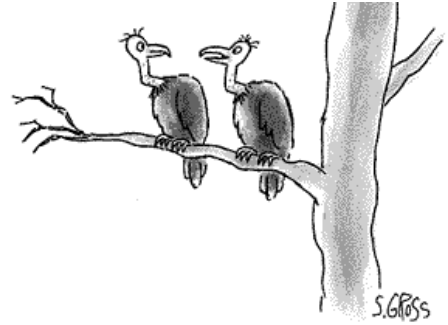


Death & Taxes

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*"Only two things are
certain—death and food."
[...and taxes]*

Summary

Dying is easy. What comes next is not.

A nuts and bolts course designed to teach advisors how to help when a client dies. This class will provide a timeline, as well as concise instructions to simplify the filing of all requisite returns, including Estate, Gift, and Inheritance, Generation Skipping and/or Income Tax forms. A sampling of topics includes how to account for income and expenses in respect of decedent, which elections are available to executors and trustees and how to maximize allowable deductions.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

Instructor

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**KEY TO ICONS (AUTHOR'S NOTES)
THROUGHOUT TEXT**




 Form to file
 Author advises
Cautionary note

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I. Introduction

The text is intended to provide the tax practitioner with a handy desk reference to facilitate the preparation of various tax returns on behalf of a deceased client and will outline basic filing requirements, as well as practical tips.



II. Types of Tax

Tax liabilities do not cease upon death. In fact, decedents—or their surviving representatives—may be liable for yet more taxes after death than before. Pre-death, an individual is typically only responsible for the Income Tax, a tax assessed on earnings. However, post-death, the estate of the decedent may be liable for taxes on earnings, as well as on assets held by the decedent on the date of death (“DOD”).

This text will focus only on those taxes imposed by the federal government, although practitioners and taxpayers should be aware that individual states may also impose one or more types of tax on taxpayers over which they have jurisdiction. A decedent who was resident of one state, but held assets or received earnings from another, may well be liable for taxes imposed by more than one state.

A. Estate Tax

By definition, the whole of property owned by anyone, including both real and personal property, is deemed to be that person’s estate. Upon death, this estate will be distributed in accordance with the terms of the decedent’s will or, if there is no will, by the laws of intestacy applicable in the state of the decedent’s domicile.

The tax is assessed on the value of the decedent’s estate on the DOD or, if elected, the Alternate Valuation Date (“AVD”)—the earlier of the date of sale or distribution or, if still held by the estate, no later than six months after the DOD. The AVD may be used only if the fair market value (“FMV”) of the decedent’s assets on that date is less than on the DOD, and serves to decrease the value of the gross estate as well as the combined Estate and Generation-Skipping Tax liability [Reg. § 20.2032-1(b)(1)].



Form 706 U.S. Income Tax Return for Estates and Trusts must be filed nine months after the DOD, but can be automatically extended six months by filing **Form 4768 Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes**, but note that while the extension request extends the deadline for filing, any tax due must still be paid within nine months.¹

ESTATE TAX

- Assessed based on the value of decedent’s holdings—it is an asset, not income tax
- FMV may be determined at the DOD or AVD, if elected.
- Form 706 is due nine months after DOD but filing deadline can be extended an additional six months with Form 4768.
- The tax liability must generally be paid nine months after DOD.

¹ A Late Filing Penalty of 5% of tax per month (up to 25%) may be assessed in addition to a Late Payment Penalty, as well as interest on any unpaid balance due.

B. Gift Tax

Generally, all transfers of property or property interests without adequate consideration are gifts subject to gift tax. Gifts can include transfers of cash or property, payments made to third parties on behalf of another, interest-free loans, below-market sales, irrevocable transfers to trust, and the creation of certain joint tenancies. Gifts are taxable in the year that they are made; they are valued on the date they are completed (i.e. when the donor no longer has the power to change its disposition) [Reg. §§ 25.2511-1 and -2].

The transfer of an asset into joint tenancy may be considered a completed gift depending upon governing state law. Generally, the gift is only complete when the asset is withdrawn by the noncontributing owner for his own use; but if the property remains in joint tenancy until the donor's death, the tenancy is treated as an inherited interest and its full value is includible in the decedent's estate. Some gifts are considered "complete" as soon as title is transferred; for instance, real property, mutual funds, stocks and bonds. Other gifts are considered complete only upon withdrawal of funds, even if title was previously transferred: Bank, savings and credit union accounts; brokerage accounts; and U.S. government bonds.

Each taxpayer is currently entitled to exclude the first \$13,000 given to each donee in any calendar year—this exclusion is indexed for inflation. To qualify for the annual exclusion, a gift must be a present interest, which is the immediate right to the use, possess, and enjoy the income from the property. The annual exclusion does not apply if these rights begin at some future time [Reg. §25.2503-3].

Direct payments of medical expenses or tuition—but not books, school supplies or room and board—for another person are not considered gifts for gift tax purposes, if paid to the school or physician and not the beneficiary [IRC §2503(e)]. While tuition for even part-time students is allowable, payments made to qualified tuition programs do not qualify. Medical payments may be for any type of expense normally deductible, including insurance premiums. Direct transfers to qualified political organizations are also not considered gifts for gift tax purposes. On the other hand, the following transfers are deemed to be "gifts" but are not reportable: (1) transfers to a U.S. citizen spouse (unless future or terminable interests are transferred), (2) transfers of present interests to a non-citizen spouse of \$136,000 or less, (3) charitable donations where the charity is the only beneficiary, and (4) any transfer of a present interest to any donee of \$13,000 or less.



All gifts in excess of the annual exclusion are reportable on **Form 709 United States Gift (and Generation-Skipping Transfer) Tax Return**. Gift tax returns cannot be filed jointly since each spouse has a separate annual exclusion attributable only to him, unless gift-splitting is elected.² In this case, a married couple can elect to treat all gifts made by either spouse as made one-half by each spouse. This allows the couple to maximize their annual exclusions and applicable credit amounts, but is only necessary when a gift is made from assets belonging to only one spouse which would otherwise not be fully excluded by that spouse's annual exclusion.

Gift tax returns must be filed by April 15th of the year following the calendar year in which the gratuitous transfer was made, unless an extension for filing the taxpayer's income tax

² To qualify, spouses must be U.S. citizens or residents. They must be married at the time of the gift and cannot remarry others before the end of the year. The election is made on lines 12 through 17 of **Form 709**. Each spouse must consent by signing line 18 of the other spouse's **Form 709**. The returns should be mailed to the IRS in the same envelope.



return has been requested using **Form 4868 Application for Automatic Extension of Time to File U.S. Individual Income Tax Return** [IRC § 6075]. If reporting gifts made by an individual since deceased, the filing deadline is the earlier of April 15th or the deadline (with extensions) for the estate tax return. While extensions extend the time for filing, they do not extend the time for payment which, if late, is subject to penalties and interest [IRC § 6651(a)(1)].

Although gifts are subject to the same tax rates and the applicable exclusion as estates, the lifetime gift exclusion is limited to only \$5 million (not indexed for inflation). Thus, gifts made in excess of the annual exclusion are reportable, but not taxable until they exceed the lifetime exclusion amount. Gifts in excess of the lifetime exclusion reduce the allowable estate tax exclusion and may ultimately become taxable once the transfers cause the estate to exceed its tax-free exemption amount.

Unlike the estate tax, the gift tax is cumulative, which means that each successive gift made during the donor's lifetime is computed on the total value of *all* gifts made. Thus, two taxpayers who have each given \$5 million are taxed at the same marginal rate, regardless whether one taxpayer gave the full \$5 million in the current year or the other taxpayer gave \$500,000 in each of the previous ten years. In other words, a donor who has made more lifetime taxable gifts will pay a higher tax on any new transfer.

GIFT TAX

- Assessed based on the value of the property transferred.
- Payments for tuition, medical costs and transfers into jt. tenancy are not "gifts".
- \$13,000 annual (\$5 million lifetime) exclusion applies.
- Eligible spouses may maximize their annual exclusion amounts by gift-splitting.
- Form 709 is due April 15th in the year after the gift was transferred and must be filed if the taxpayer gave more than \$13,000; a future interest to anyone other than a U.S. citizen spouse; a terminable interest to a non-qualified spouse; more than \$136,000 to a non-citizen spouse; a partial interest to a charity; or elects to gift-split.
- The gift tax is cumulative and so each successive gift that pushes the total of all gifts into the next marginal tax bracket is taxed at a higher rate.

C. Inheritance Tax (also known as a Legacy or Succession Tax)

Unlike the Estate Tax, which is assessed upon the decedent for the privilege of *transferring* his property at death, an inheritance tax is charged to the heir for the privilege of *receiving* property. Typically, such a tax is assessed by the state in which the decedent was domiciled and based upon the relationship of the heir to the decedent.³ For example, a decedent's estate might have been subject to estate taxation based upon the value of his estate at death prior to distribution. Then upon transfer, the decedent's heirs might also be taxed based upon the value of the assets distributed to them.

Arguably a double tax, many states⁴ no longer assess an inheritance tax, but instead impose an estate tax calculated as a percentage of the federal estate tax liability, referred to as the Pick-Up Tax. However, because the federal credit for estate taxes paid to the

³ In Iowa, for example, bequests to spouses, direct descendants, and ascendants are exempt from inheritance tax.

⁴ California levied taxes on inheritances since 1893; on gifts since 1939; both repealed by votes in 1982.

state has been repealed,⁵ even this tax has been eliminated. Only those states whose estate or inheritance tax structure has been established independently of the federal estate tax system still impose taxes on the decedent, the heir, or both.

D. Generation-Skipping Tax (“GST”)

The GST is imposed on a direct transfer of property to a grandchild that would otherwise be subject to two levels of estate taxation if first taxed as part of the parent’s estate, then transferred from parent to child, taxed as part of the child’s estate, and finally transferred to the grandchild.⁶ Because the GST rate equals the top bracket of the estate tax rate currently in effect, this tax usually exceeds that which would have otherwise been incurred at graduated rates if the property had been transferred and taxed at each successive generation.

Each transferor has a \$5 million exemption⁷ and the tax is not applied to outright gifts that are excluded by the annual gift tax exclusion or qualified transfers for medical and tuition payments. However, a gift to a trust which qualifies for the gift tax annual exclusion must meet additional requirements to qualify for the GST tax annual exclusion—for example, Crummey Trusts⁸ qualify for the gift tax but not the GST tax annual exclusion.



