BASIC TAX PLANNING

Presented at NBI, Estate Planning from A to Z, webinar broadcast on May 24 & May 25, 2016. A continuing education course provided to attorneys, financial planners, trust officers, accountants and CPA's to learn or review the basic concepts relating to the transfer of assets during life, or at death.

Estate Tax, Gift Tax, Generation Skipping Transfer Tax, and the Income Taxation of Estates and Trusts.

Presented at:

Estate Planning from A to Z

NBI, May 24 & May 25, 2016

BASIC TAX PLANNING

Estate Tax, Gift Tax, Generation Skipping Transfer Tax

Income Taxation of Estates and Trusts

Cameron R. Kelly
STILLWATER ESTATE & BUSINESS PLANNING

STILLWATER
ESTATE & BUSINESS PLANNING
105 New England Place, Ste. 230
Stillwater, MN 55082
(p) 651.705.6277 (f) 651.925.0647
www.stillwaterestateplanning.com

Basic Tax Planning

1. The Goal of Tax Planning

A commonly cited goal of estate planning is:

I want to control my property while I am alive, and plan for myself and my loved ones if I become disabled. When I die, I want to give what I want, to whom I want, in the way I want, and I want to do this with the least amount of cost and effort possible.

If you accept that as the goal of estate planning in general, what is the goal of tax planning for your client?

In my mind, it is the process of providing the most tax efficient plan possible, given the human constraints involved, such as: retaining control, achieving distribution goals, dealing with time and financial constraints, and addressing your client's unique family situation.

The tax planner should take into account the taxes that may impact their client, but will also need to tailor the plan to the specific goals and personality of the client. Some common examples of situations where the best tax approach is not necessarily the approach your client wants to follow are:

- The client who is unwilling to engage in complex planning because they are convinced that they have a "simple" estate;
- A client who currently has a taxable estate, and might benefit from disclaiming property, but does not feel financially secure enough to do so;
- A client who would benefit from systematic gifting, but wishes to retain control of their property;
- A client who wishes to make distributions in a way that does not maximize the benefits of tax planning.

While it may be the job of the planner to educate and stretch the client's thinking on some of these issues, it is ultimately the planner's job to carry out the client's wishes relating to the estate.

2. Federal Estate Tax Update

a. Inflation Adjusted Exemption / Exclusion

The basic exclusion amount under IRC § 2010(c)(3) was adjusted for inflation for 2016, and is now $5,450,000. The annual gift exemption under Section 2503 remains at $14,000.00. The annual gift exemption for non-citizen spouses under Sections 2503 and 2523(i) has been raised to $148,000.00. (Rev. Proc. 2015-53 §§ .33, and .35.)

b. Final DSUE Amount Regulations

The estate tax exemption is divided into a basic exclusion amount, which is currently $5.45 million, indexed annually for inflation, and the deceased spouse unused exemption amount ("DSUE Amount"). (IRC § 2010(c)(2).) The **DSUE Amount** is the amount of the deceased spouse's exemption amount in the year that he or she dies, minus any portion used on that spouse's estate or gift tax returns. (IRC § 2010(c)(4).)

The DSUE Amount is portable, from one spouse to another. In order for the surviving spouse to take advantage of the deceased spouse's unused exemption, the deceased spouse's executor must make an election on the estate tax return. (IRC § 2010(c)(5)(A).)

DSUE Amount was first introduced by the Tax Relief Unemployment Reauthorization and Job Creation Act of 2010, and later made permanent by the American Taxpayer Relief Act of 2012. Temporary regulations had set requirements for electing portability, and these requirements remain unchanged:

- Decedent must be a US citizen; (Reg. § 20.2010-2T(a)(5).)
- Portability must be elected on a timely filed Form 706; (Reg. § 20.2010-2T(a)(5).)
- The return must be complete and properly prepared; (Reg. § 20.2010-2T(a)(7).)

The new regulations are effective for decedents passing after June 13, 2015. Clarifications include, among other things:

- The **portability election** is to be made by the decedent's executor. If the executor does not make an election, it may be made by any person in actual or constructive possession of the decedent's property. (Reg. § 20.2010-2(a)(6).)
- The proper **calculation** of the DSUE Amount. (Reg. § 20.2010-2(c).)
- A **timely filed** return is:
  - In the case of an estate that is in excess of the basic exclusion amount, then within 9 months of the decedent's death;
  - In the case of a return that is filed solely for the purpose of electing portability, where the estate value is less than the basic exclusion amount, then an extension of time to file may be granted. (Reg. § 20.2010-2(a)(1).)

c. New FLP Valuation Discount Rules Expected

There have been indications that the IRS will release new regulations restricting the use of valuation discounts. For a number of years, the Treasury Department's greenbook proposed legislation that would have modified Section 2704 to restrict valuation discounts for family-owned entities. However, in 2013, that proposal was no longer included in the Department's greenbook.

In May of 2015, Cathy Hughes, from the Treasury Department's Office of Tax Policy, speaking at the ABA Tax Section Meeting, stated that regulations for Section 2704 would be released in September of 2015. As of March, 2016, these regulations have not yet been released, but it seems likely that regulations restricting the use of FLPs for the purpose of valuation discounts will come later in 2016. However, there are indications that the forthcoming regulations may not be as restrictive as first thought.

d. Reporting Requirements for Executors

New basis reporting rules came in the highway bill (Surface Transportation and Veterans Health Care Choice Improvement Act of 2015). The basis reporting rules were codified in Section 6035, which is applicable to returns filed after July 31, 2015. Although the effective date is past, the actual required filing date has been delayed twice.

Section 6035 requires the executor or other person required to file an estate tax return to also file a statement regarding the value of property distributed to beneficiaries. The statement should describe the property and state the value that was reported in the estate tax return. (IRC § 6035(a)(1).) The statement is due within 30 days after filing the estate tax return or any amendment, or within 30 days after the due date for the estate tax return, whichever comes first. In addition to providing the notice to the IRS, the notice will be provided to the beneficiary receiving property.

The Section 6035 notice will occur on **IRS Form 8971**. The purpose is to provide greater certainty and consistency in the reporting of basis in property. Section 1014 allows a step up in basis for property passing from a decedent. Form 8971 will notify both the beneficiary and the IRS of the value of property being passed, and the identity of the beneficiary receiving the property.

In addition to the new basis reporting rules in Section 6035, there are also **new basis consistency rules** found in Section 1014(f). This Section limits basis in the hands of a beneficiary to the amount reported in the decedent's tax return, and finally determined by the passage of time or by a court.

In addition to the codification of Section 6035 and the new Section 1014(f), **proposed regulations** have been issued. Some highlights of the proposed regulations:

- **Filing Threshold.** Form 8971 need not be filed with the IRS or sent to beneficiaries unless an estate tax return was required to be filed under Section 6018. Specifically, if a Form 706 is filed to allocate generation skipping transfer tax exemption, or to elect portability, Form 8971 will not be required. (Proposed Reg. § 1.6035-1(a)(2).) The consistency basis rules will also not apply. (Proposed Reg. § 1.1014-10(b)(3).)
- **Exempt Property.** Certain property does not require reporting under Section 6035, including: cash, IRD, tangible personal property for which an appraisal is not required, and property sold or exchanged where a gain or loss is recognized. (Proposed Reg. § 1.6035-1(b)(1).)

- **Supplemental Statements.** There is a duty on the part of the beneficiary to supplement statements if the beneficiary later gifts the property to another party. (Proposed Reg. § 1.6035-1(f).)
- **Consistency Rules.** A requirement that a taxpayer receiving property from an estate must later report basis that is consistent with the basis reported on the estate tax return and Form 8971. (Proposed Reg. §1.1014-10(b)(1).) However, this requirement does not apply to property qualifying for a marital or charitable deduction. (Proposed Reg. § 1.1014-10(b)(2).)
- **Basis Penalty.** Property that is not properly reported on the decedent's estate tax return may be assigned a basis of zero. (Proposed Reg. §1.1014-10(c)(3).)

The date for the initial filing of Form 8971 has been delayed twice. Once in Notice 2015-57 to February 29, 2016, and then again by Notice 2016-27 to June 30, 2016. The purpose of the delay is to allow additional time for filers to review and understand the reporting requirements.

3. Step-up Basis of Various Assets

a. Basic Application of the Basis Adjustment Rules

One potential benefit to passing property at death is the step up in basis available to the person acquiring the property. Section 1014 provides that the basis of the person acquiring the property shall be the fair market value of the property at the date of death. This adjustment in basis is often referred to as a step up in basis.

The purpose of the step up is to equalize the basis of the recipient, and the value in the decedent's estate. In general, the entire value of the property as of the date of the decedent's death will be part of the decedent's gross estate. Because the entire value is subject to tax, Section 1014 provides for the recipient to take the property with an adjusted basis.

In order to qualify for the step up in basis, the property must be acquired from a decedent at the time of the decedent's death. (IRC § 1014(b).) The step up in basis will not apply to property that was sold or exchanged prior to the decedent's death. (IRC § 1014(a).)

b. Step Down in Basis

Although the adjustment is commonly referred to as a step up, that is not always the case. The Internal Revenue Code provides for an adjustment of basis to the estate's valuation date, typically the date of death. If the value of the property on the date of death is less than the basis in the hands of the decedent, there will actually be a step down.

c. Basis of Property Passed by Gift

The step up rules in Section 1014 apply only to property passed by a decedent at death. The Section does not apply to property passing by gift. Gifted property is covered by

Section 1015, and such property will retain the basis that it had in the hands of the donor. (IRC § 1015(a).)

