be included in Grantor's gross estate. He retained a prescribed interest (income interest) for a prescribed period (a period that did not in fact end before his death). If Grantor lives longer than the 10-year period, § 2036 would require no inclusion in his gross estate.

78. *Id.* Note that the retained interest need not be reserved by the instrument of transfer. A simultaneous agreement on the part of the transferee may cause inclusion. It would be prudent to exercise caution when dealing with reciprocal agreements.

79. Treas. Reg. § 20.2036-1(a)(ii), (c)(1)(i) (as amended in 2008). This amount is decreased by "the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death." *Id.*

80. *Id.*

81. *See supra* Part II.A.2.a.

82. *See* Treas. Reg. § 20.2031-7T(d)(2)(ii) (as amended in 2009) (providing valuation rules for remainder interests).

83. I.R.C. § 2037(a).

includes a possibility that the transferred property may return to the decedent or his estate, or "may be subject to a power of disposition by him."[84]

Section 2037 can be illustrated best by example. Assume that the decedent transferred property in trust during his life with the income payable to his wife for life and with the remainder payable to the decedent or, if he is not living at his wife's death, to his daughter or her estate. The daughter can obtain possession or enjoyment of the property only by surviving the decedent. If the value of the decedent's reversionary interest exceeds five percent of the property transferred, § 2037 will cause the value of the property to be included in his gross estate.[85] In essence, it is uncertain whether the daughter will ever possess the property. The decedent's transfer of the remainder interest to the daughter has not been completed during the decedent's life and remains incomplete until his death.

e. Revocably Transferred Property

Section 2038 includes in a decedent's gross estate the value of any interest in property transferred by the decedent if, at the time of death, enjoyment of the interest remains subject to change through exercise of a power held by the decedent to alter, amend, revoke, or terminate the transfer.[86] Inclusion will also result if the power is relinquished by the decedent within three years of his or her death. Section 2037 is based on the notion that if the transferor has the power to revoke or terminate the transfer prior to his death and get the property back, he or she, for all intents and purposes, is the owner of the property until that power disappears at death. As with §§ 2036 and 2037, § 2038 is based on congressional concern that the estate tax should not be avoided by lifetime transfers of property when substantial ownership rights have been retained by the transferor. It should be noted that §§ 2038 and 2036(a)(2) often overlap.

f. Certain Annuities

Section 2039 of the Code includes in a decedent's gross estate "the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement" to the extent that the value of the contract or agreement is at-

84. *Id.* § 2037(b).

85. Treas. Reg. § 20.2037-1(e) ex. 3 (1960). More specifically, the value of the property, less the value of the wife's outstanding life estate, would be included in the decedent's gross estate. *Id.*

86. I.R.C. § 2038(a)(1).

tributable to contributions by the decedent or his employer.[87] Section 2039 is not applicable to insurance proceeds under a policy on the decedent's life.[88] It is applicable to agreements or plans under which the decedent "possessed the right to receive such annuity or payment . . . [1] for his life . . . [2] or for any period not ascertainable without reference to his death . . . [3] or for any period which does not in fact end before his death."[89]

g. Jointly Held Property

Several forms of property co-ownership exist. Tenancy in common is a form of co-ownership of property in which each owner has a separate, undivided interest in the property, an interest that he or she can transfer during life or at death. When one tenant dies, the surviving tenant does not automatically become entitled to the decedent tenant's interest. Under this form of ownership, § 2033 applies and includes in the decedent tenant's gross estate the value of his interest in the tenancy.[90] Similarly, when a spouse dies owning an equal share in community property, § 2033 requires that the value of one-half the community property be included in his gross estate.[91] Under community property principles, the decedent spouse is viewed as having a vested property right to the extent of half of the spousal property.[92] Therefore, with ten-

87. *Id.* § 2039(a)–(b). Subsection (a) of § 2039 provides that

> The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement . . . if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.

Id. § 2039(a). Subsection (b), entitled "Amount includable," provides that

> Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefore contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchase price of such contract or agreement . . . shall be considered to be contributed by the decedent if made by reason of his employment.

Id. § 2039(b).

88. *Id.* § 2039(a).

89. *Id.* The treasury regulations under § 2039 define the terms "annuity or other payment" and "contract or agreement." Treas. Reg. § 20.2039-1(b)(1)(ii) (as amended in 2008).

90. *See supra* Part II.A.2.a.

91. I.R.C. § 2033.

92. BLACK'S LAW DICTIONARY 317 (9th ed. 2009). "Assets owned in common by husband and wife as a result of its having been acquired during the marriage by means other than an inheritance or a gift to one spouse, each spouse generally holding a one-half interest in the property." *Id.*

ancy in common and community property interests, no special estate tax rules are applicable. In each instance, an owner's interest is unaffected by a co-owner's death, and § 2033 controls.

Other forms of co-ownership, however, carry the right of survivorship. In a joint tenancy with a right of survivorship or in a tenancy by the entirety,[93] an owner's right in the property terminates at his or her death and does not pass by will or intestate succession.[94] When a co-owner of a joint tenancy or tenancy by the entirety dies, the surviving co-tenant becomes the outright owner of the entire property by virtue of the form of ownership in which the property is held. Because a decedent's interest terminates at death in a joint tenancy, that interest will not be included under § 2033 general estate tax principles. It may be taxed, however, under § 2040 of the Code.

The general rule of § 2040 is that a decedent's gross estate includes the entire value of property held jointly at the time of death by him and another person or persons with right of survivorship.[95] Section 2040 then provides exceptions to this general rule of inclusion. If the jointly held property was acquired by the decedent and other joint owner(s) by gift, devise, bequest, or inheritance, only the decedent's fractional share of the property must be included in his gross estate.[96] In all other cases, the estate can exclude such part of the entire value as was attributable to consideration in money or money's worth furnished by the other joint owner or owners.[97] Accordingly, if the decedent furnished only a part of the purchase price, only a corresponding portion of the value of the property is included in the gross estate.[98] If the decedent furnished no part of the purchase price, then no part of the value of the property is included.[99]

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93. A tenancy by the entirety is a form of joint tenancy. It resembles joint tenancy in that upon the death of either husband or wife the survivor automatically acquires title to the share of the deceased spouse. *Id.* at 1604.

94. *Id.* As with life interests, such interests simply expire at the decedent tenant's death.

95. I.R.C. § 2040(a).

96. *Id.* ("[W]here any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy by the entirety by the decedent and spouse, then to the extent of one-half of the value thereof, or, where so acquired by the decedent and any other person as joint tenants with right of survivorship and their interests are not otherwise specified or fixed by law, then to the extent of the value of a fractional part to be determined by dividing the value of the property by the number of joint tenants with right of survivorship.").

97. *Id.* (excluding such part of the entire value of the property "as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth"). Accordingly, only that portion of the value of jointly held property that is commensurate with the decedent's share of the cost of acquisition is included in the gross estate.

98. *See* Treas. Reg. § 20.2040-1(a), (c)(2) (1960).

99. *Id.* § 20.2040-1(c)(3).

The executor bears the burden of proving that the jointly owned property was not acquired solely with consideration furnished by the decedent.[100] A number of tracing problems may arise when ascertaining whose wealth really created the asset or who was financially responsible for its purchase. If a co-owner's entire contribution to the purchase price of jointly held property is money or property that was received by the decedent before the acquisition of the joint property, the decedent's wealth effectively created all the interests and, hence, the entire value of the property is included in his gross estate.[101] If, however, the co-owner's entire contribution to the purchase price was income that was generated by that gifted property (assuming it was income producing property), the income will be treated as a contribution of the survivor's own funds and, hence, that portion of the value of the joint property commensurate with that income consideration will be excluded.[102]

Such tracing problems do not exist with joint tenancies solely between the decedent and his or her spouse. Section 2040(b) provides that if an interest in property is held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with rights of survivorship, then one-half of the value of such jointly held property will be included in the decedent's gross estate, regardless of which spouse funded the property.[103] Section 2040(b)'s bright-line rule is based on the premise that it is difficult to determine the relative contributions between a husband and wife.

A decedent's interest in property held as a joint tenancy expires upon the decedent's death. That interest passes outside of probate, but, nevertheless, may be included in the decedent's gross estate. One may understand the reasoning for inclusion by noting that a joint tenant has full enjoyment over property during his life, he has the right at any time to sever the tenancy, and he has the possibility of becoming outright owner of the property upon the death of a co-tenant. Section 2040's inclusion of a decedent's share of jointly held property in his gross estate is a predictable congressional response.

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100. *Id.* § 20.2040-1(a)(2) (stating that the executor must submit "facts sufficient to show that property was not acquired entirely with consideration furnished by the decedent, or was acquired by the decedent and the other joint owner or owners by gift, bequest, devise, or inheritance").

101. *Id.* § 20.2040-1(c)(4). This is true "notwithstanding the fact that the other property may have appreciated in value due to market conditions between the time of the gift and the time of the acquisition of the jointly held property." *Id.* Note, however, that if the co-owner sells property given by the decedent and uses the proceeds to purchase jointly held property, gain, represented by post-transfer appreciation occurring while the co-owner owned the property, has been treated as a contribution from the survivor's funds. *See* Swartz v. United States, 182 F. Supp. 540 (D. Mass. 1960).

102. Treas. Reg. § 20.2040-1(c)(5) (2010).

103. I.R.C. § 2040(b); *cf.* I.R.C. § 2056(d)(1)(B).

h. Property Subject to General Power of Appointment

A power of appointment generally is not regarded as an interest in property. Nevertheless, § 2041 includes in a decedent's gross estate the value of property over which the decedent possessed, exercised, or released certain powers of appointment.[104] A power of appointment is the power to decide who gets property and is held by one who does not own the property.[105] There are special powers and general powers. Section 2041 only causes inclusion in a decedent's gross estate if the decedent possessed, exercised, or released a "general power of appointment."[106] In contrast to a special power, a "general power of appointment" is any power of appointment exercisable in favor of the holder, or the holder's estate, his creditors, or the creditors of his estate.[107]

Certain powers over property, although exercisable for the benefit of the decedent holder, are not deemed general powers of appointment and, therefore, are outside the scope of § 2041. For instance, a power over property that is "limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent" is not considered a general power of appointment.[108] A power is limited by such a standard only if it is reasonably measured in terms of the holder's needs for health, education, or support.[109] The regulations under § 2041 provide examples of powers that are and are not limited by the requisite standard. A power to use property for the "comfort, welfare, or

104. I.R.C. § 2041. Because a power of appointment is not considered an interest in property, § 2033 would not cause inclusion of the property subject to the power.

105. A power of appointment by definition involves someone other than the owner. If the owner of the property creates a general power in herself, § 2041 would not be needed. Sections 2033 or 2036 would cause inclusion. *See* I.R.C. §§ 2033, 2036. For a definition of "power of appointment," see Treas. Reg. § 20.2041-1(b)(1) (as amended in 1961).

106. Section 2041(a)(2) provides, in pertinent part:

> To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive.

I.R.C. §2041(a)(2). See *supra* Parts II.A.2.b through e, for a discussion of §§ 2035 through 2038. This article will only address post-1942 powers. For the tax treatment of powers of appointment created on or before October 21, 1942, see I.R.C. § 2041(a)(1).

107. I.R.C. § 2041(b)(1). The regulations expand on the definition: "A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors." Treas. Reg. § 20.2041-1(c)(1) (as amended in 1961). Whether a general power of appointment exists for federal estate tax purposes depends upon the substance of the holder's legal rights under state law. *See* Keeter v. United States, 461 F.2d 714, 717 (5th Cir. 1972); *see also* Powers v. United States, 37 Fed. Cl. 709, 711 (1997).

108. I.R.C. § 2041(b)(1)(A).

109. Treas. Reg. § 20.2041-1(c)(2) (1960).

happiness" of the power holder is not limited by an ascertainable standard.[110] In contrast, a power to use property for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," or "support in his accustomed manner of living" is limited by the requisite standard.[111]

In addition to powers limited by an ascertainable standard, certain joint powers are not considered general powers of appointment. More specifically, § 2041 does not apply to a power which is exercisable only in conjunction with (1) the creator of the power or (2) another person "having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate."[112] The regulations flesh out whether a joint power holder's interest is adverse and substantial.[113]

If a decedent holds (possesses) a general power of appointment and exercises it at the time of death, the value of the property subject to the power is included in the decedent's gross estate.[114] If a decedent holds a general power at death but fails to exercise it, the result is the same.[115] Inclusion results if the interest exists at the time of the holder's death, or if the decedent exercised the power at death.[116]

Inclusion also may result if a holder fails to exercise a power within a specified time so that the power lapses. Section 2041(b)(2) provides that a "lapse" of a power of appointment is considered to be a "release" of the power.[117] That section states further, however, that such a lapse is a release only to the extent that the property which could have been appointed exceeds the greater of $5,000 or five percent of the aggregate

110. *Id.*

111. *Id.*

112. *Id.* § 20.2041-3(c); I.R.C. § 2041(b)(1)(C).

113. Treas. Reg. § 20.2041-3(c)(2).

114. I.R.C. § 2041(a)(2); Treas. Reg. § 20.2041-3(a)(2)(ii). Note that if the decedent exercised the power within three years of death by giving the property to someone else, nothing would be included in the decedent's gross estate under § 2041. There is no retained interest to trigger § 2036, for example. *See supra* Part II.A.2.c, for a discussion of § 2036. Further, § 2041 is not referenced in § 2035(d)(2). *See supra* Part II.A.2.b, for a discussion of § 2035 and near-death transfers of certain property. In sum, an inter vivos exercise or release of a general power will prevent any estate tax inclusion of the property subject to the power unless the decedent retained an interest in the property which would have caused §§ 2035 through 2038 to have applied had she owned the property. I.R.C. § 2041(a)(2).