Direct skip transfers made during lifetime are reported on **Form 709**; direct skips made at death are reported on **Form 706**.

GENERATION-SKIPPING TAX


- Assessed based on the value of property transferred to a skip person
- GST transfers reported on Form 709 if made during life; Form 706 if made at death
- The exemption is currently set at \$5 million

E. Income Tax

Presuming that most taxpayers do not die precisely at the close of an accounting period, earned income will have to be allocated between the decedent for all amounts received prior to the DOD and the estate⁹ (or trust) thereafter. **Form 1040 U.S. Individual Income Tax Return** is used to report the decedent’s portion of the income and must be

⁵ IRC § 2011 was repealed after December 31, 2004 with the passage of The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

⁶ IRC § 2612: GST is imposed on direct skips, taxable terminations, and taxable distributions made to a skip person defined as a relative who is at least two generations below the transferor. Spouses, former spouses, tax-exempt organizations and charitable trusts are non-skip persons. If the transferor’s child is deceased, the grandchildren by that child are not considered skip persons. If the transferor has no lineal descendants and a niece or nephew of the transferor is deceased, the children of the deceased niece or nephew are not skip persons [IRC § 2651].

⁷  The exemption is automatically allocated to lifetime direct skips and to lifetime indirect skips made to a GST trust (which could have future taxable distributions or taxable terminations). Transferors can elect not to have the automatic rules apply [IRC §2632(b) and §2632(c)]. NOTE: That while the estate tax exclusion became portable between husband and wife during 2011 and 2012, any unused portion of the GST exclusion is not transferable.

⁸ Crummey Trusts, named for Clifford Crummey, can be used to transform otherwise taxable gifts into tax-free transfers by granting trust beneficiaries an opportunity to withdraw contributed funds for a limited period of time, thereby converting gifts of future interest into gifts of present interest.

⁹ An “estate” is created at the moment of death and becomes the liability of the fiduciary.



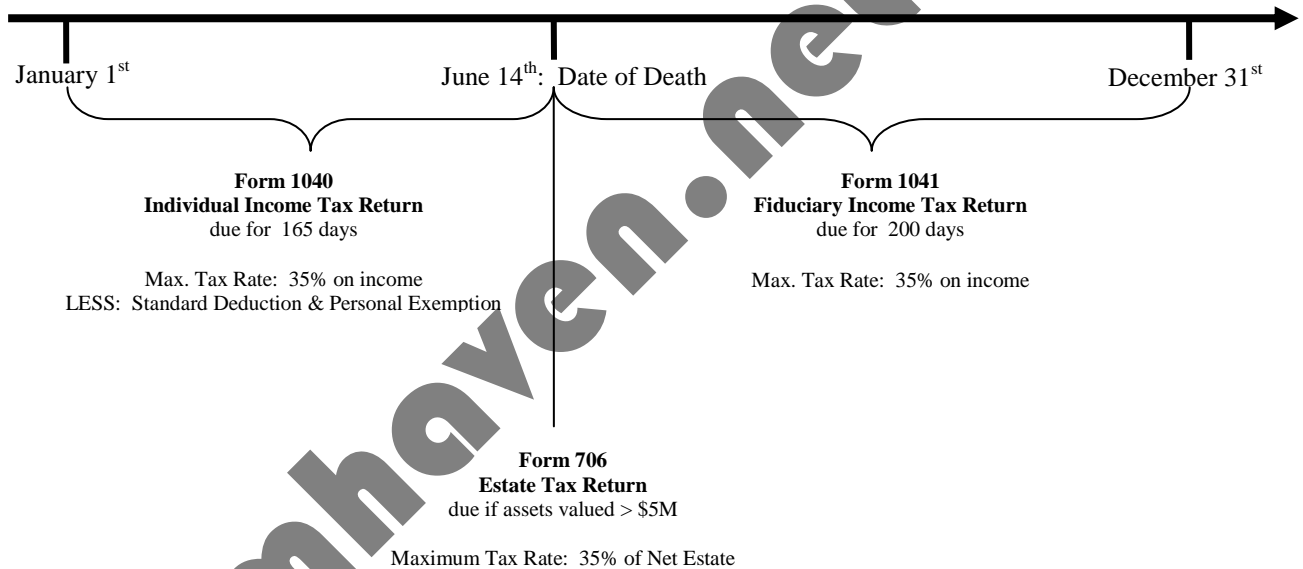
filed by April 15th of the year following the DOD. The estate's portion of the income is reported on **Form 1041 U.S. Income Tax Return for Estates and Trusts**, due by April 15th of the year following the DOD and for every year thereafter until the estate is closed.

While marginal tax rates are the same for individuals and estates, the brackets are considerably condensed for estates. Furthermore, estates and trusts are not entitled to claim Personal Exemptions or the Standard Deduction. Thus, they are effectively taxed at higher rates. The table of 2010 tax rates illustrates the point:

	10%	15%	25%	28%	33%	35%
Single	<8,375	<34,000	<82,400	<171,850	<373,650	>373,650
Married Joint	<16,750	<68,000	<137,300	<209,250	<373,650	>373,650
Estates/Trusts	N/A	<2,300	<5,350	<8,200	<11,200	>11,200

If a taxpayer died on June 14th, 2011, the following tax returns will be due:

- **Form 1040** – report income attributable to decedent before DOD (due 4/15/12)
- **Form 1041** – report income attributable to decedent's estate after DOD (due 4/15/12)
- **Form 706** – if decedent's estate over \$5 million (due 9 mo.s after DOD on 3/14/12)



INCOME TAX

- Must report income attributable to the decedent on Form 1040 and income attributable to the estate on Form 1041.
- Marginal tax rates for the estate are comparable to those for individual taxpayers, but the effective tax rate is higher since the tax brackets are narrower.

III. Estate Planning Alternatives



A brief review of estate planning alternatives follows, although each client (as well as the tax professional) should *consult with an attorney* before implementation of any strategy.

A. Will or Trust?

Planning for death is a necessary task that should be done with diligence, particularly if an individual cares to “speak from the grave” regarding such matters as (a) the disposition of his property (real and/or personal); (b) the naming of a guardian (for the care of his minor children), a custodian (to preserve assets for his minor children), or a conservator (in the event of his own incapacity); and (c) the appointment of a trusted individual to ensure that all of these wishes are carried out diligently

No Plan

Lack of planning puts these matters into the hands of the state. When a person dies intestate (without a valid will in place), local statutes are called upon to determine the distribution of the decedent’s property. Typically, intestacy laws rank heirs according to proximity of kinship. If there are no kin, the state acquires the decedent’s property.

Will (or Last Testament)


On the other hand, a will (if properly drafted and admitted into probate) can be used to distribute assets based upon the decedent’s preferences rather than kinship rules. A will, however, cannot (a) change the statutory rights of certain beneficiaries, such as a spouse or minor children, if local law mandates that they receive some or all of the estate; (b) determine the disposition of non-probate property,¹⁰ such as jointly-held assets or those assets which have beneficiary designations; (c) change the provisions of other estate planning documents, such as life insurance beneficiary designations; (d) update itself—in other words, a will only serves to express a decedent’s desires based upon the last time that he put pen to paper and will not account for changes due to intervening circumstances; (e) avoid the probate process, including all attendant costs and publicity.

Living Trust

As with all trusts, the ownership of property is divided into two parts: (1) legal title, which vests in the trustee and (2) beneficial ownership interest, which is managed by the trustee for the benefit of the beneficiaries. Created by a document signed by the trustor, the trust instrument specifies the duties of the trustee (and successor trustees, if named), as well as the management and eventual distribution of the trust’s income and principal to the trust’s beneficiaries. Because title of all trust assets¹¹ has already been transferred during the lifetime of the trustor, probate is not required to effect disposition at death.

The trustor has the right to revoke the trust and reclaim the ownership of all trust property at any time during his lifetime, but the trust becomes irrevocable on the DOD. The trust instrument (rather than a will) then controls the disposition of all trust property. However, because not all of the decedent’s assets may have been properly titled in the name of the trust—whether intentionally or accidentally omitted—most trust instruments are

¹⁰ The probate estate includes all of the decedent’s property that is subject to administration by the personal representative. Non-probate assets include those that can pass directly to the heirs based upon the operation of law, such as assets owned jointly with right of survivorship; life insurance, annuities and retirement assets with valid beneficiary designations; bank accounts and other assets with “payable on death” or trust designations; securities or security accounts that are “transferable on death;” and assets in trust, if the trust document includes a plan for distribution after death.

¹¹  Trusts *must* be funded by transferring and re-titling assets in the name of the trust at the time of the trust’s creation, as well as upon acquisition subsequent to creation. If left unfunded, a trust becomes a useless “shell.”

accompanied by a pour-over will¹² which can be used to transfer non-trust assets into the trust.

Although a living trust is considered a separate legal entity, income earned by the trusts is considered to have been earned by the grantor and, as such, is taxable to the grantor on the individual personal income tax return. And at death, trust assets are considered to be a part of the grantor's gross estate. Additionally, if an individual disposes of the right to revoke a prior transfer to a trust within three years of death, the assets in trust will be includible in the gross estate [IRC §§ 2036 and 2038].

Probate Avoidance

Probate may also be avoided by taking title as Joint Tenancy with Right of Survivorship (JTWROS) allows property to pass directly to the surviving co-owner. But unlike assets held as community property which receive a full basis step-up at the death of the co-owner, only one-half of JTWROS property is includible in the decedent's estate and therefore only one-half of this co-owned property will receive a stepped-up basis.

Gifting

An individual may choose to transfer assets to his intended beneficiaries during life, rather than bequeath them at death. Although this will have the effect of removing the gifted asset from the individual's estate, thereby avoiding probate and estate taxation, the transferor must understand that such a gift is irrevocable and that he will lose all economic benefits from and control over the gifted asset.

