The Adviser’s Guide to Financial and Estate Planning

Volume 1 of 4

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About the AICPA Personal Financial Planning Section

The AICPA’s Personal Financial Planning (PFP) Section is the premier provider of information, tools, advocacy and guidance for CPAs who specialize in providing estate, tax, retirement, risk management, and/or investment planning advice to individuals, families and business owners. For more information and education on many of the topics covered in this publication, visit our website for the Proactive Financial and Tax Planning Toolkit, PFP Resources page, PFP webcast archive, PFP Practice Center, Advanced PFP Conference recordings, and the AICPA PFP Section homepage at aicpa.org/pfp.

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The AICPA established the Sidney Kess Award for Excellence in Continuing Education to recognize individual CPAs who have made significant and outstanding contributions in tax and financial planning and whose public service exemplifies the CPA profession’s values and ethics. Sidney Kess was the first recipient of this award. Mr. Kess was selected as one of “125 People of Impact in Accounting” by the Journal of Accountancy in its June 2012 issue celebrating the AICPA’s 125th anniversary. Mr. Kess was inducted into the New York State Society of CPA’s Hall of Fame. He recently received the New York State Society’s Outstanding CPA in Education Award.

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Chapter 1

The Art of Financial Planning

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¶101 Overview

*Financial planning* is the process of setting financial goals and objectives during life, designing strategies to achieve them, and monitoring progress toward achieving them. Financial planning includes investment planning, college planning, insurance planning and risk management, employee benefits planning, retirement planning, income tax planning, and estate planning. This publication addresses each of these areas of financial planning and gives special emphasis to estate and tax planning.

Guidelines for the practice of financial planning services have been promulgated by the AICPA Personal Financial Planning Section, effective July 1, 2014. CPAs advising clients in estate, retirement, investment, or risk management planning need to understand the [AICPA, Professional Standards, PFP sec. 100](http://www.aicpa.org/InterestAreas/PersonalFinancialPlanning/Resources/PracticeCenter/ProfessionalResponsibilities/Pages/PFPexposuredraft.aspx). The statement and available compliance toolkit issued by the AICPA PFP Section are discussed later in this guide.

*Estate planning* is setting goals and objectives and developing strategies for disposing of assets and providing for family members, friends, and charities at death. Estate planning is a part of financial planning because estate planning goals, objectives, and strategies directly affect the financial planning process during life.

Although people often think of estate planning as being important for the wealthy, anyone who owns property or has money has an estate. Estate planning includes more than tax implications. The federal and state governments regulate the use of property. However, the property owner decides what to do with the property—whether to keep it, sell it, exchange it, or give it away. The property owner may devise or bequeath the property upon his or her death or allow the state to determine the property’s disposition under state law. Asset protection planning, regardless of tax issues, is an important element of financial planning. For business owners, succession planning is an essential element of the financial planning process.
Although a financial planner may concentrate in one of the highly specialized areas of financial planning, the best financial planner needs a working knowledge of all areas. The goals of financial planning include anticipating and avoiding potential problems and fulfilling the client’s wishes. Financial planning is an art because it is a skill obtained by study and experience.

Investment planning includes developing investment strategies. These strategies could include designing a systematic investment plan and developing an asset allocation strategy. Investment planning is a major part of retirement planning. College planning includes saving and investing for future college costs of the client’s children or other family members. Insurance planning and risk management include analysis and evaluation of risks, choosing which risks to insure, and obtaining the right kind of insurance to protect against such risks. Life insurance is often a major part of estate planning. Employee benefits planning includes the evaluation of group insurance plans, employee stock options, retirement savings plans and other employee benefit programs. The financial planner should consider income taxes and estate taxes when developing employee benefit plans, investment plans, insurance plans, and retirement plans. Some strategies require the planner to consider tradeoffs between income taxes and estate and gift taxes.

Financial planning requires the client to make value judgments. The individual’s personal investment philosophy toward potential returns and risks is an important consideration in making these value judgments. The client must also consider family, emotional, and religious considerations. The financial planner should be careful not to impose his or her values, philosophy, or personal feelings upon the client, but should offer wisdom and experience. The role of the financial planner includes informing the client about alternative financial and tax planning strategies and the potential consequences of those strategies.

State laws and, where applicable, state inheritance and estate taxes affect any estate plan. The federal estate and gift tax exacts a toll for transferring property of substantial value.

Gifts made during lifetime and transfers at death are taxed as part of an integrated system with a unified federal estate and gift tax schedule. The law allows various deductions, exclusions, and credits when computing the estate and gift taxes. One of the allowable credits against the estate tax is the unified credit that corresponds to an applicable exclusion amount. The unified tax credit takes into account the estate and gift tax rates and the applicable exclusion amount.

The enactment of the American Taxpayer Relief Act of 2012 (ATRA) has imposed a "permanent" basic exclusion amount for purposes of the gift, estate, and generation-skipping transfer (GST) taxes. The amount of the basic exclusion for transfers by every individual is $5 million, indexed annually for inflation after 2011. The basic exclusion amount for 2017 is $5,490,000. This increased exclusion amount will protect the majority of clients from being payers of transfer taxes. However, for the wealthiest clients with assets in excess of the applicable exclusion amounts, the tax rate is 40 percent. Despite the fact that most clients may be freed of the burden of transfer taxes, and regardless of the size of one’s estate, the need for competent financial and estate planning is still present, as will be discussed in detail in the following chapters.

1 IRC Section 2001.
Planners may confront the very special circumstances surrounding a 2010 decedent. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Tax Relief Act) created a federal estate tax "choice" for persons who died in 2010. Either the estate tax was applicable with a $5 million exclusion and a maximum tax rate of 35 percent (and an heir’s basis in inherited property was adjusted to equal the decedent’s date of death or alternate valuation date value of such property), or an election could have been made for 2010 decedents to opt out of the federal estate tax system and be subject to the modified carryover basis rules of IRC Section 1022.

In 2011, a person’s lifetime gift exclusion was increased from $1 million to $5 million, adjusted annually for inflation. The exclusion numbers were $5,120,000 in 2012, $5,250,000 for 2013, $5,340,000 for 2014, $5,430,000 for 2015 and $5,450,000 for 2016. The exclusion from estate tax for persons dying in 2011 was also $5 million, increased in 2012 to $5,120,000, to $5,250,000 for 2013, to $5,340,000 for 2014, to $5,430,000 for 2015, and to $5,450,000 for 2016, the same exemption as made available for the gift tax. The maximum tax rate for transfers made in 2011 and 2012 (whether by gift or as the result of death) was 35 percent.

For persons making gifts in 2010 and thereafter, who made total lifetime gifts above $500,000 for years prior to 2010, it will be necessary to recompute the amount of the unified credit they have used in prior years due to the temporary reduction in the gift tax rate from 45 percent to 35 percent for 2010–2012 and then the increase in the tax rate to 40 percent for 2013 and beyond (IRC Section 2505). These calculations can be quite complex, and the use of a software program is recommended.

The 2010 Tax Relief Act also introduced the concept of portability of transfer tax exemptions between spouses (allowing the unused exemption of a deceased spouse to carry over to a surviving spouse) and also modified the GST tax rules. Both the portability rules and the enhancements to the GST tax rules were made permanent by ATRA. Portability, in particular, is a game-changer for clients and financial planners. At first look, portability appears to greatly simplify estate planning. It will accomplish that desired simplicity for many clients. But, for others, it will further complicate already difficult personal and tax-planning choices. Both portability and the GST enhancements will be addressed in detail in subsequent chapters.

Planning Pointer.

Proactive Financial and Tax Planning Toolkit

The American Taxpayer Relief Act of 2012 (ATRA) and Net Investment Income Tax (NIIT) have added more complexity to planning given that you now have to navigate through a multi-layer tax system in conjunction with running multi-year scenarios to gain a clear picture of the tax landscape in order to advise your clients on virtually all of their personal financial planning decisions. CPA financial planners now have an unprecedented opportunity to demonstrate their value to clients by providing guidance, planning, and tax expertise.

With the more generous estate tax exclusions under ATRA, the financial planner’s focus will increasingly turn to multi-year income tax planning. The thresholds for having a client become subject to the tax on net investment income and the higher rates on qualified dividends and long-term capital gains are planning areas that will need to be addressed. Gaining a stepped-up basis in assets wherever possible takes on increased importance. These issues and techniques to accomplish them are discussed throughout later in the guide.
The financial planner and client must also consider state estate and inheritance taxes. Federal law previously allowed a limited credit against the federal estate tax for state estate and inheritance taxes.\(^2\)

Congress repealed the state death tax credit and changed it to a deduction for the years 2005–2012. ATRA permanently repealed the federal credit for state death taxes and permanently continued the deduction on the federal estate tax return (Form 706) for estate and inheritance taxes paid to states.

The financial planner should check the applicable state law to determine whether the state imposes transfer taxes at a death, and, if so, the nature and extent of a particular state’s estate or inheritance tax. A number of states have decoupled from the federal system and have instituted their own estate tax exemption, often at an amount substantially lower than the federal exemption. The exemptions vary from state to state. The financial planner must be sure to advise a client that a federally tax-free estate plan does not necessarily also mean a state tax-free estate plan.

If an estate plan is designed to utilize the full federal basic exclusion amount at a person’s death ($5,490,000 in 2017) instead of passing such amount to a surviving spouse or charities, the state estate tax will be approximately $450,000, whereas it would have been zero had a spouse or charities been the beneficiaries of the basic exclusion amount. The state estate tax due would be $450,000 in a state that has an independent estate tax where the decedent fully funded a credit shelter trust in 2017—or left the full available exclusion amount to beneficiaries other than a surviving spouse or charities.

The costs of the probate process exact another toll on the decedent’s estate. The costs of probate vary from state to state and with the size of the estate. The principal costs are the attorney’s fees and executor’s fees. These fees may be based on the value of the probate estate and not on the taxable estate. The gross estate includes assets that pass to beneficiaries outside the provisions of a will or trust by operation of law, but the probate estate does not include these assets. The attorney’s fees and executor’s fees might be in the range of 5 percent to 9 percent for a small estate of $100,000, decreasing to about 4 percent or less for an estate of $10 million. Some states have strict statutory allowances and guidelines about allowable fiduciary and professional fees; others do not. It is not unreasonable to expect an attorney to charge a fee based upon the amount of time actually expended, rather than a fee based solely on a percentage of the estate. The nature of the estate assets will certainly influence the amount of work that needs to be done to complete the administration of the estate. Complications due to a poorly drafted will or trust, unhappy heirs, or a challenge of the competency of the testator can cause the professional fees to be much greater.

\(^2\) IRC Section 2011.
The estate may also incur substantial accounting fees. If the client sets up trusts, the client must pay fees for setting up the trusts and trustees’ fees for administering the trusts. Annual fiduciary income tax returns must be prepared for the trusts included in the estate plan. If the client has minor children, appoint a guardian in his or her will to safeguard the interests of the minor children. Pay attention to the possible imposition of the kiddie tax in these circumstances. If the decedent failed to appoint a guardian, the court will appoint a guardian for minor children with no living parent. The choice of the court may not reflect the parent’s wishes or values. In any case, the fees of the guardian exact another toll on the estate. In addition to the costs of transferring property at death, the estate will incur miscellaneous costs, such as court filing fees and routine expenses. These will vary from state to state.