115. I.R.C. § 2041(a)(2); Treas. Reg. § 20.2041-3(a)(2)(i). The power is considered to exist at death

> even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.

Treas. Reg. § 20.2041-3(b) (1960).

116. I.R.C. § 2041(a)(2).

117. *Id.* § 2041(b)(2).

value of the property subject to the power.[118] To understand the significance of § 2041(b)(2) and how it works, one must first understand the general rule that a "lapse" equals a "release."

An inter vivos exercise or release of a general power will prevent any estate tax inclusion of the property subject to the power, because the holder does not possess the power at death.[119] This is not true, however, if the decedent retained an interest in the property which would have caused §§ 2035 through 2038 to have applied had he owned the property.[120] For example, if the decedent exercised a power during his life by appointing the income to himself and the remainder to someone else, the value of the remainder would be included in the decedent's gross estate; his exercise was one to which § 2036 would have applied had he owned the property.[121]

This article earlier discussed the estate tax consequences when a decedent transfers property to a trust yet retains an income interest for life; the value of the remainder is included in the decedent's gross estate under § 2036.[122] Now assume that D, the income beneficiary of a trust, holds a non-cumulative right to withdraw $10,000 each year from the principal of the trust. When a person is the income beneficiary of a trust and also possesses an annual general power to invade the corpus of the trust, a lapse of that general power is like a § 2036 transfer. This is because D is treated as though with each lapse of the annual power, he appropriated $10,000 from the trust and then put it back in while retaining a life income interest in the property. Thus, the lapse of a general power of appointment held by the income beneficiary of a trust will trigger an inclusion of the trust property subject to the power in the gross estate of the holder of the lapsed power.

The second part of § 2041(b)(2) limits the amount of inclusion. It requires inclusion only to the extent that the property which could have been appointed by exercise of the lapsed power exceeds the greater of $5,000 or five percent of the corpus.[123] Thus, the amount over $5,000 or five percent is all that is included in the decedent's gross estate for each year of lapse.[124] This article later addresses how the $5,000 or five percent rule can provide important estate planning opportunities.[125]

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118. *Id.*

119. But inter vivos exercise or release may give rise to gift tax. *See id.* § 2514.

120. *Id.* § 2041(a)(2).

121. *Id.*

122. *Id.* § 2036. See *supra* Part II.A.2.c, for a discussion of § 2036.

123. I.R.C. § 2041(b)(2).

124. Note that in the year of death, the $5,000 or five percent rule will not apply, and the full amount subject to the power will be included in the decedent's gross estate; a general power of appointment would be held by the decedent at death. See *infra* note 311 and accompanying text, for one way to avoid inclusion.

125. *See infra* Part III.B.

i. Certain Life Insurance Proceeds

Life insurance is a very common estate planning tool for young people with children and few assets, for young or middle-aged people with few assets but other dependents, for owners of a closely-held business with a buy-sell agreement, and for those estates with valuable assets that are not readily marketable or that need to be kept within the family. Insurance often is purchased simply to create wealth. Other times it is bought to create liquidity. If a decedent purchases a policy, and the proceeds are payable to survivors at his death, Congress views this as a testamentary transfer of wealth which should be subject to the estate tax.

Section 2042 requires a decedent to include in his gross estate the proceeds of insurance on his life if (1) the proceeds are payable to his estate,[126] or (2) the proceeds are payable to other beneficiaries and the decedent had at the time of death any incidents of ownership in the policy.[127] Critical to an understanding of this section is an understanding of the term "incidents of ownership." If a decedent does not possess any incidents of ownership in a policy at the time of death, nor transfers all incidents within three years of death,[128] no part of the insurance proceeds is included in his gross estate.[129]

The term "incidents of ownership," which is defined in the regulations under § 2042, "is not limited in its meaning to ownership of the policy in the technical legal sense . . . . [However,] the term has reference to the right of the insured or his estate to the economic benefits of the policy."[130] It generally includes (1) the power to change beneficiaries, (2) the power to cancel or surrender the policy, (3) the right to borrow against the surrender value of the policy, (4) the power to assign the policy or revoke an assignment, and (5) a reversionary interest in the policy which exceeds five percent of the value of the policy.[131] In certain circumstances, incidents of ownership held by a corporation are attributable to a controlling shareholder, causing the proceeds to be included in the shareholder's gross estate under § 2042.[132]

126. I.R.C. § 2042(1); Treas. Reg. § 20.2042-1(b) (as amended in 1979). Whether the estate is specifically named as a beneficiary under the terms of the policy is irrelevant. I.R.C. § 2042.

127. I.R.C. § 2042(2); Treas. Reg. § 20.2042-1(c).

128. If a decedent assigns his entire interest in a policy on his life (including all incidents of ownership) within three years of death, § 2035 will apply to cause inclusion of the policy in his gross estate. I.R.C. § 2035(a), (d); *see supra* Part II.A.2.b.

129. Treas. Reg. §20.2042-1(c)(1).

130. *Id.* § 20.2042-1(c)(2).

131. *Id.* § 20.2042-1(c)(2)–(3).

132. Consider a corporation that owns an insurance policy on the life of a controlling stockholder (one who owns stock possessing more than 50% of the total combined voting power of the corporation). If the proceeds are payable to the decedent's spouse, the incidents of ownership held by the corporation will be attributed to the decedent shareholder through

j. Qualified Terminable Interest Property

A decedent must include in her gross estate the entire value of property in which she possessed a "qualifying income interest for life" and for which a marital deduction was allowed under § 2056(b)(7) to a predeceasing spouse.[133] Although the surviving spouse receives only a qualifying income interest for life (terminable at death) in a trust, for example, she must include the entire value of the trust in her gross estate under § 2044 when she dies. This is the quid pro quo for the predeceasing spouse receiving the benefit of a marital deduction under § 2056(b)(7), which reduced his gross estate, for the property passing to the spouse in trust. The marital deduction is addressed later in this article in connection with allowable deductions from a decedent's gross estate.[134] Section 2044's role will become clearer at that point.

To summarize the discussion of gross estate, a decedent's gross estate includes not only property actually owned by him at death; it also includes certain life insurance proceeds, property held jointly with a co-owner or co-owners, and property subject to a general power of appointment held by the decedent. In addition, some property given away during life, but which the tax law nevertheless treats the decedent as owning until death, is included in the gross estate. It should be noted that many of these inter vivos transfers of property will not be drawn back into the gross estate if they are bona fide sales for adequate and full consideration in money or money's worth.[135] If consideration is received by the decedent, but the transfer is not a bona fide sale for an adequate and full consideration in money or money's worth, the decedent must include in the gross estate the excess of the property's fair market value at the time of death over the value of the consideration received.[136]

3. Allowable Deductions from Gross Estate

Once a decedent's gross estate is determined, allowable deductions are taken into account in order to determine the decedent's taxable es-

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his stock ownership, and the proceeds will be included in his gross estate under § 2042. If, however, the proceeds are payable to the corporation, the corporation's incidents of ownership will not be attributed to the decedent shareholder, and the proceeds will not be included in his gross estate. *Id.* § 20.2042-1(c)(6).

133. I.R.C. § 2044. In general, the surviving spouse has a qualifying income interest for life if she is entitled to all of the annual income from the property and no person has a power to appoint the property to anyone other than the surviving spouse during her life. *Id.* § 2056(b)(7)(B)(ii).

134. *See infra* Part II.A.3.c.

135. *See, e.g.*, I.R.C. §§ 2035(b), 2036(a), 2037(a).

136. *Id.* § 2043(a) (referring to transfers described in §§ 2035–2038, inclusive, and § 2041).

tate.[137] Allowable deductions from the gross estate are set out in §§ 2053 through 2056 of the Code.

a. Deduction for Expenses and Debts

Section 2053 permits a deduction for expenses falling within two categories. The first category includes amounts which are payable out of property subject to claims and which are allowable under the law of the local jurisdiction (expenses in respect of probate assets). These include (1) funeral expenses,[138] (2) administration expenses,[139] (3) claims against the estate,[140] and (4) unpaid mortgages on property.[141] The second category includes expenses incurred in administering property not subject to claims that is nevertheless included in the gross estate (expenses in respect of non-probate assets).[142] An item is deductible under § 2053 only if it is "ascertainable with reasonable certainty, and will be paid."[143]

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137. *Id.* § 2051. (defining taxable estate as the gross estate minus deductions set out in §§ 2053–2056).

138. *Id.* § 2053(a)(1); Treas. Reg. § 20.2053-2 (1958) (providing as deductible "[a] reasonable expenditure for a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family, including a reasonable expenditure for its future care, . . . provided such an expenditure is allowable by the local law").

139. I.R.C. § 2053(a)(2); Treas. Reg. § 20.2053-3 (as amended in 2009) (providing requirements for deductibility of administration expenses and listing executor's commissions, attorney's fees, and miscellaneous expenses as examples).

140. *Id.* § 2053(a)(3); Treas. Reg. § 20.2053-4 (1958) (providing that claims against the estate are deductible only to the extent of "personal obligations of the decedent existing at the time of his death, whether or not then matured, and interest thereon which had accrued at the time of death" (quoting the 1958 version of Treas. Reg. § 20.2053-4 before the 2009 revisions)). It should be noted that a claim against the estate founded on a promise to pay made by the decedent is not always deductible. A deduction is permitted only when the claim, founded upon a promise or agreement, was "contracted bona fide and for an adequate and full consideration in money or money's worth." I.R.C. § 2053(c)(1)(A). This consideration requirement prevents a gratuitous testamentary transfer from escaping the estate tax. It also should be noted that a release or promised release of dower or curtesy, or other marital rights, generally is not considered consideration in money or money's worth. I.R.C. § 2043(b)(1). However, certain relinquishments of marital rights, pursuant to certain property settlements under § 2516(1), are considered to be made for adequate and full consideration in money or money's worth. *Id.* §§ 2053(e), 2043(b)(2), 2516(1).

141. I.R.C. § 2053(a)(4); Treas. Reg. § 20.2053-7 (as amended in 1963).

142. I.R.C. § 2053(b). The second category of expenses must represent amounts which would be allowed as deductions in the first category if the amounts were in respect of property passing through probate. *Id.*; Treas. Reg. § 20.2053-1(a)(2)(i) (1958). For example, an estate may incur termination expenses in connection with an inter vivos trust, which is included in the decedent's gross estate under I.R.C. § 2036(a). Alternatively, an estate may incur legal expenses in defending the validity of the inter vivos trust. These expenses would not be deductible under subsection (a) of § 2053, as the property is not part of the probate estate and the expense is not "allowable" by local law. Subsection (b) of § 2053 remedies the obstacle to deductibility under subsection (a). *See* Treas. Reg. § 20.2053-8 (1958).

143. Treas. Reg. § 20.2053-1(d)(4)(i) (as amended in 2009) ("[N]o deduction may be taken upon the basis of a vague or uncertain estimate.").

b. Deduction for Casualty Losses and Contributions to Charity

Section 2054 allows a deduction for losses incurred during the settlement of the decedent's estate arising from casualty transactions, to the extent such losses are not compensated for by insurance.[144] A deduction is permitted only for losses from casualties or theft occurring during the settlement of the estate.[145] Section 2055 allows a deduction from the gross estate for the value of property included in the decedent's gross estate and transferred for public, charitable, and religious uses.[146]

c. The Marital Deduction

For married people, the most important deduction from a planning perspective is the marital deduction authorized by § 2056. The amount of the decedent's marital deduction is the value of all property that passes during life or at death from the decedent to the surviving spouse that is (1) includible in the decedent's gross estate, and (2) not considered a terminable interest.[147] As is apparent, a decedent can easily wipe out his gross estate by passing property to his surviving spouse. The theory behind § 2056 is that a husband and wife should be treated as a unit with shared marital wealth. That wealth should not be taxed when transferred within that unit; rather, transfer taxes should follow only when the property is transferred outside the unit to a third party or to

144. I.R.C. § 2054.

145. Treas. Reg. § 20.2054-1 (1958).

146. I.R.C. § 2055.

147. *Id.* § 2056(a), (b)(1), (c). Section 2056 provides, in part:

> (a) ALLOWANCE OF MARITAL DEDUCTION.-- For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.
>
> (b) LIMITATION IN THE CASE OF LIFE ESTATE OR OTHER TERMINABLE INTEREST.--(1) GENERAL RULE.--Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction will be allowed under this section with respect to such interest--(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and (B) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse . . . .

I.R.C. § 2056(a), (b)(1)(A)–(B).

younger generations.[148] At the surviving spouse's death, the property will be taxed in the surviving spouse's gross estate to the extent she retained the property until her death. Hence, the quid pro quo of the marital deduction is inclusion in the estate of the second spouse to die. The marital deduction merely postpones payment of the federal estate tax until the death of the surviving spouse. Thus, it is important to balance its use against the use of the decedent spouse's unified credit. However, the spousal unified credit portability clause introduced in The Tax Relief Act of 2010 somewhat reduces this concern.[149]

Section 2056 imposes a number of requirements before mandating a marital deduction.[150] First, an interest in property must "pass" from the decedent to his surviving spouse.[151] Almost any means of transmittal that involves ownership by the decedent followed by ownership by the surviving spouse will satisfy this first requirement.[152] Second, the property passing to the surviving spouse has to be includible in the dece-

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148. See STEPHENS ET AL., *supra* note 11, ¶ 5.06[1], for a brief discussion of the history of I.R.C. § 2056. For a more detailed discussion see PRICE & DONALDSON, *supra* note 11, §§ 5.1 to 5.3.