Charitable Transfers

An individual's estate may also be reduced by contributing property to a qualified charitable organization although, once again, such a gift is irrevocable and the gifted property would be unavailable to the decedent's heirs at death. This strategy is particularly beneficial when an individual chooses to donate an appreciated asset. Rather than selling the asset at FMV, paying the attendant capital gains tax, and then donating the residual cash, the individual could transfer the asset and reap a tax deduction for the current value of the property, subject to applicable income limitations.¹³

Additional Planning Documents



Estate planning should not be limited to post-death considerations and should include provisions for managing an individual's affairs in the event of incapacity, disability, or temporary emergencies. Documents that should be drafted, where appropriate, include:

1. **Power of Attorney ("POA")**, which allows one person (the principal) to authorize another (the attorney-in-fact) to act on his behalf. A durable POA remains effective even if the principal becomes incapacitated or incompetent, whereas a springing POA does not become effective until the principal becomes disabled. A healthcare POA (or living will) can be used to appoint an agent to make health care decisions when the principal becomes incapacitated or is unable to communicate. POAs are

¹² Property subject to a pour-over will passes under the terms of the trust, but is subject to probate since it was not held in the trust at the time of death. Most states offer a "small estate" exception to the probate filing requirement if the total value of the probate assets does not exceed a legislated amount.

¹³ The deduction for charitable contributions cannot exceed 50% of the taxpayer's Adjusted Gross Income ("AGI"). A reduced limit of 30% for donations of capital gain property to a 50% limit organization (unless the donor elects to reduce the FMV of the property by the amount of the long-term capital gain that would have been recognized had the property had been sold) and 20% for donations of capital gain property to qualified organizations that are not 50% limit organizations.



valid only during the lifetime of the principal and expire automatically at death (sooner if the document contains an expiration date or the principal revokes the power). **Form 2848 Power of Attorney and Declaration of Representative** must be used to appoint an attorney-in-fact to act on the principal's behalf regarding federal tax matters only. Most state tax authorities have their own comparable forms.

- 2. Will Supplements** can be used to provide instructions that are more detailed, more personal, or otherwise not included in the will or trust documents. A testamentary letter can be addressed to the executor and/or heirs to explain the workings of the will and the individual's desires in layman's terms. Alternatively or additionally, a memorandum may be used to identify personal property to be given to specific individuals but like the letter, is not binding and only provides guidance concerning the testator's wishes.
- 3. Ethical Wills** allow an individual to bequeath more than just hard assets to loved ones. By documenting values, beliefs, hopes, love, and life lessons, an individual can leave behind "values, rather than valuables."

ESTATE PLANNING ALTERNATIVES

- **Intestacy statutes apply when a decedent dies without having a valid will in place. These state laws typically identify beneficiaries based on kinship to the decedent.**
- **A will publicly announces decedent's desires and is often time-consuming and expensive to probate.**
- **A revocable trust may be established by a grantor and, if fully funded, used to transfer assets to beneficiaries outside of probate, as well as ensure that the grantor's assets can be managed during lifetime if he becomes disabled.**
- **Accounts with named beneficiaries and joint ownership can be used to avoid probate**
- **Estate reductions can be accomplished by gifting or donating assets.**

B. Special Needs

Often times an individual would like to accommodate special circumstances or ensure that his loved ones will be cared for in the event of his death.

Disabled Beneficiary

A Special Needs Trust ("SNT")—also known as a Supplemental Needs Trust—can be used to ensure that a disabled beneficiary can enjoy the use of a decedent's property without jeopardizing the beneficiary's eligibility for government aid. Most often funded with the proceeds from an inheritance or personal injury litigation and insurance settlements, SNTs are designed to comply with Medicaid rules which severely limit the number and value of assets that an individual may own.

Pets

Historically, pet trusts (used to ensure that a beloved pet is cared for after its owner's death) have failed to satisfy the rule against perpetuities¹⁴ which requires that the duration of a trust be measured against a human life and therefore should not exceed twenty-one years, no matter how unlikely it is that the trust would actually exceed this

¹⁴ The rule originates from Common Law (*Duke of Norfolk's Case* of 1682). The Duke tried to pass his titles to his sons and succeeding generations, if certain conditions should occur. When the second son failed to pass his title on to his younger brother as per their father's instructions, the court held that shifting conditions could not exist indefinitely and held that tying up property long past the lives of those currently living was improper.

time-frame. Today, some courts allow (just as others invalidate) testamentary provisions for pets depending on the jurisdiction, although most do not intercede where a trust is carried out voluntarily. Nevertheless, it is commonly accepted that outright gifts of money or property to a pet cannot be made because animals, classified as property, cannot hold title to other property. A pet, of course, can be gifted to an individual, along with a cash bequest to defray the costs of the animal's future care. Alternatively, a trust—either testamentary or inter vivos—can be established, naming a human caregiver (not the pet) as the beneficiary.

PLANNING FOR SPECIAL NEEDS

- **Third-party trusts, entitled Special Needs Trusts, may be established by a relative or court-appointed guardian for the benefit of a disabled beneficiary without jeopardizing the disabled person's eligibility for Medicaid.**
- **While property may not be bequeathed to a pet, an individual can transfer assets to a trust with a human beneficiary charged with the responsibility of caring for the animal.**

C. Duties of the Executor (Successor Trustee)

To ensure that all matters—personal and financial—are accomplished satisfactorily, it is crucial that an individual not only expresses his desires in a clear and legally binding manner, but that he also selects one or several appropriate fiduciaries whom he can trust to act in accordance with his wishes. Although bestowed with many titles,¹⁵ most have the following duties:

- **Duty of Loyalty** – the fiduciary must seek to avoid all conflicts of interest, cannot engage in self-dealing, and must act in the best interest of the beneficiary. In the event of breach, courts will neither investigate the fiduciary's reasons nor look for any element of fairness—no further inquiry will be made. Beneficiaries may then ratify the offending transaction (if the outcome was positive for them), trace and recover the misappropriated property (if possible), or sue the fiduciary (and demand that he disgorge his ill-gotten profits).
- **Duty of Care** – the fiduciary is required to act prudently and therefore cannot delegate fundamental duties. He must render periodic accounts to the beneficiaries as well as payout the income to which they are entitled; enforce and defend against claims on behalf of the trust; earmark the assets to prevent commingling; and act with impartiality and prudence.

FIDUCIARY RESPONSIBILITIES

- **Fiduciaries, appointed to act on behalf of another—in life or after death—owe a duty of loyalty and care to the principal for whom they are acting.**
- **Personal representatives of an estate must attend to all personal and business matters, including the management and preservation of the decedent's estate.**

Selection of Executor or Trustee

Fiduciaries appointed by will, trust, or court order to manage and eventually close a decedent's estate, must perform a host of duties that entail many accounting and

¹⁵ Personal representatives or fiduciaries can include: **Executor** if acting under the terms of a will, **Administrator** if court-appointed, **Trustee** if named in a trust document, **Guardian** if charged with the care of another person, **Conservator** if court-appointed to manage the affairs of another; **Custodian** if asked to safe-guard assets.



bookkeeping functions, as well as legal obligations.¹⁶ Therefore, when selecting a fiduciary, an individual must keep in mind that he is not bestowing an honor upon a relative or friend, but a burden!

More often than not, individuals place this burden upon an adult child who couldn't balance his own checkbook, let alone manage his parent's estate. Other times, individuals name their friends, forgetting that these individuals are likely of the same age and may either pass away sooner or certainly be unable or unwilling to accomplish the requisite tasks of a fiduciary in their quiet retirement years. To compensate for some of these short-comings, people often name multiple fiduciaries to act in concert (i.e. co-executors) or in succession. But asking feuding family members to co-manage property or call upon fiduciaries to discharge their duties from afar when they may live out-of-state is unreasonable. It is, therefore, important to select someone who may not only be implicitly trusted, but is also willing and able to act. And back-ups should be named in the event that the first-choice fiduciary is unable to assume his duties.


SELECTING A PERSONAL REPRESENTATIVE

- **The executor of an estate or trustee of a trust faces a “job” fraught with responsibility and liability—a job that requires honor, honesty, and integrity.**
- **Selecting the right person for the job is crucial and should be done with considerable thought based on the abilities and willingness of the individual to act when called upon. It is important to also select at least one or two successor representatives.**
- **State law may require the personal representative to be licensed and/or registered with one or more authorities.**

D. Marital Estate Planning

Keeping in mind that inter vivos trusts can, if properly funded, eliminate probate and ensure continuity of management in the event of the grantor's disability or death, it is important to note that the living trust, in and of itself, does *not* offer income or estate tax savings. Trust income and deductions are reported on the grantor's individual tax return. At death, when the trust becomes irrevocable, the trust is taxed as a separate entity subject to taxation on marginal brackets that are narrower than those applied to individual taxpayers. And because the trust assets belonged to the grantor, the estate will eligible for the same estate tax exclusion as if the assets were held in the individual's name. No tax savings can be achieved unless an inter vivos trust is used to take advantage of the unlimited marital deduction (“UMD”), but only if the grantors are married (to each other).¹⁷

¹⁶ California requires the personal representative of a probate estate to notify state authorities of a decedent's death and guarantee that he will discover and resolve the decedent's income tax obligations before distributing assets to the heirs [CA Probate Code § 9202]. *Similar rules may be applicable in other states.* Additionally, California requires all private fiduciaries to be licensed, including conservators and guardians who act on behalf of two or more unrelated beneficiaries, trustees and attorneys-in-fact who act for the benefit of more than three people or families. Although changes have been proposed, the following professionals remain exempt from registration if acting within the scope of their employment or practice: Trust Company and bank employees, investment advisors, attorneys, CPAs and enrolled agents. *Are you a Professional Fiduciary*, California Department of Consumer Affairs, available at http://www.fiduciary.ca.gov/forms_pubs/areyou.pdf [last accessed May 22, 2011].

¹⁷  Under current law (effective through December 31, 2012), the need for A-B and A-B-C Trusts has been eliminated for all but the wealthiest taxpayers due to the portability of the estate and gift tax exclusion which allows spouses to shelter up to \$10 million. However, portability may be forfeited if the surviving spouse remarries and then outlives the new spouse. Under these circumstances, the surviving spouse “inherits” the unused exclusion only from the last spouse. Traditional 2- or 3-trust estate planning should still be considered in the event existing estate tax legislation expires and is not renewed in its current incarnation or in situations where it is desirable to permanently exempt the assets of the bypass trust form estate and GST tax regardless of post-death appreciation or future legislative changes.