Gifted property will receive a step up in basis equal to any gift tax actually paid with respect to the gift up to a maximum of the actual value of the property. (IRC § 1015(d).)

d. Property Receiving a Step up in Basis

While most property receives a basis adjustment at the decedent's death, not all property will. IRAs and qualified plans will not receive a step up in basis, and withdrawals will continue to be taxed as ordinary income to the beneficiaries. In general, any property considered Income in Respect of a Decedent (IRD) will not receive a basis adjustment under Section 1014(a).

e. Alternate Valuation Date

While the general rule is that the basis of property passing from the decedent at death is adjusted to the value of the property at the date of death, it is possible that property will be valued on an alternate date. If the executor of the estate elects a Section 2032 alternate valuation date, the basis of the property will instead be adjusted to the value of the property on the alternate valuation date. (IRC § 1014(a)(2).) The same is true if an alternate valuation is elected for qualified property under Section 2032A. (IRC § 1014(a)(3))

f. Strategy Associated with Step Up in Basis

All other things being equal, a step up in basis (assuming the property has appreciated and not depreciated) is preferred to taking the basis in the hands of a decedent. For example, a parcel of real estate with basis of $50,000 in the hands of the decedent, but now worth $200,000 would benefit from a step up in basis.

That being said, there may be reasons to make a gift of the property despite the basis adjustment advantage to passing property at death. For example, in order to minimize the value of a large estate it may be beneficial to gift property to a beneficiary or in trust in order to take the value out of the donor's estate. Where an asset is expected to appreciate, it may make sense to gift the property in order to freeze the estate value of the property at the value at the time of the gift.

4. Federal Estate Tax

a. The Gross Estate

The federal estate tax is a tax on property passed by a decedent at death. The tax applies to the property in the **taxable estate** of a decedent. (IRC § 2001(a).) The taxable estate is equal to the gross estate, minus deductions.

The **gross estate** generally includes any property over which the decedent had an interest at the time of death. (IRC § 2031(a).) Subsequent Sections provide for the inclusion of specific property, including the following:

- Property over which the decedent had an interest at the time of death, whether probate property or not (IRC § 2033, Reg. § 20.2033-1), including:
    - Real property;
    - Personal property;
    - Stock and securities;
    - Bonds;
    - Notes and claims held by decedent;
    - Accrued interest, dividends, and rents; and
    - Cemetery plots;
- Dower or curtesy interests; (IRC § 2034.)
- Gift tax paid, and certain gifts made by the decedent within 3 years of death; (IRC § 2035)
- Transfers with retained beneficial enjoyment, or powers, such as:
    - Life estates; (IRC § 2036(a).)
    - Voting rights in a controlled corporation; (IRC § 2036(b).)
    - Reversionary interests; and (IRC § 2037.)
    - Revocable transfers; (IRC § 2038.)
- Annuities payable to survivor beneficiaries; (IRC § 2039.)
- Jointly held property; (IRC § 2040.)
- Property over which the decedent held a general power of appointment; (IRC § 2041.)
- Life insurance on the life of the decedent over which the decedent possessed incidents of ownership; (IRC § 2042.)
- QTIP property. (IRC § 2044.)

b. Deductions

After determining the gross estate, **deductions** are allowed to reduce the gross estate in order to calculate the taxable estate. (IRC § 2051.) Deductions include:

- Funeral expenses, claims against the estate, expenses of administration; (IRC § 2053.)
- Casualty losses during administration; (IRC § 2054.)
- Charitable and non-profit contributions; (IRC § 2055.)
- Estate and inheritance taxes paid at a state level; (IRC § 2058.)
- Unlimited marital deduction (citizen spouses only). (IRC § 2056.)

c. The Tentative Tax and Tax Imposed

Once the taxable estate has been calculated, the next step is to determine the **tentative tax**. The tentative tax is determined by adding the taxable estate of the decedent to the post 1976 taxable gifts made by the decedent, and then applying the **rate tables** found in Section 2001(c). (IRC § 2001(b)(1).)

Once the Section 2001(b)(1) tentative tax is determined, tax is calculated on the decedent's post 1976 gifts (again using the Section 2001(c) tax tables), and subtracted from the Section 2001(b)(1) tentative tax. The result is referred to as the **tax imposed**. (IRC § 2001(a).)

The purpose of adding in and subtracting out the decedent's lifetime gifts is to apply the current tax rates to the gifts. Depending on how the current tax rates apply to previous tax rates, this may either benefit or be to the detriment of the estate.

d. Rate of Tax

The tax table found in Section 2001(c) provide a graduated tax rate, with the **marginal rate** of 40% beginning after reaching $1 million dollars. These rates are used for the calculation of the Section 2001(b)(1) tentative tax and the Section 2001(b)(2) gift tax calculation.

For estates over $1 million dollars, the tax imposed equals $345,800 plus 40% of the excess above that amount. (IRC § 2001(c).)

e. Lifetime Exclusion and Unified Credit

Section 2010(a) provides that each taxpayer receive a credit against the tax imposed by Section 2001. The credit is equal to the tentative tax that would be applicable to the amount of the basic exclusion, $5 million, indexed for inflation. (IRC 2010(c)(3).) The current inflation indexed basic exclusion amount is $5.45 million. (Rev. Proc. 2015-53 §§ .33.) The tentative tax on that amount would be $2,125,800, which is the current **unified credit** amount.

After calculating the tax imposed, the unified credit is subtracted to equal the **tax payable**. This will be the amount due from the decedent's estate.

f. Tax Inclusive

The federal estate tax is considered tax inclusive. This means that the estate pays tax on the value of the estate, and also uses the estate property to pay the tax. The tax is imposed on the taxable estate, and paid by the executor out of the estate proceeds. (IRC §§2001(a), 2002.) The inclusive nature of the tax results in a slightly higher tax rate than the tax exclusive federal gift tax.

g. Liability for the Tax

The **executor** of a decedent's estate is responsible for the payment of tax. (IRC § 2002.) This includes filing **Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return** within 9 months after the decedent's death. (IRC §§ 6018(a), and

6075(a).) While the time for filing the return may be extended, the time for payment of the tax due must be made within 9 months and may be extended only in limited circumstances. (IRC § 6151(a), *see* Paragraph 5, The Federal Gift Tax, Section (h) Liability for the Tax.)

5. The Federal Gift Tax

a. Gift Tax Generally

The federal gift tax was first enacted in 1924, and revised in 1932. Congress enacted the gift tax in order to prevent the avoidance of the estate tax. Prior to its enactment, it was possible to simply gift large amounts of property during life in order to avoid the estate tax at death. By enacting the gift tax, Congress attempted to plug the hole in the estate tax system by ensuring that both lifetime and post mortem transfers were subject to tax.

Section 2501 imposes a tax on the transfer or property by gift. Section 2511 broadly describes the property that is subject to the gift tax, including, "transfer[s] in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." The value of the gift is determined as of the date of the transfer. (IRC § 2512(a).) The gift tax applies to any transaction where there is less than adequate consideration. The value of a transfer for less than full consideration will be the excess of the value of the property transferred over the value of the consideration received. (IRC § 2512(b).)

b. Annual Exclusion

The gift tax is an annual tax on gifts made by a taxpayer. (IRC § 2501(a).) However, there is an **annual exclusion** from the tax. The exclusion is equal to $10,000 indexed for inflation. (IRC § 2503(b), (c).) The annual gift exclusion is currently $14,000. (Rev. Proc. 2015-53 § .35.) Each taxpayer is allowed annually to transfer a **present interest** in property to any other person without tax so long as the property transferred is valued at $14,000 or less. (IRC § 2503(b).)

Each taxpayer can make annual exclusion gifts to as many people as they wish. So, a single parent with 10 children could make a $14,000 gift to each child, totaling $140,000, in 2016 without incurring any gift tax.

Spouses making gifts can elect to **split gifts**, making it possible for the couple to gift up to twice the annual exclusion amount to any person. The gift will be treated as though made one-half by each spouse. (IRC § 2513(a).) This applies no matter whether a single spouse or both are the source of the transferred property.

Annual gifts in excess of the annual exclusion amount are subject to the gift tax. Further, the gift tax will apply to gifts below the annual exemption amount that do not constitute a present interest. For example, a gift in trust where the beneficiary does not have a right of withdrawal will be subject to the gift tax even if the gift is for less than the annual exclusion amount. (Reg. 25.2503-3(a), *see,* Paragraph 10, Section (a) Current Gifts and the Annual Gift Tax Exclusion.)

c. Medical and Educational Expenses

Qualified gifts for medical and educational expenses are excluded from the gift tax. (IRC § 2503(e).) A qualified transfer is an amount paid to an educational organization or medical provider for the benefit of another. The payment must be made directly to the institution or provider. If the payment is for educational expenses, it must be for tuition, and cannot be for collateral expenses such as books or lodging. (IRC § 2503(e)(2), Reg. § 25.2503-6(b)(2).)

d. Deductions

When gifts are made that do not qualify for an exclusion, then a gift tax return will be due. (IRC § 6019.) Before computing the tax, the **taxable gifts** must be determined. **Deductions** are allowed from the annual gift transfers. (IRC §§ 2522(a), and 2523(a).)