149. *See* I.R.C. § 2010(c)(2)(B), (c)(4) (as amended in 2010) (discussed *infra* Part II.A.4.a). It is important to remember that the provision is slated to sunset on December 31, 2012. Thus, it has limited utility as a planning tool at present. It apparently has no application, if it is not renewed, where one spouse dies while it is effective and the second spouse dies after its repeal. Thus, the second spouse might consider making gifts using the unused credit before December 31, 2012.

150. In addition to those outlined in the text, a decedent's surviving spouse must be a U.S. citizen. Treas. Reg. § 20.2056(a)-1(a) (as amended in 1994). The decedent has to be survived by a spouse. I.R.C. § 2056(d)(1); Treas. Reg. § 20.2056(a)-1(b)(1)(i) (citing Treas. Reg. § 20.2056(c)-2(e) (as amended in 1994)). *But see* I.R.C. §§ 2056(d)(2), 2056A (providing an exception if property passes in a "qualified domestic trust").

151. See *supra* note 147, for a restatement of § 2056(a).

152. Section 2056(c) states:

> (c) DEFINITION.--For purposes of this section, an interest in property shall be considered as passing from the decedent to any person if and only if—(1) such interest is bequeathed or devised to such person by the decedent; (2) such interest is inherited by such person from the decedent; (3) such interest is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent; (4) such interest has been transferred to such person by the decedent at any time; (5) such interest was, at the time of the decedent's death, held by such person and the decedent (or by them and any other person) in joint ownership with right of survivorship; (6) the decedent had a power (either alone or in conjunction with any person) to appoint such interest and if he appoints or has appointed such interest to such person, or if such person takes such interest in default on the release or nonexercise of such power; or (7) such interest consists of proceeds of insurance on the life of the decedent receivable by such person.

I.R.C. § 2056(c). Accordingly, if the surviving spouse is the named beneficiary of a life insurance policy which the decedent husband owned, the proceeds are deemed to pass to her. *Id.* § 2056(c)(7). Property is deemed to pass if the decedent exercises a power of appointment. *Id.* § 2056(c)(6). An inter vivos gift even meets the passing test. *Id.* § 2056(c)(4) ("transferred . . . any time"). But to get the marital deduction, the property must be includible in the decedent's gross estate.

dent's gross estate.[153] If the property passing is not included in the decedent's gross estate, it makes little sense to allow the decedent to deduct from his gross estate the value of that property. Third, the interest passing to the surviving spouse cannot terminate or fail.[154]

If the surviving spouse's interest is terminable, the decedent will not receive a marital deduction under § 2056. A surviving spouse has a "terminable interest" if (1) the interest passing to her will terminate or fail "on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur";[155] (2) the decedent has also given an interest in the property to a person other than the surviving spouse;[156] and (3) upon the termination or failure of the spouse's interest, that other person may come into possession of the property.[157] All three elements must be present for the interest to be "terminable" and, hence, non-deductible.[158]

An example of a terminable interest is a decedent giving a life estate in realty to a spouse, remainder to a child. In this transaction, the first two requirements for a deduction are met: an interest in property passes to the surviving spouse, and that interest is included in the decedent's gross estate. The third requirement for a marital deduction, however, is not satisfied. The interest passing is a terminable interest because (1) the spouse's interest will end at her death, (2) the decedent has given an interest in such property to another person, a child, and (3) upon the spouse's death (termination of her interest), that child may possess or enjoy any part of such property. Accordingly, in this example, a marital deduction would not be allowed to the decedent.

The policy behind the terminable interest rule is easy to understand by remembering the policy behind the marital deduction. As noted earlier, the price for the marital deduction is inclusion in the surviving spouse's gross estate (unless she consumes the asset before death). The government will permit a postponement of tax if property passes within the marital unit to the surviving spouse, under the assumption that the wealth will be included in the surviving spouse's gross estate upon her death. If the surviving spouse is given a "terminable interest" in the decedent's property, such as a life estate, nothing will be included in her gross estate upon her death. Her interest, that terminates at death, will

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153. See *supra* note 147, for a restatement of § 2056(a).

154. See *supra* note 147, for a restatement of § 2056(a), (b).

155. I.R.C. § 2056(b)(1). For example, a surviving spouse's interest may terminate or fail at the expiration of a stated period, upon the surviving spouse's remarriage, or if a daughter does not marry by a certain age.

156. *Id.* § 2056(b)(1)(A).

157. *Id.* § 2056(b)(1)(B).

158. A patent, for example, is terminable, but the second and third elements may not be present; in such case, the marital deduction would still be available. A terminable interest also exists if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust. *Id.* § 2056(b)(1)(C).

not be taxed under § 2033.[159] In such case, a marital deduction for the decedent is not appropriate.

There are several exceptions to the terminable interest rule, only two of which are addressed in this article.[160] One exception exists if a surviving spouse is given a life estate, with income payable to her at least annually, and a general power of appointment over the property exercisable by the spouse alone during her life or at death.[161] The surviving spouse's interest is clearly terminable. Nevertheless, a marital deduction is given to the decedent husband since the surviving spouse's general power of appointment will cause the value of the property to be included in her gross estate under § 2041.[162] The quid pro quo of the marital deduction is inclusion of the entire property in the surviving spouse's estate under § 2041.

Another exception to the terminable interest rule exists if the surviving spouse receives "qualifying terminable interest property" (QTIP).[163] QTIP is property passing from the decedent to the surviving spouse, in which the surviving spouse has a "qualifying income interest for life," and to which an election is made by the executor to have the property qualify for the marital deduction.[164] A surviving spouse has a qualifying income interest for life only if she is entitled to income payable at least annually, and if no person has a power to appoint the property to anyone other than the surviving spouse during her life.[165] If a QTIP election is made, § 2044 requires that the remainder be included

159. *See* Treas. Reg. § 20.2033-1(a) (as amended in 1963); *supra* text accompanying note 48; and *supra* discussion Part II.A.2.a.

160. For the exceptions to the terminable interest rule, see I.R.C. § 2056 (b)(3) (interest of spouse conditional on survival for limited period), (b)(5) (life estate with power of appointment in surviving spouse), (b)(6) (life insurance or annuity payments with power of appointment in surviving spouse), (b)(7) (election with respect to life estate for surviving spouse), and (b)(8) (special rule for charitable remainder trusts).

161. Section 2056(b)(5) provides an exception to the terminable interest rule:

> In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse . . . .

Id. § 2056(b)(5).

162. See *supra* Part II.A.2.h for a discussion of § 2041.

163. I.R.C. § 2056(b)(7).

164. *Id.* § 2056(b)(7)(B)(i). The executor must make the election on the estate tax return, Form 706, and the election is irrevocable. *Id.* § 2056(b)(7)(B)(v). The election provides an opportunity for post-mortem estate planning depending on the conditions existing after the decedent's death.

165. *Id.* § 2056(b)(7)(B)(ii). Another person may have the power to appoint the property only if the power is exercisable at or after the death of the surviving spouse. *Id.*

in the surviving spouse's gross estate (despite the fact that the spouse had a terminable interest).[166] The price for the decedent receiving the benefit of the marital deduction is inclusion of the property in the surviving spouse's gross estate under § 2044.[167]

An estate planner must keep in mind that the marital deduction is mandatory and not elective, except in the case of a QTIP election.[168] In addition, the marital deduction is unlimited. A planner must be careful not to allow the marital deduction to defeat the use of the unified credit. This is explained later in the estate planning portion of this article.[169]

d. Deduction for State Death Taxes

Section 2058 authorizes deduction of "the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate."[170] At present this provision is slated to be replaced by § 2011 on January 1, 2013. Section 2011 is addressed in the next section of this article.

4. The Unified Credit and State Death Tax Credit

Once the gross estate is determined and allowable deductions are taken to arrive at the "taxable estate," the actual estate tax payable can be computed. To the "taxable estate" is added all post-1976 taxable gifts not included in the taxable estate to arrive at a "tentative taxable estate."[171] The graduated rates found in § 2001(c) are then applied to the

166. *Id.* § 2044(a), (b)(1)(A). Although premature at this point, if the surviving spouse disposes of all or part of her income interest for life to avoid estate tax, the gift tax will apply as if she gifted all her interest in the property other than her qualifying income interest. *Id.* §§ 2519, 2207A(b).

167. Note that the surviving spouse's estate may recover from the person receiving the property any estate tax paid as a result of inclusion in her gross estate by reason of inclusion under §§ 2044, 2207A.

168. I.R.C. § 2056(b)(7) (providing for QTIP election). Note that a marital deduction is not allowed if a surviving spouse makes a qualified disclaimer with respect to the property passing to her. *See id.* § 2518.

169. *See infra* Part III.B.

170. I.R.C. § 2058(a).

171. *Id.* § 2001(b)(1)(B). Lifetime gifts after 1976 are added in the estate tax computation to push the taxable estate into higher marginal brackets for purposes of the § 2001(c) rate table (§ 2001(c) is a multipurpose rate table and applies to lifetime gifts and testamentary dispositions). Why inter vivos gifts affect the rate of tax applicable to testamentary dispositions has to do with the integration, albeit imperfect, of the gift and estate taxes. The gift tax is discussed *infra* part II.B. The question arises whether post-1976 gifts are being taxed twice, once when the gift was made and later when added in the estate tax formula. Section 2001(b)(2) prevents double taxation by reducing, in the formula, the amount of gift taxes that would have been payable on the lifetime gifts at the § 2001(c) rates in effect at the date of

"tentative taxable estate" to arrive at the "tentative estate tax" due.[172] From that tentative tax figure is subtracted (1) the taxes already paid on the lifetime gifts,[173] and (2) allowable credits against tax.[174] The result is the actual estate tax payable.

A number of credits against the estate tax are allowed, only two of which are discussed below.[175]

a. The Unified Credit

The first, and by far most important, estate tax credit is the unified credit provided in section 2010 of the Code: "A credit of the applicable credit amount shall be allowed to the estate of every decedent against the tax imposed by section 2001."[176] The most important innovation in The Tax Relief Act of 2010 was the alteration of the unified credit to include an addition for the unused credit of a decedent's deceased spouse.[177] This so-called "portability"[178] clause will have limited planning utility unless Congress extends the life of this provision beyond December 31, 2012. In any event, the applicable exclusion amount is an amount equal to the sum of the "basic exclusion amount" and the "deceased spousal unused exclusion amount."[179] The basic exclusion amount is $5,000,000.[180] The credit that derives from the basic exclusion amount is the amount of tax computed under § 2001 on $5,000,000, or $1,590,800. As noted this amount could be increased by the unused credit of an earlier deceased spouse. The important point is to understand

death. *Id.* § 2001(b)(2). Again, the post-1976 gifts serve only to push the estate into a higher marginal rate bracket.

172. *Id.* § 2001(c).

173. *Id.* § 2001(b)(2). The reduction is the amount of gift tax with respect to post-1976 gifts which would have been payable at the § 2001(c) rates in effect at the time of the decedent's death. This serves to prevent double taxation of the post-1976 gifts, once at the time of gift and then at the decedent's death.

174. *Id.* §§ 2010–2016.

175. *See Id.* §§ 2010 (unified credit against estate tax), 2011 (credit for state death taxes paid), 2012 (credit for gift tax), 2013 (credit for tax on prior transfers), 2014 (credit for foreign death taxes), 2015 (credit for death taxes on remainders), 2016 (recovery of taxes claimed as credit).

176. *Id.* § 2010(a).

177. *Id.* § 2010(c)(2)(B), (c)(4).

178. *See* Joint Committee on Taxation (J.C.T. Rep. No JCX-55-10), *reprinted in* CCH 2010 ANALYSIS, *supra* note 9, ¶ 10,130.

179. I.R.C. § 2010. There are some technical aspects to employing the deceased spouse's unused credit. The deceased spouse's executor must have filed an estate tax return and have elected to have the unused credit made available to the surviving spouse. *Id.* § 2010(c)(5)(A). For more discussion of the portability provision see CCH 2010 ANALYSIS, *supra* note 9, ¶ 718. Note that the portability of the unified credit does not apply to the GST tax exemption. *Id.* ¶ 718, at 375. The Joint Committee Report gives some examples of its application. *Id.* ¶ 10,140.

180. I.R.C. § 2010(c)(3)(A).

that the unified credit effectively shields at least $5,000,000[181] of property from all three federal wealth transfer taxes.[182] Therefore, maximum use of the credit is an important estate planning objective. This article later discusses the need to balance the use of the marital deduction against the use of the unified credit, so as not to allow the marital deduction to defeat the credit.[183] The portability of the unified credit reduces some of the risk here, but currently the portability clause expires on December 31, 2012.[184] Indeed, it is also important to remember that the applicable exclusion amount of $5,000,000 also currently is set to drop to $1,000,000 on January 1, 2013. As will be discussed, in many cases this last point argues in favor of making inter vivos gifts before that date.

b. The State Death Tax Credit (Temporarily Repealed and Replaced by § 2058)

Historically, § 2011(a) allowed a credit for "inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate . . . ."[185] The credit was repealed by Economic Growth and Tax Relief Reconciliation Act (EGTRRA) through a phase out process that ended in 2004.[186] However, it is presently slated to return into law on January 1, 2013, in the form it enjoyed on December 31, 2001, so we offer this brief description here. The credit as it existed in 2001 was subject to a dollar limit pursuant to a table in § 2011(b).[187] The state death tax credit was limited further if it

181. *Id.* The applicable exclusion amount is indexed for inflation. *Id.* § 2010(c)(3)(B). This provision will only be meaningful if it remains in the law beyond December 31, 2012, its present sunset date.