The UMD must be claimed for the value of property that is included in the decedent's estate but that is then transferred to the surviving spouse [IRC § 2056]. The deduction is available when (1) an outright transfer is made to the surviving spouse, (2) a marital trust is established that provides the surviving spouse an annual income interest for life and a general power of appointment, (3) the surviving spouse receives the benefit of life insurance or annuity proceeds payable to a trust naming the surviving spouse as beneficiary, or (4) the decedent's property is transferred to a qualified terminable interest property (QTIP) trust.¹⁸

A-B Trust¹⁹

To achieve maximum tax savings, an estate plan for a married couple must take advantage of both the applicable exclusion amount—currently \$5 million—and the UMD. Thus, if the couple's combined net worth exceeds \$5 million, effective estate planning calls for the creation of two trusts. At the death of the first spouse, a credit shelter trust—also known as a bypass trust—is established and funded with assets equal to the applicable exclusion amount, thereby avoiding taxation of these assets. All remaining assets then pass to the surviving spouse subject to the UMD, thereby postponing taxation of these assets until the death of the surviving spouse. Even though the surviving spouse may have access to the income generated from the bypass trust, those assets are not owned by the survivor and therefore will not become a part of the survivor's estate when that spouse later dies. Thus, assets equal to the current applicable exclusion amount are permanently sheltered from estate taxation.


A-B-C Trust

Alternatively, a married couple may want to use a three-prong approach, particularly when one spouse would like to provide for the children of a prior marriage.

Qualified Domestic Trust (QDT)

U.S. tax law imposes restrictions on transfers to non-U.S. citizens for fear of losing jurisdiction and the ability to tax dollars that have left the country. With the enactment of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the marital deduction for the transfer of property to a non-citizen spouse is no longer allowed [IRC § 2056(d)(1)], nor may one-half of jointly-held spousal property be excluded from the decedent's estate [IRC § 2040(a)]. However, the marital deduction is permitted—and the estate tax is deferred—if the estate of a citizen spouse is transferred to the non-citizen spouse in trust [IRC § 2056(d)(2)], under the following conditions:

- All trustees must be individual U.S. citizens or, if trust assets exceed \$2 million, the trustee must be a domestic bank;
- The surviving spouse must receive all of the trust's income, paid at least annually;
- The trust must pay the requisite tax on any income other than what is distributed annually to the surviving spouse as well as the tax due upon the death of the surviving spouse; and

¹⁸  A QTIP trust can be used to transfer property to a spouse that would otherwise be ineligible for the estate and gift tax deductions available to other marital transfers based upon the Terminable Interest Rule. If the decedent has chosen to make the surviving spouse's interest transient, allowing it to terminate in favor of another's interest contingent upon the occurrence of an event (i.e. a term of years or remarriage), no UMD is allowed [IRC § 2056(b)(3)(A)]. However, if the executor makes an irrevocable election when filing the estate tax return to treat some or all of the estate's assets as qualified terminable interest property, the UMD may be taken.

¹⁹ REMEMBER: A-trust assets are allocated to survivor who is above ground; B-trust assets to decedent who is below ground.

- An irrevocable election to treat the trust as a QDT must be made on the decedent's estate tax return.

The estate tax will be triggered and based on the value of any distribution of trust principal or based upon the value of the trust's remainder on the death of the surviving spouse, whichever occurs first. The tax is due on the 15th day of the fourth month following the year in which the taxable event occurs.

MARITAL ESTATE PLANNING WITH TRUSTS

- **Married couples can use A-B trusts to maximize available tax benefits: A-trust property can be (temporarily) sheltered from estate taxation on the death of the first spouse by the UMD; B-trust assets can be sheltered (permanently) by the decedent's applicable exclusion amount.**
- **A-B-C Trusts can be used to pass property to the surviving spouse and also preserve estate assets for third-party beneficiaries, such as the children of a prior marriage.**
- **Any estate tax due upon the death of the first spouse may be deferred until the death of the surviving non-citizen spouse, if a QDT is established.**

IV. Preparing the Fiduciary Return

Regardless of the type of trust employed, certain rules of taxation are applicable to all. Here is a step-by-step outline the practitioner may follow to prepare a proper fiduciary return, recalling however that any trust income attributable to a grantor trust managed by the grantor is allocated and reported on the grantor's individual tax return.



Unfortunately, individuals unfamiliar with the rules often apply for an EIN in the name of the revocable trust and then provide this number to the financial institutions where the trust assets are held. The payers, unaware of the error, issue **Forms 1099** at year-end incorrectly attributing income to the trust entity rather than to the grantor. Unless these improper 1099s can be re-issued using the grantor's Social Security Number (SSN), the fiduciary will be required to file a tax return for the trust, claiming all income and then deducting comparable amounts for which the trustee has now issued 1099s to the grantor [Treas. Reg. § 1.671-4(b)(2)(iii)].

Upon the grantor's death, the living trust becomes irrevocable. Trust provisions may call for a complete distribution of assets as soon as logistically feasible or may require a division of assets and the creation of additional trusts. At this juncture, new EINs must be assigned to each trust entity (or the decedent's estate if the inter vivos trust was not fully funded or the decedent's property passes under the provisions of a will). Once the respective trusts are funded (or a probate estate exists), **Form 1041** will have to be filed for each based upon the following rules:

Filing Requirements

- Estates must file with gross income over \$600 or a non-resident alien beneficiary.
- Trusts must file with gross income over \$600 (or *any* taxable income) or a non-resident alien beneficiary.
- A *new* **Form 1041** must be filed to amend any previously filed returns.

Tax Year

- Estates: The DOD is the beginning of the first tax year, which can cover any period of twelve months or less that ends on the last day of a month. (The executor makes the choice of the tax year when the first tax return is filed.)

- Trusts: Must use a calendar year,²⁰ except a grantor trust that files **Form 1041** must use the same tax year as the grantor. Therefore, in the year of the grantor's death, the trust must file for a short tax year from the DOD through December 31st.
- Returns are due on the 15th day of the fourth month after the close of the tax year.
- Beneficiary: Must report income in the tax year in which the trust or estate year ends.

*The executor of an estate of a decedent who died on February 17, 2010, elects to close the first taxable year twelve months later on January 31, 2011 and files **Form 1041** using a 2010 form (the year that corresponds to the start of the taxable year). But because the beneficiary does not receive the K-1 until early in 2011, he will report the income on his year 2011 **Form 1040** even though he received a 2010 Schedule K-1.*



- The filing deadlines may be automatically extended six months by filing **Form 7004 Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Return**. If the extension is not filed, a late filing penalty of 5% of tax per month up to 25%, plus late payment penalties and interest, will be assessed but may be waived if an explanation showing reasonable cause for the delay is attached to the return. If a return is more than 60 days late, the minimum late filing penalty is the smaller of \$100 or the tax due.

Estimated Tax Payments



- Estates: Estimated payments are only required for tax years ending two or more years after the decedent's death [IRC § 6654(l)].
- Trusts: Estimated payments are required if the tax liability is \$1,000 or more and the total of withholdings and credits is less than the smaller of either 90% of the tax for the current year or 100% of the tax from the previous year. If AGI in the previous year was more than \$150,000, the safe harbor is 110% (not 100%) of the previous year's tax. Estimated payments are based on income through February 28th for the April 15th payment, April 30th for the June 15th payment, July 31st for the September 15th payment, and November 30th for the January 15th payment.



A trust (or an estate in its final year) may allocate estimated tax payments to beneficiaries [IRC § 643(g)] and must file **Form 1041-T Allocation of Estimated Tax Payments to Beneficiaries** by the 65th day after the close of the tax year. A beneficiary is not required to include income distributed during the first 65 days of the following year in annualized income for the January 15th payment when a trust or estate elects to treat such income as if it were paid during the current year [Rev. Rul. 78-158].

Exemptions

- Estates: \$600.
- Trusts: \$300, if required to distribute all income currently (i.e. simple trust) or \$100 if permitted to accumulate income (i.e. complex trust).²¹ Qualified disability trusts are allowed an exemption amount equal to that of single taxpayers [IRC § 642(b)(2)(C)].

²⁰ However, the trustee of a qualified revocable trust may make an election to be treated as part of the decedent's estate under IRC § 645 to minimize duplicative filing requirements. The election must be filed by the due date (plus extensions) for **Form 1041** for the first taxable year of the estate, regardless of whether there is sufficient income to require the filing of that return using **Form 8855 Election to Treat a Qualified Revocable Trust as Part of an Estate**. During the election period, **Form 1041** is filed for the combined estate and trust under the name and EIN of the estate—the trust is only required to file a separate **Form 1041** if it terminates during the election period.

Accounting Income & Distributable Net Income (“DNI”)

Distinguishing between those beneficiaries entitled to a trust’s income (“income beneficiaries”) and those entitled to the trust’s principal (“remainder beneficiaries”), accounting income²² is the amount that the income beneficiaries are entitled to receive from the trust each year. The trust document may include a specific allocation or allow the trustee to make the allocation according to applicable state law, which typically requires that interest and dividends (classified as income) and capital gains (considered to be principal) be allocated to achieve fairness amongst the beneficiaries.

A trust earned \$3,000 of interest income and \$2,000 capital gains and paid fiduciary fees of \$600. The trust instrument allocates interest and dividends to “income;” capital gains to “principal;” requires that administrative costs be allocated equally between income and principal; and requires that all income be distributed to the beneficiary each year. The beneficiary will receive:

$\$3,000$ interest
 $- 300$ fiduciary fees (50%)
 $\$2,700$ beneficiary’s share



Accounting income does not determine how much of the trust’s income is taxable, nor does it establish whether the trust or the beneficiaries will pay the applicable tax. The income distribution deduction determines how the tax liability²³ will be allocated and is the lesser of (a) actual distributions less tax-exempt income included in that distribution; or (b) the distributable net income (DNI) less tax-exempt interest. DNI is an approximation of the actual economic benefit available to the income beneficiaries” and is the maximum amount that can be taxed to the beneficiaries—excess amounts are usually treated as tax-free distributions of principal.