The estate can also incur hidden costs. If the estate must sell assets quickly, it may not receive the fair market value of the assets sold. The estate may have to settle accounts receivable at deep discounts. The better the advance planning for these issues, the less likely problems will be encountered.

The decedent’s gross estate for federal estate tax purposes may include more property than just the property transferred at death. Property transferred during life will be included in the decedent’s gross estate if, at the time of death, the decedent retained an income interest in the transferred property or the right to use and enjoy it.³ Revocable transfers are included in the gross estate.⁴ In addition, property over which the decedent held a general power of appointment is included in the gross estate.⁵ If the decedent made a gift of properties over which a revocable power or general power of appointment had previously been held within three years of the date of death, the value of the properties will be included in the decedent’s gross estate.⁶ Any gift of a life insurance policy within three years of the decedent’s death is included in the gross estate.⁷ The gift tax paid on any gift the decedent made within three years of the date of death is included in the decedent’s gross estate.⁸

Generally, if the decedent held property as a joint tenant with right of survivorship at the time of death, the full value of the property is included in the decedent’s gross estate.⁹ If the only other joint tenant is the decedent’s spouse, only one half of the full value of the property is included in the decedent’s gross estate, regardless of which spouse furnished the consideration for the property. The law allows an exception to reduce the inclusion in a decedent’s estate if the executor can prove that a surviving joint tenant, other than the decedent’s spouse, contributed to the property’s acquisition cost. Proving what took place perhaps years ago is difficult without access to the appropriate records. These examples are only some

³ IRC Section 2036.
⁴ IRC Section 2038.
⁵ IRC Section 2041.
⁶ IRC Section 2035(a).
⁷ IRC Sections 2035(a)(2) and 2042.
⁸ IRC Section 2035(b).
⁹ IRC Section 2040(a).
of the examples of how the gross estate can include property not actually owned by the decedent at the time of death.

The law may impose the estate tax on what appear to be "phantom" values. Proving the fair market value of stock in a closely held corporation to an IRS agent may be quite difficult. Chances are the executor and the IRS agent will suggest valuations that are vastly different. If the executor does not agree with the agent’s determination, the executor can request a hearing with an IRS Appeals officer. If the executor cannot negotiate an acceptable compromise with the IRS Appeals officer, the estate will receive a statutory notice of deficiency.\(^{10}\) Such a notice allows the executor 90 days to file a petition with the U.S. Tax Court.\(^{11}\) Recent announcements by the IRS have suggested limited access to the Appellate Division due to budget constraints, especially if the taxpayer does not apply for an appellate conference well in advance of the expiration of the applicable statute of limitations. Planners should be aware of this policy and act promptly in the appropriate cases.

The executor could pay the proposed tax assessment and sue for a refund in a U.S. District Court or the U.S. Court of Federal Claims. Filing an appeal of an IRS agent’s determination with the IRS Appeals Division and then litigating the issue can be very expensive. However, the cost of disputing a proposed tax assessment by the IRS is reduced somewhat because these costs are deductible when computing the taxable estate.\(^ {12}\) The executor may need to file a supplemental return or a protective refund claim to claim these expenses when computing the taxable estate. Thus, in effect, the IRS might be paying a substantial portion of the costs incurred by the estate for challenging a proposed tax assessment.

The estate generally bears the burden of proof that the proposed IRS assessment is incorrect.\(^ {13}\) Although the law now allows the taxpayer to shift the burden of proof to the IRS in certain cases, meeting the requirements for shifting the burden of proof is often difficult.\(^ {14}\)

The executor often settles for a higher valuation than the executor believes to be fair because of the time and expense of litigation with uncertain results. Compromise is typically the end result of a valuation audit. The higher valuation has other effects along with the additional tax. Higher valuations generally increase administration costs because the size of the estate often serves as a base for determining administration costs. One advantage of a higher valuation is that it delivers a higher income tax basis to the decedent’s heirs. In cases where there will not be any federal tax to pay, higher valuations will be welcomed.

\(^ {10} \) IRC Section 6212.
\(^ {11} \) IRC Section 6213.
\(^ {12} \) IRC Section 2053(a).
\(^ {13} \) U.S. Tax Court Rule 142(a).
\(^ {14} \) IRC Section 7491(a).
In addition, the hidden costs often continue after the probate court closes the estate. The *unlimited marital deduction* allows an individual to transfer the entire estate to the surviving spouse free of estate taxes.\(^{15}\) However, this provision operates more as a means of estate tax deferral rather than a permanent saving of estate taxes. This result occurs because all the assets owned by the surviving spouse are included in the gross estate of the surviving spouse, who, of course, has his or her own basic exclusion available at death. If portability was elected at the death of the first spouse, the survivor may also have available the deceased spouse’s unused exclusion. Unless the surviving spouse remarries and transfers assets at death to the new spouse, no further marital deduction will exist upon the surviving spouse’s death.

The transfer of property at death can be very expensive. The costs of transferring property at death include federal estate taxes, state inheritance and estate taxes, and probate costs. The estate may also receive less than the fair market value on a sale of its assets. Reducing or eliminating these costs should be a central concern for financial and estate planning.

However, financial and estate planning involves much more. Financial and estate planning is concerned with providing for the welfare of individuals and the protection of their interests and assets through trusts and other means. Estate planning is concerned with the disposition of an estate, but it also involves the acquisition and preservation of an estate during the client’s life. Estate planning includes building tax-sheltered retirement benefits, a whole range of employee and executive compensation benefits, investments, and reducing the family’s income tax. Thus, estate planning is an integral part of personal financial planning.

\section{105 The Financial and Estate Planner}

The *estate owner* is the person who must take the responsibility for planning his or her own estate. However, the estate owner will need professional help to do so. No one can expect a layperson to understand the complex law involving the federal income tax, estate tax, gift tax, and GST tax without professional guidance. Anyone who attempts to do so is placing his or her estate plan in serious jeopardy and endangering the financial security of the family and others for whom he or she is responsible.

To assist individuals in planning their financial affairs and estates, the financial planner must approach estate planning with a breadth of knowledge and experience. Typically, estate planning requires a team approach. Estate planning often involves accountants, appraisers, attorneys, financial planners, life underwriters, and trust officers.

At its 2017 level of $5,490,000, the basic exclusion amount provides an exclusion from federal estate taxes for the estates of many clients. This amount is increased annually by an inflation factor. The unlimited marital deduction allows for deferral of estate taxes for married individuals until the death of the second spouse. Nevertheless, the financial planner must consider the potential imposition of the federal estate tax, even if the client’s estate is apparently not subject to that tax in the current tax year. The client’s estate could increase significantly due to an unforeseen event. The client’s marital status could

\(^{15}\) IRC Section 2056(a).
change due to marriage, divorce, or the death of his or her spouse. Despite the “permanent” provisions of ATRA, the law may change and provide for a less or more generous exemption from the federal estate tax. The financial planner must ask if making full use of the unlimited marital deduction makes sense because the marital deduction only defers estate tax. If the basic exclusion amount is insufficient to avoid all estate taxes, the financial planner should consider strategies such as lifetime gifts to take advantage of the annual exclusion from taxable gifts. For 2017, the annual exclusion amount for gifts of present interests is $14,000, indexed annually for inflation. The financial planner must consider the need of the estate and its beneficiaries for liquidity, especially if the estate consists of valuable but illiquid assets (such as family businesses, real estate holdings, artwork, and so on). The financial planner or estate planning team should discuss these issues with the client and provide the client with valuable input toward making the decisions regarding planning options.

The financial planner must also consider state property laws and family law and probate procedures when formulating an estate plan to recommend to the client. In addition, the financial planner must examine the income tax consequences of the estate plan for the client, his or her estate, and for the family. Factors the financial planner should consider include the following:

- Basis of assets
- Legal title of assets
- Income in respect of a decedent
- Life insurance
- Retained incidents of ownership
- Assignments
- Insurance and retirement plan beneficiary designations and settlement options
- Annuities
- Employee benefits
- Executive compensation
- Charitable giving
- Income splitting within the family
- Alternative minimum tax

16 IRC Section 2503(b).
• Income taxation of trusts
• The impact of the Net Investment Income Tax

Special considerations apply to an individual who is a business owner either as a shareholder in a closely held corporation, a member of a limited liability company, a partner, or a sole proprietor. The financial planner may need to address how corporate and partnership law, securities law, and accounting practices affect the estate plan.

For tax years beginning in 2017, the highest marginal income tax rate is 39.6 percent for taxpayers above taxable income thresholds of $470,700 (married filing jointly), $418,400 (single filers), and $235,350 (married persons filing separately). High federal income taxes combined with high employment taxes, the alternative minimum tax, the additional 0.9 percent Medicare tax on wages and self-employment income, the net investment income tax, and state income taxes have created demands on financial planners to develop strategies to minimize these taxes. Planners should be mindful of the words of Judge Learned Hand: "There is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right. Nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions." Planners have a positive duty to maximize tax-saving opportunities that goes beyond the words of Judge Hand.

The financial planner must be aware of tax-advantaged or tax-sheltered investments, including the exclusion from gross income for gains on certain small business stock, which may range from 50 percent to 100 percent, depending upon when the stock was acquired. The financial planner should be familiar with the complex rules that limit deductions for passive losses and the need for passive income to absorb passive losses. The financial planner should understand the basic types of investments, such as real estate, stocks and bonds, mutual funds, tax-exempt bonds, Treasury securities, annuities, life insurance, and limited partnerships. The planner should know what types of assets produce net long-term capital gains taxed at lower tax rates. The maximum tax rate on qualified dividends and long-term capital gains is permanently set at 15 percent for most taxpayers and at 20 percent for those taxpayers exceeding the highest taxable income thresholds for 2017 and beyond.

Knowledge of the client’s investment portfolio takes on increased importance in 2017 and thereafter in view of the 3.8 percent tax on net investment income along with the 39.6 percent marginal tax rate and related additional capital gains tax for taxpayers over certain thresholds. The net investment income tax applies to the net investment income of single tax return filers with adjusted gross income in excess of $200,000 and married persons filing joint returns with adjusted gross income in excess of $250,000. Married persons filing separately face this tax when their adjusted gross income exceeds $125,000.

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17 IRC Section 1202. The 100% exclusion was made permanent in 2015.
18 IRC Section 469.
19 IRC Section 1222.
20 IRC Section 1(h), as amended by the 2006 Tax Increase Prevention and Reconciliation Act (hereinafter TIPRA), Section 102.
These threshold amounts are not indexed for inflation. Planning is possible in several areas, namely de-
veloping strategies to minimize income that will be treated as net investment income (such as increasing
investment in municipal bonds) and reducing income that will be included in adjusted taxable income
(such as by converting traditional IRAs to Roth IRAs to avoid having required distributions from tradi-
tional IRAs be included in adjusted gross income in 2017 and subsequent years).

Planning Pointer.