182. Thanks to The Tax Relief Act of 2010, the gift tax version of the unified credit is equal in amount to the estate tax unified credit. *See id.* § 2505(a). For years prior to 2011 it was $1,000,000. *See infra* Part II.B.4. The Generation Skipping Transfer tax exemption amount is also equal to the estate tax applicable exclusion amount. I.R.C. § 2631(c). The "unified" in "unified credit" refers to the fact that the § 2010 estate tax credit is unified with the gift tax credit provided under § 2505. Although it appears that a taxpayer can make two tax-free transmissions of $5,000,000 (one during life and one at death), the unified credit is used effectively only once to cause a single reduction of $1,590,800 for gift tax and estate tax purposes. This is accomplished in the estate tax computation when the reduction for gift tax payable is reduced by the § 2505 credit. *Id.* § 2001(b)(2). Reducing the reduction avoids using the credit twice.

183. *See infra* Part III.B.

184. For a discussion of the portability provision see Paulukonis, *supra* note 9, § 1.03; 2010 CCH ANALYSIS, *supra* note 9, ¶¶ 718, 10,130.

185. I.R.C. § 2011(a) (as amended in 2002).

186. *See id.* § 2011(f).

187. *Id.* § 2011(b).

exceeded the federal estate tax liability because of the unified credit.[188] Several states, including Idaho, had what is commonly referred to as a "pick-up" tax.[189] These states would tax the estate only to the extent of the maximum § 2011 credit.[190] Thus, the estate would not pay any more taxes than it would have paid anyway. It just paid a portion of its total tax bill to the state rather than to the federal government. If the state death tax credit comes back into operation on January 1, 2013, the pickup taxes are likely to come back as well. Otherwise, those states without an estate tax would simply be augmenting the federal treasury at no gain to decedents' estates or themselves. In the meantime, current law provides for a deduction for state death taxes.[191]

5. Estate Tax Filing Requirements

An estate tax return must be filed on Form 706 for the estate of every U.S. citizen or resident whose gross estate exceeds $5,000,000.[192] The return must be filed within nine months of the decedent's death,[193] but the Service may grant a reasonable extension of time, up to six months, for filing it.[194] A reasonable extension of time to pay the estate tax may be granted by the Service as well.[195]

B. The Gift Tax

The gift tax is an excise tax on the privilege of transferring property during life.[196] It serves to backstop the estate tax; without a gift tax, one could avoid tax on transfers from one generation to the next by making inter vivos gifts. The gift tax is structured similar to the estate tax in that it has, for example, a marital deduction for gifts to a spouse, and it uses the multi-purpose rate table found in section 2001(c) of the

188. *Id.* § 2011(e) ("The credit provided by this section shall not exceed the amount of the tax imposed by section 2001, reduced by the amount of the unified credit provided by section 2010.").

189. *See, e.g.*, IDAHO CODE ANN. §§ 14-402(3) to -403(1) (2010). Idaho provides for apportioning the credit where more than one state taxes the estate of the decedent. *Id.* § 14-403(2). Idaho has left its pickup tax on the books, but has not enacted any other form of estate tax. Thus, at present it is collecting no estate taxes.

190. *See id.* § 14-403(1).

191. I.R.C. § 2058.

192. *Id.* § 6018(a)(1). "In all cases where the gross estate at the death of a citizen or resident exceeds the basic exclusion amount in effect under section 2010(c) for the calendar year which includes the date of death, the executor shall make a return with respect to the estate tax . . . ." *Id.* Every nonresident not a citizen of the United States must file an estate tax return if the value of that part of the gross estate situated in the United States on the date of death exceeds $60,000. *Id.* § 6018(a)(2).

193. *Id.* § 6075(a).

194. *Id.* § 6081(a).

195. *Id.* § 6161.

196. *See* Treas. Reg. § 25.2511-2(a) (as amended in 1999).

Code.[197] Like the estate tax, the gift tax is levied on the transferor (donor).[198] Although an annual return is used, all gifts since 1932 are used to compute the tax rate.[199] Thus, earlier years' gifts push current gifts into higher tax brackets.[200] More specifically, the tax on the current year's gifts is computed by first figuring the tax under the current table for all taxable gifts (aggregating current and past taxable gifts) and then subtracting the tax under the current rate table for the past taxable gifts (using the unified gift tax credit).[201] This concoction of rules has little consequence at the moment because of the increased size of the unified credit and the reduced maximum rate implemented by The Tax Relief Act of 2010.

1. The Concept of Gift

A gift for gift tax purposes is different than the concept of a gift for income tax purposes. For income tax purposes, a gift must arise out of the donor's detached and disinterested generosity.[202] Hence, donative intent is an essential element for income tax purposes.[203] For gift tax purposes, however, the subjective intent of the donor is irrelevant and "application of the tax is based on the objective facts of the transfer and the circumstances under which it is made."[204] A gift occurs whenever there is a transfer of property without receipt by the transferor of full and adequate consideration. Normally, consideration will eliminate any gift tax potential to the extent that the consideration is equal to the fair market value of the gift.[205] To the extent the property given exceeds the value of the property received, a gift has occurred.[206]

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197. Prior to 1976, the estate and gift taxes were separate and distinct. Each had its own exemption and rates. In 1976, Congress attempted to integrate the two taxes. Congress replaced the separate rates with a single, unified rate table applicable to both transfer taxes. I.R.C. § 2001(c). In addition, Congress eliminated the exemptions and created a unified credit. *Id.* § 2010 (estate tax), *Id.* § 2505 (gift tax).

198. Treas. Reg. § 25.2511-2(a) (as amended in 1999) (stating the gift tax "is a primary and personal liability of the donor" and "an excise upon his act of making the transfer").

199. I.R.C. § 2502.

200. *See id.*

201. By subtracting the second tax figure, past gifts will not be taxed twice. The only effect of using past taxable gifts in the computation is to make higher rates applicable to current gifts. Congress has always sought to tax current year gifts at escalated rates using past taxable gifts. Note that the unified credit applies to both the gift tax and the estate tax. Similar to its effect under the estate tax, it can offset $192,800 of gift tax (or $600,000 of taxable gifts). *Id.* § 2505.

202. Comm'r v. Duberstein, 363 U.S. 278, 285–86 (1960). This is not the rule in the gift tax context as such a rule would not favor the government.

203. *Id.* at 286–87.

204. Treas. Reg. § 25.2511-1(g)(1) (as amended in 1997).

205. I.R.C. § 2512; Treas. Reg. § 25.2511-1(g)(1).

206. I.R.C. § 2512(b).

The gift tax applies only to a transfer of a beneficial interest in property.[207] It applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."[208] The gift must be complete, that is, the donor must part with "dominion and control" over the property.[209] A gift is incomplete if, for example, the donor reserves the power to revest beneficial title to the property in himself, or the power to name new beneficiaries or change the beneficial interest among the beneficiaries (unless it is a fiduciary power limited by an ascertainable standard).[210] A gift is not incomplete, however, if the donor merely reserves the power to affect one's time or manner of beneficial enjoyment.[211]

2. Disclaimers

A donee may refuse to accept the ownership of property.[212] If such refusal is a "qualified disclaimer," then the disclaimed interest is treated as though it was never received by the donee, and as passing directly from the transferor to the person entitled to receive the disclaimed interest.[213] This prevents the person making the qualified disclaimer from being treated as though she made a gift and, hence, being forced to pay a transfer tax. A disclaimer is a qualified disclaimer only if it meets certain requirements: (1) it must be irrevocable and an unqualified refusal to accept the property, (2) it must be in writing, (3) it must be received by the transferor no later than nine months after the transfer, or the date the disclaimant becomes twenty-one years old, whichever occurs later, and (4) the disclaimant must not have accepted any interest or benefits from the property.[214]

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207. *See id.* § 2501(a)(1) (providing that the tax is imposed each year "on the transfer of property by gift during such calendar year"). Treas. Reg. § 25.2511-1(g)(1) (as amended in 1997) (providing that the tax applies only on transfers of beneficial interests in property and not on transfers of bare legal title). Accordingly, a gift of legal services would not be subject to gift tax liability.

208. I.R.C. § 2511.

209. Treas. Reg. § 25.2511-2(b) (as amended in 1999). The donor must have "no power to change its disposition, whether for his own benefit or for the benefit of another." *Id.*

210. *Id.* § 25.2511-2(c). The regulations continue: "A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom." *Id.* § 25.2511-2(e).

211. *Id.* § 25.2511-2(d).

212. The disclaimer rules apply to disclaimed bequests as well as to inter vivos gifts. I.R.C. §§ 2046, 2518.

213. *Id.* § 2518; Treas. Reg. § 25.2518-1(b) (as amended in 1997) (describing the effect of a qualified disclaimer).

214. I.R.C. § 2518(b). The interest must also pass either to the decedent's spouse or a person other than the disclaimant without any direction on the part of the disclaimant. *Id.* § 2518(b)(4). *See* Treas. Reg. § 25.2518-2 (as amended in 1997) (outlining requirements for a qualified disclaimer).

3. Valuation of Gifts

If a gift of property is made, the value of the gift is determined as of the date of gift.[215] The value of a gift for gift tax purposes is similar to the value of property for estate tax purposes: the price an informed and willing buyer would pay an informed seller not under a compulsion to sell.[216] If the donee provides consideration for the gift but such consideration is less than the property's value, then only the excess of the property's value over the consideration received is the amount of the gift.[217]

In 1990, Congress enacted §§ 2701 through 2704 of the Code to provide special valuation rules for transfers of interests in corporations, partnerships, and trusts between related family members to deal with the problem of estate freezes.[218] Section 2701 provides special valuation rules to determine the amount of a gift of an equity interest in a corporation or partnership to a member of the transferor's family.[219] It ap-

215. I.R.C. § 2512(a). If a gift occurs in stages (e.g., a transfer to a revocable trust which later becomes irrevocable), the date of gift is the date of completion.

216. Treas. Reg. § 25.2512-1 (as amended in 1992). See *supra* Part II.A.1, for a discussion of value for estate tax purposes.

217. I.R.C. § 2512(b). An exception, known as the ordinary course of business rule, exists in the regulations. *See* Treas. Reg. § 25.2512-8 (as amended in 1992). Assume a transferor sells or exchanges property to someone in the ordinary course of his business, and that the consideration received is less than the value of the property transferred. This transfer for insufficient consideration might be considered a gift under the "objective facts of the transfer." Treas. Reg. § 25.2511-1(g)(1) (as amended in 1997) (noting that donative intent is irrelevant for gift tax purposes). The regulations under § 2512, however, provide that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." Treas. Reg. § 25.2512-8. This suggests that donative intent is relevant, at least in this context. *Commissioner v. Wemyss* is a fascinating case that gave meaning to Treas. Reg. § 25.2512-8. 324 U.S. 303 (1945). In *Wemyss*, a widow had an income interest in a trust, created by her former husband, which was forfeitable upon marriage. *Id.* at 303–04. She refused to re-marry until her prospective husband transferred property to her to offset her loss of trust income. *Id.* at 304. The Court addressed whether the transfer was made for consideration in money or money's worth. *Id.* The Court held that the transfer was a taxable gift, reasoning that detriment to the donee was not consideration for the transfer. *Id.* at 304–05. Citing the predecessor section to Treas. Reg. § 25.2512-8, the Court noted in dicta that the transfer to the prospective wife was not made at arm's length in the ordinary course of business. *Id.* at 306–07.

218. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as amended in scattered sections); *see* I.R.C. § 2701 (dealing with classic estate freezes and transfers of interests in a corporation or partnership); I.R.C. § 2702 (providing valuation rules for interests in trust); I.R.C. § 2703 (dealing with buy-sell agreements); I.R.C. § 2704 (dealing with interests with voting rights that lapse). For a detailed discussion of these special valuation rules, see generally Louis A. Mezzullo, *Transfers of Interests in Family Entities Under Chapter 14: Sections 2701, 2703 and 2704*, Tax Mgmt. (BNA) No. 835-3d (2005); L. Paul Hood, *Valuation: General and Real Estate*, Tax Mgmt. (BNA) No. 830-2d (2003).

219. I.R.C. § 2701 (as amended in 1996).

plies, for example, if a taxpayer gives an equity interest (e.g., common stock) to a member of the transferor's family[220] and immediately thereafter holds an "applicable retained interest" (e.g., preferred stock with certain rights).[221] The amount of the gift is determined by subtracting the value of the applicable retained interest from the value of the taxpayer's interest immediately before the transfer.[222] Section 2701 places a value of zero, however, on distribution, liquidation, put, call, or conversion rights attributable to applicable retained interests held by the transferor, or an applicable family member, immediately after the exchange.[223] Consequently, the amount of the gift may be the entire value of the entity, and a higher taxable gift may result.

Section 2702 provides a similar rule for transfers of interests in trust to (or for the benefit of) a member of the individual's family when the transferor or an applicable family member retains an interest in the trust.[224] With certain exceptions, § 2702 values the retained interest of the transferor at zero so that the amount of the gift is the full value of the trust corpus for gift tax purposes.[225] Certain transfers are not subject to § 2702, such as incomplete transfers,[226] transfers to a personal

220. *Id.* § 2701(a)(1), (e)(1) (defining "member of the family").

221. *Id* § 2701(a)(1)(B), (b) (defining "applicable retained interest"). In the classic estate freeze, this would occur after a recapitalization of a business entity in which a single class of stock, for example, would be exchanged for shares of preferred stock and common stock. The transferor would transfer the common stock (the future value of the business entity) and retain the preferred stock, all at a low gift tax cost.

222. *See id.* § 2701(a)(1), (3) (placing value on retained interest).

223. *Id.* § 2701(a)(3)(A), (e)(2) (defining "applicable family member"). An exception to the zero valuation exists if the retained interest consists of a "qualified payment." *Id.* § 2701(a)(3).