DNI = Taxable Income
+ Tax-exempt Income
– Allocated Expenses
+ Personal Exemption
+ Capital Losses
– Capital Gains (if distributed or in year of termination)
– Expenses Allocable to Tax-exempt Income

A trust has \$10,000 dividends, \$10,000 LT capital gains, and \$1,200 fiduciary fees...

Simple trust required to distribute all income, including capital gains

Fid. Inc. = 10K + 10K – 1.2 = 18.8K

Tax. Inc. = 18.8 – 0.3 exemption = 18.5K

DNI = 18.8K

→ Trust’s taxable income after distribution = 18.8 – 18.8 = 0; Beneficiary’s taxable income = 18.8

Trust is not required to distribute capital gains

²¹ Simple trusts are those which are required to pay out all of the net income to beneficiaries, whether the distributions are actually made—income is taxable to the beneficiaries. All other trusts are complex; all income not distributed is taxed to the trust.

²² Report on Line 9, Schedule B of **Form 1041** as “income required to be distributed currently” if simple trust; on Line 8 of Schedule B if complex trust.

²³ Capital gains, however, are allocated on Schedule D. Generally capital gains are allocated to the trust, unless used to make a charitable contribution or actually distributed to the beneficiary [Reg. §1.643(a)-3]. When capital gains are taxed to the trust, the trust’s basis in these assets is increased to FMV and this stepped-up basis may be used for depreciation calculations, if applicable. On the other hand, capital gains are included in DNI and taxable to the beneficiary if required by the terms of the trust or the fiduciary exercises his discretionary power as per the trust instrument.

Fid. Inc. = 18.8
Tax. Inc. = 18.5
DNI = 18.8 – 10 cap. gain = 8.8
 → Trust's taxable income after distribution = 18.8 – 8.8 = 10; Beneficiary's taxable income = 8.8

Income distributions are classified based on whether they are required to be distributed (Tier 1)²⁴ or subject to the fiduciary's discretion and actually paid to the beneficiaries (Tier 2).²⁵ DNI is apportioned amongst multiple beneficiaries based on the amount and type of distribution made to each, but the trustee cannot designate which beneficiaries receive taxable income and which receive nontaxable distributions of principal. If DNI exceeds the income required to be distributed currently, it is first apportioned to the first-tier beneficiaries and then divided proportionately among second-tier beneficiaries.



Discretionary (Tier 2) distributions are generally deductible by the trust only in the year that accounting and make the required distributions, he may elect to treat amounts distributed in the first 65 days of the next tax year as though they were distributed in the current tax year by checking the box on Line 6, page 2 of **Form 1041**. Since simple trusts may not make discretionary distributions, this rule applies only to complex trusts.

	Fiduciary's Inc.	DNI	Taxable Inc.
Ordinary Income	✓	✓	✓
Tax-exempt Inc.	✓	✓	x
Dividends	✓	✓	✓
Cap. Gains	x	x	✓
Fiduciary Fees	✓	✓	✓
Exemptions	x	x	✓
Inc. Dist. Ded.	x	x	DNI – TE Inc.

Tax-exempt Income

A trust's tax-exempt income may be derived from life insurance benefits [IRC § 101], municipal bond interest [IRC § 103], personal injury compensation [IRC § 104], or income from discharge of indebtedness. [IRC § 108]. If a trust or estate has tax-exempt income, some of its deductions may be disallowed or reduced [IRC § 265]. For example, interest expense on debt incurred to buy tax-exempt bonds is not deductible. Indirect expenses—those not specifically related to tax-exempt or taxable income²⁶—must be reduced by the allocable amount attributable to tax-exempt income.²⁷

Deductions

Most deductions allowed to individuals are also deductible by the fiduciary, including:

- Investment interest (limited to net investment income)

²⁴ For a simple trust, the DNI equals the accounting income and is entered on **Form 1041**, Schedule B, Line 9. For a complex trust, DNI is the percentage of accounting income required to be distributed under the terms of the trust.

²⁵ Entered on **Form 1041**, Schedule B, Line 10. Lump-sum gifts or specific bequests (paid all at once or in less than three installments) are not included on either line 9 or line 10 [IRC §663].

²⁶ Only § 212 expenses must be allocated; other expenses, such as state and local income taxes and business expenses, are fully deductible even if directly allocable to the exempt interest income. § 212 expenses are administrative expenses that are generally subject to the 2% AGI limitation including expenses for the production of income, investment management fees, fees for tax advice and preparation unrelated to **Form 1041**, legal fees to defend decedent against creditor's claims, and fiduciary fees.

²⁷ $\frac{\text{Gross Tax-Exempt Income}}{\text{Gross Accounting Income}} \times \text{Indirect Expenses} = \text{Non-deductible Expenses}$

- Home mortgage interest if secured by a home that is owned by an estate or trust and a beneficiary uses the home as his principal residence
- Interest paid on the unpaid portion of the estate tax attributable to the value of a reversionary or remainder interest in property [IRC § 163(h)(2)(E)].
- State and local income tax, as well as property taxes
- Deductions *not* subject to the 2% limitation, including administrative expenses that would not have been incurred if the property were not held by the estate or trust [IRC § 67(e)(1)], trustee fees, attorney and accountant fees, fiduciary tax return preparation, fiduciary bonds, court fees, court-required appraisal fees and other required expenses



Most administrative expenses can be deducted on either **Form 706** or **Form 1041**, but not both.²⁸ For example, if expenses for selling property are deducted on **Form 706**, the same expenses cannot be included in the basis of the asset when the sale is reported on **Form 1041**. On the other hand, deductions in respect of a decedent (“DRD”) may be deducted on *both* returns, if the expenses were incurred by the decedent prior to his death but paid by the estate after death.

Estates and trusts are not entitled to the § 179 expense deduction. Generally, depreciation and depletion deductions must be allocated between the trust and its income beneficiaries on the same basis as the accounting income is allocated. However, if the trust instrument requires that the fiduciary maintain a depreciation reserve (and the trustee actually does), the depreciation expense is first allocated to the trust up to the amount of the reserve [Reg. §1.167(h)-1(b)].

The trust instrument requires that 30% of the its income must be distributed Beneficiary #1, 20% to Beneficiary # 2, and 50% may be accumulated by the fiduciary. If the annual depreciation allowance totals \$4,000, then the deduction will be allocated as follows:
\$1,200 to Bene 1 + 800 to Bene 2 + 2,000 to the trust = \$4,000

Charitable Deduction

A trust (or estate) may deduct charitable contributions *only* if (1) the contribution is required by the terms of the trust instrument or estate and (2) the payment is made from taxable gross income [IRC § 642(c)]. Unlike personal tax returns, the deduction for trusts and estates is not limited to a percentage of AGI. Unless the trust instrument or applicable state law requires that the charitable contribution be made from taxable income, the deduction must be reduced by the proportion of tax-exempt income included in gross accounting income [Reg. §1.642(c)-3(b)(2)].



Although paid in the current year, the trust may elect to push back some or all of the charitable deduction into the prior year. The election must be made by the due date (plus extensions) of the current return with a statement that includes the fiduciary’s name, address and identification number; the name and address of the donee organization, the amount and date of the contribution [IRC § 642(c)(1)].

	Individuals	Trusts & Estates
Ceiling	50% AGI	Unlimited
Recipient	Qualified Org.	Any charitable purpose
Locale	US only	Worldwide
Deductible Amount	Amount Paid	Amount <i>set aside</i>
When deductible?	In year paid	In year paid or prior (if elected)
Source of funds	Any income	Taxable income only*
Authorization	n/a	Controlling Instrument

²⁸ If the expenses are deducted on **Form 1041**, attach a signed statement stating, “These expenses have not been claimed as deductions for federal estate tax purposes and all rights to claim such deductions have been *irrevocably* waived.”



Excess Deductions

If, in the *final* year, a trust (or an estate) has deductions—not including charitable contributions or personal exemptions—which exceed gross income, the excess may be allocated to the beneficiaries and reported on a personal income tax return.²⁹ Capital losses may also be distributed to and deducted by the beneficiaries when the trust terminates or the estate is closed; excess losses may be carried forward.

FIDUCIARY INCOME TAX REPORTING

- Trusts and estates must file Form 1041 if they have gross income in excess of \$600.
- While trusts must use a calendar year, the executor of an estate may elect a fiscal year that covers any period up to twelve months after the DOD.
- No estimated tax payments are due for the first two years after the DOD for an estate or when the tax liability is less than \$1,000 for a trust.
- A \$600 exemption is allowed to an estate; \$300 to a simple trust, \$100 to a complex trust.
- It is important to distinguish between the fiduciary's accounting income, the trusts' taxable income, and the distributable net income which is the maximum taxable amount of distributions made to the beneficiaries.
- Trusts and estates are entitled to many of the same deductions as individual taxpayers. Some of these deductions may be deducted on either Form 1041 or Form 706, but not both.
- Deductible expenses must be pro-rated if the trust or estate has tax-exempt income.
- Charitable contributions may be deducted by the fiduciary only if the contribution is made from taxable gross income pursuant to the terms of the trust or will.
- Excess deductions in the final year of an estate or trust may be passed through to the beneficiaries, who may claim them on the current individual tax return, but cannot carry-forward any unused deductions.

Termination of the Estate or Trust

An estate (or trust) is considered terminated when all assets have been distributed (except for a nominal amount set aside for the payment of unascertained or contingent liabilities). Once terminated, the liability for tax reporting and payment shifts to the beneficiaries.

Since the fiduciary remains liable for all obligations of the estate or trust until termination, it is best that he does not make a final distribution to the beneficiaries, lest he be forced to reclaim the distributed funds [long spent!] from the beneficiaries in the event another liability surfaces at a later date. While creditors' claims must usually be discharged within one year from the DOD (although this deadline may vary according to state law), tax liabilities cannot be considered final until the applicable statute of limitations has passed or closing letters have been received from the tax authorities.³⁰



²⁹ These deductions may be claimed on Schedule A of **Form 1040** as miscellaneous itemized deductions subject to the 2% AGI limitation and may *not* be carried forward into future years [Reg. § 1.642(h)-2].

³⁰ As per Treas. Reg. §20.2204-1, the personal representative may request to be discharged from personal liability for estate tax by writing to the district director. The IRS must notify the fiduciary of any tax liability within nine months of filing the request or **Form 706**, whichever is later. An executor may also apply for discharge of personal liability for income and gift tax returns using **Form 5495 Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905**.