Resources to Plan for the NIIT

Several resources are available to PFP and PFS members to help plan properly for the 3.8 percent NIIT,
which became effective January 1, 2013. These resources include a summary of the NIIT regulations,
checklists to plan for the NIIT for individuals and estates and trusts, in-depth newsletters and articles,
podcasts, webcasts, and more. Use these resources, available in the Proactive Financial and Tax Plan-
ing Toolkit and on the Additional NIIT Resources web page, to plan and communicate with your cli-
ents about this issue.

The financial planner must also be alert to the impact of the increasingly significant alternative mini-
mum tax (AMT). Once only a concern of the wealthy, the AMT is now affecting many middle class in-
dividuals. This shift has occurred for a number of reasons. The AMT exemptions have not kept pace
with inflation. Because the AMT applies only when it exceeds the regular income tax, the reduction (for
some taxpayers) in the regular income tax rates has placed more taxpayers in AMT territory. In any
case, financial planners must be careful to consider the AMT when mapping income tax strategies. The
AMT exemption amount will be permanently indexed annually for inflation.

The financial planner needs to be aware of how current economic trends, such as inflation and interest
rates, affect the financial plan. The financial planner must make a reasonable forecast of the overall
economy. The financial planner must also be aware of pending tax and legal changes that could affect
the financial plan. Financial planning is an ongoing process, and the financial planner should reevaluate
the plan periodically in light of changing circumstances.

The financial planner also needs good human relations skills. The financial planner needs to be sensitive
to the needs of the client and the client’s family. The financial planner must be able to work with other
professionals on the financial and estate planning team. Communication skills, especially the ability to
listen intently, are very important.

No one person can know everything about financial and estate planning. Perfect financial planners and
perfect plans do not exist. However, the law does not require perfection. Although the financial planner
may feel that he or she needs to be highly knowledgeable about all aspects of financial and estate plan-
ning, the law holds the financial planner only to a standard of reasonable skill and competence. The fi-
nancial planner should recognize his or her own limitations. The financial planner should suggest the in-
clusion of other professionals when he or she cannot serve the client’s entire needs effectively.

Financial and estate planning is often a team effort that requires the input of the lawyer, the accountant,
the life underwriter, the trust officer, and the investment counselor. Practitioners often recognize the
need for teamwork, even with respect to clients with smaller amounts of wealth. These practitioners seek
to build mutually beneficial relationships with other practitioners or informal networks. These relation-
ships and networks allow planners to tap the specialized expertise needed to safeguard the interests of their clients and themselves in developing a plan of any complexity.

However, cost and time factors may preclude or limit the use of a true team effort. The distinction between the separate functions of each team member is becoming less clear. Accountants are obtaining licenses to sell insurance and securities, and securities firms are acquiring accounting firms. Financial planners who are not lawyers need to be careful not to engage in the unauthorized practice of law. Only a lawyer may prepare a will or trust for a client.

The public needs to have reasonable confidence in the professional competence of those holding themselves out as financial and estate planners. Most professional planners recognize the public interest involved. The big question is how best to protect the public interest: through governmental regulation, self-regulation, or some mixture of the two as one can find in the legal and accounting professions. The AICPA has developed the Personal Financial Specialist (CPA/PFS) designation for its members who meet its examination, experience, and education requirements. The American College has a similar program in which its graduates earn the designation Chartered Financial Consultant (ChFC). The Certified Financial Planner Board of Standards assures some measure of competency by conferring the Certified Financial Planner™ certificate designation (CFP®) upon candidates who satisfactorily complete its requirements. The AICPA has issued SSPFPS No. 1, providing authoritative guidance and a framework for delivering PFP services with the highest levels of integrity, professionalism, objectivity and competence so that a CPA financial planner can serve the best interest of his or her clients and the public. See the discussion in chapter 43.

In many cases, the accountant can best identify financial and estate planning opportunities for clients. The accountant typically has access to the client’s books, records, tax returns, and financial statements. Lawyers, life underwriters, bankers, and investment counselors may also be privy to financial conditions of their clients or prospects that present planning opportunities.

_The Adviser’s Guide to Financial and Estate Planning_ is a guide to many of these opportunities, with warning lights around the pitfalls. This guide is intended to serve as a road map to the financial and estate planning process. It shows practical ways of building, preserving, and transferring wealth.

§110 Staying Ahead of Tax Law Changes

Over the last two decades, Congress has revised the tax law many times. This level of change makes the financial planner’s job much more difficult but also much more important. Although tax laws seem to change almost every year, the financial planner can rely on some general guidelines.

A competent individual may revoke or revise a will at any time. The same rule applies to a revocable trust. Accordingly, a lawyer should draft a will and trust documents based on the current tax law. If the tax law changes, the financial planner can urge the client to review these documents. The lawyer can then make any needed revisions. A will or trust based on an anticipated change in the tax law that never materializes may lead to undesirable results. Generally, an individual should plan a will or revocable trust as though it would soon take effect.
A gift, an irrevocable trust, or a sale of property requires a different strategy. Because the client cannot change the documents after these transfers absent court intervention or special statutory allowances, the financial planner should conduct a careful review of tax law changes under consideration. The financial planner should communicate the likely impact of the proposed changes on the client’s financial and estate plan.

Obvious uncertainties surround predictions of future tax rules. Therefore, the financial planner should carefully document plans and their purposes. When the financial planner considers future tax rules or deliberately ignores them, the financial planner should keep adequate documentation. File memoranda and letters to the client should fully document whether the financial planner considered future tax rules and indicate who (the financial planner or the client) made the final decision. The more documentation that exists, the more the financial planner will be insulated from legal liability should the client or his or her beneficiaries or heirs later allege malpractice. In addition, the more explanation given to the client, the better the opportunity the client has to evaluate the alternatives and make the best possible decisions. For example, when the financial planner makes projections of future tax consequences, the planner should inform the client that the financial planner is basing the projections on the current tax law. If possible, the financial planner should show the client additional projections based on anticipated and known tax law changes.

The 2012 ATRA is a good case in point. ATRA made permanent many of the numerous changes in the tax code originally made as temporary changes in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). For some taxpayers, ATRA resulted in permanently increased income and estate tax rates. For others, taxes, especially transfer taxes, were dramatically reduced.

Another case in point is the 3.8 percent tax on net investment income that became effective in 2013 (see ¶105). The tax applies to the net investment income of single tax return filers with adjusted gross income in excess of $200,000 and married persons filing joint returns with adjusted gross income in excess of $250,000. Married persons filing separately face this tax when their adjusted gross income exceeds $125,000. The financial planner can assist the client to take steps to possibly change the mix of investments or find ways to reduce the amount of adjusted gross income to avoid liability for the NIIT tax.

Hindsight is 20/20 when pointing out past errors in financial and estate plans. Reconstructing the situation at the time the financial planner gave the advice is much more difficult. The financial planner should guard against potential liability with thorough documentation. Focusing on the current tax law and pointing out the changes under active consideration can help prevent future complaints. A plan designed to be flexible as changes in the law arise is often the ideal plan. No financial plan lasts forever. Clients should be contacted regularly to determine whether there have been changes in their personal or financial lives. The next chapter provides guidance on the documents the financial planner should gather in the estate planning process.
A good way for a financial planner to get started in the planning process is to begin with the information contained in a client’s federal individual income tax return. Many financial planners began with an accounting and tax preparation background, and many continue to serve in that capacity, as well as in the role of financial planner. Use the client’s tax return as an easily accessible roadmap to begin to understand the client’s personal financial situation.

With your client’s permission, look at the client’s tax return to understand the client’s cash flow and income and expense issues. When the tax return is reviewed in conjunction with the client’s personal balance sheet (see the discussion in chapter 2 regarding the personal balance sheet), the financial planner gets an excellent look at the personal finances of the client. Perhaps this will enable the planner to uncover planning opportunities that may have been previously overlooked.

Let’s review Form 1040 section by section:

**Section 6c**

The section of Form 1040 that lists dependents will give the planner a snapshot of the family tree of the client—at least with respect to those persons being supported. This will create an awareness of issues addressing education of children, as well as possibly the support of elderly parents. The listing of income and its sources will help identify whether the clients are employees or self-employed. This can lead to a discussion of retirement planning savings and contributions. Issues, such as Roth IRA conversions and possible recharacterization, can be raised in this context. Are the clients collecting Social Security? If so, are there possibly some strategies to employ for them that would help them maximize their benefits and possibly reduce the income tax impact of receiving those benefits?

**Schedule B**

Examine the Schedule B of Form 1040 that lists dividend and interest income. This gives the financial planner important clues about the client’s investment strategies and risk tolerance. Is there a sufficient safety net of savings as a possible emergency fund available? Is the client properly diversified? Is cash flow sufficient? How are the assets owned—primarily by one spouse or the other or primarily in joint names? Do married clients reside in a community property state? Once this is determined, it will be possible to make some estate planning recommendations regarding separation of the ownership of the family assets. Look at the amount of tax-exempt income being reported. How does this category of income fit in with the client’s effective tax bracket?
Schedule D

Look at the Schedule D of Form 1040 where capital gains and losses are reported. Is there a capital loss carryover that can be used to offset aggressive trading gains? Should long-held positions be liquidated, especially if that will generate loss harvesting that can be put to positive use with a better flow of investments? Consider appropriate capital gain or loss harvesting to take advantage of the more favorable capital gain rates. Be wary of the Wash Sale rule requiring that stock sold at a loss not be repurchased for 30 days if losses are to be recognized and claimed as offsets to gains or as deductions, or both. What is the client paying for asset management or trading activity, or both? Perhaps the financial planner can suggest a more attractive arrangement.

Schedule E

Schedule E of Form 1040 is used to report information from rental property activities, as well as investment income from partnerships, limited liability companies (LLCs), and S corporations. Does the client have passive income or losses? Are there carryovers that can be used advantageously? Have the client explain the status of various investments. Which are marginal and candidates for replacement, and which are performing well? Schedule E also is the place where income from trusts and estates is reported. What is the client’s interest in such income—is it a short- or a long-term interest? How valuable is the interest, and will the client receive principal from the interest as well as income?

Income sections

Form 1040 may or may not list income from pension plans, IRAs, annuities, and similar sources. That would depend on whether the client is presently receiving distributions from these sources. If so, work with the client to determine how much is being withdrawn annually from retirement assets to determine if the underlying assets are sufficient to sustain the client throughout retirement. As age 70½ approaches, or if it has already been reached, make certain that the client is aware of the requirement to take required minimum distributions from his or her retirement plans.