224. *Id.* § 2702; *see id.* § 2701(c)(2), (e) (defining "member of the family"); *see also* § 2702(a)(1), (e)(2) (defining "applicable family member").

225. *Id.* § 2701(a)(2)(A). To understand § 2702, consider the following. D transfers property into trust, retaining an income interest for 10 years, remainder to R (D's daughter). D has made a taxable gift of the remainder interest to R, discounted to present value (the amount of the gift is the entire value of the property less the value of D's retained interest). If D dies before the ten years are up, § 2036 applies to bring the remainder into D's gross estate. *See id.* § 2036. If, however, D lives beyond ten years, the remainder passes to R with no further tax consequences. D would have effectively removed the property from his estate at a small gift tax cost (gift tax on an artificially depressed value—the actuarially determined value of the remainder at the time of the gift). Section 2702 deals with this by valuing the retained interest of D at zero so that the amount of the gift is the full value of the corpus for gift tax purposes. *See id.* § 2702.

226. *Id.* § 2702(a)(3)(A)(i), (B) (defining the term incomplete transfer as "any transfer which would not be treated as a gift whether or not consideration was received for such transfer").

residence trust,[227] and transfers in which the transferor or an applicable family member retains a qualified interest.[228]

Section 2703 provides that, for purposes of all wealth transfer taxes (the estate, gift, and generation-skipping transfer taxes), property is valued without regard to any right or restriction relating to the property.[229] A right or restriction is an option, agreement, or right to acquire property for less than fair market value.[230] Accordingly, if a shareholder's agreement provides for the disposition of stock held by the first to die at the time of death, the value of the stock for transfer tax purposes will be determined without regard to the right or restriction relating to the stock.[231] Section 2703 does not apply if the option, agreement, right, or restriction meets each of the following requirements: (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to the decedent's family for less than full and adequate consideration in money or money's worth, and (3) its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.[232]

Sections 2701 through 2704 are complex and require a careful reading. The regulations are helpful in understanding their application and should be consulted. Further, many commentators have suggested planning opportunities in the wake of these anti-estate freeze rules.[233]

4. Exclusions, Deductions, and the Unified Credit

A number of exclusions and deductions are available to reduce an individual's gift tax liability. Whereas an exclusion item never enters

227. *Id.* § 2702(a)(3)(A)(ii). See *infra* Part III.F for a discussion of Qualified Personal Residence Trusts.

228. I.R.C. § 2702(a)(2)(A), (b) (defining "qualified interests"). Qualified interests are not assigned a value of zero, but rather are valued under § 7520 of the Code. *Id.* §§ 2702(a)(2)(B), 7520.

229. *Id.* § 2703(a).

230. Treas. Reg. § 25.2703-1(a)(2) (as amended in 1992).

231. Other agreements containing rights or restrictions may be found in a partnership agreement, articles of incorporation, or corporate bylaws, to name a few. *Id.* § 25.2703-1(a)(3).

232. I.R.C. § 2703(b). *See generally* Pamela J. Tyler, *The Impact of Section 2703 on Estate Planning for Closely Held Corporations*, 18 MICH. TAX. LAW. 9 (1992).

233. *See, e.g.*, James M. Delaney, *Split Interest Valuations: The Devil is in the Detail*, 37 CAP. U. L. REV. 929 (2009); Dwight Drake, *Transitioning the Family Business*, 83 WASH. L. REV. 123, 169 (2008); T. Randolph Harris, *Freezing the Family Business: Estate Planning Techniques to Give the IRS the Cold Shoulder*, *in* TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES: VALUATION, TAXATION & PLANNING TECHNIQUES FOR SOPHISTICATED ESTATES 1999, at 561 (1999), *available at* WESTLAW, 276 PLI/Est 561; Dan W. Holbrook & Daniel P. Murphy, *Two-Year, Overlapping GRATs Can Maximize the Benefits of Split-Interest Transfers*, 78 J. TAX'N 154 (1993); Hamid K. Kordestani, *Section 2701 Valuation Issues in a Transfer of Family Business Interests*, 73 TAXES 403 (1995); Wayne L. Warnken & Pamela R. Champine, *Anti-Estate Freeze Rules Can Have Wide Scope*, 20 ESTATE PLANNING 220 (1993).

the tax base, a deductible item is included in the tax base, but a deduction is allowed before the tax rate is applied. A credit, such as the unified credit, is applied after the tax is computed. Section 2503(a) defines taxable gifts as the "total amount of gifts" made during the year, reduced by deductions for charitable gifts and gifts to a spouse.[234] Because an exclusion item never enters the tax base, the phrase "total amount of gifts" does not include any gifts that qualify for an exclusion.

The most important exclusion is the annual gift tax exclusion. Section 2503(b) allows a donor to exclude from his tax base the first $13,000 of gifts made per donee per year if the gifts are of present interests in property.[235] The exclusion is not available for transfers of future interests in property, such as reversions and remainders, whether vested or contingent, which will "commence in use, possession, or enjoyment at some future date or time."[236] A special rule exists, however, for a transfer for the benefit of a donee who has not attained the age of twenty-one on the date of the gift. Such transfer will not be considered as a gift of a future interest (and, hence, an annual exclusion will be available) if the conditions in § 2503(c) are met: (1) both the property and its income may be expended by or for the benefit of the donee before he turns twenty-one, (2) any portion of the property and income not expended will pass to the donee when he turns twenty-one, and (3) if the donee dies before attaining the age of twenty-one, any portion of the property and income not disposed of will be payable to the minor's estate or as he may appoint under a general power of appointment.[237] This is a common planning device by which the donor creates a present interest while limiting the beneficiary's ability to get at the property.[238]

Section 2513 allows spouses to treat a gift made by either spouse as though it had been made half by each.[239] It applies only to gifts to third

234. I.R.C. § 2503(a) (referring to I.R.C. §§ 2522–2524).

235. *Id.* § 2503(b). Section 2503(b) provides in part:

> In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year.

Id. The annual exclusion is indexed for inflation and currently stands at $13,000. *See id.*; *see also* Rev. Proc. 2010-40, 2010-46 I.R.B. 663.

236. Treas. Reg. § 25.2503-3(a) (as amended in 1983). "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property." *Id.* § 25.2503-3(b).

237. I.R.C. § 2503(c).

238. *See infra* Part III.A.

239. Section 2513 provides in part:

> A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States.

parties and not to gifts between spouses. The spouses must be married at the time of the gift[240] and must signify their consent to treat all gifts made to third parties as having been made one-half by each spouse.[241] The effect of the split gift provision is to give two annual gift tax exclusions and allow one spouse to take advantage of the other spouse's unified credit. For example, if a wife makes a $30,000 cash gift to a child during the calendar year and her husband makes no gifts to that child during that time, the $30,000 gift is treated as made half ($15,000) by wife and half ($15,000) by husband. Applying the annual gift tax exclusion of § 2503(b) and the gift splitting rule of section 2513, each spouse has made a $2,000 taxable gift.[242]

In addition to the annual gift tax exclusion, an exclusion exists for amounts paid on behalf of an individual (1) to a qualifying educational organization as tuition for the education or training of that individual,[243] or (2) to any health care provider as payment for qualifying medical expenses arising from medical care with respect to that individual.[244] The exclusion applies "without regard to the relationship between the donor and the donee"[245] and, in most instances, is unlimited.[246]

In computing the amount of taxable gifts each calendar year, the Code allows deductions for (1) charitable and similar gifts[247] and (2) gifts

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I.R.C. § 2513(a)(1). Section 2513 equalizes the result in separate property states with that in community property states. In a community property state, almost everything owned by one spouse is owned half by the other and, thus, any gift is already half by one spouse and half by the other in a community property state.

240. *Id.* The spouses cannot remarry during the remainder of the calendar year. *Id.*

241. *Id.* § 2513(a)(2). The consent applies to "all such gifts made during the calendar year by either while married to the other." *Id.* For the manner and timing of the consent, see *id.* § 2513(b); Treas. Reg. § 25.2513-2 (as amended in 1983).

242. To the extent § 2513 treats the wife's gift as that of the husband, the husband's unified credit may be utilized, another benefit of the gift-splitting provision. *See* I.R.C. § 2505.

243. *Id.* § 2503(e) (citing I.R.C. § 170(b)(1)(A)(ii)). "[A] qualifying educational organization is one which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." Treas. Reg. § 25.2503-6(b)(2) (as amended in 1984) (citing I.R.C. § 170(b)(1)(A)(ii)).

244. I.R.C. § 2503(e) (citing I.R.C. § 213(d)). "[Q]ualifying medical expenses . . . include expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care." Treas. Reg. § 25.2503-6(b)(3) (as amended in 1984) (citing I.R.C. § 213(d)).

245. Treas. Reg. § 25.2503-6(a) (as amended in 1984).

246. The exclusion for qualified tuition payments exists only for payments made directly to the qualifying educational organization and is not permitted for amounts paid for books, supplies, dormitory fees, etc., which are not direct tuition costs. *Id.* § 25.2503-6(b)(2). The unlimited exclusion for medical expenses does not apply "to amounts paid for medical care that are reimbursed by the donee's insurance."*Id.* § 25.2503-6(b)(3).

247. I.R.C. § 2522.

to a spouse.[248] Unlike the exclusion items discussed above, which never enter the gift tax base, these deductible items are included in the tax base and then deducted before the tax rate is applied.[249] The charitable deduction is allowed only if the donor is a citizen or resident of the United States at the time of the gift, and the donee is a permitted donee.[250] The marital deduction is allowed only if the donee is the donor's spouse and a U.S. citizen or resident at the time of the gift.[251]

After the annual exclusions and gift tax deductions are taken into account, the tax rates of § 2001(c) can be applied to determine pre-credit gift tax liability.[252] That amount can then be reduced by the portion of the unified credit remaining to the donor to determine actual gift tax liability due. Section 2505 provides a credit against the gift tax equal to $1,590,800 (calculated by reference to an applicable exclusion amount of $5,000,000), minus the amount of the credit used for all preceding calendar years.[253] This is not a separate credit from the unified credit provided in § 2010 with respect to the estate tax.[254] The unified credit applies to the gift tax as well as to the estate tax. A taxpayer cannot offset $1,590,800 of gift tax liability and $1,590,800 of estate tax liability. Through the estate tax computation, the unified credit is used effectively only once to offset only $1,590,800 of gift or estate tax, or a combination of the two.[255] As noted earlier, the applicable exclusion amount of $5,000,000 from which the credit is derived is slated to return to $1,000,000 on January 1, 2013.

5. Gift Tax Filing Requirements

Any citizen or resident of the United States who makes any transfer by gift must generally file a gift tax return on Form 709 for the calendar year.[256] However, the donor need not file a return for transfers that are not included in the total amount of gifts for the calendar year

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248. *Id.* § 2523. This is referred to as the "marital deduction."

249. These deductions are "allowed only to the extent that the gifts therein specified are included in the amount of gifts against which such deductions are applied." *Id.* § 2524.

250. *Id.* § 2522.

251. *Id.* § 2523(a), (i); Treas. Reg. § 25.2523(a)-1(a) (as amended in 1995). Special rules exist in the case of a transfer to the spouse of a terminable interest. *See* I.R.C. § 2523(b).

252. *See supra* Part II.B.

253. I.R.C. § 2505(a); *see also id.* § 2001(b)(2).

254. *See supra* Part II.A.4.a. The "unified" in "unified credit" refers to the fact that the § 2010 estate tax credit is unified with the gift tax credit provided under § 2505. Although it appears that a taxpayer can make two tax-free transmissions of $5,000,000 (one during life and one at death), the unified credit is used effectively only once to cause a single reduction of $1,590,800 for gift tax and estate tax purposes. This is accomplished in the estate tax computation when the reduction for gift tax payable is reduced by the § 2505 credit. I.R.C. § 2001(b)(2). Reducing the reduction avoids using the credit twice.

255. *See supra* note 254.

256. *See generally* I.R.C. § 6019.

because of (1) the annual gift tax exclusion of $13,000 per donee, or (2) the exclusion for the payment of certain education and medical expenses.[257] Further, the transferor need not file a gift tax return with respect to transfers for which a marital deduction is allowed.[258] The gift tax return must be filed on or before the 15th day of April following the close of the calendar year in which the gift was made.[259] The Service may grant a reasonable extension of time, up to six months, for filing the return.[260]

C. The Generation-Skipping Transfer Tax

Like the estate and gift taxes, the generation-skipping transfer (GST) tax is an excise tax.[261] It is a tax on the gratuitous transfer of property to a person who is more than one generation below the generation of the transferor. Succinctly put, it taxes transfers that skip a generation, forcing every generation to pay a transfer tax even if the generation did not get the benefit of the property transferred. The GST tax mainly is a device for closing the loophole that exists in the estate and gift taxes for transfers of property from one generation to another without any tax. [262] For example, assume Grandfather dies leaving $10,000,000 to Father who lives off the income but not the principal; Father dies, leaving the $10,000,000 to Granddaughter. In this scenario, the transfer to Father is subject to estate tax because the property is included in Grandfather's gross estate, and the transfer to Granddaughter is subject to estate tax because the property is included in Father's gross estate. The property benefited two generations, and there were two transfer taxes. Assume, however, that Grandfather leaves $10,000,000 in trust to Father for life, remainder to Granddaughter. In this scenario, the transfer to the trust is fully taxed to Grandfather or his estate; when Father dies, however, there is no further tax because

257. *Id.* § 6019(1). See *supra* notes 243–46 and accompanying text, for a discussion of this exclusion.

258. I.R.C. § 6019(2); *see supra* note 225 and accompanying text.

259. I.R.C. § 6075(b).

260. *Id.* § 6081(a).