V. Preparing the Estate Tax Return

Depending on the size of the decedent's estate, **Form 706** may be required. Although a return is in fact only required if the decedent's estate (valued on the DOD) plus taxable lifetime gifts exceeds the applicable exclusion amount for the year of death,³¹ the fiduciary may nevertheless opt to file:

- To obtain a closing letter from the IRS, definitively putting all estate tax matters permanently to rest, or
- To establish cost basis for the surviving heirs, stepped-up to the valuations at the DOD as reported on the return, or
- To preclude claims by disgruntled heirs based on accepted asset valuations



Filing Deadline

Form 706 is due nine months after the DOD [IRC § 6075(a)]. **Form 4768** can be used to automatically extend the filing (but not payment) deadline by six months. No estimated tax is due since the tax liability must be paid with the filing of the return or the extension request. However, extensions for payments are available:³²

- for up to ten years for reasonable cause [IRC § 6161(a)(2)], although interest on the unpaid balance will continue to accrue
- for up to five years if the decedent's wealth (more than 35% of his estate) is tied up in a closely-held business or farm—the tax must then be paid in ten equal annual installments.

Statute of Limitations


As with all returns, the IRS has three years in which to audit the estate tax returns, however, the estate's representative may file **Form 4810 Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)** to shorten the statute of limitations to eighteen months. Instructions for the form specifically state that it may not be filed until all returns listed on the request have already been filed. The practitioner should advise the fiduciary that this request will almost assuredly invite scrutiny of the tax return by IRS examiners and so the request should be made with only be made upon due consideration.


Tax Rates

The currently effective rate in 2011 and 2012 is 35%.³³

The Estate Tax Calculation

- Gross Estate (GE) = Value of *all property* wherever situated
- Taxable Estate (TE) = GE – Deductions [IRC § 2051]
- Tax Base = TE + Adjustable Taxable Gifts (ATG) [IRC § 2001]

³¹  The applicable gift and estate tax exclusion amount in 2011 is \$5 million (\$10 million for husband and wife). The exclusion will be indexed for inflation after 2011. Effective January 1, 2011, the exclusion for married couples is treated as a collective exemption which means that any portion of the exclusion which was not used by the first spouse to die transfers to the surviving spouse [Tax Relief Act of 2010, § 303(a)]. BEWARE: If portability of the exclusion between husband and wife is not renewed after 2012, the surviving spouse will have to forego the inherited exclusion from the spouse who died in 2011 and 2012.

³²  Interest accrued on an estate tax liability deferred for hardship reasons is deemed to be personal interest not deductible on the fiduciary income tax return [IRS Chief Council Advice 200836027], although it may be claimed on the estate tax return as an administration expense.

³³ This is the lowest rate in 70 years! Unless the existing law is extended or new legislation is adopted before 2013, the tax rate and exclusion will revert to pre-2001 rules: 55% rate; \$1 million exclusion.

Decedent made \$1.5M taxable gifts between 2002 and 2005. His gross estate is valued at \$6 million when he died in early 2011 and he has no allowable deductions.

\$555,800	gift tax liability on previously-made \$1.5 million taxable gifts ³⁴
<u>- 345,800</u>	lifetime credit allowed on \$1 million of gifts [IRC § 2505]
\$210,000	gift tax previously paid during lifetime
\$6M	gross estate (GE)
<u>\$0</u>	assume: no deductions
\$6M	taxable estate (TE)
<u>+ 1.5M</u>	previously made taxable gifts (ATG)
\$7.5M	tax base
\$2,605,800	tentative estate tax liability
<u>- 1,730,800</u>	applicable credit based on \$5M in 2011
\$875,000	tax
<u>\$210,000</u>	gift tax previously paid [see above]
\$665,000	estate tax due now

Gross Estate

A decedent's gross estate includes his worldly possessions; in other words, the total of all of his property owned—wherever situated—on the DOD. This includes (a) cash, investments, retirement assets, tax-exempt assets, business assets, real and personal property; (b) probate, as well as jointly-held assets; (c) non-taxable assets exempt from taxation under the marital or charitable deductions; (d) life insurance and annuities, as well as special interests and powers [IRC § 2505]; and (e) one-half of the decedent's community property.

Under certain circumstances, additional assets may be added back to the gross estate that had been previously transferred and would appear to no longer have been in the decedent's possession on the DOD. When an individual retains the right to revoke a transfer to a trust until his death, or disposes of that right within three years of death, the trust assets in that trust will be includible in his gross estate [IRC § 2038]. Conversely, gifts from a grantor trust will be treated as though they were made by the decedent himself and will be eligible for the annual gift tax exclusion (and not includible in the estate) [IRC § 2035(e)].

Deductions

- 1. State Death Taxes** – prior to 2005, federal law allowed for a credit against the federal liability for estate taxes paid to state taxing authorities, but the credit was replaced with a deduction [IRC § 2058]. States that previously calculated their tax liability by charging an amount equal to the maximum federal credit (now no longer in existence) were required to change their tax structure or lose estate tax revenues.³⁵
- 2. Other Expenses** – to be deductible, expenses must be reasonable and necessary both under federal and state law [Treas. Reg. § 20.2053-3a]. For example, the interest expense incurred by a trustee to maintain, rather than sell a trust asset for seven years was disallowed because the expenditure was incurred for the benefit of the heirs and not the estate [*Hibernia Bank*, 581 F2d 741 (1978)].

³⁴ IRC § 2001(c) provides the current rate schedule.


³⁵ A detailed and updated listing of applicable state laws is available at http://www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf [last accessed May 22, 2011].

Specifically, commissions and fees may be deducted if actually paid or reasonably estimated. The expense of selling estate assets is deductible if it is necessary to pay the estate's obligations. The cost of recourse debt is deductible, although assets secured by non-recourse debt are reported on **Form 706** net of the liability and so that mortgage payment is not deductible. Deductions may be taken for services (i.e. caretaking) provided to the decedent at the full value of the consideration bargained for—even if that amount exceeds what would otherwise be considered FMV.

Basis and Holding Periods³⁶

The heir to a decedent's property receives what is known as "stepped-up basis." Unlike gifts, inherited property is assigned a basis equal to its value as claimed on **Form 706**. If no estate tax return is filed, the basis is the FMV on the DOD. Because we assume that most property increases in value throughout the decedent's lifetime, we assume that property is worth more on the DOD than when originally acquired—hence, we assume that basis is increased or stepped-up at death. However, values can also decline and so basis may, on occasion, be stepped-down.

This step-up or step-down is applied to all property acquired from a decedent, whether that property has passed through probate, by operation of law, or by contract. For jointly-held property, only that portion that is includible in the decedent's estate receives the step-up or step-down.³⁷ Basis revaluation does not apply to income in respect of decedent; annuity payments and lump-sum payouts received to the extent that they exceed the decedent's investment in the

³⁶  The rules outlined here apply to the estates of decedents who died prior to January 1, 2010 or after December 31, 2010, but estates resulting from *deaths occurring during the calendar year of 2010* were subject to special rules. During that period, the estate tax exclusion was raised to an unlimited amount, which meant that estates passed tax-free to heirs and assets were not revalued. This, in turn, meant that heirs did not receive a stepped-up basis, but rather assumed the decedent's basis (and holding period) and also inherited tremendous capital gain exposure.


Several exceptions applied:

- The fiduciary could allocate up to \$1.3 million of value to the heir's basis, though the new basis could not exceed the FMV on the DOD. The increase for non-resident, non-citizen decedents was limited to \$60,000.
- The fiduciary could allocate an additional \$3 million of basis to assets passing to a surviving spouse or QTIP.
- Basis increase did not apply to IRD property or to assets acquired by the decedent within 3 years prior to death.

<p><i>Bene inherited property with FMV of \$6 million (donor's basis = \$1.5 million) → Bene's basis = \$2.8 million</i> <i>Spouse inherited property with FMV of \$6 million (donor's basis = \$1.5 million) → Bene's basis = \$5.8 million</i> <i>Bene inherited property with FMV of \$6 million (donor's basis = \$8.7 million) → Bene's basis = \$6 million</i></p>
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Last-minute legislation in late 2010 ("Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act") not only re-introduced the estate tax exclusion and stepped-up basis, but also allowed estates of 2010 decedents to be taxed under the rules in effect for 2011 [§ 301(c)]. Since 2011 rules are favorable for most estates, the IRS presumes that an *automatic* election has been made to operate under these rules. If, however, a fiduciary of a 2010 estate wishes to operate under the 2010 law, an *affirmative* election must be made by filing **Form 8939 Allocation of Increase in Basis for Property Acquired from a Decedent** which, however, has not yet been drafted by the IRS!

³⁷ Unless the joint tenant contributed to or provided consideration for his portion of the jointly-held property, the entire value of the property is included in decedent's estate and, therefore, receives a stepped-up basis. On the other hand, only one-half of qualified joint interests—properties held exclusively by the decedent and spouse, both of whom must be U.S. citizens—are included in the decedent's estate and receive only one-half stepped-up basis. [IRC § 2040(b) and 2056(d)].

 **Community Property:** Although only the decedent's one-half share must be included in the estate, the surviving spouse's share also receives the stepped-up basis [Rev. Rul. 68-80 and 87-98]. NOTE: Property held in joint tenancy may not qualify for this treatment in all community property states.

contract [IRC §1014(b)(9) and §72, Rev. Rul. 2005-30]; excludable life insurance proceeds paid because of the insured's death; or appreciated property given to the decedent within one year of death that reverts from the decedent back to the original donor [IRC §1014(e)].



Capital gains from the sale of inherited property are always considered to be long-term, even when the property is sold less than one year after its receipt [IRC § 1223(11)].

Valuations and Appraisals

It soon becomes clear that much hinges on the proper valuation of a decedent's property. First, the total value of the estate determines whether, in fact, an estate tax return is even due. Then, upon filing, the valuations assigned to each asset determine the tax liability.

Obviously, the IRS typically favors high rather than low valuations to boost tax collections. The decedent's personal representative would obviously prefer the reverse, unless, of course, he is looking beyond mere estate tax consequences. Since the estate tax valuation becomes the property's basis, future capital gains taxes would be less if property were valued high at DOD. In this instance, the IRS would favor a low valuation. Statistically, more estate and gift tax returns are audited than all other types of returns filed. And many of those reviewed result in audit adjustments, primarily due to asset revaluations.