Schedule A

Turn attention next to the itemized deductions reported on Schedule A of Form 1040. Each category of Schedule A contains valuable information that can be discussed with your client. The listing of medical expenses leads to a discussion of the client’s general health, as well as issues involving health insurance coverage, health savings accounts, long-term care insurance, and similar issues. If the client is at or approaching age 65, is he or she registered for Medicare, and has consideration been given to an appropriate supplemental Medigap policy? The listing of state income and property taxes may allow the planner to raise issues of residency and the possible change of domicile to a more tax-friendly jurisdiction, if that is something the client is willing to consider. Does the client maintain residences in more than one state? If so, that could possibly lead to complexity in the event of death if both states claim sufficient contact with the client to assert the state’s transfer taxes at death. The planner can point out the effect of state and local tax deductions on the client’s AMT calculation.
Interest expenses will be reported on Schedule A but only the interest arising from home mortgage obligations and investment interest expense. Has the client refinanced a home mortgage recently to take advantage of lower interest rates? Is the client in a position to carry more debt if that will lead to a more successful investment picture, or should the client reduce debt and eliminate the monthly carrying charges the debt requires? The client may, of course, have other obligations requiring the payment of interest that are not reflected on Schedule A. This could be business interest reported elsewhere, such as on Schedule E, if associated with business or investment properties, or personal and nondeductible interest expense from items such as consumer loans, car loans, credit card debt, and so on. The financial planner should be certain to address these expenses, as well.

The listing of a person’s charitable deductions on Schedule A of Form 1040 is another clue for the planner about the client’s intentions. How are the charitable goals being realized—by cash contributions or by contributions of appreciated property? Is the client obtaining the required acknowledgements from the charitable organizations to substantiate the contributions being made? Is the client using a "device" for contributions, such as a donor-advised fund or a split-interest charitable trust? Does the client have any charitable contribution carryovers? If the client has reached age 70½, is the client aware of the opportunity to have a contribution to charity made directly from his or her IRA, and have the contribution avoid being taxed to the client as income, and also count towards the client’s minimum required distribution? The planning opportunity has been made permanent by the Protecting Americans from Tax Hikes Act of 2015 (Path Act).

The miscellaneous itemized deductions reported on Schedule A offer additional clues about the client’s financial situation. What the client is paying for investment management advice and tax return preparation services is typically listed there. Is the client taking advantage of possible deductions for expenses incurred as an employee? What is the relationship between the deductions being claimed and the limitation of these deductions because of the 2 percent of adjusted gross income rule? Be aware that the Pease limitation reducing the use of certain itemized deductions by higher income taxpayers has been permanently restored. Can anything be done to improve the client’s situation here, such as moving some of these deductions to Schedules C, E, or F, if that is appropriate, given the client’s circumstances?

AMT

Check to see if the client has reported liability for the AMT. It may be possible to suggest some changes in the timing of receiving income or paying for deductible expenses that will have the effect of reducing AMT liability over several tax years. If the client has paid AMT, might an AMT credit carryover be available, and what can the planner suggest to utilize that carryover?

Schedule C

If the client is self-employed and filing Schedule C of Form 1040, examine the income and deductions being reported. A number of suggestions may be possible here, such as employing family members, adopting a medical reimbursement plan, maximizing retirement plan contributions, claiming a home office deduction, and so on.
The preceding suggestions address items that will emerge from the tax returns of many clients that the financial planner encounters. Of course, not every issue will arise on every tax return, and a client with special circumstances may have issues addressed on his or her return that are not suggested in the preceding discussion. The point to be made here is that Form 1040 can be viewed as a comfortable and understandable starting point for the financial planner—a way to get acquainted with the client’s situation and begin to offer suggestions that will make a difference for the client’s circumstances.

Many CPA financial planners added financial planning services to their tax practices because their clients asked questions that went beyond income taxes, including educating children, transferring wealth, protecting assets, selecting investments, and funding retirement. These CPAs have built their financial planning practices out of their existing income tax practices and have taken a holistic approach in the delivery of financial planning services to ensure all of their clients’ needs are met, including tax, estate, retirement, investments, and insurance. If you are interested in adding financial planning to your existing tax practice, visit aicpa.org/PFP/Pathway for additional resources and archived webcasts from the AICPA’s PFP Division to help you make this transition.

In addition to a myriad of other resources available at aicpa.org/PFP/Pathway, you will be able to access the customizable AICPA Personal Finance Report Card. The Personal Finance Report Card was developed as an interview tool with new clients and as a way of periodically reviewing client progress. Not only does it help identify important issues, but it also is a great motivational tool, encouraging the client to take actions that will raise the score at the next meeting. To complete the report card, have your client assign themselves a score in each of the 25 categories. Included with the report card are assessment questions to ask in each category for deciding how many points to assign. Discussions could lead to other billable services, such as the creation of a comprehensive or segmented financial plan, or could simply be used as an informal coaching opportunity with your clients.

Additionally, the checklist provided in exhibit 1-1 can be used to help CPA practitioners integrate financial planning into existing tax services.

Exhibit 1-1: AICPA Personal Financial Planning Division Analysis of a Tax Return for Personal Financial Planning

The following checklist (download a PDF copy) was developed by leading CPA financial planners to help you find personal financial planning opportunities in your tax practice. This checklist will help you analyze and identify key issues to consider as you prepare, review, and discuss your individual tax returns with your clients.
### AICPA Personal Financial Planning Division (aicpa.org/PFP)

**Analysis of a Tax Return for Personal Financial Planning**

The following checklist was developed by leading CPA financial planners to help you find personal financial planning (PFP) opportunities in your tax practice. This checklist will help you analyze and identify key issues to consider as you prepare, review, and discuss your individual tax returns with your clients. If you are looking to formalize your PFP services, download a free copy of the *Roadmap to Developing and Managing a CPA Personal Financial Planning Practice*. The *Roadmap* is your PFP atlas, with the information you need to plot a route to successfully add PFP as another value-added service to your established practice. The CPA's Guide to Financial and Estate Planning (free to PFP/PFS members) and the CPA/PFS Education Program (for sale; discounted for PFP/PFS members) provide in-depth information to help you handle client questions and plan in the areas identified in this checklist. Members of the AICPA's Personal Financial Planning Section have access to these resources and more! Join today and save $50 off membership. Enter promocode CPALDPFP at checkout.

<table>
<thead>
<tr>
<th>Done</th>
<th>Dependants and Filing Status</th>
<th>Notes</th>
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<tbody>
<tr>
<td></td>
<td>What is the client's filing status?</td>
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<td></td>
<td>Consider running Married Filing Jointly vs. Married Filing Separately analysis for possible lower tax result.</td>
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<td></td>
<td>Is the client divorced? If so, consider filing status and dependency exemptions.</td>
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<td></td>
<td>Does the client have dependents?</td>
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<td></td>
<td>Review dependency rules if parents are being claimed to confirm eligibility.</td>
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<td></td>
<td>Review dependency rules to consider if any children are eligible to claim themselves. Consider income shifting to take advantage of the children's lower tax rates.</td>
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<td></td>
<td>Review current and future cash flow analyses with respect to expenses of children and elderly parents. Consider full analysis to include retirement and estate planning (see below).</td>
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<td></td>
<td>Discuss the future financial commitment of this care with the client. Do the number and ages of dependents indicate that income continuation needs are likely to be high?</td>
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<td></td>
<td>Has the client considered gift and estate planning opportunities for his or her dependents?</td>
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<td></td>
<td>Discuss annual exclusion gifting (use it or lose it!). Have gift tax returns been filed?</td>
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<td></td>
<td>Discuss potential for education planning, including Section 529 plans, gift exclusions, or both, for payments made directly to an institution for tuition.</td>
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<td></td>
<td>Discuss potential for medical expense planning, including gift exclusion for payments made directly to a medical service provider.</td>
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<td></td>
<td>Discuss overall estate planning with the client, including desire for trusts for future generations. Consider cash flow analyses to determine the amount the client may be comfortable giving away today.</td>
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<tr>
<th>Done</th>
<th>Income (except for investment income, flow-through income, and Schedule C income, discussed later)</th>
<th>Notes</th>
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<tbody>
<tr>
<td></td>
<td>What is the source of the client's income?</td>
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<td></td>
<td>Understand sources of income—wages, self-employment, partnership, etc. and the client’s entire earned income situation.</td>
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<td></td>
<td>Review controllable and noncontrollable items of income (for example, wages, stock options, etc.) for use in income tax projection planning.</td>
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<td>Are there any income deferral opportunities available given the client’s income source?</td>
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<td></td>
<td>Discuss the benefits of saving through 401(k), 457, 403(b), Simplified Employee Pension Plans (SEP), or IRAs (including Roth).</td>
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<td></td>
<td>Are maximum 401(k) contributions being made? Assist client in discussions around benefit of maximization of contributions and deferrals and tax-deferred time value of money. Consider full projections to illustrate.</td>
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<td>Discuss benefits of 83(b) elections, if applicable.</td>
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<td></td>
<td>Discuss benefits of exercising stock options in one year or another (prepare income tax projections).</td>
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<td></td>
<td>Consider retirement planning cash flow analyses to assist in determining if current deferral and savings will suffice.</td>
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<tr>
<td></td>
<td>Does the client have income from a retirement plan still held with former employers?</td>
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<td></td>
<td>Discuss rollover of funds to an IRA or consolidating IRAs.</td>
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<td></td>
<td>Does the client have Social Security income?</td>
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<td></td>
<td>Consider whether any of the Social Security income-maximizing strategies might apply.</td>
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<td>Consider other planning opportunities.</td>
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<td></td>
<td>Review beneficiary designations on tax-deferred accounts.</td>
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<tr>
<th>Done</th>
<th>Schedule B</th>
<th>Notes</th>
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<tbody>
<tr>
<td></td>
<td>What are the sources of the client’s interest income?</td>
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<tr>
<td></td>
<td>If taxable, does it come from bonds, CDs, savings accounts, etc.?</td>
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<td></td>
<td>If tax-exempt, understand the state tax impact.</td>
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<td></td>
<td>If the source is savings accounts, consider the FDIC limits.</td>
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<td></td>
<td>If the source is municipal bonds, consider the safety of the bond.</td>
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<td>Does the client have any foreign bank accounts? Consider the boxes on Schedule B related to foreign accounts and consider whether Report of Foreign Bank and Financial Accounts (FBAR) or Form 8938 need to be completed.</td>
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<tr>
<td></td>
<td>What are the sources of the client’s dividend income?</td>
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<tr>
<td></td>
<td>Understand the types of stocks or funds generating the dividend income.</td>
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</table>
Is it mostly from mutual funds or stocks?

Are there alternatives to the investments you see here?

Consider other planning opportunities.

How are assets custodied?

How are assets titled? Does titling line up with client’s desires? Explain to the client various ownership options and impact of each.

Overall, does the client have investment strategy in place that guides decisions related to all investments held? If not, assist with this if desired.

Does the investment income indicate a concentration of certain investments? Discuss with client diversification strategies to mitigate market risk.

Has dividend or interest income dramatically increased or decreased since last year? If so, why? Does this represent a significant change to a client’s income vs. growth strategy, and should asset allocation be revisited?

Consider the amount of interest income compared to dividend income and how this represents the underlying portfolio.

Consider the tax efficiency of the investments and review asset "location." Given the Affordable Care Act taxes, should the client move investments that create taxable income into tax-deferred accounts and vice versa, while still maintaining an appropriate allocation?

Has the client established an account for emergency funds? If so, where and how much? Assist client with revisiting liquidity needs, including reviewing cash flow analyses.

Does the client have Schedule C income?

Determine what type of activity the business is and discuss hobby, investment, active trade, or business rules, including loss deductibility or limitation based on character.