The first is a **charitable deduction** for transfers to government and charitable organizations. (IRC § 2522(a).)

There is also a **marital deduction** for gifts to spouses. In most cases, there is an unlimited deduction for gifts between spouses. (IRC § 2523(a).) One exception to this is where the donee spouse is not a citizen. (IRC § 2523(i).) Another exception is where the gift is of a terminable interest. However, similar to a bequest from a decedent's estate, a lifetime QTIP election can be made for qualified terminable interests. (IRC § 2523(f), *see,* Paragraph 7, Marital Deduction Planning.)

e. Calculating the Gift Tax

Once the amount of the taxable gifts is determined **tax imposed** is calculated by:

- Calculating the tentative tax on the current years gifts and all gifts that have been made by the donor in prior years; (IRC § 2502(a)(1).) and subtracting
- The tentative tax calculated on all prior year gifts. (IRC § 2502(a)(2).)

The result is the tax imposed. (IRC § 2502(a).) Both tentative tax calculations are computed using the tax tables in Section 2001(c).

f. Lifetime Exemption and Unified Credit

In addition to the annual exclusion, each taxpayer has a unified credit amount. This is the same unified credit that is available to the taxpayer at death for the federal estate tax. (IRC §§ 2505(a)(1), and 2010(c).) Lifetime gifts subject to the tax imposed by Section 2502(a) reduce the unified credit available in subsequent years for both federal gift taxes and federal estate tax. (IRC §§ 2505(a)(2), and 2010(c).)

The tax calculated under Section 2502(a) is reduced by the remaining unified credit under Section 2505(a). Once the unified credit has been exhausted, gift tax will be due. If spouses elect to split gifts, the gift will be split between the unified credits of the two spouses. (IRC § 2513(a).)

g. Tax Exclusive

Unlike the federal estate tax, which is tax inclusive, the federal gift tax is tax exclusive. This means that the donor does not pay additional gift tax on the money used to pay the federal gift tax. (IRC § 2035(b), 2502(c).) This results in a lower rate of tax. Compared to the tax inclusive federal estate tax marginal rate of 40%, the federal gift tax actually results in less than 29% tax.

While this is an advantage of the gift tax, gifts made within 3 years of the donor's death will ultimately become tax inclusive. Section 2035(b) pulls any gift tax paid within 3 years of the donor's death back into the donor's estate. Because the tax paid becomes part of the estate and subject to tax, this renders the gifts made within 3 years tax inclusive.

h. Liability for the Tax

The donor has the responsibility for paying the gift tax. (IRC § 2502(c).) This includes the responsibility for filing the **Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return**. (IRC § 6019.) The return is due by April 15 of the year following the calendar year of the gift, unless it is due in the same year as the decedent's estate tax return, in which case it would be due on the same date as the estate return. An extension may be granted, but the extension will not, in and of itself, postpone the time for payment of tax. (IRC §§ 6075(b), and 6051(a).)

Under limited circumstances there may be an ability to extend the payment of tax. If the estate of a US citizen or resident owns a closely held business that makes up of 35% of the value of the gross estate, then that estate may make an election under Section 6166. Making an election allows the payment of tax to be deferred through a payment plan. The tax may be paid in as few as 2 or as many as 10 equal, annual, installments. (IRC § 6166(a)(1).) The taxpayer will pay interest on the deferred tax. (IRC § 6166(e).) If the closely held asset is disposed of, the payment will be accelerated. (IRC § 6166(g).)

Tax can also be deferred for:

- Reasonable cause; (IRC § 6161(a)(1).)
- Undue hardship; (IRC § 6161(a)(2).)
- Estates holding remainder interests. (IRC § 6163.)

6. Generation-Skipping Transfer Tax

a. The Generation Skipping Tax Generally

The federal estate tax is imposed on transfers taking place at death. The federal generation skipping transfer tax was created to prevent the avoidance of the estate tax by passing property over multiple generations. Instead of leaving property to the taxpayer's child, the taxpayer could instead leave the same property to their grandchild or great-grandchild. This would save the tax that would have otherwise been due for federal estate tax when the child and/or grandchild die. Because the estate tax is currently 40% of the amount in excess of the lifetime exemption, this is a significant tax savings. The more generations that are skipped, the larger the tax savings.

The generation skipping transfer tax was implemented in 1976, and subsequently revised in 1986 to address this. The generation skipping transfer tax is a tax on the taxable amount of transfers to persons two or more generations below the generation of the transferor. (IRC § 2601 - 2664.) This ensures that tax is paid at each generation.

b. Transferor, Generation Assignments, and Skip Persons

A generation skipping transfer tax may be made by gift or at death. The decedent is the transferor for federal estate tax purposes. (IRC § 2652(a)(1)(A).) The donor is the transferor for federal gift tax purposes. (IRC § 2652(a)(1)(B).)

The **transferor** is important because the generation skipping transfer tax applies when property passes to a skip person. A **skip person** is someone who is two or more generations below the generation of the transferor. (IRC § 2613(a)(1).) You must, therefore, first identify the transferor before generational assignments can be made. Once the transferor is determined, **generation assignments** can be made by determining the familial generational assignments, or by determining the age gap between the transferor and the beneficiary.

When a beneficiary is a **lineal descendant** of the transferor's grandparent, then the generational assignment is determined by comparing:

- The number of generations between the grandparent and the transferor; with
- The number of generations between the grandparent and the beneficiary.

(IRC §§ 2651(a), (b)(1).) If the beneficiary is two or more generations below the transferor, then the beneficiary is a skip person. (IRC § 2613(a)(1).)

Marriage to a transferor or a lineal descendant will cause the spouse to be assigned the same generation as the transferor or lineal descendant. (IRC § 2651(c).) Lineal descendants of a grandparent of a spouse will be assigned a generation in relation to the spouse's grandfather for the purpose of comparing generations. (IRC § 26551(b)(2).)

When a beneficiary is not a lineal descendant of the transferor's grandparent, then the beneficiary will be assigned a generation based on a comparison of the beneficiary's date of birth to the **transferor's date of birth**.

- A beneficiary born 12½ years or less after the transferor will be assigned the same generation as the transferor;
- A beneficiary born more than 12½ years after the transferor, but not more than 37½ years after the transferor will be assigned to the generation below the transferor;
- Each succeeding 25 years will represent the next generation below the transferor.

(IRC § 2651(d).)

A trust qualifies as a skip person if:

- All interests in the trust are held by skip persons; (IRC § 2613(a)(2)(A).) or
- If no person holds an interest in the trust and no distribution may be made to a non-skip person. (IRC § 2613(a)(2)(B).)

For the purposes of the second requirement, if the chance of distribution is 5% or less that a distribution will be made to a non-skip person, then the trust will qualify as a skip person. (Reg. 26.2612-1(d)(2).)

c. Taxable Transfers

A **tax is imposed on generation skipping transfers**, and there are three types of transfers that are subject to generation skipping transfer tax: direct skips, taxable terminations, and taxable distributions. (IRC § 2601.) The type of transfer made will determine the party responsible for the tax and whether the transfer will be tax inclusive or tax exclusive. Further, as described in Paragraph 6, Section (e), the type of transfer will determine the deductions that are available in determining the **taxable amount** of the transfer.

A **direct skip** is a transfer of property either directly to a beneficiary, or to a trust where all of the beneficiaries are skip persons. (IRC § 2612(c).) The transferor is responsible for payment of the tax on a direct skip. (IRC § 2603(a)(3).) The direct skip is tax exclusive, meaning that the payment of tax on the transfer is not subject to additional GST tax. (IRC § 2623.) However, the payment of tax on the GST, if any, will be considered a gift, and subject to the gift tax. (IRC § 2515.)

A **taxable distribution** is a distribution of income or principal from a trust to a skip person. (IRC § 2612(a).) The beneficiary receiving the property, the skip person, is responsible for the payment of the tax on a taxable distribution. (IRC § 2603(a)(1).) If, however, the trustee does pay the GST tax, then the tax paid will be considered an additional taxable distribution, subject to GST tax. (IRC § 2621(b).) Either way, a taxable distribution is tax inclusive. (IRC § 2621.)

A **taxable termination** takes place when an interest in a trust terminates and:

- There are no remaining non-skip persons with an interest in the trust following the termination, and
- Distributions may no longer be made to a skip person.

A termination includes a death, lapse of time, release of power, or other event terminating a non-skip person's interest, leaving only skip persons. (IRC § 2612(a)(1).) Upon a taxable termination, tax is paid by the trustee of the trust. (IRC § 2603(a)(2).) A taxable termination is tax inclusive. (IRC § 2622(a).)

d. Special Rules

Following a taxable termination, generations are reassigned under the **transferor move down rule**. The rule exists to make sure that generation skipping transfers are not taxed multiple times. When there is a generation skipping transfer, such as a taxable termination, and the property transferred continues to be held in trust, the transferor will be reassigned to the generation above the highest generation of any person holding an interest in the trust. (IRC § 2653(a).)The effect of this is that distributions from the trust to the highest generation holding an interest will not be treated as taxable distributions, while distributions to succeeding generations will be.