261. For a detailed discussion of the GST tax, see Carol A. Harrington, *Generation-Skipping Transfer Tax,* Tax Mgmt. (BNA) No. 850-2d (2010); STEPHENS ET AL., *supra* note 11, at chs. 12–18; Joshua S. Rubenstein, *Understanding Estate, Gift & Generation-Skipping Transfer Taxes 2002, in* TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES: UNDERSTANDING ESTATE, GIFT & GENERATION-SKIPPING TRANSFER TAXES 2002, at 7 (2002), *available at* WESTLAW, 317 PLI/Est 7.

262. The ideal gratuitous transfer tax should do three things: (1) tax inter vivos and at-death transfers the same, (2) create the same amount of tax liability irrespective of the form of the transfer, and (3) apply once each generation. The GST tax is designed to foster the last requirement.

Father's interest terminated at death.[263] Thus, the property benefited two generations, but there was only one transfer tax. The GST tax is a device for closing this opportunity.

The GST tax is triggered by any one of three events: "(1) a taxable distribution, (2) a taxable termination, [or] (3) a direct skip."[264] All involve transfers of property to "skip persons." A skip person is one who is two or more generations below the transferor.[265] The generation to which a transferee belongs is determined in accordance with mechanical rules. For lineal descendants of the transferor, one need only count generations. For example, a grandchild is two generations below a grandparent.[266] For transferees who are not lineal descendants, generation assignments are made on the basis of the date of birth of such transferees in relation to the transferor's date of birth.[267]

The direct skip is perhaps the easiest triggering event to comprehend. A direct skip is a transfer, subject to estate or gift tax, to a skip person.[268] To illustrate a direct skip, assume that Grandfather dies leaving $1,000,000 to Grandchild. This transfer is a direct skip because it is subject to the estate tax, and it is a transfer to someone two generations below the transferor.[269]

Taxable terminations are terminations of any interest held in trust, unless after the termination (1) the interest is held by a non-skip person, or (2) there can be no distributions from the trust to a skip person.[270] To illustrate, Father establishes a lifetime trust, with income to be paid to himself for life, then to Son for life, and then remainder to Grandson. At Father's death, with Son surviving, enjoyment of the

263. Father had nothing at death and his life estate was not a retained life estate triggering § 2036 inclusion. *See supra* Part II.A.2.c.

264. I.R.C. § 2611(a).

265. *Id.* § 2613(a)(1). A skip person can also mean a trust "if all interests in such trust are held by skip persons," or "if there is no person holding an interest in such trust," and "at no time after such transfer may a distribution . . . be made from such trust to a non-skip person." *Id.* § 2613(a)(2). A "non-skip person" is "any person who is not a skip person." *Id.* § 2613(b).

266. *See id.* § 2651(b)(1). The transferor's spouse, as well as children, nieces, and nephews are not skip persons. *See id.* § 2651(b)(2), (c).

267. *See id.* § 2651(d). If an unrelated transferee is not more than 12 1/2 years younger than the transferor, he is assigned to the transferor's generation. If an unrelated transferee is more than 12 1/2 years younger but not more than 37 1/2 years younger than the transferor, the transferee is assigned to one generation below the transferor. Each 25 years thereafter, the transferee is assigned to a new generation. *Id.*

268. *Id.* § 2612(c)(1).

269. This illustration assumes that Father (Grandfather's child) was still living at the time of transfer. There is a special rule, however, that applies when the child of the transferor is dead. In such case, the grandchild is assigned to the parent's generation and the great-grandchild is assigned to the grandchild's generation. *Id.* § 2651(e)(1)(B). Thus, when the child is deceased, a transfer from a grandparent to a grandchild is not subject to the GST tax because the grandchild is assigned to a generation that is only one generation below the transferor.

270. *Id.* §§ 2611, 2612(a).

property shifts to Son who is a non-skip person. Therefore, termination of Father's interest is not a taxable termination. However, at Son's death, with Grandson surviving, enjoyment of the property shifts to Grandson, who is a skip person (one who is more than two generations below Father's). This shift constitutes a taxable termination subject to the GST tax.

Taxable distributions are distributions from a trust to a skip person.[271] When a trust distributes to someone assigned to two or more generations below the generation of the transferor (usually the settlor of the trust), there is a taxable distribution. For example, in a transfer of property to Child and Grandchild for the life of Child, remainder to Grandchild, the distribution of income to Grandchild is a taxable distribution. The amount against which the GST tax is levied (the "taxable amount") varies depending upon several factors, including whether it arises out of a direct skip, taxable termination, or taxable distribution. In general, the taxable amount is the fair market value of the property interest passing to the skip person,[272] valued at the time of the transfer.[273] The tax is computed by multiplying the "taxable amount" by the "applicable rate."[274] This is not as simple as it appears because the applicable rate must be derived through a number of computational steps.[275]

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271. *Id.* §§ 2611(a)(1), 2612(b). If a taxable distribution is also a taxable termination or direct skip, the taxable distribution rules do not apply; instead, the taxable termination or direct skip rules will apply. *Id.* § 2612(b).

272. *Id.* § 2602 (stating the amount of the GST tax as the "taxable amount" multiplied by the "applicable rate."). *See id.* §§ 2621 (defining taxable amount in the case of taxable distributions), 2622 (defining taxable amount in the case of taxable terminations, 2623 (defining taxable amount in the case of direct skips).

273. *Id.* § 2624(a). The Code provides for use of an alternate valuation date. *Id.* § 2624(b), (c).

274. *Id.* § 2602.

275. The applicable rate is the product of the "maximum federal estate tax rate" and "the inclusion ratio" for the transfer. I.R.C. § 2641(a). The maximum federal estate tax rate is the highest marginal rate imposed by § 2001(c), which is currently 35%. *Id.* § 2641(b). Thus, 35% X the inclusion ratio = the applicable rate. The inclusion ratio with respect to the transfer is the excess of one over "the applicable fraction" determined for the trust from which the transfer is made, or, in the case of a direct skip, the applicable fraction determined for the skip. *Id.* § 2642(a)(2). Thus, 1 – the applicable fraction = the inclusion ratio. The applicable fraction is a fraction, the numerator of which is the amount of the $5,000,000 GST exemption provided by § 2631 which has been allocated to the trust or to the direct skip. *Id.* § 2642(a)(2)(A). Recall that the allocation of the exemption amount is elective by the transferor or, in the absence of the election, is specified by statute. The denominator of the applicable fraction is generally the value of the property transferred. *Id.* § 2642(a)(2)(B). Thus, the GST exemption allocated to the trust or direct skip divided by the value of the property transferred equals the applicable fraction. The $5,000,000 exemption amount was adopted in The Tax Relief Act of 2010 and, like the other transfer tax provisions in that act it is scheduled to sunset on December 31, 2012. *See* CCH 2010 ANALYSIS, *supra* note 9, ¶ 105. If that happens, it will revert to $1,000,000. *Id.* Similarly the 35% maximum rate is slated to sunset on De-

The GST tax is designed to be a powerful impediment to the use of transfers which skip generations for tax avoidance purposes. There are several tools which ameliorate this effect in some cases. Of significance to the estate planner is a $5,000,000 GST exemption per transferor, which the transferor may allocate to any particular transfers as she chooses.[276] There are special rules for designating how the exemption is used in the absence of a specific allocation by the transferor.[277] If the GST transfer is a gift for which the transferor and her spouse have elected to use the gift-splitting device under § 2513,[278] they also are allowed to split the transfer for GST tax purposes.[279] In this way, one spouse can take advantage of the other spouse's GST exemption. It should be noted further that inter vivos GSTs also receive the benefit of the annual gift tax exclusion and the exclusion for certain qualified educational and medical expenditures, which were discussed earlier.[280]

This article simplifies many aspects of the GST tax, as its operation is quite complex.

III. FUNDAMENTAL ESTATE PLANNING TOOLS

For some clients, tax savings are not of first importance; rather, designating recipients of wealth and timing the disposition of property are of first concern. In such cases, the estate planner must evaluate the transfer tax consequences of the client's plan and recommend alterations to the plan for minimizing overall tax costs. Many clients, in contrast, have no plan and seek the planner's advice regarding tax and non-tax considerations. In either case, the estate planner must have a working knowledge of the wealth transfer taxes. This article has provided a general overview of the federal estate and gift and generation-skipping transfer (GST) taxes and now discusses a few fundamental estate planning techniques.

A. Annual Gift Tax Exclusion, Gift Splitting, and Leveraging the Credit

If a client intends to transfer substantial wealth, it usually is advisable for the client to make some inter vivos gifts. The annual gift tax exclusion permits a client to transfer tax free up to $13,000 each year to an unlimited number of donees.[281] Because such gifts do not enter the

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cember 31, 2012, and revert to 55%. *Id.* For year 2010 The Tax Relief Act of 2010 revived the GST tax but established a zero rate. *See id.* at 361–62.

276. I.R.C. §§ 2631(a), 2632(a). See *supra* note 275, for a discussion of the sunset of the exemption amount.

277. I.R.C. § 2632(b), (c).

278. See *supra* Part II.B.4 for a discussion of I.R.C. § 2513.

279. I.R.C. § 2652(a)(2).

280. *Id.* § 2642(c) (citing I.R.C. § 2503(b), (e)). *See supra* Part II.B.4 for a discussion of these exclusions.

281. *See supra* Part II.B.4.

gift tax base, they will not use up any of the unified credit, which can be left available for other transmissions of wealth. Gifts to grandchildren and great-grandchildren, if they qualify for the annual exclusion, will not be subject to the GST tax[282] and will use up none of the $5,000,000 GST tax exemption. If a husband and wife utilize the split-gift provision of § 2513, a gift by one or the other will be considered as made one-half by each spouse.[283] Thus, the couple can effectively double the annual exclusion and transfer tax free up to $26,000 annually to each donee. To the extent gifts are swallowed by the annual exclusion, a gift tax return does not have to be filed.[284]

The $13,000 annual gift tax exclusion is available only for gifts of present interests in property. The question arises whether a gift to a guardian or trustee for the benefit of a minor is a gift of a present interest and thus qualifies for the annual exclusion.[285] Section 2503(c) provides a useful planning tool in which such a gift, which is not outright or immediately enjoyable by a minor beneficiary, may nevertheless qualify for the annual exclusion.[286] Both the income interest and the principal will qualify for the annual exclusion if (1) the property and income may be expended by or for the benefit of the donee before he attains the age of twenty-one years, and (2) to the extent not disposed of, the property will pass to the donee when he turns twenty-one or, if he dies before that age, will be payable to the donee's estate or as he may appoint under a general power of appointment.[287] The Service has taken the position that gifts under the Uniform Gifts to Minors Act and state statutes in such form qualify for the annual exclusion.[288] The downside of this tax planning technique is that it may place substantial wealth in the hands of young people at a time when they are not mature enough to manage that wealth responsibly. This has led to efforts by planners to limit access to the wealth, while still qualifying under § 2503(b) for the annual

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282. I.R.C. § 2642(c)(3)(A); *see supra* Part II.C.

283. I.R.C. § 2513(a); *see supra* Part II.B.4.

284. *See supra* Part II.B.4.

285. For a detailed analysis of the tax consequences of gifts to minors, see Henry J. Lischer, Jr., *Estates, Gifts and Trusts: Gifts to Minors*, Tax Mgmt. (BNA) No. 846-2d (2005); PRICE & DONALDSON, *supra* note 11, §§ 7.29 to 7.40.

286. I.R.C. § 2503(c); *see supra* Part II.B.4.

287. I.R.C. § 2503(c). The Ninth Circuit, in *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), previously adopted the rule that a withdrawal or demand power given to a minor would qualify a transfer in trust as a present interest. *See* Cristofani v. Comm'r, 97 T.C. 74 (1991) (allowing annual exclusion for transfers in trust for minor grandchildren despite the lack of a vested present interest or vested remainder interest in trust). A gift will qualify for the annual exclusion if either the requirements of § 2503(e) or the tests of *Crummey* are satisfied. Note that *Crummey* powers often are utilized in Irrevocable Life Insurance Trusts, discussed *infra* Part III.E.

288. Rev. Rul. 59-357, 1959-2 C.B. 212. The Idaho Uniform Transfers to Minors Act would satisfy the requirements of § 2503(c). *See* IDAHO CODE ANN. §§ 68-801 to -825 (2010).

exclusion. In *Cristofani v. Commissioner*,[289] the Tax Court allowed the annual exclusion for transfers in trust for minor beneficiaries despite the fact that the minors only held unexercised demand rights and contingent remainder interests in the trust.[290] According to the court, a present interest exists when the beneficiaries have an unrestricted legal right to withdraw trust corpus, and it does not require that the beneficiaries will actually receive present enjoyment of the trust at some future time.[291] The Tax Court stated that the annual exclusion is available despite the lack of a vested present interest or vested remainder interest in the trust income or corpus.[292] While one may wonder at the court's logic, it is clear that *Cristofani* represents a planning opportunity.

In addition to the annual gift tax exclusion, an unlimited exclusion is also available for amounts paid, on behalf of an individual, directly to an educational institution for tuition payments, or directly to a health care provider for medical expenses.[293] As with gifts qualifying for the $10,000 annual exclusion, such transfers are also exempt from the GST tax and, hence, can be made on behalf of grandchildren or great grandchildren.[294]

Use of the gift tax exclusions permits inter vivos transmissions of wealth to be achieved at little or no tax cost. It also ensures that the unified credit will be preserved for the estate's later use.[295] In some instances, however, it is prudent to utilize the credit during life. With the $5,000,000 exemption-equivalent of the unified credit, substantial wealth can be transferred during life over and above those amounts qualifying for gift tax exclusions and deductions at little or no tax cost. Although the amount of the credit available to the estate will be decreased or eliminated, an estate freeze can be accomplished by utilizing the credit during life. If property is rapidly appreciating in value, an inter vivos gift will ensure that future appreciation escapes transfer tax. This is one way of "leveraging" the credit. The client will take a gift tax hit only to the extent the value of the property exceeds the exemption-equivalent of the unified credit or what is remaining of the credit if taxable gifts were made in previous years. There is a downside to this approach. As discussed in the next section, property transferred during life does not get the § 1014 basis step-up. But the transfer tax savings will often more than offset this income tax consideration. An added reason to consider inter vivos gifting is the scheduled sunset of the $5,000,000 applicable exclusion amount on December 31, 2012. If Congress takes no action, the exclusion amount will fall to $1,000,000 on January 1, 2013.