Review groupings of activities under Internal Revenue Code (IRC) Section 469 to determine if elections should be made that would benefit the client (also see Schedule E).

Consider the use of different types of retirement plans for a self-employed individual.

Determine the income-shifting opportunities among family members via employment.

Discuss range of options to structure the business for risk management. Compare limited liability company (LLC), S corporation, C corporation, limited liability partnership (LLP), etc.

Discuss succession planning related to the business with the client.

Does the client have capital gains and losses reported on Schedule D?

If there is substantial trading activity, discuss with the client the overall strategy and ensure the client is aware of fees associated with such activity.

Consider the benefits of loss harvesting as a part of ongoing wealth management and as part of planning around higher tax brackets and new taxes.

Does the client have any retirement plan distributions?

Were any required minimum distributions (RMDs) taken, if they are required?

Consider net unrealized appreciation (NUA) election from the 401(k) if the client has substantial employer stock—should there be distributions?

Discuss with the client his or her beneficiary designations to ensure they agree with the client’s wishes.

Consider which retirement accounts the client should be taking distributions from to ensure highest tax efficiency.

Prepare retirement planning cash flow analyses to assist in determining if current deferral and savings will suffice based on client’s time horizon. Determine if current withdrawal rate is sustainable.

Is there income flowing through from an LLC, S corporation, or partnership to Schedule E, page 2?

Consider whether the activities are passive or active for purposes of deducting losses. Consider impact of additional investment income tax of 3.8% on passive activities under IRC Section 1411. Consider whether a change in level of participation might be available based on client facts.

Consider whether activities should be grouped under IRC Section 469.

Consider whether income from LLCs should be considered self-employment income.

If alternative investments and hedge funds are owned, be sure proper reporting is done for nonpassive vs. active items of income, including publicly traded partnerships. Discuss compliance complexities with client in relation to return on investments.

Prepare tax basis and at-risk basis schedules for all flow-through entities to ensure any tax impact from negative basis has been accounted for. Be sure to include regular and alternative minimum tax (AMT) tax basis.

How do any hedge funds, venture capital, or other alternative investments fit into their overall investment allocation?

Are there rental real estate properties being reported on Schedule E, page 1?

Consider risk management with the client (for example, consider single member LLC ownership).
Discuss the ownership of the rental properties with the client.
Discuss the estate planning impacts of the properties with the client.
Consider the passive activity loss rules. Could your client be considered a real estate professional?
Does insurance expense appear reasonable in relationship to property characteristics?
Consider what type of rental activity is reported: farm, residential rental, commercial, etc.
If the client is considering buying or selling properties, discuss benefits of using like-kind exchanges (IRC Section 1231).

Is there income flowing through from a trust?
Understand what assets are being managed in this trust.
Discuss the trustee selection with the client.
Find out from the client what the purpose of the trust arrangement is.
Review trust agreement, if available, and be sure to integrate any trust planning into overall estate planning.

Trusts reach highest tax brackets (for income and new Medicare taxes) at much lower thresholds than individuals. Consider whether distributions to individual beneficiaries makes sense to mitigate overall tax impact, but be sure any distributions line up with the estate plan and the reason the trust was created.

Consider other planning opportunities.
Is the client open to using business entities for estate planning purposes? If so, discuss with the client opportunities and risks related to valuations and discounting.
If grantor trusts exist, consider overall estate plan and whether it makes sense at some point in time to exercise powers inside the trust to turn off grantor trust status.
Given higher tax rates on individuals, consider S corporation to C corporation conversion. Run full analyses and consider all advantages, disadvantages, and pitfalls.
Consider succession planning if any flow-through entities are family-owned businesses. If children have varying degrees of involvement in the business, discuss opportunities to equalize descendants through estate planning.

Does the client have substantial charitable contributions?
Discuss with client overall charitable intent, both long and short term, to assist with income and estate planning.
Consider the timing of contributions to decide how to maximize the benefit. Run income tax projections to demonstrate phase-out.
Discuss charitable remainder trusts (CRTs), private foundations, charitable lead trusts (CLTs), and donor advised funds.
Consider having the client make contributions with appreciated securities to avoid the capital gains tax.
Consider the use of an IRA distribution direct to charity if client is over 70 1/2.

Does the client have a significant state tax deduction?
Discuss opportunities to bunch deductions in one year or the next to perhaps lower multiyear tax liability and increase effectiveness of other deductions (like charitable deductions). Run projections and be sure to include opportunities related to AMT and how state tax payments can contribute to AMT.
Ensure that all state tax deductions have been reported, including state payments made on client's behalf via flow-through entities.
Determine if the client has any residency issues (multiple residences, etc.) or is changing residency. Discuss opportunities but also ensure client is following rules related to residency changes.
Discuss opportunity for credits in your particular state that may be available to your client.
Discuss potential tax liability in other states with the client, including risk associated with hedge fund and alternative investments that file in various states.

Are there substantial medical expenses being deducted?
If there is a deduction for long-term care insurance, discuss this policy with the client.
Discuss with the client his or her current health insurance coverage.
Understand the Medicare rules and their impact on the client.
Explain to the client the issues related to elder care.
Do the expenses indicate inadequate health insurance coverage or special needs?
Ensure client is only deducting expenses related to himself or herself, spouse, or dependents. Consider gift tax implications.

Does the client itemize miscellaneous deductions?
Determine if the investment fees are reasonable or excessive.
Ensure that any investment fees related to tax exempt income are being allocated and disallowed. Be sure to account for state impact of this disallowance on state returns.
What other expenses are being deducted, and is Schedule A the right location? Are any expenses related to a business or investment property and, therefore, could be deducted elsewhere or capitalized for future use?
Explain to the client the 2% of AGI limit.
Consider planning opportunities to avoid the loss of deductions.

Does the client have interest expense that is being deducted?
Explain the benefits of the mortgage interest deduction.
Consider planning and refinance opportunities related to mortgage interest.
Discuss with client opportunities with deductibility of home equity lines of credit interest expense.
Be sure that the client is not exceeding the limits on mortgage interest.
Understand the investment interest expense carryover rules and what qualifies as investment interest expense.

If the client consistently has investment interest expense carryovers, consider election to use long-term capital gains and qualified dividends to offset. Consider rate impact of doing so vs. current reduction of tax liability.

Consider the various types of loans for education.

When will the client’s itemized deductions phase out? Does this affect your client’s decisions on things like charitable contributions, when to pay state income taxes, how to manage interest expense on debt, etc.? Beginning in 2013, itemized deductions phase out at the threshold of $289,400 for single taxpayers and $311,300 for married filing jointly.

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Is the client in AMT or have they been in the past?

Understand why the client owed an AMT liability.

Consider any planning opportunities that can be used to minimize the AMT impact.

Explain to the client the rules of exercising incentive stock options (ISOs) and the planning opportunities available.

If there is a minimum tax credit carry forward, identify when it was generated and consider implications.

Is the client potentially losing the AMT credit carryover?

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Consider the education credit alternatives.

Consider the available energy credits.

If client has foreign tax credits that are carrying over, even if small, consider deductibility on Schedule A vs. Form 1116.

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Does the occupation indicate special coverage needs (such as adequate disability insurance for a surgeon)?

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Always consider multiyear planning opportunities and potential future tax rate changes. Discuss future income and deduction items within the client’s control that may be able to be timed to result in a more favorable long-term tax liability.

Does the client live in a state where estate, gift, and generation-skipping transfer (GST) tax laws differ from federal law? Does the state have its own estate or inheritance tax? Review state law to ensure appropriate planning and consider transfers to minimize the impact of the state death tax.

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Special thanks to Sarah Hughes, CPA/PFS for her assistance in updating this checklist.

AICPA Personal Financial Planning Division (aicpa.org/PFP)
Chapter 2

Estate and Client Analysis

¶201 Overview

This chapter provides helpful tips and techniques for obtaining a client’s financial and estate plan information. Useful checklists to help the financial planner get started are provided in exhibit 2-1 at the end of the chapter.

¶205 Plan Prerequisites

Development of a sound financial plan requires the following:

- Full disclosure by the client of all assets and liabilities
- Determination of the client’s needs and objectives, without regard to the tax consequences, and feelings about the family members, including their requirements, strengths, potentials, weaknesses, and goals
- Full disclosure and review of any existing plan
- Full communication between the client and the financial planner concerning the existing plan’s merits and disadvantages, the options open for improving or replacing it, and the consequences of the various choices

The financial planner can normally expect a certain reluctance on the part of the client to make the full disclosures needed. The client might fear a breach of confidence. The client may have emotional difficulties when examining attitudes and feelings toward members of the family. The client might share some of the common misconceptions about financial planning and the financial planner’s role. The client might be concerned about the legitimacy of the different tax avoidance techniques. In addition, the
client often has the understandable tendency to avoid facing his or her own mortality in the estate planning part of financial planning.

210 Encouraging Disclosure

The client must be able to trust the financial planner. The client must have some understanding of financial planning to provide the financial planner with necessary information. Here are some approaches that have been helpful when eliciting information.

.01 Financial Planning

Financial planning involves meeting goals and objectives through financial management. Financial planning includes such areas as investment planning, college planning, retirement planning, income tax planning, insurance planning and risk management, employee benefits planning, and estate planning. Some clients view estate planning as a separate activity, but it is an integral part of financial planning. To some, estate planning is an unpleasant activity because it is associated with death. However, the financial planner can change this attitude by pointing out that building, preserving, and transferring wealth and property are key factors in the estate planning process.

The financial planner should remind the client that proper planning can help ensure that the needs of the client’s heirs will be met.

.02 Financial Disclosure

The financial planner should make clear the possible cost of nondisclosure or incomplete disclosure in terms of lost opportunities for tax savings. The financial planner should inform the client about income tax rates, deductions, and credits and estate and gift tax rates, deductions, and credits.

.03 Personal Disclosures

Specific inquiries about disabled children, the marital status of children, divorces, separations, estrangements, intra-family jealousies, and similar issues are not likely to be as fruitful as less direct approaches. When outlining the nature of individualized planning, the financial planner might suggest hypothetical situations requiring trusts for the disabled and protection for the spendthrift. Other possible hypothetical situations include anticipating the possible adverse effects of an out-of-state or foreign divorce on a later marriage and the availability of the marital deduction and detailing the advantages in terms of gift tax exclusions of a joint gift to a child and the child’s spouse.

The hidden message is that even seemingly irrelevant matters can be pertinent to the financial and estate plan.

.04 Getting Realistic Values

Values given by clients for assets without established market values may be unreliable. Clients might give lower values if estate or gift taxes are being considered than if a sale is the issue. The financial planner must clearly inform the client that fair market value, not book value or cost, is the relevant figure. If a business interest is involved, the financial planner might suggest an independent appraisal. If the financial planner needs insurance values, an agent or broker or the insurance company itself might supply the answers.
The tax basis of assets that are to be the subject of a gift will be important to both the donor and the donee. The basis of a lifetime gift from a donor to a donee is generally the same as it would be in the hands of the donor. This is referred to as carryover basis. For the donee, the tax basis will provide a benchmark for measuring gain on the disposition of the gifted assets in a taxable transaction. For the donor, the tax basis will be important in those situations in which the donor is deemed to realize gain on the gift, that is, the donee assumes or takes subject to a mortgage in excess of the donor’s basis, or possibly if the gift is conditioned on the donee’s payment of the gift tax (a net gift). Assets passing from a decedent receive a basis equal to their fair market value at the date of death or the value determined six months later if the executor elects the alternate valuation date.