The predeceased ancestor rule is in some ways similar to the transferor move down rule. The **predeceased ancestor rule** is a limited exception to the GST tax when a transferor makes a gift to a skip person whose parent is predeceased. A skip person will be reassigned to the first generation below the transferor if:

- The skip person is a descendant of the parent of the transferor;
- The skip person's parent is:
    - a lineal descendant of the parent of the transferor, and
    - is deceased at the time of a transfer
- The transfer is subject to either the gift or estate tax.

(IRC § 2651(e)(1).) The Section includes skip persons who are not direct lineal descendants of the transferor, such as a niece or nephew. However, there is a limitation on that collateral inclusion. The rule will not apply to a collateral heir if the transferor has living lineal descendants. (IRC § 2651(e)(2).)

e. Value, Deductions, and the Taxable Amount.

The key to determining the tax on a generation skipping transfer is the calculation of the taxable amount. The starting point is to determine the value of the transfer. (IRC §§ 2621(a)(1), 2622(a)(1), 2623) Deductions are then subtracted from the value in order to determine the **taxable amount**. The taxable amount is ultimately used to determine the **tax imposed**. (IRC § 2601, 2602.)

The deductions available to the transferor will depend on the type of transfer. Deductions are allowed in the case of a Taxable Distribution for expenses related to the determination, collection, or refund of the tax imposed. (IRC § 2621(a)(2).) For taxable terminations, there are deductions available for expenses, indebtedness and taxes, so long as the costs are attributable to the property over which the taxable termination has occurred. (IRC §§ 2622(b), 2053.)

A deduction is also allowed from the value of the transfer for any generation skipping transfer for 1) federal or state death tax paid in relation to the property, and 2) charitable deductions allowed under Sections 2055 or 2522. (IRC § 2642(a)(2)(B)(ii).) Instead of being used to determine the taxable amount, this deduction is used to reduce the denominator of the applicable fraction used in calculating the inclusion ratio.

f. Calculating the Generation Skipping Transfer Tax

There is a **tax imposed** by Section 2601 on generation skipping transfers. Section 2602 provides the calculation for the tax, which is the value of the **taxable amount** multiplied by the applicable rate. The **applicable rate** is determined by multiplying the current maximum federal estate tax rate imposed by Section 2001 by the inclusion ratio. (IRC §§ 2641(a), (c).) The current maximum federal estate tax rate is 40%. (IRC § 2001(c).)

The **inclusion ratio** is determined by subtracting the applicable fraction from the number 1. (IRC § 2642(a).) The **applicable fraction** is a fraction where the numerator is the amount of **GST exemption allocated** to the transfer, and the denominator is the **taxable value** of the transfer minus deductions for estate taxes paid and charitable deductions. (IRC § 2642(a)(2)(B)(ii).)

By allocating enough GST exemption to a transfer (numerator), covering 100% of the value of the transferred property (denominator), the transferor will achieve an inclusion ratio of zero. When the inclusion ratio is zero, there will be no tax on a transfer. This is because the inclusion ratio is multiplied by the federal estate tax rate. So, [0 x .40% x value of the transfer = 0].

g. Transfers Exempt From GST

If a **direct skip** qualifies for the gift tax exclusion in Section 2503(b), or the exclusion for tuition and medical expenses in Section 2503(e), then the transfer will be given an inclusion ratio of zero. (IRC § 2642(c)(1), (3).) If the transfer exceeds the annual gift tax exemption, it will instead be divided into two transactions, with the gift tax-exempt portion receiving an inclusion ratio of zero, and the non-exempt portion requiring an allocation of GST exemption or it will be subject to the GST Tax.

Indirect gifts, meaning gifts made in trust, will receive a similar exclusion from tax only if the following conditions are met:

- The trust principal and income are distributable only for the benefit of a single skip person;
- If the trust terminates before the individual dies, the trust property is included in the gross estate of the skip person;

Qualifying trusts will receive an inclusion ratio of zero. (IRC § 2642(c).)

h. GST Exemption

Each transferor is given a **GST exemption** amount that may be allocated to transfers made over the transferor's lifetime. (IRC § 2631(a).) The exemption is equal to the **basic exclusion amount** under section 2010(c). (IRC § 2631(c).) The current GST exemption is $5.45 million. (Rev. Proc. 2015-53 § .33)

The GST exemption is not portable. For the purposes of the estate tax, the applicable exclusion amount is the basic exclusion amount plus the DSUE Amount. IRC § 2010(c)(2). However, the GST exemption amount is specifically only equal to the basic exclusion amount. (IRC § 2010(c).)

i. Allocation of GST Exemption

A transferor may make an **election to allocate** GST exemption to a gift transaction on Form 709, or their executor may elect to allocate GST exemption to a bequest on Form 706. The allocation can be made regardless of whether a return is actually due. (IRC § 2632(a)(1).) It is common for a transferor to file a gift tax return for the sole purpose of making an allocation of GST exemption.

The Code also includes **auto allocation rules**. GST exemption will be automatically allocated to both direct and indirect skips unless the transferor elects out of the auto allocation. If the auto allocation rules apply, exemption will be applied in the amount necessary to bring the inclusion ratio to zero, or until the transferor's GST exemption has been exhausted. (IRC §§ 2632(b)(1), (b)(3), (c)(1), and (c)(5).) If GST exemption is insufficient to cover all transfers, it will first be allocated to direct skips, and then to indirect skips. (IRC § 2632(a)(1).) Allocations within those categories will be made proportionally when there is not enough remaining exemption to cover the entire gift. (IRC § 2632(e)(2).)

Auto allocation only applies to trusts that are "indirect skip[s]." An **indirect skip** is a transfer to a GST trust. (IRC § 2632 (c)(3)(A).) A **GST trust** generally includes any trust that could result in a generation skipping transfer, but there are a number of exceptions. The exceptions deal with situations where a significant portion (normally more than 25%) of a trust is likely to be distributed to a charity, a non-skip person, or a non-skip person's estate. (IRC § 2632(c)(3)(B).)

An election out of the auto allocation rules may be made on a timely filed gift tax return. The **election out** can be for:

- Any one or more prior year transfers (relating to ETIP transfers);
- One or more current year transfers to a specified trust;
- One or more future transfers to a specified trust;
- All future transfers made by the transferor to all trusts, whether currently in existence or not;
- Any combination of the above.

(Reg. § 26.2632-1(b)(2)(iii).)

An **express allocation** on a timely filed gift or estate tax return is effective as of the date of the transfer or alternate valuation date. (IRC § 2642(b)(1), (2).) In cases where an allocation is made after the fact, such as where there was insufficient GST exemption available at the time of the transfer, a late allocation may be made. After an annual inflation adjustment to the basic exclusion amount, a transferor will often file a supplemental gift tax return allocating additional GST exemption, which will be applied to the value of the transferred property as of the first day of the month in which the late allocation is made. (Reg. § 26.2642-2(a)(2).)

An allocation of GST exemption can be made after the fact when a non-skip person who is the beneficiary of a trust, predeceases the transferor. In that case, the GST exemption, filed on Form 709 in the year of the non-skip person's death, will apply retroactively to the date of the transfer of the assets. (IRC § 2632(d).) This allows the exemption amount to be based on the historic value on the date of the transfer, which may be lower than the current value of the property.

An election can also be made to allocate GST exemption relating to QTIP property. Qualified terminable interest property is part of the surviving spouse's estate for GST purposes. However, the decedent's executor can make a **reverse QTIP election**. A reverse QTIP election will cause the QTIP property to be treated, for GST purposes only, as though the Section 2056(b)(7) QTIP election had not been made. (IRC § 2652(a)(3).) This allows the transferred property to be considered part of the surviving spouse's gross estate for federal estate tax purposes, but to take advantage of the deceased spouse's GST exemption.

j. Strategy For GST Transfers

A goal for most trusts is to achieve **an inclusion ratio of zero or one**. In fact, the Code allows for a qualified severance of a trust into separate shares in order to create separate trusts with the inclusion ratio of zero and one. (IRC § 2642(a)(3).)

For example, if $1.25 million is transferred into a trust for the benefit of the transferor's granddaughter, and the transferor has only $1 million of GST exemption remaining, the trust could be split. The first trust would contain $1 million and have an inclusion ratio of zero. The second trust would contain $250,000, and have an inclusion ratio of one. The property in the larger trust will grow GST tax free, until the trust terminates by its own terms, or by operation of the rule against perpetuities. The property in the smaller trust will be subject to GST in the case of a taxable distribution or taxable termination.

GST trusts with a zero inclusion ratio are sometimes used as **dynasty trusts**. These trusts are designed to run for long periods of time in order to maximize growth of the trust assets. The primary limitation on the duration of these trusts is the rule against perpetuities. There has been a movement among a handful of states to significantly increase the term of the rule against perpetuities. Taxpayers wishing to skip multiple generations while avoiding estate, gift, and generation skipping transfer tax should consider the use of a dynasty trust.

If a transferor has insufficient GST exemption in the year of a gift, there is the potential to correct this in subsequent years. Upon an increase in the transferor's GST exemption amount for inflation, a **late allocation** of GST exemption can be made on Form 709 using a notice of allocation. While the allocation will not relate back to the date of the original transfer, the allocation will help to reduce the inclusion ratio of the trust. (Reg. § 26.2632-1(b)(4)(ii).)