The general rule for **Form 706** reporting requires the decedent's property to be valued on the DOD [IRC § 2031], but the estate's representative may instead elect to report values on the alternate valuation date ("AVD"), up to six months later [IRC § 2032]. The AVD may only be used if it serves to *decrease* the value of the gross estate, as well as the attendant estate tax liability. If the AVD is elected, the following guidelines must be followed.

- The value on the date of disposition must be used for all assets sold, exchanged or otherwise disposed of within six months after the DOD. "Disposition," however does not include the transfer of title from the decedent to his surviving spouse or beneficiary.
- All other assets are valued at FMV on the AVD, except those affected by the mere lapse of time, such as remainder and reversionary interests which are valued at DOD.
- Interest earned after death but before the subsequent valuation date does not need to be included on **Form 706** when the AVD is elected [Treas. Reg. § 20.2032-1(d)].

While FMV can best be established when a willing buyer and a willing seller agree to a transaction at arm's length, most estate property cannot, need not, or will not be sold. Hence, guidelines have been established to assist with the valuation of specific types of property:

- Vehicles must be valued based on retail, not trade-in value as established by Kelly Blue Book, public auction prices, or a classified advertisement; the sale was made within a reasonable period following the valuation date; and no substantial change has occurred in the market for similar items [Rev. Proc. 65-19].
- Household items and personal effects should be inventoried on a room-by-room basis and each item should be valued individually, except those which are each worth less than \$100 may be grouped [Treas. Reg. 20.2031-6].
- The checking account balance may be reduced by the as-yet uncleared checks written by the decedent prior to his death. Alternatively, the uncleared checks may be claimed on Schedule K of **Form 706**.
- Checks payable to charities written by the decedent but not yet cashed on the DOD are excludable, but uncashed gift checks to individuals are deemed to be incomplete gifts and must be included on the estate tax return.
- Publicly-traded stocks and bonds must be valued based on the average of the high and low selling prices on the DOD. If the decedent died on a weekend, the highs and lows for the prior Friday and following Monday should be averaged. If the security was not traded

on a trading day, the value must be calculated using a weighted average for sales on the nearest sales dates [Treas. Reg. §20.2031-2].


- Mutual funds should be valued at the net asset value (“NAV”) on the DOD. If, again, the DOD occurred on a weekend or holiday, then the NAV from the day preceding should be used [Treas. Reg. §20.2031-8(b)].
- Rev. Rul. 59-60 outlines some of the many factors that should be considered when valuing business or partnership interests, including the company’s net worth, prospective earning power, dividend-paying capacity, goodwill, the industry’s economic outlook, the company’s position within the industry, and the value of comparable securities. Although no definitive standard exists, discounts may be applied where the shareholder has a minority interest or there is no ready market for the shares.
- Certain real property may be eligible for special use valuation [IRC § 2032A], allowing valuation based on *current* use rather than *highest and best* use. To be eligible for this election, the property must have been used as a family farm for five of the most recent eight years prior to the DOD *and* continued to be used in the same manner for the next 10 years after death. Furthermore, the property must constitute 25% of the gross estate.

Often it is best to get an appraisal to determine the value of property that cannot otherwise be objectively determined. The IRS requires appraisals that are deemed “qualified” to substantiate taxpayer claims, which means that the appraisal must be prepared no earlier than sixty days prior to the date of contribution of the appraised property; be signed and dated by a qualified appraiser who may not charge a prohibited fee (based on a percentage of the appraised value); and contain all of the following information: a detailed description of the property, including its physical condition; the date (or expected date) of contribution; the terms of any understanding between the donor and donee regarding the use, sale, or disposition of the property contributed; a statement that the appraisal was prepared for income tax purposes; the date on which the property was appraised; the appraised FMV of the property; the method, basis, and justification of the valuation used; the name, address, and taxpayer identification number of the qualified appraiser, as well as his background and qualifications; and a description of the fee arrangement between the appraiser and the donor. A qualified appraiser is an individual who holds himself out to the public as an appraiser or performs appraisals on a regular basis; is qualified to make appraisals of this type because of his expertise; is not an excluded individual (i.e. the donor, the donee, or someone affiliated with either); and understands that intentionally false valuations may subject him to penalties.

Income in Respect of Decedent (IRD)

Cash-basis taxpayers report only that income on their tax returns which they have actually received. Therefore, if a decedent dies after he has earned the income but before it is paid to him, he will not have had taxable income. Instead, the income—now known as IRD—is taxed to the estate or heir to whom this income is actually paid [IRC § 691(a)]. The courts look to two tests to determine whether the decedent or the estate should be taxed on the income: (1) Legal Enforceability Test [could the decedent have enforced his right to the income?]; or (2) Economic Activities Test [have all requisite events to create the income occurred?].

Taxed at the time of receipt, IRD retains the same character when reported by the estate or beneficiary as it would have if it had been reported by the decedent. IRD is claimed *both* as income on **Form 1041** *and* as an asset on **Form 706**. The estate tax attributable to the IRD inclusion on **Form 706** is deductible as an expense on **Form 1041** [IRC § 691(c)].³⁸ Note, however, that IRD does not receive a stepped-up basis.

³⁸  The total Estate Tax Deduction (ETD) equals the estate tax paid on *net* IRD (after DRD has been deducted). To compute the ETD, reduce the Adjusted Gross Estate (**Form 706**, Page 1, Line 5) by the net IRD and recompute the estate tax due. The



If the marginal tax rate of the decedent is lower than that of the estate or the decedent is entitled to deductions that might otherwise go unused if there is no offsetting taxable income, it is best to accelerate the anticipated income, rather than have it be treated as IRD. For example, accrued but previously unreported interest from U.S. savings bonds may either be reported as income on the decedent's **Form 1040** [Rev. Rul. 68-145], as IRD on the estate's **Form 1041**, or as income on the heir's **Form 1040** if he cashes in the bonds. Option two is the least favorable as the estate's tax liability will probably be higher than that of the decedent or his heir. Similarly, the executor may want to elect out of installment treatment for sales occurring in the year of death to once again accelerate income onto **Form 1040** rather than **Form 1041**.

Examples of IRD include, but are not limited to:

- Proceeds from the sale of a jointly-owned residence unless the surviving tenant becomes the full owner of the property by operation of state law
- Deferred compensation and bonuses, as well as retirement plan distributions
- Annuity payments in excess of the decedent's investment in the contract
- Pre-death leasehold income

Just as there may be IRD, there may also be attendant deductions in respect of decedent ("DRD") which the decedent would have had the right to deduct had he paid them prior to the DOD. Most deductions which could be claimed on Schedule A of **Form 1040** are eligible for DRD treatment, except:

- Credit card charges made by decedent, since they are considered paid when charged
- Checks written before death if decedent had *sufficient* funds (if insufficient, then DRD)
- Decedent's medical expenses and alimony payments
- Depreciation is not deductible as DRD by the estate since it gets the stepped-up basis instead (but depletion expenses are deductible)
- Prior-year passive and net operating losses, as well as capital loss carry-forwards are deductible on **Form 1040** only—unused deductions are forfeited and not considered DRD

Common Estate Tax Audit Triggers

A number of issues may trigger the audit of an estate tax return—a few suggestions follow:³⁹

- Avoid deficient appraisals by ensuring that the appraisal is as specific as possible, that it does not use boilerplate language, that it thoroughly substantiates any valuation discounts applied, that it is clear and understandable, and that it does not include arithmetic errors.
- Include all previously-filed gift tax returns, if available.
- Adhere to the tax allocation between the marital or charitable share of the estate as mandated by the governing instrument.
- Report jointly-held assets properly and use the appropriate percentage when calculating the includible amount in the estate.
- Do not exclude or under-value personal property.
- Do not omit any of the decedent's assets, even those that may be hard to value.
- Explain any valuations that may appear to be lower than expected.
- Include all relevant supporting documentation.

recomputed tax is then subtracted from the actual estate tax due to determine the tax attributable to the net IRD only. This, then, is the amount of ETD that may be allocated to the fiduciary of the estate (deductible on **Form 1041**), or the beneficiaries (deductible on **Form 1040**), or ratably between both. The ETD based on IRD taxed as ordinary income may be deducted as a miscellaneous itemized deduction *not* subject to the 2% AGI limitation; the ETD associated with capital gains on the estate tax return is netted against capital gain income on the beneficiaries' or fiduciary's Schedule D. NOTE that there is no ETD if: (1) **Form 706** is not required, (2) there is no **Form 706** tax liability, (3) there is no IRD on **Form 706**, or (4) DRD exceeds IRD.

³⁹ Jill Miller, *Common Estate Tax Audit Triggers and How to Avoid Them*, excerpted by RIA Newsstand (December 17, 2007).

- Make sure that the submitted return looks professional, is easy to read, and does not include typographical errors.

FILING THE ESTATE TAX RETURN

- The executor may elect to file an estate tax return—even if the value of the estate is less than the applicable exclusion amount—to establish valuation amounts and prevent potential disputes.
- Form 706 is due nine months after the DOD, but filing may be extended for six months; and payment may be deferred for up to ten years for reasonable cause.
- The statute of limitations for examination and assessment is generally three years, but can be shortened to eighteen months upon request.
- The tax base upon which the estate tax is calculated includes all taxable gifts made by the decedent.
- Deductions must be reasonable and necessary under federal and state law.
- The state death tax credit was replaced by a deduction for state taxes paid, resulting in the elimination of the pick-up tax in those states which tied their tax structure to the federal system.
- The basis of inherited assets is stepped up to the DOD valuation and the holding period is always long-term.
- The executor may elect to use the alternate valuation date—up to six months later—only if it serves to reduce the estate tax liability.
- FMV is determined by comparable retail sales transactions or, better yet, by appraisals.
- IRD is included on Form 1041 as income and again on Form 706 as an asset of the estate. The estate tax attributable to the IRD may be deducted on Form 1041.

VI. Preparing the Gift Tax Return

Gift tax returns must be filed for all taxable transfers of property for which inadequate consideration was given in exchange, with some exceptions—no return is due for gifts that do not exceed the allowable annual exclusion to each donee, donations of the donor's full interest in the donated property, transfers to political organizations as defined in IRC § 527(e)(1), or payments that qualify for educational and medical exclusions.