Congress repealed the value at death basis rules for property acquired from a decedent who died in the year 2010 and replaced them with a modified carryover basis system, provided the decedent’s estate elected to opt out of the federal estate tax system for 2010. The modified carryover basis system is applicable, if at all, only to the estates of 2010 decedents.

Under the modified carryover basis system (for deaths in 2010 only when the estate’s representative elected to opt out of the federal estate tax system), inherited property will have a basis equal to the lesser of (1) the adjusted basis of the property in the hands of the decedent or (2) the fair market value of the property on the date of the decedent’s death. However, the executor may increase the basis of assets the executor chooses by up to $1,300,000. The executor may increase this $1,300,000 general basis increase by the sum of any capital loss carryover and the amount of any net operating loss carryover that the decedent would have had available had he or she lived. In addition, the executor may increase the $1,300,000 general basis increase by the sum of any allowable losses if the decedent had sold the property for its fair market value immediately before his or her death.

In addition to the $1,300,000 general basis increase as adjusted for the items noted previously, the law allowed an additional $3 million increase in basis for qualified spousal property passing to the decedent’s surviving spouse. Qualified spousal property includes an outright transfer of property or qualified...
fied terminable interest property (QTIP). An outright transfer must not terminate or fail due to the lapse of time or because some event or contingency occurred or failed to occur. A property interest will fail this test under the following conditions:

- An interest in the same property has passed for less than full and adequate consideration in money or money’s worth from the decedent to any person other than the surviving spouse or the estate of the surviving spouse.
- By reason of its passing, such person, or his or her heirs or assigns, may possess or enjoy any part of the property after such termination or failure of the interest passing to the surviving spouse.
- Such interest is to be acquired for the surviving spouse pursuant to directions of the decedent, by the decedent’s executor, or by a trustee of a trust.

A requirement that a marital bequest is subject to the surviving spouse living more than six months after the decedent’s death or not dying in a common disaster with the decedent will not disqualify a marital bequest from being an outright transfer. However, the surviving spouse must meet the specified contingencies.

The definition of qualified terminable interest property for the modified carryover basis rules closely follows the rules for the marital deduction. To qualify for the spousal basis increase under the QTIP provision, the property must pass from the decedent to the surviving spouse, who must have a qualifying income interest for life in the transferred property. The surviving spouse will have a qualifying income interest, provided the interest meets both of the following conditions:

- The surviving spouse is entitled to all the income from the property, payable at least annually, or has a usufruct interest for life under Louisiana property law.
- No person has a power to appoint any part of the property to anyone other than the surviving spouse while the surviving spouse is alive.

An annuity will be treated similarly to an income interest in property, regardless of whether the property from which the annuity is to be paid can be separately identified.

11 IRC Section 1022(c)(3).
12 IRC Section 1022(c)(4)(B).
13 IRC Section 1022(c)(4)(C).
14 IRC Section 2056(b)(7).
15 IRC Section 1022(b)(5)(A).
16 IRC Section 1022(b)(5)(B).
Property passing to the surviving spouse on account of the death of a decedent who died in 2010 (and whose estate opted out of the federal estate tax system) may receive both the $1,300,000 general basis increase and the $3 million spousal property increase. Thus, a total basis increase of $4,300,000 for the surviving spouse is possible. Increases in basis under either provision may not cause the adjusted basis of any property to exceed its fair market value on the date of the decedent’s death.\footnote{17}

For the property to qualify for the general basis increase or the spousal basis increase, the decedent must have owned the property at the time of his or her death.\footnote{18} Special rules apply to jointly held property, revocable trusts, property subject to a power of appointment, and community property.

The decedent’s ownership interest in property held as joint tenants with the right of survivorship will be determined using several factors. These factors include the following:\footnote{19}

- The number of joint tenants
- Whether the joint tenants are spouses
- The consideration the decedent furnished in acquiring the property
- How the joint tenants acquired the property

If the decedent and his or her spouse are the only joint tenants, the law deems the decedent to have owned 50 percent of the property. This rule applies regardless of how the couple acquired the property and regardless of the consideration the decedent furnished, if any.\footnote{20}

In cases in which the decedent is one of three or more joint tenants, the decedent’s ownership interest will be based on the decedent’s proportionate contribution compared with that of the other joint tenants.\footnote{21} If the decedent and two or more other persons acquired property as joint tenants with the right of survivorship by gift, bequest, devise, or inheritance, state law will determine the decedent’s share of the property interest. If state law does not specify or fix the ownership interests in such cases, the decedent’s share, for purposes of the carryover basis rules, will be computed by dividing the value of the property by the number of joint tenants.\footnote{22}

\footnote{17} IRC Section 1022(d)(2).
\footnote{18} IRC Section 1022(d)(1)(A).
\footnote{19} IRC Section 1022(d)(1)(B)(i).
\footnote{20} IRC Section 1022(d)(1)(B)(i)(I).
\footnote{21} IRC Section 1022(d)(1)(B)(ii).
\footnote{22} IRC Section 1022(d)(1)(B)(i)(III).
The decedent will be treated as owning property that he or she transferred while living to a qualified revocable trust. A revocable trust meets this definition if the decedent is deemed the owner of the trust under IRC Section 676 because the decedent retained the power to revoke the trust.23

The law does not deem a decedent to own property for the purposes of the basis increase rules solely because the decedent held a power of appointment over the property at the time of his or her death.24

The law deems community property to have been acquired from the decedent. However, at least half of the community property must be treated as owned by, and acquired from, the decedent without regard to the basis rules.25

The law does not allow increases in basis for property the decedent acquired by gift or by a lifetime transfer for less than adequate and full consideration in money or money’s worth within three years of the decedent’s 2010 death.26 This prohibition generally does not apply to property the decedent received from a spouse during this three-year period. However, the spouse must not have acquired the property in whole or in part by gift or by a lifetime transfer for less than adequate and full consideration in money or money’s worth.27

The increases in basis do not apply to the following properties:28

- Stock or securities of a foreign holding company
- Stock of a domestic international sales corporation (DISC) or a former DISC
- Stock of a foreign investment company
- Stock of a passive foreign investment company (PFIC)

An exception to the prohibition for the stock of a passive foreign investment company applies if the stock is a qualifying electing fund with respect to the decedent. To be treated as a qualified electing fund under IRC Section 1295, the investor in the PFIC must have elected to treat the PFIC as a pass-through entity, which limits the deferral on its investment income.

The estates of nonresidents who are not citizens are allowed only a $60,000 general basis increase instead of the $1,300,000 general basis increase allowed to the estates of U.S. citizen and U.S. resident de-

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23 IRC Section 1022(d)(1)(B)(ii).
24 IRC Section 1022(d)(1)(B)(iii).
25 IRC Section 1022(d)(1)(B)(iv).
26 IRC Section 1022(d)(1)(C)(i).
27 IRC Section 1022(d)(1)(C)(ii).
28 IRC Section 1022(d)(1)(D).
cedents. In addition, the estates of nonresidents who are not citizens are not allowed the $3 million spousal basis increase.\textsuperscript{29}

If the carryover basis rules were elected to apply for 2010, the financial planner should have ascertained the client’s date of acquisition and basis for each asset.

If the death occurred in any year other than 2010, or if there was no election out of the federal estate tax system for a death in 2010, the above-described carryover basis rules do not apply.

\textbf{.06 Estate Planning Misconceptions}

A little knowledge can be a dangerous thing, in estate planning and elsewhere. The client might have acquired views similar to the following:

- Avoiding probate is always a good thing.
- Taking the full marital deduction is always advisable.
- Making lifetime gifts to children cannot hurt.
- Assigning ownership of a life insurance policy to one’s spouse is always a smart move.
- Joint ownership of property is the easiest and best way of transferring property on death.
- The only reason one might want to put property in trust for his or her spouse is if one feels that he or she will not be able to handle the management of the funds.

If these or other misconceptions surface, the financial planner must deal with them. Even if they do not surface, the financial planner should clarify any possible misconceptions. In this way, the financial planner can often establish credibility with the client.

\textbf{.07 Spouse’s Possible Remarriage}

The financial planner can discuss a spouse’s possible remarriage after the client’s death hypothetically. For example, the financial planner could explain the use of a trust for the surviving spouse’s benefit. The financial planner can show how the trust would serve to relieve the surviving spouse of management responsibilities and free the spouse from the claims of creditors or the demands of relatives, while at the same time protecting the children as the ultimate beneficiaries, even if the surviving spouse should remarry.

\textbf{.08 Disinheriting Children}

If a parent wants to disinherit a child, perhaps the financial planner should not try to dissuade the client. However, suggesting that such feelings might be transitory would be appropriate. An estate plan is in-

\textsuperscript{29} IRC Section 1022(b)(3).
tended to stand for several years. A hasty and ill-considered disinher-itage can produce severe and un-
imagined effects on family relationships and the disinherited child.

.09 Checklist of Common Estate Planning Mistakes—and How to Avoid Them

1. Failure to plan


   b. If there is no plan, the laws of intestacy govern and select beneficiaries by degree of rela-
tionship.

   c. If there is no Will or Trust, a surety bond will have to be obtained by the administrator of
the estate. The bond premium is costly and can be avoided by waiving it in a Will or
Trust.

   d. The client can complete a simple balance sheet indicating assets, their value and owner-
ship, and list liabilities. The client can provide a list of family members, indicating their
ages. This will be sufficient to begin a planning discussion.

   e. Even a simple will or living trust is better than having nothing. Beneficiaries can be des-
ignated, fiduciaries selected, guardians appointed. Where important, probate can be
avoided and privacy protected. The surety bond can be waived.

2. Planning was done but is outdated

   a. When was the last time a plan was reviewed and possibly revised?

   b. Changes in family circumstances may have occurred (deaths, divorces, estrangement of
children, special needs, substance abuse issues).

   c. Changes in the law have occurred. The federal transfer tax exclusion is now $5,490,000
in 2017, indexed for inflation. Income tax planning may be more important for many cli-
ents than estate tax planning. Income tax basis is a key planning issue.

   d. Is lifetime gifting still appropriate? Especially of appreciated property?

   e. Is there a state death tax to be taken into account in planning?

   f. Are there outdated formula clauses in the client’s plan? Will they lead to unintended con-
sequences?
g. Don’t rely on a handwritten (holographic) will. State laws differ on their validity.

h. Be certain the document is properly executed. (Was the document witnessed and notarized? Were the witnesses non-beneficiaries? Were staples removed to photocopy the will?) Any failure to follow procedure can have potentially negative consequences.

3. Has portability been considered when there is a surviving spouse?

a. Portability must be elected on a timely filed federal estate tax return.

b. Portability allows transfer of the decedent’s unused transfer tax exemption to the surviving spouse.

c. Even if family assets appear modest, consider whether a possible windfall to the surviving spouse (luck, inheritance, personal injury) or remarriage could lead to a large estate for the surviving spouse.