The **selection of the beneficiaries** receiving distributions from a trust is important as well. By providing primarily for skip persons with the GST exempt funds, and primarily for non-skip persons with non-exempt funds, the transferor will maximize the use of their exemption.

A **power of appointment** is a powerful tool in planning with GST exemption. A trust calling for property to be held in GST exempt and non-exempt shares can also give a general power of appointment over the property in the non-exempt share to a non-skip person. The exercise or lapse of the non-skip person's power of appointment will cause the property in the non-exempt portion of the trust to be included in the non-skip person's estate. (IRC § 2041(a)(2).)

It is often better to **make GST elections expressly** rather than to rely on the automatic allocation rules. This allows the exclusion amount to be carefully applied to trusts that most benefit skip persons.

If **gift splitting** is elected on a gift tax return, then the gift will also be split for GST purposes. (IRC §§ 2513 Although there is not a marital deduction for GST transfers between spouses, which is unnecessary because the spouse is automatically assigned to the same generation as the transferor, a gift to a spouse may be useful in order to take advantage of the other spouse's GST exemption.

7. Marital Deduction Planning

a. The Unlimited Deduction

Marital deduction planning is the most common form of tax planning when dealing with a married couple. Marital deduction planning gets its name from the **unlimited marital deduction** found in Sections 2056 and 2523. Section 2056(a) allows a deduction from the gross estate for amounts passed at death from the decedent to the surviving spouse. Section

2523(a) allows a transferor to deduct from the gross value of the transferor's annual gifts any amounts where the donee is the transferor's spouse.

The deductions are unlimited, meaning that any amount of property can be left from one spouse to the other, and the deduction can be taken on the entire value. The purpose behind the deduction is to provide a **tax deferral**, rather than a tax avoidance tool. By allowing one spouse to leave property to the other without incurring tax, the spouses are allowed to continue their lifestyle while living. When the surviving spouse passes away, the property is then included in the surviving spouses gross estate. Further, the marital deduction puts taxpayers in separate property states on equal footing with taxpayers in community property states.

b. Exceptions to the Marital Deduction

The unlimited marital deduction has two significant exceptions: 1) where the surviving spouse is not a US citizen, and 2) where the interest given to the surviving spouse is a terminable interest.

In the case of a non-citizen spouse, the unlimited marital deduction is not available. (IRC §§ 2056(d) and 2523(i).) Instead, at death there is a $13,000 credit available to a non-citizen spouse, and for gifts there is an annual exemption of $148,000. (IRC 2523(i)(2), 2503(b), (Rev. Proc. 2015-53 § .35.) Planning for non-citizen spouses can still include a deferral of tax though, through the use of a qualified domestic trust. (IRC § 2056A.)

The second exception to the marital deduction is for **terminable interest property**. Section 2056(b)(1) disallows the marital deduction where the interest left to the spouse will terminate with the lapse of time, upon an event, or upon a contingency.

An example would be where a wife predeceases her husband, leaving her property for him in trust. Husband is to receive all income for life, and principal pursuant to an ascertainable standard. At the husband's death, the remainder of the trust is to pass to the wife's son from a prior marriage. This is a terminable interest because it terminates upon the husband's death. The property will not qualify for the marital deduction unless an election is made as described in Paragraph 7, Section (c).

The purpose of the exception is to ensure that if the property is not taxed in the estate of the first spouse, that the property is included in the estate of the surviving spouse. However, if the interest of the surviving spouse terminates, there will be no inclusion.

c. QTIP Elections

One of the most valuable tools available to taxpayers is the qualified terminable interest (QTIP) election. **Qualified terminable interest property** is an interest that:

- Passes from the deceased/donor spouse;
- To the surviving/donee spouse;

- Where the surviving/donee spouse is entitled to all income from the property at least annually for life;
- No person has the power to appoint the property to anyone other than the surviving/donee spouse; and
- Where the decedent's executor/transferor makes a QTIP election.

(IRC §§ 2056(b)(7)(B), and 2523(f).)

By making the election for property passing by gift or at death, the QTIP property will qualify for the Section 2056(a) and Section 2523(a) marital deductions. A QTIP election is irrevocable. (IRC §§ 2056(b)(7)(B)(v), and 2523(f)(4)(B).) Property for which an election is made will be **included in the estate** of the surviving/donee spouse. (IRC § 2044.)

d. Utilizing the Marital Deduction in Planning

The combination of the lifetime exemption and the unlimited marital deduction is the basis of most tax planning for married couples. Through outright gifts or bequests, or the use of trusts a spouse can pass an unlimited amount of property to the second spouse.

Both spouses will have a **lifetime exemption** amount which can be used to pass property to another person. (IRC § 2010(c)(3).) At the death of the first spouse, couples will often take advantage of that spouse's lifetime exemption, and pass property to their children, grandchildren, or another party. However, most couples do not want to lose control of such a substantial amount of property at the first death (in the case of the federal estate and gift tax, the exemption amount is $5.4 million), so, rather than leaving property outright to beneficiaries, couples will often use a trust to retain control.

The trust used to take advantage of the lifetime exclusion is often referred to as the **family trust**. The family trust will hold up to the lifetime exclusion amount. More property can be transferred into the family trust, but tax would be paid on the excess over the lifetime exclusion. The terms of the family trust often provide for the surviving spouse to receive income, principal or both, but the terms are flexible. For example, the family trust could instead be set up to provide income or principal to the decedent's descendants only, or the descendants and the surviving spouse.

After funding the family trust, the remaining funds are transferred to the surviving spouse, taking advantage of the unlimited marital deduction. This transfer can be, and often is an outright transfer. However, many couples utilize a marital trust.

A **marital trust** is a flexible tool for a grantor. The terms of the trust can be drafted to create a terminable property interest in favor of the surviving spouse that will qualify for the **marital deduction** under Section 2056(b)(7) after the **QTIP election** has been made. This allows a grantor to provide for a surviving spouse during life, while retaining control over the disposition of the property after the surviving spouse dies. For example, a marital trust might provide for income for life to the surviving spouse, but leave the principal to the decedent's children at the death of the surviving spouse. The property in the marital trust is included in the surviving spouse's estate at death. (IRC § 2044.)

Prior to the introduction of the **DSUE Amount** in 2010, couples were required to either use their lifetime exclusion amount, or it would simply be lost at their death. Some planners have chosen to rely on the portability of the DSUE Amount rather than engaging in marital deduction planning. However, this type of planning is not as flexible as the use of marital deduction planning, and does not allow the couple as much control over the disposition of their assets. This method will require the filing of an estate tax return, and relies on the fact that the executor or surviving spouse will make a timely election of portability. Finally, the GST exemption of the deceased spouse is not portable, which makes planning important if substantial property will eventually pass to skip persons.

8. Tax Planning in Decoupled States

Federal estate taxation has changed significantly since 2001. In that time, the **estate tax exemption** has gone up from $675,000 to the current $5.45 million. (Rev. Proc. 2015-53 §§ .33) In addition, the lifetime exemption amount of one spouse is portable upon death to the surviving spouse. (IRC § 2010(c)(4), (5).) This means that with very little planning, a married couple can currently pass nearly $11 million dollars in gifts and estate transfers without being subject to federal taxation.

While less than .5% of the US population need worry about the federal estate tax, many states have continued to have lower estate, gift and/or GST exemptions. Currently, there are 18 states with estate taxes, inheritance taxes, or both. Marginal tax rates typically fall between 15% and 20%.

Where the **state estate tax exemption** amounts are lower than the federal exemption amount, it causes complications with typical marital deduction planning. For a grantor living in a state with a decoupled estate tax, if a family trust if funded with the federal exemption amount at the death of the first spouse, it would be partially taxed by the state.

For example, a grantor who dies in Minnesota in 2016 with $6 million in assets, who plans solely for the federal estate tax, might fund a family trust with $5.45 million, and make a QTIP election over the remaining $550,000 funded to the marital trust. Minnesota has an exemption amount in 2016 of $1.6 million, meaning that $3.85 million of the grantor's estate ($5.45 million family trust, minus $1.6 million Minnesota exemption) would be taxed. This would result in a Minnesota estate tax of $250,000 prior to taking into account deductions. (Minn. Stat. § 291.03 Subd. 1(c).) This is a problem for couples, who typically plan to defer tax until the death of the second spouse.

This problem can be addressed through the use of **separate state and federal marital trusts**. A combination of federal and state QTIP elections can be used to defer tax until the death of the second spouse. Minnesota, and some other decoupled estates allow for a **state QTIP elections** similar to the election available under Section 2056(b)(7), and provides for the inclusion of state specific qualified income interests into the estate of the surviving spouse similar to the federal inclusion in Section 2044. (Minn. Stat. § 291.03 Subd. 1(d).)

In the example above, the family trust could be funded with $1.6 million, a state marital trust could be funded with $3.85 million, and a federal marital trust could be funded with $550,000. A state QTIP election would be made over the state marital trust, and both a federal and a state QTIP election would be made over the federal marital trust. No tax would be paid at the death of the first spouse because of the unlimited marital deduction. Additionally, the spouses will have passed part of the funds to their benefit without electing the marital deduction, which reduces the value of the second spouse's gross estate. At the death of the second spouse, the property for which QTIP treatment was elected will be part of their gross estate, but they will be able to apply their own state and federal exemption amounts to the remaining, reduced, estate.