289. 97 T.C. 74 (1991).
290. *Id.* at 83.
291. *Id.* at 80.
292. *Id.*
293. I.R.C. § 2503(e); *see supra* Part II.B.4.
294. I.R.C. §§ 2642(c)(3)(B), 2503(b); *see supra* Part II.C.
295. See *supra* Parts II.A.4.a and II.B.4 for discussion of the unified credit.

Consequently, high net worth individuals should consider whether to make inter vivos gifts before that date. But we must offer a word of caution here. Tax savings alone may not justify gift giving. For example, a single client age 60 with a net worth of $6,000,000 could give away $5,000,000 before January 1, 2013, in order to assure that there is no transfer tax applicable to that sum no matter what action Congress may take in the future. Assuming that client has a 15 to 20 year life expectancy, would it be sensible to give away over three quarters of her wealth? Probably not. On the other hand the same person with a net worth of $20,000,000 might well choose to make a $5,000,000 gift before January 1, 2013, in order to lock in the tax savings.

B. Marital Deduction and Unified Credit

One may make inter vivos gifts to his or her spouse to take advantage of the gift tax marital deduction.[296] Such gifts become especially important when one spouse owns substantial property while the other does not. If the spouse with substantial property dies first, he will be able to utilize what is left of his unified credit. Historically, if the spouse with little or no property died first, however, her unified credit was wasted. The unified credit portability rules introduced in The Tax Relief Act of 2010[297] promise to change this outcome if they remain on the books beyond their currently scheduled sunset date of December 31, 2012. At the present time, however, it would be imprudent to rely upon them for planning purposes.[298]

One way for the spouses to fully utilize the credit shelter of the less wealthy spouse is to balance the estates using the unlimited marital deduction under § 2523.[299] The husband can make inter vivos gifts to his wife to reduce his estate and utilize her credit. To the extent possible, the transferor spouse should gift property having a high income tax basis and should retain low basis property. The donee of a lifetime gift generally must take the donor's own basis as his or her basis in the gifted property.[300] Upon the transferor's death, the "low basis" property retained and transferred at death will receive a "stepped-up" basis equal to the property's fair market value at the date of death.[301] For spouses in a community property state, one can transmute separate property into

296. I.R.C. § 2523; *see* discussion *supra* Part II.B.4.

297. I.R.C. §§ 2010(c)(2)(B), (c)(4), 2505(a); *see* discussion *supra* Part II.A.4.a.

298. An interesting projection by one commentator is that marriage rates among the well-to-do elderly will rise for the next two years. *See* CCH 2010 ANALYSIS, *supra* note 9, ¶ 705, at 359.

299. I.R.C. § 2523; *see* discussion *supra* Part II.B.4.

300. I.R.C. § 1015(a).

301. *Id.* § 1014(a)(1). If the property is valued six months after the date of death, pursuant to the election under § 2032, the property's basis will be determined as of that date, rather than the date of death. *See id.* § 1014(a)(2).

community property to equalize the estates. However, state law ramifications should be considered. The estate tax marital deduction is an equally important planning tool for married persons. The deduction allows a spouse to transfer at death an unlimited amount of property to his or her surviving spouse tax free under the assumption that the surviving spouse will be taxed on the property when she subsequently dies.[302] If all of a decedent's property is transferred in fee simple to his surviving spouse, however, the decedent's unified credit cannot be utilized.[303]

The unified credit should normally be utilized to the fullest extent possible, as the marital deduction serves only to postpone payment of tax until the second spouse dies, while the unified credit avoids tax on $5,000,000 altogether.[304] Accordingly, estate planners must understand the need to balance the use of the marital deduction against the use of the unified credit. The marital deduction is not a substitute for the unified credit, but something that should be used in tandem with the credit if spouses have big enough estates to worry about taxes.

To prevent the marital deduction from defeating or wasting the credit, a credit shelter or bypass trust can be utilized, or transfers can be made to persons other than the surviving spouse. A credit shelter trust is designed so that the decedent's property passing into the trust will avoid or bypass tax in the estate of the second spouse to die. Because the property will not be included in the surviving spouse's estate upon her death, the decedent spouse will not receive a marital deduction for that property but will be able to utilize the unified credit. If the property equals the exemption equivalent of whatever remains of the unified credit, then no tax will be owed by the first spouse to die. To ensure that the correct amount of property is put in the credit shelter or bypass trust to zero out the estate, a planner should use a "cut back" clause. Such clause provides, in general, that in no event should the amount of the marital deduction be more than necessary to reduce the federal estate tax liability to zero, taking into account other deductions and whatever is remaining of the unified credit.[305] But it is also necessary to consider that fully utilizing the greatly enlarged unified credit creates the risk that the surviving spouse will be inadequately supported.[306] One way to address this concern is to make the surviving spouse the life beneficiary of the creditor shelter trust or to use the QTIP trust described below. Another strategy might be to draft the client's will with

302. *See supra* Part II.A.3.c.

303. The marital deduction is mandatory and unlimited. *See supra* Part II.A.3.c.

304. *See supra* Parts II.A.3.c, II.B.4.

305. For typical formula clauses, *see* Jeffrey N. Pennell, *Estate Tax Marital Deduction*, Tax Mgmt. (BNA) No. 843-2d, at A-121 to -124 (2004); Streng, *supra* note 16, at A-63 to -64; PRICE & DONALDSON, *supra* note 11, §§ 5.32 to 5.40.

306. *See* CCH 2010 ANALYSIS, *supra* note 9, ¶ 705.

alternative clauses depending on the size of the unified credit and the size of the estate on the date of death.

If the decedent spouse wishes to provide for his surviving spouse during life, but also would like to protect the remainder for his children, then an outright transfer of property qualifying for the marital deduction to the surviving spouse may not be prudent. The client's goal can be achieved by creating a second trust, sometimes called a "marital deduction" trust.[307] This trust gives the surviving spouse an interest in property that will be taxable in her estate and, therefore, deductible in the decedent's gross estate. The QTIP trust is a very flexible marital deduction trust.[308] It allows the decedent to qualify property for the marital deduction and to take care of the surviving spouse through a life estate. In addition, it permits the decedent to keep control over the ultimate disposition of the property and, for example, take care of children from a prior marriage. The QTIP trust provides opportunity for post-mortem estate planning, in that the marital deduction is available on an elective basis. Pursuant to proper instruction from the decedent, the executor can exercise the election in a manner that utilizes the full benefit of the decedent's unified credit.

In the marital deduction trust (property that qualifies for the marital deduction) and the credit shelter trust (property that does not qualify for the marital deduction), the surviving spouse is given an income interest in each. She could also be given the power to invade the corpus of each. If the surviving spouse is given a power that is limited by an ascertainable standard relating to her (or her legal dependent's) health, education, support, or maintenance,[309] it is better that she consume the corpus of the marital deduction trust before she consumes the corpus of the credit shelter trust. This is because the corpus of the marital deduction trust, and not that of the credit shelter trust, will be included in the surviving spouse's gross estate.

To provide additional security to the surviving spouse, while avoiding adverse estate tax consequences, the surviving spouse can be given a lapsing general power of appointment limited to the greater of $5,000 or five percent of the corpus.[310] The $5,000 or five percent power can be an important estate planning tool because it can be used to care for the

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307. The two most common marital deduction trusts are the § 2056(b)(5) power of appointment trust and § 2056(b)(7) QTIP trust. *See* I.R.C. § 2056(b)(5), (7). In each of these, the surviving spouse will have inclusion of the trust corpus in her estate when she dies, even though she has a terminable interest. *Id.* §§ 2041, 2044. Therefore, a marital deduction is permitted to the decedent. *See supra* Part II.A.3.c. For selection and drafting considerations, see, *e.g.*, Pennell, *supra* note 305, at A-109 to -119e.

308. *See supra* Part II.A.3.c. For discussion of when to use the QTIP, see HENKEL, *supra* note 11, ¶ 4.02[2][a].

309. *See supra* Part II.A.2.h. Such power is not considered a general power of appointment and, therefore, will not cause inclusion of the trust corpus in the gross estate.

310. See *supra* Part II.A.2.h, for a discussion of the $5,000 or five percent lapse rule.

surviving spouse without increasing that person's potential gross estate significantly. As long as the power to invade is limited to the greater of $5,000 or five percent annually, the only potential inclusion from the trust in the gross estate of the survivor is $5,000 or five percent in the year of the surviving spouse's death (the property subject to a power held at death). The surviving spouse is, thus, in the position of being able to invade the corpus to a limited extent if she needs to do so. But if she lets the power to invade lapse in any particular year, there is no resulting inclusion in her gross estate even though she has an income interest in the trust. To avoid the $5,000 or five percent inclusion in the year of death, the time period over which the spouse can exercise the power should be restricted.[311]

C. Disclaimers

The planner can use the qualified disclaimer in a variety of circumstances to produce federal tax benefits.[312] In the marital deduction context, it can be an important post-mortem estate planning device. A surviving spouse may disclaim property to reduce the amount of the marital deduction transfer and effectively utilize the decedent's unified credit (reducing the size of the surviving spouse's gross estate). Accordingly, the disclaimer is an important alternative to the QTIP election by the executor and the marital deduction formula provision.[313] The disclaimer may be used by financially secure beneficiaries, after which property might pass to the disclaimant's children in trust or to designated charitable remaindermen in a way that will qualify for the charitable deduction.[314] The disclaimer also may be used by grandchildren or great-grandchildren to eliminate any GST tax consequences on a bequest to same.[315] The planner must advise beneficiaries of the opportunities and consequences of a disclaimer.[316]

Estate planners have developed important devices for transferring substantial property during life with little or no resulting gift tax consequences. This article will discuss a few of these advanced tools, namely the family limited partnership and limited liability company, the irrevocable life insurance trust, and the qualified personal residence trust.

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311. PRICE & DONALDSON, *supra* note 11, § 10.24; STEPHENS ET AL., *supra* note 11, ¶ 4.13(7)(f) n.109 (noting a common method to avoid inclusion is to limit exercise to "a particular month of the year or a particular day of each month").

312. For use of disclaimers in estate planning, see Christopher P. Cline, *Disclaimers—Federal Estate, Gift and Generation-Skipping Tax Considerations*, Tax Mgmt. (BNA) No. 848-2d (2005); Streng, *supra* note 16, at A-59 to -60; A-243 to -246; PRICE & DONALDSON, *supra* note 11, § 12.32 to .36.

313. PRICE & DONALDSON, *supra* note 11, § 12.36; Streng, *supra* note 16, at A-243.

314. PRICE & DONALDSON, *supra* note 11, § 12.36.

315. *Id.*

316. *Id.*

D. Family Limited Partnerships and Limited Liability Companies

Family Limited Partnerships (FLP's) and Limited Liability Companies (LLC's) are very popular, and controversial, tools for estate planners with high net worth clients.[317] In a typical FLP or LLC, a client transfers appreciated property to the entity in a tax free exchange for a small managing interest and a large non-managing interest.[318] The client retains the managing interest and subsequently gifts the non-managing interest to children or grandchildren. By retaining the managing interest, the client can retain control over the property transferred. By transferring the non-managing interests, the client can transfer the underlying property, and all future appreciation and income attributable to it, at minimal gift tax cost. A wide array of assets can be used to fund these entities, even marketable securities,[319] but the assets best calculated to withstand the government scrutiny discussed below are operating businesses.

The transfer tax cost is minimized because of the availability of substantial discounts in valuing the transferred interests. Valuation discounts are allowed because of the minority status of the gifted interests and their lack of marketability, or a combination of the two.[320] These discounts, in conjunction with the annual gift tax exclusion and split-gift provision, can be used to maximize annual gifts. Accordingly, these entities are useful tools to arrange a client's property so as to depress its

317. For detailed discussions of FLPs and LLCs, see Louis A. Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, Tax Mgmt. (BNA) No. 812-3d (2009); Howard M. Zaritsky, *The Year in Review: An Estate Planning Perspective on Recent Tax Developments*, 35 EST. GIFTS & TR. J. 3, 15–26 (2010); Louis A. Mezzullo, *Recent Cases Affecting FLPs and LLCs*, 34 AM. C. OF TR. AND EST. COUNS. J. 88 (2008). *See also* Mary F. Radford, *Ethical Challenges in Representing Families in Family Limited Partnerships*, 35 AM. C. OF TR. AND EST. COUNS. J. 2 (2009). This article examines the ethical issues that a lawyer may encounter when representing family members and a FLP in the context of a case study. It covers conflicts of interest and duties relating to client information and suggests courses of action for estate planning lawyers.

318. For tax purposes most FLPs and LLCs are partnerships governed by Subchapter K. *See* I.R.C. 701 et seq. From a non-tax perspective they are quite different animals governed by state law. For analysis of the choice of entity considerations see Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, *supra* note 317, at Part VI, A-47 et seq. In a FLP the managing interest is a general partnership interest and a non-managing interest is a limited partnership interest. In an LLC the managing/non-managing distinction usually rests on voting rights or lack thereof. *See id.* at III.F.2 & 3, A-12 to -17.