4. Are collectibles and tangible assets being handled properly?

a. Address the often-forgotten "stealth" assets (collectibles).

b. Consider family pets and their care.

c. Provide for intellectual property (copyrights, patents, royalties, trademarks).

d. Consider a list outside the will if state law allows.

e. Be sure assets are in existence if named in a document.

f. Address expenses for disposition of the tangible property.

g. Be certain tangible property is provided for when using a revocable living trust.

h. Provide for digital assets.

5. Life insurance policy mistakes

a. Failure to name a beneficiary

b. Naming one’s estate as the policy beneficiary

c. Naming a minor child as a beneficiary without providing for appropriate guardian provisions

d. Failure to choose per stirpes or per capita for the next generation

e. Disqualifying a special needs beneficiary from government assistance

f. Failure to consider whether one spouse owns a policy on the other spouse payable to the children. That will be considered a gift from the policy owner to the children.

g. Failure to change the beneficiary from the divorced spouse if a divorce occurs
6. Mistakes with retirement plan designations

   a. Who is the beneficiary of a qualified plan? Law requires a presumption that favors the rights of a spouse.

   b. Who is the beneficiary of an IRA? A spouse is not a required beneficiary of an IRA.

   c. A will or trust does not control the plan beneficiary; the beneficiary designation forms controls.

   d. When a spouse is named beneficiary, rollover is available, marital deduction applies, and minimum distribution rules are favorable.

   e. When a child is named beneficiary, there is no rollover, inherited IRA may apply, and estate tax liability is possible.

   f. Where trusts are beneficiaries, distinguish accumulation trust and conduit trust.
      i. Advantages: stretch out, creditor and spendthrift protection, investment management, matrimonial protection, no inclusion in estate of beneficiary
      ii. Disadvantages: compressed income tax rates, administration fees, complexity.
      iii. Are distributions income or principal? Consider IRD issues.

   g. What are the ages of the designated beneficiaries? Are contingent beneficiaries named?

   h. If there has been a divorce, change the beneficiary. (See Kennedy v. DuPont Savings Plan [spouse gave up rights] [US S. Ct. 2009] and Egelhoff v. Egelhoff [state law said divorce revokes an ex-spouse’s beneficiary designation] [US S. Ct. 2001].) In both cases, despite the spouse’s relinquishment of rights, the spouse ended up with the retirement plan funds.

7. Mistakes with real estate planning

   a. Failure to confirm how title is held—tenant in common or joint tenant?

   b. Failure to address responsibility for loans and mortgages

   c. Failure to preserve property and casualty insurance for estate property

   d. Failure to allow fiduciaries discretion to permit survivors to remain in a home

8. Mistakes involving executors, trustees, and guardians

   a. Not choosing the right person(s)

   b. Choosing too few in a complicated estate

   c. Choosing too many

   d. Selecting fiduciaries that do not get along
e. Selecting fiduciaries with a conflict of interest

f. Selecting an even number of fiduciaries

g. Failing to provide adequate compensation for fiduciaries

h. Not properly considering spouse and children when selecting fiduciaries

i. Allowing (or not allowing) discharge of a corporate executor

j. Carelessly choosing guardians for minor children

9. Mistakes involving divorces and premarital agreements

   a. Failure to take into account the terms of an existing divorce or separation agreement

   b. Failure to recognize a spouse’s statutory right of election

   c. Failure to modify all planning documents when divorce appears inevitable

   d. Ignoring a prenuptial agreement or failing to refer to it in a will

10. Failure to address generation-skipping tax issues

    a. GST issues should always be considered when preparing gift or estate tax returns.

    b. If there is a direct transfer to skip persons (typically grandchildren), has there been an allocation of the GST exclusion? Has there been a decision to opt out of the automatic allocation rules? Late allocations can have negative GST consequences.

    c. Understand that the GST exclusion is not portable. Is a reverse QTIP election desirable?

11. Understanding the charitable contribution rules

    a. Understand the value of the gift for charitable deduction purposes (fair market value or cost basis).

    b. Understand the tax consequences of the type of property gifted (cash, ordinary income property, long-term capital gain property).

    c. Understand the donor’s allowable income tax contribution base (50 percent, 30 percent, or 20 percent of adjusted gross income).

    d. Understand the differences in allowable deduction by the nature of the donee (public charity or private foundation).

    e. Avoid the sale of appreciated property and gift of sale proceeds; instead, give the appreciated property itself.
f. Understand the opportunity for a five-year carryover on an income tax return.

g. Respect and follow the strict substantiation requirements (receipts, contemporaneous written acknowledgments, qualified appraisals from independent appraisers [Mohamed v. Commissioner, T.C. Memo 2012-182]).

12. Mistakes involving business owners

   a. Failure to have a business succession plan

   b. If not leaving the business to family members, failure to have a buy-sell agreement to transfer the business in the event of death or disability

13. Failure to recognize a grantor trust

   a. Grantor trusts require income to be taxed to the grantor, not to the trust or to its beneficiaries. There are specific powers retained in a trust that make it a grantor-type trust.

   b. Having a trust be a grantor trust may provide significant income tax benefits. The powers that make a trust a grantor trust must be recognized. Some are more subtle than others. They include reversionary powers, powers to control beneficial enjoyment, administrative powers, powers of revocation, and power to distribute income to or for the benefit of the grantor.

14. Failure to minimize income taxation of trusts

   a. Failure to make distributions from a trust to beneficiaries to avoid the compressed trust income tax rates

   b. Failure to take advantage of the 65-day distribution rule of IRC Section 663(b)

   c. Failure to include capital gains in the distributable net income (DNI) of the trust when allowable

   d. Failure to avoid the 3.8 percent tax on net investment income.

15. Other issues to be aware of

   a. Be sure to have a proper tax allocation clause. Avoid allocating taxes to be paid from a marital or charitable share of an estate. Avoid allowing a surviving spouse to pay taxes on QTIP property from the survivor’s own estate.

   b. Avoid multiple codicils. They may lead to confusion and they may create a trail of embarrassment.

   c. If a disclaimer is planned to be utilized, pay attention to the requirement that it be completed and delivered within nine months of the date of the transfer by gift or the date of
death of a decedent. No extensions are permitted. Do not "accept" the property and then disclaim. Do not "direct" where the property goes.

d. If disinheriting a person who is a "logical heir" with a legal "expectation" of inheritance, do not fail to name them in the will or trust. Be sure to name them and state the intention that they are intentionally omitted. Avoid a claim that such persons were "inadvertently" omitted.

¶215 Questionnaires

A questionnaire is a good way to obtain pertinent information. Whether the client should complete it before, during, or after the meeting with the financial planner depends on the client and the relationship with the financial planner. If an established relationship exists, advance preparation of the questionnaire by the client will save time and make the meeting easier and more fruitful. The questionnaire should not touch on sensitive personal relationships and attitudes requiring special handling.

If the relationship has not been established, the financial planner should usually meet and establish a relationship with the client, raise the sensitive issues, and ask the client to complete and return the questionnaire at a later time. The financial planner should encourage the client to inquire about any items that might present problems.

In either case, the financial planner should carefully review with the client the information that the client has provided to ensure full disclosure. The following sample questionnaire (exhibit 2-1) is quite comprehensive.

Exhibit 2-1: Financial and Estate Planning Questionnaire

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**DOCUMENTS TO BE ATTACHED**

1. Existing wills of both spouses  
2. Durable powers of attorney, living wills, and medical directives  
3. Gift tax returns filed by either spouse  
4. Life insurance policies  
5. Pension, profit-sharing, stock bonus, or deferred compensation plans  
   Also Keogh plans, traditional IRAs, Roth IRAs, SEP plans, and SIMPLE plans  
6. Buy/sell or stock redemption agreements

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7. Trust instruments
8. Income tax returns for the past five years
9. Business agreements and documents regarding interests in corporations, partnerships, limited liability companies, and sole proprietorships
10. Pre- or postnuptial agreements, separation agreements, and divorce papers
11. Instruments showing the basis of assets held
12. Instruments creating spouses’ joint tenancies, tenancies by the entireties, or separate property in community property states
13. The will and trusts of a predeceased spouse
14. List of user names and passwords to financial information sites on personal computer

FAMILY INFORMATION

1. Personal:  
   a. Name  
   b. Home address  
   c. Home phone  
   d. Citizenship  
   e. Employer & business address  
   f. Business telephone  
   g. Principal residence (indicate state and county)  
   h. Other current (indicate state[s]) residences  
   i. Prior residences (indicate state[s])  
   j. Birth date  
   k. Place of birth  
   l. Social Security number  
   m. Marital status  
   n. If married, date and place of marriage  
   o. If divorced, prior marriages (name of former spouse[s], date and place of divorce[s])  
   p. If unmarried and living with another person, name and age of that person  
   q. If surviving spouse, information about the estate of the predeceased spouse, including the use of the portability election. Include a copy of the Form 706 for the predeceased spouse.
2. Your Children:*

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|                  |              |                      |
|                  |              |                      |

3. Particulars regarding your grandchildren:*  

<table>
<thead>
<tr>
<th>Their Parents</th>
<th>Names of Grandchildren</th>
<th>Birth Date**</th>
<th>Social Security***</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>(1)</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>(2)</td>
<td></td>
<td></td>
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<td>(3)</td>
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<td></td>
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<tr>
<td>b.</td>
<td>(1)</td>
<td></td>
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<td></td>
<td>(2)</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>(3)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Indicate if any children or grandchildren are stepchildren, adopted children, or are from a prior marriage.

** A child’s income above a threshold amount is generally taxed at the parents’ marginal tax rate if the child is either (1) under age 19 or (2) under age 24 and a full-time student.

*** The taxpayer must have the dependent’s Social Security number in order to claim a dependency exemption for any individual.
4. Parents:

<table>
<thead>
<tr>
<th>Husband</th>
<th>Wife</th>
</tr>
</thead>
<tbody>
<tr>
<td>Father:</td>
<td></td>
</tr>
<tr>
<td>Name</td>
<td>Name</td>
</tr>
<tr>
<td>Address</td>
<td>Address</td>
</tr>
<tr>
<td>Date of Birth/Date of Death</td>
<td>Date of Birth/Date of Death</td>
</tr>
<tr>
<td>Mother:</td>
<td></td>
</tr>
<tr>
<td>Name</td>
<td>Name</td>
</tr>
<tr>
<td>Address</td>
<td>Address</td>
</tr>
<tr>
<td>Date of Birth/Date of Death</td>
<td>Date of Birth/Date of Death</td>
</tr>
</tbody>
</table>

5. Other dependent persons: Names, addresses, relationships, degree of dependency, and date of birth:

6. Medical history: Please list all significant medical conditions or medical history for you and your family:

ADVISERS

Names, addresses, and telephone numbers

1. Attorney:
2. Accountant:

3. Life insurance adviser:

4. Banker and trust officers:

5. Stockbrokers:

6. Executor or personal representative:

7. Trustee:

8. Designated guardian for children:

9. Investment adviser:
10. Financial planner:

11. Physician:

12. Clergyman:

13. Casualty insurance agent:

14. Appraiser:

DISTRIBUTION OBJECTIVES

1. Upon your death, how and to whom do you want your assets distributed?

2. (a) If you and your spouse both die before your children reach the age of majority, should children receive property at the age of majority, or should it be held until they reach a more mature age?