Filing Requirements

Form 709 must be filed in the following situations, even if no tax is due with the return:

- A taxpayer gave gifts in excess of the annual exclusion amount (\$13,000) to someone (other than a spouse)
- A taxpayer made a gift in excess of \$136,000 to a non-citizen spouse
- A taxpayer made a gift of a future interest of any amount since it is not exempted by the annual exclusion amount
- A married couple elects to split gifts regardless of the amount or either spouse makes a gift of jointly-held or community property (treated as though each spouse made a gift of one-half of the property)⁴⁰
- If the individual is a beneficiary, partner, or shareholder of a trust, estate, partnership, or corporation that has made a gift
- If the donor has died prior to filing a gift tax return, the executor must do so on his behalf
- If the donor has not paid the gift tax and the liability transfers to the donee

Filing Deadline

Form 709 is due on April 15th of the year following the year in which the reportable gift was made. If the gift tax return is filed on behalf of a decedent, it is due on the earlier of April 15th or the

⁴⁰ Each spouse must file a separate **Form 709** since joint gift tax returns cannot be filed.



deadline (with extensions) for the estate tax return. If an individual has requested an automatic six-month extension to file his personal tax return, the filing deadline for the gift tax return is also automatically extended; however, any gift or GST tax that is due must be sent with the extension request.⁴¹ The usual late filing and/or late payment penalties and interest apply [IRC 6651(a)(1)].



Form 709 must be filed whenever a donor makes a reportable gift, whether or not he anticipates that his cumulative gifts will be exempt under the lifetime exclusion or that his estate will ultimately be too small and not subject to the estate tax.

Tax Rates

The applicable rates are the same as those applied to the estate tax (currently 35%).

Exclusions

Each year, each individual may make tax-free gifts up to the annual exclusion amount to as many recipients as he would like. The annual exclusion amount is indexed for inflation but is adjusted only when the next \$1,000 increment has been reached. Thus, the current exclusion amount is \$13,000 per donee per year.⁴² The exclusion for transfers between spouses is unlimited, except for those transfers made to a non-citizen spouse which are limited to \$136,000 per year. Any excess is subject to gift tax.⁴³

Even when **Form 709** is required, not all gifts need to be reported since each donee is considered separately. If all gifts to one donee can be excluded by the annual exclusion, no gifts to that donee are reported; however, if gifts to a second donee exceed the exclusion, then those gifts must be reported on Schedule A, Part 4.

Additionally, each donor is limited to a lifetime exclusion of \$5 million (\$10 million for married couples), which is *not* indexed for inflation. This exclusion translates to a gift tax credit of \$1,730,800 (based on current applicable tax rates). Thus, if an individual makes taxable gifts in excess of the annual exclusion amount, he must report them on **Form 709** when made, but need not pay any tax until his current or subsequent taxable gifts cumulatively exceed the lifetime exclusion. Accumulated gifts excluded by the lifetime gift exclusion serve to reduce the applicable exclusion available to the decedent on his estate tax return.

Gifts can include cash transfers, payments made to third parties on behalf of a donee, interest-free or below-market-rate loans, the creation of certain joint tenancies, irrevocable transfers to a trust, amongst others. However, such transfers are only valued, reported, and subject to tax once the gift is considered “complete.” A gift is deemed complete when the donor relinquishes all rights to change the disposition of the property in any manner [Treas. Reg. § 25-2511-1 and -2].



⁴¹ Payment must be submitted with **Form 8892-V Payment Voucher**. If **Form 4868** is not used to extend the individual return, **Form 8892 Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax** must be filed to extend the gift tax return.

⁴² The annual exclusion is available to gifts of present interest only. Examples of interest that do not qualify include:

- A gift to a trust where the trustee has discretion to withhold payments to the beneficiaries or choose which beneficiary to pay currently—both are examples of *future* interests.
- A gift to A for life and then to B at death, although the trustee has the discretion to also pay principal to A—here, the income is a *present* interest, but the corpus is *future*.

⁴³ The creation of a joint tenancy between a U.S. citizen and a non-citizen spouse is not subject to gift tax at the time of its creation, but will be taxed upon its termination.

Dad loans Son \$200,000 to be repaid in five years without interest. As the IRS presumes that the son should be charged a fair rate of interest (computed at the applicable federal rate), Dad is effectively making a gift of the interest that should have been charged and is liable for the gift tax thereon [IRC § 7872]. Additionally, Dad is liable for the income tax attributable to this imputed interest, while Son may claim the interest expense deduction [IRC § 163]. After two years, Dad chooses to forgive Son's debt and thereby makes a gift of the unpaid principal balance. Because this is a gift, Son does not have any income tax consequences on the debt forgiveness.

Family loans are often a bad idea. If made, the parties should (a) document the transaction, (b) set up an amortization schedule, (c) charge interest, and (d) limit the life of the loan.

The Gift Tax Calculation

- (Taxable Gifts during lifetime X Applicable Tax Rate)
- (Taxable Gifts in current year X Applicable Tax Rate)
- = Tentative Tax (calculated at cumulative graduated rate)
- Credits (i.e. Applicable Credit Amount)
- = Tax Due

Sequence of Gift and Estate Calculations

Assume \$500,000 gifted in 2003 and \$600,000 gifted in 2006...

\$ 500K in 2003	→ tax = \$155,800	but \$0 paid since < \$345,800 lifetime credit
600K in 2006		
\$ 1.1M total		
	\$ 386,800	tentative tax on total gifts made in both years
	-155,800	tax on 2003 gift
	\$ 231,000	tax attributable to 2006 gift
	-190,000	remaining credit (= \$345,800 - 155,800 used in 2003)
	\$ 41,000	tax due in 2006

Assume taxable estate of \$2.9 million on DOD in 2006...

\$ 2.9M estate in 2006		
+ 1.1M prior taxable gifts (see above)		
\$ 4.00M tax base		
	\$ 1,700,800	tentative tax on \$4 million tax base
	-41,000	tax previously paid on gifts (see above)
	\$ 1,659,800	estate tax liability
	-780,800	unified credit (based on \$2M in 2006)
	\$ 879,000	tax due @ 2006



The gift tax is tax-exclusive, while the estate tax is tax-inclusive since prior gifts are added back into the estate, thereby effectively subject to tax atop tax. Furthermore, the estate tax is based on the value of the decedent's assets on the DOD—these assets include the cash he will need to pay the estate tax. On the other hand, cash used to pay the gift tax is not part of the gift tax base—as a result, a larger amount can often be transferred in life rather than death.

Basis and Holding Period

The donee's basis and holding period of property transferred by gift generally equals the donor's basis and holding period [IRC §§ 1015 and 1223(2)]. The basis may be increased by the amount of gift tax attributable to the accumulated appreciation, if actually paid.

Donee received a gift with basis of \$100K and FMV of \$120K; Donor paid \$5K gift tax; Donee sold the item for \$150K... Donee's basis = \$100K + [(\$120K FMV - \$100K Basis) ÷ \$100K Basis X \$5K gift tax] = \$101K

However, if the donee sells the gifted property for less than the FMV at the time of the gift, his basis is the lower of the donor's basis or the FMV of the property at the time of the gift.

	<i>Example # 1 Sell < FMV</i>	<i>Example # 2 Sell btx FMV & D's Basis</i>	<i>Example # 3 Sell > FMV</i>
Donor's Basis	100	100	100
FMV at the time of the gift	90	90	90
Donee's Sales Price	80	95	120
→ Donee's Basis	90 <i>the lower of FMV or Donor's Basis, since property was sold at a loss</i>	90 or 100 <i>basis for gain is 100, but no gain; basis for loss is 90, but no loss</i>	100 <i>since donee sold the property at a gain, basis is equal to Donor's basis</i>
Donee's Capital Gain (Loss)	(10) = 80 - 90	0	20 = 120 - 100

If an owner sells his property for less than its FMV, the transaction is deemed be part sale/part gift. The buyer's basis is the greater of the amount paid for the property or the seller's basis, increased for any gift tax paid attributable to the appreciation. However, basis for loss cannot exceed FMV at the time of the gift. The seller's capital gain is the difference between the amount realized from the sale and the adjusted basis; loss is not deductible [Treas. Reg. § 1.1001-1(e)].

	<i>Example # 1 Donee sells at gain</i>	<i>Example # 2 Donee sells at loss</i>
Donor's Basis	12	40
FMV at the time of the gift	35	35
Donor sells to Donee for...	20	20
Donor's reportable gift	15 = 35 - 20	15 = 35 - 20
Donor's Capital Gain (Loss)	8 = 20 - 12	(20) = 20 - 40 <i>BUT Donor cannot deduct loss</i>
→ Donee's Basis	20 <i>the greater of amount Donee paid or Donor's basis</i>	35 <i>greater of amt. Donee paid or Donor's basis BUT never more than FMV</i>
Donee sells for...	50	15
Donee's Capital Gain (Loss)	30 = 50 - 20	(20) = 15 - 35

Valuation of Gifted Property

Gifted property must be valued at FMV at the time that the transfer from donor to donee is completed. However, certain gifts may be subject to valuation discounts unavailable to testamentary transfers that can lessen the gift tax bite. On the other hand, transfers at death generally receive a stepped-up basis which may serve to lessen a future capital gains tax.

FILING THE GIFT TAX RETURN

- Form 709 must be filed to report all transfers made for inadequate consideration unless the gift amount to each donee is less than the annual exclusion amount or otherwise excludable.
- The filing deadline for Form 709 is April 15th of the year following the completed transfer or if made in the year of death, the gift tax return must be filed along with the estate tax return.
- Each donor is entitled to a \$5 million lifetime exclusion.
- Gift tax is tax-exclusive since assets used to pay the tax are not part of the taxable gift.
- Donee assumes donor's basis and holding period; however, if the gifted property is later sold at a loss, basis is limited to the lesser of the FMV at the time of the gift or the donor's basis.
- Property sold at less than FMV results in part sale/part gift treatment.

When asked what he wanted done with his ashes after cremation, a man on his deathbed said, "Just put them in an envelope and mail them to the IRS. Make sure to write on the envelope, 'Now you have everything'."