319. *See* Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, *supra* note 317, Part III.H, p. A-17.

320. *Id.* As noted earlier, the general standard for valuing transfers subject to transfer taxes is the fair market value of the property. *See* discussion *supra* Parts II.A.1, II.B.3; *see also* Rev. Rul. 59-60, 59-1 C.B. 237 (establishing criteria the Service will use in valuing closely held corporations); Harwood v. Comm'r, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986). Nevertheless, as we will discuss minority discounts and lack of marketability discounts have been upheld for gifted limited partnership interests.

value for gift tax purposes. However, the government has contested the tax advantages claimed by taxpayers in a great many cases, mostly involving FLPs, and has prevailed in a number of them.[321] The primary weapon in the government's arsenal for attacking the discounts claimed by taxpayers is § 2036.[322] Recall that this provision draws back into the gross estate for estate tax purposes certain remainders given away during life.[323] Its application to FLPs has often involved factors that undermine the finding of a business purpose for the entity such as deathbed formations, failure to honor the formalities of formation and operation, disproportionate distributions, funding with personal use assets, and lack of proper accounting for income and distributions. The legal analysis in these cases often turns on whether full and adequate consideration was received during formation. But the underlying logic in the cases where taxpayers have lost is that the entity was a mere device to pass an interest that did not truly come into enjoyment until the transferor's death.

Because of the high degree of governmental scrutiny they attract, a general practitioner handling an occasional estate planning client should consult specialized counsel when advising the use of a FLP or an LLC for estate planning purposes. Moreover, there are more than transfer tax issues to consider. For example, § 704(e) prescribes elaborate requirements that must be satisfied before a donee of a limited partnership interest will be treated as a partner for federal income tax purposes.[324] In addition, a number of issues should always be considered, such as the possibility of using an S corporation, a trust, or other entity. Estate planning with the use of entities is a rapidly evolving area. A planner in the field must be certain of having current information.

E. Irrevocable Life Insurance Trusts

An asset easily transferred during life is a life insurance policy. If an insured transfers all incidents of ownership in a life insurance policy to the beneficiary, the proceeds of such policy generally will not be in-

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321. *See generally* Mezzullo, *Recent Cases Affecting FLPs and LLCs, supra* note 317; *see also* JEROME OSTROV, TAX AND ESTATE PLANNING WITH REAL ESTATE, PARTNERSHIPS AND LLCS, § 14:4-5 (2d ed. 2009) (updated annually).

322. Mezzullo, *Family Limited Partnerships and Limited Liability Companies, supra* note 317. But other lines of attack are possible. OSTROV, *supra* note 321.

323. *See* discussion *supra* Part II.A.2.c.

324. Treas. Reg. § 1.704-1(e) (as amended in 2008). Items of income, gain, loss, and deduction pass through to partners of a FLP; the potential exists to shift income from the client to the donees (limited partners), who may be in lower income tax brackets. However, the requirements of § 704(e) must be met. For instance, the donee has to be the real owner of his partnership interest. *Id.* (listing factors to be considered in determining real ownership). The donee must receive a capital interest in the FLP. *Id.* In addition, the donee's interest must be a material income-producing factor in the FLP. *Id.*

cluded in the transferor-insured's gross estate.[325] Although the proceeds of the policy will escape inclusion in the insured's gross estate, the transferor may pay gift tax on the replacement value of the policy at the time of gift unless the donee is the spouse of the donor.[326] In addition, the remainder beneficiary will include whatever is left of the proceeds in her gross estate.[327] The Irrevocable Life Insurance Trust (ILIT) is an important device to remove life insurance proceeds from the estates of both the insured-transferor and the non-insured-life tenant, at little or no gift tax cost.[328]

In its simplest form, the insured irrevocably transfers ownership of an insurance policy to the trustees of a trust.[329] The trust terms can provide for an income interest to spouse, remainder to children or grandchildren. If structured properly, the estate tax consequences are simple. Nothing will be included in the insured's gross estate[330] and, similarly, the proceeds will not be included in the non-insured spouse's gross estate.[331]

The transfer of the life insurance contract to the trust may be subject to the gift tax on the replacement value of the policy.[332] Because the beneficiaries of the trust have a future interest, availability of the annual gift tax exclusion seems impossible. By using *Crummey* powers, however, the trust may be drafted so that the $13,000 annual exclusion is available.[333] A *Crummey* power is a demand or withdrawal power over the trust that converts a donee's future interest into a present interest

325. *See supra* Part II.A.2.i.

326. Treas. Reg. § 25.2512-6(a).

327. Whatever is left of the proceeds would be included under § 2033. *See supra* Part II.A.2.a.

328. For detailed information and model ILIT forms, see Georgiana J. Slade, *Personal Life Insurance Trusts*, Tax Mgmt. (BNA) No. 807-2d (2009) and James Spallino, Jr., *Drafting and Administering Irrevocable Life Insurance Trusts: The Basics and Beyond*, 20 OHIO PROB. L.J. 91 (2009). This article covers ILITs, admittedly with an Ohio focus for the fiduciary duties of the ILIT trustee. *See also* PRICE & DONALDSON, *supra* note 11, § 6.24.

329. The transferor must be careful not to retain any incidents of ownership. *See supra* Part II.A.2.i. The trust may be unfunded, in which case any premiums paid later will constitute additional gifts. If the trust is funded, sufficient funds are also transferred to the trustee to satisfy premium payments.

330. The trustee must not be obligated to use the insurance proceeds for the benefit of the insured's estate. I.R.C. § 2042. In addition, the insured must have retained no incidents of ownership over the policy. *Id.* § 2042(2); *see also supra* Part II.A.2.i. Note also that the insured-transferor must survive the transfer by three years or more to avoid estate inclusion under § 2035. I.R.C. § 2035(a)(1).

331. *Id.* § 2033; *see supra* Part II.A.2.a. The non-insured spouse will not have inclusion provided she made no transfers to the trust, I.R.C. § 2036, nor had a general power of appointment over the trust corpus, I.R.C. § 2041. For a discussion of the $5,000 and five percent power, *see supra* Part II.A.2.h,

332. *See supra* Part II.B.3. Note that the value of the policy for gift tax purposes can be reduced prior to the gift by borrowing against the policy.

333. *See* STEPHENS, *supra* note 11, ¶ 9.04(3)(f).

for purposes of the annual exclusion.[334] Accordingly, gift tax can be minimized or avoided altogether if each beneficiary is given such power over the trust. The GST tax can also be eliminated by using the annual gift tax exclusions.[335] In practice, the *Crummey* power is usually limited to $5,000 or five percent to avoid any tax problems associated with a lapse of the power.[336]

F. Qualified Personal Residence Trusts

Another powerful estate planning tool that permits a donor to transfer certain property in trust to avoid gift and estate taxes is the Qualified Personal Residence Trust (QPRT).[337] Because of an exception in the estate freeze rule of § 2702, a donor can irrevocably transfer a personal residence in trust, retain a term interest for himself, and designate certain family members as remainder persons with minimal gift or estate tax costs.[338] As noted earlier in the tax portion of this article, § 2702 provides a special rule for transfers of interests in trust to, or for the benefit of, a member of the individual's family, when the transferor or an applicable family member retains an interest in the trust.[339] With certain exceptions, § 2702 values the retained interest of the transferor at zero so that the amount of the gift is the full value of the donated property for gift tax purposes. In the case of a QPRT, however, the donor's retained income interest is not valued at zero, but rather may be overvalued pursuant to the QPRT valuation rules which are beyond the scope of this article. This reduces the value of the remainder interest, resulting in less gift tax. As long as the term of years expires before the transferor dies, there will be no estate tax inclusion.

The regulations under § 2702 provide a number of requirements for a trust arrangement to qualify as a QPRT. For instance, the home must be a "residence" of the donor, but not necessarily the primary resi-

334. See *supra* Part III.A and note 287, for a discussion of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

335. *See supra* Part II.C.

336. See *supra* Part II.A.2.h, for a discussion of the $5,000 and five percent power.

337. *See* Jonathan G. Blattmachr et al., *Partial Interests – GRATs, GRUTs, QPRTs*, Tax Mgmt. (BNA) No. 836 (2009); OSTROV, *supra* note 321, § 13.7; Jeremy T. Ware, *Using QPRT's to Maximum Advantage for Wealthy Clients*, 32 EST. PLAN. 34 (Nov. 2005); J. Michaels & Laura M. Twomey, *Qualified Personal Residence Trusts Offer Helpful Planning Options for Potentially Large Estates*, N.Y. ST. B. J., Nov.–Dec. 2003, at 10; *see also* Steven E. Alkire, *QPRT—A Tool of the Estate Planning Trade*, ADVOCATE, Sept. 1995, at 14; Joseph M. Mona, *A Close Examination of the Qualified Personal Residence Trust*, TR. & EST., Oct. 1994, at 67; Ameek Ashok Ponda, *Using Qualified Personal Residence Trusts*, TAX NOTES TODAY, May 18, 1995, at 97-65; Angelo F. Tiesi, *Qualified Personal Residence Trusts—Give Your Home Away and Live in it Too*, TAXES, Feb. 1994, at 82.

338. If the donor does not survive the term, the value of the residence will be included in his gross estate. *See* I.R.C. § 2036(a).

339. *See supra* notes 224–28 and accompanying text.

dence,[340] no assets other than the residence can be held in the trust,[341] and no one but the donor may receive distributions of trust corpus.[342] A lawyer drafting a QPRT should consult these regulations in detail.

G. The Generation-Skipping Transfer Exemption and Dynasty Trusts

If a client wishes to transfer wealth to individuals who are two or more generations removed from the client, the $5,000,000 generation-skipping transfer (GST) exemption is an important planning tool. As discussed earlier, the exemption shelters from tax $5,000,000 of direct skip transfers or transfers into generation-skipping trusts.[343] Planners should keep in mind that transfers excluded from gift tax, because of the $13,000 gift tax exclusion, are also excluded from the GST tax.[344] With the split gifting provision, substantial amounts can be gifted to skip persons without any GST tax implications.[345] Also important is the unlimited exemption for direct-skip transfers by a client to a grandchild whose parent predeceased the client.[346] Finally, spouses planning to make substantial generation skipping transfers should make sure to utilize fully each of their $5,000,000 exemption amounts.

Under the GST tax, each transferor has the discretion to allocate the $5,000,000 exemption to any particular transfer she chooses.[347] For many clients, it is advantageous to allocate the exemption to a long-term "dynasty trust."[348] In these trusts, clients transfer property in trust to pay the income to children for life, then grandchildren for life, then great-grandchildren for life, with remainders over. Estate and GST taxes can be avoided for several generations (e.g., the trust can accumulate for the perpetuities period). Lawyers who are dealing with dynasty trusts that qualify for the GST exemption should take care to comply with the state's rule against perpetuities, which governs the duration of trusts. In states that do not have the rule against perpetuities, such as Idaho, a dynasty trust can endure forever.[349] In states adopting the Uni-

340. Treas. Reg. § 25.2702-5(c)(2), -5(c)(7)(i) (as amended in 1997).
341. *Id.* § 25.2702-5(c)(5).
342. *Id.* § 25.2702-5(c)(4).
343. *See supra* Part II.C.
344. *See supra* Part II.C.
345. *See supra* Part II.C.
346. *See supra* Part II.C and note 265.
347. *See supra* Part II.C.
348. For overviews of dynasty trusts, see Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1318–19 (2003); Mary Louise Fellows & Gregory S. Alexander, *Forty Years of Codification of Estates and Trusts Law: Lessons for the Next Generation*, 40 GA. L. REV. 1049, 1081–82 (2006); and Jesse Dukeminier, *The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities*, 30 REAL PROP. PROB. & TR. J. 185 (1995).
349. The common-law rule against perpetuities is not in force in Idaho. Locklear v. Tucker, 69 Idaho 84, 203 P.2d 380 (1949). Idaho has adopted a system governing alienation

form Statutory Rule Against Perpetuities, ninety-year dynasty trusts are popular.[350]

IV. CONCLUSION

A lawyer who does any estate planning should have a working knowledge of the federal estate, gift, and GST taxes. This article has provided a general overview of each wealth transfer tax and has described fundamental planning tools in light of the impact of these taxes. The present instability of the law, especially with respect to the unified credit and the transfer tax rate structure, makes long range planning particularly challenging. Moreover, many new planning techniques will undoubtedly be tried and tested in the coming years. But each will draw upon the fundamentals addressed above. Accordingly, one with a working knowledge of the transfer taxes and planning fundamentals is positioned to follow the trends and adopt the new techniques as they develop. A final comment is in order, however. One who merely dabbles in this area is likely to get burned. A preferred approach, accordingly, is for the knowledgeable practitioner to consult with a tax planning specialist as she develops the estate plan of a client with a high net worth.

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of real property. IDAHO CODE ANN. § 55-111 (1979). Idaho has no suspension rule for personal property. *Id.* Accordingly, for dispositions of realty in trust, the trustee must have discretion or the power to sell the trust property to avoid any suspension problem. *See* Ira Mark Bloom, *Perpetuities Refinement: There is an Alternative*, 62 WASH. L. REV. 23, 57 n. 203 (1987). Some states, such as Delaware, have abolished the rule against perpetuities. *See* DEL. CODE ANN. tit. 25, § 503(a) (2000), discussed in Dukeminier & Krier, *supra* note 348, at 1314 n.44.

350. UNIF. STATUTORY RULE AGAINST PERPETUITIES § 1, 8B U.L.A. 236 (amended 1990). *But see* Dukeminier & Krier, *supra* note 348, at 1314 ("Florida has extended its USRAP wait-and-see period from ninety years to 360 years for any interest in trust. Washington now provides that no interest in trust is invalid for 150 years.").