In addition to determining whether the taxpayer's state has an estate or inheritance tax, it should also be determined whether there is a **state gift or generation skipping tax**. Again, using Minnesota as an example, the state level gift tax has been abolished. This is another planning opportunity for decoupled states. So long as the grantor survives three years after making a gift, property can be transferred from a donor to a donee or a trust without impacting the state estate tax exemption. This is especially advantageous for taxpayers who have an estate that is taxable at the state level, but do not reach the level of a federally taxable estate, a common situation.

For example, a taxpayer with a $2.5 million estate with a $1 million whole life insurance policy could transfer the life insurance policy to an irrevocable life insurance trust (ILIT), reducing the Minnesota estate to $1.5 million, below the state exemption amount (depending on the date of gift value of the policy). While there will be a reduction of the taxpayer's federal lifetime exemption, it may be of little consequence depending on the situation.

Another method of planning for state taxes is to balance the property interests of the spouses to ensure that their exemption amounts are not wasted. At the federal level, the exemption amount is higher and portable. The portability of the exemption makes it less important which spouse owns property. However, in states with a non-portable estate tax, it is important to make sure that the first spouse to dies holds at least an amount equal to the exemption amount, which would be passed to the beneficiary directly or in trust in order to take advantage of their state exemption amount. If that does not happen, the state exemption of the first spouse to die will be wasted.

It is not practical to balance the estates of two spouses in all cases. For example, where the funds are in retirement accounts, or where the spouses are in a second marriage. However, when it is possible, the balancing of funds, at least to the extent of the state exemption, can be very useful for state specific planning.

9. Disclaimer Trusts

a. Qualified Disclaimers

A refusal to accept estate property is referred to as a disclaimer, and it is a taxable transfer unless it meets certain requirements. The estate and gift taxes are taxes on transfers, not on the receipt of property. (IRC §§ 2001(a), 2511(a).) When a disclaimer is a qualified disclaimer, the property will be treated as though it was never transferred to the recipient. A qualified disclaimer occurs when:

- There is an irrevocable and unqualified refusal to accept property;
- Made in writing;
- Received by:
  - The transferor;
  - The transferor's legal representative; or
  - The holder of the legal title to the property;
- By the later of:
  - Nine months from the date of transfer; or
  - The day the person making the disclaimer turns 21;
- Prior to accepting any interest or benefit; and
- Passes without the direction of the person making the disclaimer.

(IRC § 2518(b).)

b. Planning with Qualified Disclaimers

The family trust and marital trusts in marital deduction planning can be funded using a variety of methods. These include a pecuniary formula, a fractional share formula, the use of a Clayton election, and a disclaimer. A disclaimer would most likely be used to fund a family trust. The trust instrument would call for all property to be left to the marital trust. However, any disclaimed property would go to family trust.

The disclaimer method might be appropriate in an estate that is unlikely to exceed the grantor's lifetime exemption amount (or the state amount in a state that imposes an estate tax). The disclaimer method is beneficial in this situation because, although tax planning is unlikely to be necessary, it provides a fallback in case it becomes necessary in the future. If the estate ends up being larger than the available exemption amount, the spouse can disclaim within 9 months, which by default leaves the remaining property to the family trust. This method is more likely to be appropriate in first marriage situations, where there is less need for the decedent to control the distribution of property.

Although a qualified disclaimer must pass to someone other than the person making the disclaimer, there is a specific exemption that allows a surviving spouse to disclaim property left to a marital trust, but still be the beneficiary of the same funds held by a non-marital trust. (IRC § 2518(b)(4).)

Although it is possible to plan with disclaimers, it has drawbacks. People receiving property are often reluctant to disclaim their interest in the property. The instinct is to keep the property, despite the possibility of tax, in order to make sure they have sufficient funds in the future.

c. Disclaimers to Reform a Defective Trust

In addition to using a disclaimer as a method of funding, a disclaimer might be useful in order to reform estate planning documents that fail to meet legal requirements. For example, where a trust is intended to qualify for the marital deduction, but has a lifetime beneficiary other than the surviving spouse, a disclaimer by the lifetime beneficiary would be useful to qualify the trust for the marital deduction.

10. Crummey Powers and the IRS

a. Current Gifts and the Annual Gift Tax Exclusion

In 2016, a person can make a gift of $14,000 to any one person, and that transfer will be excluded from the gift tax. (IRC § 2503(b), Rev. Proc. 2015-53 § 35.) However, in order to qualify for the exclusion, the gift must be of a **present interest**. A gift of a future interest, such as a remainder or the beneficial interest in a trust which cannot be used, possessed, and enjoyed until a future date does not qualify. (Reg. § 25.2503-3(a).)

It is possible that a gift may consist of both a present interest and a future interest in property. For example, a gift in trust that restricts access to the principal until a future date, but gives immediate and unrestricted access to the income. (Reg. § 25.2503-3(b).) In that case, the gift of income would be a present interest, while the restricted principal would be a future interest. However, if the income can be accumulated in the trust, this will be considered a future interest as well. This is true whether or not the interest is subject to an ascertainable standard. (*C.I.R. v. Disston*, 325 U.S. 442, 447 (1945).) Additional concerns relating to the income include situations where a trust is able to hold non-productive property, or where the trustee has broad powers to choose how the trust property is invested, both of which could severely impact the income of the trust and cause difficulty in valuing the beneficiary's income interest.

A minor's trust is an exception to the present interest rule if it meets the requirements of Section 2503(c). The Section, among other things, requires:

- That the property must be expendable for the benefit of the minor prior to reaching the age of 21;
- Pass to the minor at the age of 21; and
- Contain a general power of appointment for the minor or be payable to the minor's estate if the minor dies before reaching the age of 21.

(IRC § 2503(c).)

While a minor's trust can be useful in certain circumstances, the common concern is that the minor will not be of a suitable age to receive property upon the expiration of the trust. Some trusts solve this by providing a limited right of withdrawal to the minor upon attaining the age of 21, which would expire after a period of time such as 60 days.

Despite their limitations, a minor's trust is useful in certain circumstances. One example is where a grandparent wishes to create a trust for their grandchild with less administrative expense than might be required by other options. Another example is where the likelihood of the funds being expended on the grandchild's living expenses and education is high, leaving only a small amount to be distributed upon reaching the age of 21.

b. The Crummey Case

A common technique for qualifying a gift to a trust for the annual exclusion is to provide the trust beneficiary with a right of withdrawal for a limited period of time. This type of withdrawal right is now referred to as a Crummey Power.

The name "**Crummey Power**" comes from the case *Crummey v. Commissioner*. (397 F.2d 82 (9th Cir. 1968).) In the *Crummey* case beneficiaries of a trust had the right to withdraw up to $4,000 dollars annually. Two of the beneficiaries were minor children of the donor, and one was an adult child of the donor. The withdrawal right could be exercised at any time during the calendar year. The donors claimed that the withdrawal right qualified the gifts as a present interest. The IRS disagreed, issuing a deficiency relating to the two gifts to minor children. Its position was that the minors lacked the ability to exercise the withdrawal right, and the interest was therefore a future interest. (*Crummey*, at 83.)

The case came down to whether the minors had an actual right to withdraw. In addition to being minors, they were the children of the donors, which made it even more unlikely that someone would exercise the withdrawal rights on their behalf.

The court ruled that even though it was unlikely that the **rights of withdrawal** would be exercised, the minors did have the *right* to withdraw under the trust agreement, and that right could not have been resisted by the donors had it been exercised. Because the right existed, all of the beneficiaries, including the minor children had a **present interest**, and the **annual exclusion** applied. (*Crummey*, at 88.)

In 1973, the IRS issued Rev. Rul. 73-405, stating that the right conferred on a done to use or possess property is sufficient, and that actual use or possession is not required. The ruling went on to state that the right to withdraw the property creates a present interest even in cases where exercising the right may require the appointment of a legal guardian.

c. The Use of Crummey Powers in Planning

Crummey powers are often used by grantors of an **irrevocable trust** to qualify contributions to the trust for the annual exclusion. The purpose of these gifts can vary, but is often to reduce the overall value of the grantor's estate.

A married grantor, making gifts to 10 grandchildren, could gift up to $280,000 per year. Rather than making these gifts directly to the grandchildren, many grantors will prefer to make the gifts in trust. By using Crummey powers, the gifts in trust will qualify as present interests, and no gift tax return would be required.

One of the most common estate planning techniques, the **irrevocable life insurance trust (ILIT)**, will normally make use of Crummey powers to pay annual insurance premiums. An ILIT is a trust designed to hold the insurance policy on the life of a grantor. A common purpose is to remove the face value of the insurance from the estate of the grantor. The life insurance can either be purchased by the trust, or transferred to the trust by the grantor. If the policy is transferred, the grantor is deemed to have made a gift of the current value of the policy, typically the cash value of the policy.

One of the benefits of an ILIT is that the cash value is typically much lower than the face value of the policy. The face value is removed from the estate because the grantor no longer has incidents of ownership that would cause inclusion in the grantor's estate under Section 2042. This allows a reduction in the grantor's estate equal to the difference between the cash value and the face value of the policy.

In order to make the policy payments, the grantor will often use gifts to the trust. The gifts, though, are not of a present interest because they are made to a trust and not immediately available to the beneficiary. (Reg. § 25.2503-3(a).) The grantor can qualify the gifts for the annual exclusion by making gifts accompanied by a Crummey power, giving the beneficiary the right of withdrawal.

d. The Mechanics of Making a Crummey Gift

The mechanics of making a gift using a Crummey power can vary widely. One common practice is to provide in the **trust agreement** that the beneficiaries have the immediate right to withdraw any contribution made to the trust for a limited period of time.

The IRS has ruled that in order for such a trust provision to be effective, the beneficiary must know that they have the power and have a **reasonable opportunity** to exercise the right. The failure of the grantor to inform the beneficiary that they have the right of withdrawal is conduct that may indicate that the power is illusory. (Rev. Rul. 81-7.) However, compare *Estate of Turner v. Commissioner*, which cites the Crummey case, and states that lack of knowledge of the withdrawal right does not affect the legal right to exercise, or the status as a present gift. (T.C. Memo. 2011-209, 102 T.C.M. (CCH) 214.)

Best practice would be to **provide a notice** to the beneficiary, informing them of their right to withdraw funds. Further, the trust instrument itself should instruct the trustee to provide reasonable notice to the beneficiaries of their rights, including a notice of the time period for withdrawal. Although shorter periods have been upheld, a minimum of 30 days is recommended for the withdrawal period. It should be considered whether a signed acknowledgment of the notice would be beneficial, but also the potential adverse effect of an acknowledgement being sent to for a signature a beneficiary, but never returned.

e. GST and lapsing powers of withdrawal

The ability of the beneficiary of a trust receiving a Crummey power to exercise that power is considered a **general power of appointment**. If the beneficiary does not exercise the power within the time allowed, the power will be considered to have lapsed. The **lapse** of a general power of appointment is treated as a gift to the extent that it exceeds $5,000 or 5% of the aggregate value of the trust. (IRC § 2514(e).)

Unless the value of the trust exceeds $100,000, the amount of the gift that exceeds $5,000 will be considered a lapse, and therefore a gift from the beneficiary. In the case of a trust with a total of $60,000 in assets, and a $14,000 gift to the beneficiary, $9,000 will be considered a gift subject to Section 2501.

In addition to the gift tax consequences, there are also **GST consequences** if the beneficiary is a skip person. First, a transfer to a trust using a crummy power will not be exempt from GST in the same way that it is exempt from the gift tax. Normally, only direct skips are considered non-taxable for GST purposes. There is an exception where the beneficiary is the sole beneficiary of the trust assets, and where the trust assets will be included in the beneficiary's estate. (IRC §§ 2642(c), and 2503(c).)

Assuming the trust does not qualify for the exclusion, the $9,000 in excess of the $5,000 allowed under Section 2514(e) will be deemed to be a distribution to the beneficiary. (Reg. 26.2612-1(C)(1).) This distribution will be considered a **taxable distribution**, subject to GST unless the grantor has allocated GST exemption to the gift. Any tax on the $9,000 taxable distribution will be payable by the beneficiary, even though the beneficiary does not actually receive property out of which to make the payment. (IRC § 2603(a)(1).)

Techniques to avoid the gift and GST problems include:

- Allocating GST exemption to the transaction in a sufficient amount to avoid payment of GST tax on the lapse;
- Limit the amount of the gift to the greater of $5,000 or 5% of the trust value.
- Using a hanging power of appointment which allows the beneficiary to withdraw up to $5,000 or 5% per year until all contributions are accounted for.

11. Planning for the Final Income Tax Return

a. Returns Due from the Decedent

Upon the death of a taxpayer, the **decedent's executor**, or other person in possession of their property, will be charged with filing income tax returns that remain outstanding for the periods ending in the decedent's death. Depending on the date of death and the amount of income, an executor could end up filing two income tax returns for the decedent. For example, if a decedent dies on March 15, 2016, the executor will be responsible for filing the decedent's 2015 tax return as well as the decedent's 2016 tax return. (IRC § 6012(b)(1), Reg. 1.443-1(a)(1).)

The decedent's final returns will be filed using **Form 1040**. The return is due on the fifteenth day of the fourth month following the conclusion of the tax year. This will normally be **April 15** of the year following the decedent's death. (Reg. § 1.6072-1(b).) An extension to file can be submitted prior to April 15, which will extend the due date for the return by six months. However, the estimated tax due must be paid by April 15. (Temp. Reg. § 1.6081-4T.)

The **filing threshold** for filing an income tax return is where the decedent's income exceeds the standard deduction and personal exemption amount. (IRC § 6012, IRC § 63.) A return may need to be filed even if either tax or the decedent's income is less than the standard deduction and personal exemption amount if a refund would be due to the decedent. To claim a refund due to a decedent, the executor must file Form 1310. Conversely, the executor will need to file a return even if the income does not exceed the threshold if it is determined that tax is due.

b. Collecting of Information

Upon the decedent's death, the executor will need to quickly begin collecting information necessary for tax returns. This will include obtaining, among other things, at least the last three years income tax returns (federal, state and local), any gift tax returns, the decedent's bank statements, documentation relating to income, and year-end tax documents. The executor should have the decedent's mail forwarded to the executor's address. Obtaining these returns and other documentation will help inform the executor about the decedent's property, sources of income, and the deductions made on prior returns that may be available on the current returns.

c. Joint Returns

The executor must consider whether it is in the estate's interest to have a **joint return** filed. The executor and the surviving spouse can decide together to file a joint return. A spouse may make the return on their own if:

- No return has been made by the decedent;
- No executor or administrator has been appointed; and
- No executor or administrator is appointed before the last day for filing the return.

(IRC § 6013(a)(3).) If an executor is subsequently appointed, he or she can choose to disaffirm a joint return filed by the surviving spouse. A **disaffirmance** must be made within one year of the filing of the joint return by filing a separate return for the decedent. (Reg. 1.6013-1(d)(5).)

The decision to make a joint return will depend on a number of factors, including the impact that the return has on the taxes owed or due to the estate. Also important, though, is that a joint return may make the estate liable for acts of the surviving spouse. There may be some protections against that liability in the innocent spouse rules, but the potential liability should be considered in filing a joint return. (IRC § 6015.)

d. Medical Deductions

The executor must make a decision about how medical expenses will be deducted. Expenses that are not compensated by insurance are deductible if they meet a minimum percentage of the taxpayer's adjusted gross income. (IRC § 213(a).) Expenses incurred by a decedent, and paid within 1 year of the date of death may be deducted on the decedent's 1040. (IRC § 213(C)(1).) However, the executor must decide whether to elect to deduct the medical expenses paid after death on the decedent's 1040, or on the estate tax return. The election may not be made on both returns. (IRC §§ 213(c)(2), 2053(a).)

e. Income

The decedent's executor will be responsible for reporting any income **actually received** by the decedent during the decedent's lifetime, including income received on or before the date of the decedent's death. In addition, any income that was available to the decedent, constructively. In order to be **constructively received**, the income must be credited to, or set apart for the decedent, and available for withdrawal. (IRC § 1.451-2(a).)

Income due, but not actually or constructively received by the decedent during his or her life is taxable to the decedent's estate, the beneficiary, or other person who acquires the property from the estate. (IRC § 691(a)(1).) Such income is characterized as **income in respect of a decedent** ("IRD"). IRD is treated in the hands of the recipient as having the same character as it would have had in the hands of the decedent. (IRC § 691(3).)

12. Final Gift Tax Returns

In addition to preparing the decedent's final income tax returns, the executor must prepare and file the decedent's final gift tax returns. (Reg. § 25.6019-1(g).) In order to do this, the executor will need to have access to the decedent's records, and review them carefully in order to make sure that all gifts during the calendar year are known. The sources of information for these returns will include many of the same sources as referenced for the decedent's final income tax return, the decedent's spouse, and the decedents' accountant, attorney, and other professionals.

13. Income Tax Treatment of Trusts

a. Income Taxation of Grantor Trusts

When a grantor of a trust reserves control over the trust assets, such as the power to revoke, the trust will be considered a **grantor trust**. Income to the grantor trust will be taxed to the grantor. (IRC § 671.) The most common example of a grantor trust is a **revocable living trust**, but other, more complex planning techniques include the use of a grantor trust.

The grantor will be considered the owner of the trust if:

- The grantor has a **reversionary interest** in the trust when the interest is valued at 5% or greater of the trust value; (IRC § 673(a).)
- The grantor holds a retained power to impact the **beneficial enjoyment** of the trust without the approval or consent of an adverse party; (IRC § 674(a).)
- The grantor retains **administrative powers** over the trust enabling the grantor to:
  - deal with the trust property with less than adequate security;
  - take loans without repayment within the year the loan is taken;
  - vote or direct stock or securities;
  - Control the investments of the trust;
  - Reacquire trust property by substituting property; (IRC § 675.)
- The grantor retains the **power to revoke** the trust; (IRC § 676.) or
- The grantor retains the **power over the income** of the trust for the benefit of the grantor, the grantor's spouse, or to an insurance policy on the life of either, without the approval of an adverse party. (IRC § 677.)

A grantor is a person who has contributed to the funding of the trust. The grantor will be considered the owner if the grantor has one of the specified powers, either on their own or with the consent of a non-adverse party. (IRC § 671.)

b. Income Taxation of Estates

Following the death of a decedent, an estate is often opened to administer and distribute the decedent's property. An estate is allowed to exist for a time period reasonable to complete the administration. The estate is a separate taxable entity which is formed to account for income received following death. (IRC § 641(a).) A tax return will be due if the estate has **gross income of $600** or more for the taxable year, or if a beneficiary is a non-resident alien. (IRC § 6012 § (a)(3), and Reg. 1.6012-3(a).) This amount is equal to the personal exemption deduction for estates. (IRC § 642(b)(1).) The executor is responsible for making the income tax return. (IRC § 6012(b)(4).) Income is reported on a **U.S. Income Tax Return for Estates and Trusts, Form 1041**. (Reg. 1.6012-3(a).)

A decedent's estate may be taxed on either a calendar **year or a fiscal year,** on the election of the executor. (IRC § 441(b), and Reg. 1.441-1.) The executor does not need to seek permission from the IRS to adopt a fiscal year. If a calendar year is elected, the return will be due on **April 15** following the close of the calendar year. If a fiscal year is elected, the return will be due on the **15th day of the fourth month** following the close of the fiscal year. (IRC § 6072(a).)

The ability to file a return on a fiscal year gives the executor flexibility, and the opportunity for tax planning. For example, if decedent Dies in February of Year 1, the tax year can close on January 31 of Year 2. The tax return and reporting of distributions to beneficiaries would be due on April 15 of Year 2. If income is being reported to a beneficiary, it would in turn need to be reported on the beneficiary's income tax return. The advantage of using a fiscal year for the estate is that even though the income may have occurred during year 1, it will not need to be reported by the beneficiary until the beneficiary files their next income tax return, presumably on April 15 of Year 3. It does not always make sense to extend the tax year, and may instead make sense to shorten the year. The advisor should be aware of the possibility to close the tax year any time during the first 12 months following the decedent's death, and adopt the plan that makes the most sense for the estate.

Certain deductions, such as expense of administration and professional fees may be deducted on the estate income tax return, or on the estate tax return. (IRC §§ 641(c)(2)(c), 2053(a), and 2054.) Double deductions are not allowed. The executor must elect to take the deductions on one return or the other, and may not take the deductions on both. In order to take the election on the income tax return, the right to take the election on the estate tax return must be waived. (IRC § 642(g).)

c. The Section 645 Election

A trustee of a trust and the executor of an estate may make an election to have a qualified revocable trust treated as part of the estate. (IRC § 645(a), (c).) A qualified revocable trust is one that was owned by a decedent who had the power to revoke the trust. If the election is made, the revocable trust can be considered part of the grantor's estate for a period of up to two years. (IRC § 645(b).)

This election can be beneficial in consolidating the estate and the trust. It can also be beneficial because of the ability that the estate has to elect a fiscal year.

d. Taxation of Trusts

Roughly speaking, a trust is a legal arrangement where a grantor appoints a trustee who holds property for the benefit of third parties, the trust's beneficiaries. Grantor trusts are discussed above. (*see,* Paragraph 13, Section (a) Income Taxation of Grantor Trusts.)

Trusts other than grantor trusts are taxed under the Internal Revenue Code as either simple trusts or complex trusts.

A **simple trust** is a trust that:

- Requires the trust distribute all income in the current taxable year (whether or not that actually occurs; and
- Does not provide for any charitable contributions.

If a trust that would otherwise be categorized as a simple trust distributes principal, then it will be considered a complex trust. Because those distributions may vary from year to year, a trust may be considered a simple trust in one year, and a complex trust in the next. (Reg. § 1.651(a)-1.)

A **complex trust** is a trust that is not a simple trust, meaning that it has made a distribution of principal, is allowed to accumulate income, or makes charitable distributions. (Reg. 1.661(a)-1.)

A tax return will be due if:

- The trust has taxable income;
- The trust has **Gross income of $600** or more for the taxable year;
- The trust has a non-resident alien beneficiary;
- The trust makes a 645 election, and there is aggregate gross income of $600 or more from the trust and estate.

(IRC § 6012(a)(4), and Reg. § 1.6012-3(a)(1).) A simple trust is allowed a personal exemption of $300. A complex trust is allowed a personal deduction of $100. (IRC § 642(b)(2).) The executor is responsible for making the income tax return. (IRC § 6012(b)(4).) Income is reported on a **U.S. Income Tax Return for Estates and Trusts, Form 1041**. (Reg. 1.6012-3(a).)

A decedent's trust must be taxed on a calendar **year**. (IRC §§ 644(a), and 441(b), and Reg. § 1.441-1.) The exception to this is where a 645 election is made. (IRC § 645.) The return will be due on **April 15** following the close of the calendar year. (IRC § 6072(a).)

e. Distributable Net Income

Both simple and complex trusts are allowed a deduction for distributions to beneficiaries, but that deduction is limited to the amount of **Distributable Net Income ("DNI")** in the trust. (IRC §§ 661(a), and 651.) DNI is the taxable income for the estate or trust modified as follows:

- In calculating the taxable income, no deduction is allowed for DNI;
- No deduction allowed for personal exemptions;
- Capital gains are excluded except in certain circumstances.
- Capital losses are generally excluded;
- Extraordinary dividends are excluded for simple trusts;
- Tax exempt interest is deductible after subtracting deductions allocable to the interest;

(IRC § 643(a).)

A **simple trust** may deduct income distributed to beneficiaries. The deduction is limited to the amount of the DNI. (IRC § 651(b).) The income distributed will be included in the income of the beneficiary. (IRC § 652(a).) The character of the income will be the same in the hands of the beneficiary as it was in the hands of the trust. If necessary, the amount distributed will be adjusted to match the proportion of each class of income that was previously in the trust. (IRC § 652(b).)

A **complex trust** may deduct income and principal distributed to beneficiaries. The deduction is limited to the amount of the DNI. (IRC § 661(a).) The beneficiaries will be taxed on the income distributed, and the distributions made to the beneficiaries shall retain the same character as the income in the hands of the trust. If the amount distributed and the amount of DNI differ, the amounts in the hands of the beneficiaries will be adjusted in proportion to the amounts in the hands of the trust. (IRC § 661(b).)

f. Tax Brackets for Trusts

A tax is imposed on income to estates and trusts. (IRC § 1(e).) The tax rates begin at $2,550 and a 15% rate of tax, and continue to the marginal rate of 39.6% for amounts over $12,400. (IRC § 1(e), Rev. Proc. 2015-53 § .01, Table 5.) The rate table is often referred to as "compressed." In other words, the top rate is reached at a low dollar threshold. By comparison, the individual income tax rates reach the maximum rate of 39.6% when income reaches $415,050.

g. Net Investment Income Tax

In addition to income tax at compressed rates, there is another tax, is referred to as the **Medicare Tax or Net Investment Income Tax ("NIIT")** which has a rate of 3.8%. Net investment income is income from the following sources:

- Gross income from interest, dividends, annuities, royalties, and rents, other than income in the ordinary course of a trade or business;
- Passive business activities.

(IRC § 1411(c)(1).)

The 3.8% tax is due on estates and trusts with adjusted gross income exceeding the level of the highest income tax bracket where net investment income is not distributed. (IRC § 1411(a)(2).)

The high tax rate imposed on small amounts of trust income, coupled with the NIIT, is an incentive in many cases for trusts to distribute income to beneficiaries. This does not always fit with the grantor's purpose in creating the trust, but is a consideration in drafting, and in later administering the trust.

14. Simple Tips for Minimizing Income Tax Burden

- Plan ahead to give the trustee the discretion to make the appropriate distributions from a trust. This happens during drafting.

- Make a Section 645 election for the decedent's formerly revocable trust. This will allow for taxes to be paid on the trust and the estate together. It also allows the trust to elect a fiscal year.

- One of the easiest ways to minimize the tax burden of a trust is to distribute income. The trust is allowed a deduction for distributions up to the amount of the trusts DNI. Because the trust reaches the 40% tax bracket at such a low dollar amount, it is often the case that less tax will be paid if the property is passed to a beneficiary. This will be the case as long as the beneficiary is in a lower tax bracket.

- A trustee is allowed to treat a distribution to a beneficiary that happens within 65 days of the end of the tax year as though it was made in the previous year. (IRC § 663(b).) This allows the trustee to take a "wait and see" position. The trustee can distribute property to a beneficiary who has not maximized their tax bracket, or who is in a significantly lower tax bracket than the trust. In order for the amount to be considered paid in the prior year, the trustee must make an election. IRC § 663(b)(2).)

- Consider whether the trust is the appropriate owner of a passive investment in the first place. The passive activities rules are not favorable for trusts. Depending on the circumstances, it may be beneficial for the trust to sell the passive investment and avoid the NIIT.

- Consider transferring income producing property to an irrevocable trust that qualifies as a grantor trust. This not only takes the income producing property out of the trust, but also takes the tax for the property out of the grantor's estate. While it might not sound beneficial for the grantor to have an additional tax burden, it can be an effective way of minimizing the grantor's estate and benefiting the beneficiaries of the trust.