   (b) Do any of your children have special educational, medical, or financial needs?
3. Is there anyone in your family whom you consider to be a good money manager?

4. Who do you want to manage your estate from an investment standpoint?
   To whom would that person look for management help?

5. Is reducing or eliminating estate taxation of great importance to you?

6. Is minimizing income taxes of great importance to you?

7. Do you contemplate making future gifts?
   Furnish details:

8. Do you wish to make bequests to a religious organization or order or gifts to any other charitable organization?
   Name of charitable organization | In cash or in kind?
   --------------------------------------------------------
   Furnish details:

9. If none of your children is living at the time of your spouse’s death, do you want your estate:
   To go to: Your family? Spouse’s family? Elsewhere?

10. Does your spouse have employment skills? Do you expect that the survivor will work?
11. Will your spouse live in your present home?

12. Who will serve as your executor or personal representative? Successors?

**IMPORTANT QUESTIONS**

1. Have you lived in any other state or foreign country? If so, where and for how long?

2. Did you or your spouse own any substantial separate property before marriage?

3. Have any gifts or inheritances been received by either you or your spouse separately, or do you expect any in the future?
**CASH AND EQUIVALENTS**

<table>
<thead>
<tr>
<th>Bank accounts:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Certificates of deposit:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Other (money market funds, etc.):</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
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<td></td>
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<tr>
<td></td>
</tr>
</tbody>
</table>

**Total $**

---

**PERSONAL EFFECTS**

<table>
<thead>
<tr>
<th>Automobiles (state whether leased or owner)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Household furnishings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Club memberships</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Aircraft</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Boats</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Furs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Jewelry</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>
Collections (Art, coins, stamps, etc.)
Others (describe)

<table>
<thead>
<tr>
<th>Policy</th>
<th>Company</th>
<th>Policy number</th>
<th>Type (term, whole life, endowment, or universal life)</th>
<th>If nonterm, date policy was entered into*</th>
<th>Insured</th>
<th>Owner</th>
<th>Beneficiary</th>
<th>Contingent beneficiary</th>
<th>Face value</th>
<th>Amount of loan**</th>
<th>Settlement terms</th>
<th>Employee’s contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Policy</th>
<th>Company</th>
<th>Policy number</th>
<th>Type (term, whole life, universal, or variable life)</th>
<th>Insured***</th>
<th>Owner</th>
<th>Beneficiary</th>
<th>Contingent beneficiary</th>
<th>Face value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
Current cash surrender value
Amount of loan**
Settlement terms
Annual premium

* Some investment-oriented policies (for example, single premium) entered into on or after June 21, 1988, may be subject to special tax rules (under which amounts received, including loans, are treated first as income, and a 10-percent penalty tax may apply).

** Interest paid on loans under life insurance contracts is generally not deductible after 1990.

*** Include policies on lives of spouse and children.

<table>
<thead>
<tr>
<th>STOCKS AND MUTUAL FUNDS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company or Fund and Type</td>
</tr>
<tr>
<td>Total Current Market Value/Listed on What Exchange</td>
</tr>
</tbody>
</table>

| Total $ |

* Indicate restrictions on transfer, if any.

<table>
<thead>
<tr>
<th>TREASURY BONDS, NOTES, AND BILLS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
</tr>
</tbody>
</table>

| Total |
* Final maturity for Series E savings bonds issued on or before November 1965 is 40 years. Series E bonds issued in December 1965 and later have a 30 year maturity. Series H bonds have a 30 year maturity. Series HH bonds have a 20 year maturity. No interest is earned after this point. Series EE bonds earn interest for 30 years. Series EE Savings Bonds issued and dated on or after May 1, 2005, will earn a fixed rate of interest for 20 years, at which time the bond should have reached its face value. If the bond has not reached its face value, the Treasury will make a one-time adjustment up to the face value.

### MUNICIPAL BONDS, NOTES, AND BILLS

<table>
<thead>
<tr>
<th>Issuer</th>
<th>AMT*</th>
<th>Non-AMT</th>
<th>Date of Purchase</th>
<th>Maturity</th>
<th>Current Value</th>
</tr>
</thead>
</table>

* Interest paid by private purpose municipals may be subject to the alternative minimum tax (AMT).

### CORPORATE BONDS AND NOTES

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Date of Purchase</th>
<th>Interest Rate—Maturity</th>
<th>Current Value</th>
</tr>
</thead>
</table>

Page 45
### NOTES AND MORTGAGES

<table>
<thead>
<tr>
<th>Debtor</th>
<th>Type of Debt and Maturity</th>
<th>Interest Rate—Security</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### REAL ESTATE

<table>
<thead>
<tr>
<th>Property 1</th>
<th>Property 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal description</td>
<td>Please Attach</td>
</tr>
<tr>
<td>Location</td>
<td></td>
</tr>
<tr>
<td>Type of property (Residential, commercial, vacant land, and so on)</td>
<td></td>
</tr>
<tr>
<td>Owned in names of</td>
<td></td>
</tr>
<tr>
<td>Form of ownership</td>
<td></td>
</tr>
<tr>
<td>Date of acquisition</td>
<td></td>
</tr>
<tr>
<td>How acquired (By gift, purchase, exchange)</td>
<td></td>
</tr>
<tr>
<td>Cost (Note costs of improvements)</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation*</td>
<td></td>
</tr>
<tr>
<td>Current market value</td>
<td></td>
</tr>
<tr>
<td>Encumbrances (Names of mortgagee, lienors, easements)</td>
<td></td>
</tr>
<tr>
<td>Amount</td>
<td></td>
</tr>
<tr>
<td>Monthly payments (principal &amp; interest)</td>
<td></td>
</tr>
<tr>
<td>Interest rate</td>
<td></td>
</tr>
<tr>
<td>Remaining period of loan</td>
<td></td>
</tr>
<tr>
<td>Purpose of loan/use of $100,000 home equity loan amount</td>
<td></td>
</tr>
</tbody>
</table>
Annual interest
Annual taxes
Annual income (gross)*
Annual depreciation*
Annual costs (Maintenance, insurance, repairs, etc.)*
Annual net income*
Farm property**

* Income-producing property only.
** Address the excess of value of property, if any, when put to highest and best use over value as operating farm.

CLOZELY HELD BUSINESS INTERESTS
(Use separate sheet for each business interest. Indicate whether you or your spouse materially participate.)
Name
Percent Owned
Type of entity:
C Corporation
Partnership (General or Limited)
Sole Proprietorship
S Corporation
Limited Liability Company
Is interest jointly owned with spouse?
Has your spouse participated in the business?
Your estimate of the fair market value of your interest
Your tax basis for your interest
Do you have any plans to dispose of business interest during your lifetime?
If so, please describe
What are your wishes regarding disposition of ownership after death or during your lifetime:

1. Transfer to family

2. Sale to co-owner of business

3. Sale to key employee

4. Other

Is there a buy/sell or redemption agreement?  Yes ________  No ________

If yes, please furnish copy for review.

Have you considered liquidating the business?

Please provide financial statements and tax returns for the previous five years and a copy of any buy/sell or redemption agreements.

ANNUITIES, RETIREMENT, DISABILITY, AND DEATH BENEFITS

(Include qualified plans, Keogh plans, 401k plans, 403(b) plans, 457 plans, traditional IRAs, Roth IRAs, deferred compensation plans, simplified employee pension and IRA [SEP] plans, and savings incentive match plans for employees [SIMPLE plans].)

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Joint v. Survivor Annuity</th>
<th>Name of Beneficiary</th>
<th>Form of Payment</th>
<th>Present Vested Benefits</th>
</tr>
</thead>
</table>

Page 48
### OTHER ASSETS

<table>
<thead>
<tr>
<th>Description</th>
<th>Fair Market Value</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incentive stock options (include option price):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonqualified stock options (include option price):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property received for services that is subject to a substantial risk of forfeiture:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock appreciation rights:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Copyrights or patents:</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Accounts receivable:

Notes receivable:

Archer medical savings accounts:

Health savings accounts:

Other:

Computer/Online Account Information and Passwords:

Note: Include other assets, such as a remainder, reversionary, or income interest in a trust. Also include the source and approximate amount of any expected inheritance. Describe powers of appointment over trust property.

<table>
<thead>
<tr>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Not previously listed [for example, mortgages on real estate])</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Creditor</th>
<th>Secured By</th>
<th>Interest Rate</th>
<th>Date Incurred</th>
<th>Due Date</th>
<th>Repayment Schedule</th>
<th>Current Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tr>
</tbody>
</table>

Page 50
GIFT DATA

GIFTS MADE

Have you made any gifts, other than to charities, in any one year to any one or more persons that exceeded in value $10,000* if made by you alone ($3,000 if before 1982) or $20,000* ($6,000 if before 1982) if both you and your spouse consented to gift splitting?

Yes _____ No _____

Did you make any gifts to pay for medical or education expenses?**

Yes _____ No _____

If gift tax returns were filed, please furnish federal and state tax returns and appraisals.

If the gift amounts above were exceeded and gift tax returns were not filed, describe the gift, date, fair market value, and to whom given:

________________________________________________________________________

Have gifts been made by creating a trust?

Yes _____ No _____

If so, provide the trust document.

Did you set up a Clifford trust before March 2, 1986??*

Yes _____ No _____

Did you set up a spousal remainder trust before March 2, 1986??*

Yes _____ No _____

Have gifts been made under the Uniform Gifts to Minors Act or the Uniform Transfers to Minors Act?

Yes _____ No _____

If either spouse is the custodian, please give details on the property.

________________________________________________________________________

Have any gifts been made within the past three years? _____________

If so, what was the subject of the gifts?

________________________________________________________________________

REMARKS
*The dollar values apply to gifts of a present interest. If the gift is of a future interest, the exclusions do not apply. If in doubt about whether a gift is of a present or a future interest, so indicate in the remarks. The $10,000/$20,000 amounts apply for transfers occurring after 1982 and before 1999. These amounts are indexed for inflation for calendar years after 1998. For 2001, the amounts remained at $10,000 and $20,000 (IRC Section 2503(b)). For 2002 through 2005, the amounts are $11,000/$22,000. For 2006–2008, the amounts are $12,000 and $24,000. For 2009–2012, the amounts are $13,000 and $26,000. For 2013 through 2017, the amounts are $14,000 and $28,000.

**An unlimited gift tax exclusion applies for amounts paid directly to providers for qualified medical or education expenses (IRC Section 2503(e)).

***Benefits for such trusts created after March 1, 1986 have been eliminated.

### ANNUAL EXPENDITURES

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto</td>
<td>$</td>
</tr>
<tr>
<td>Care and maintenance</td>
<td>$</td>
</tr>
<tr>
<td>Insurance</td>
<td>$</td>
</tr>
<tr>
<td>Payments</td>
<td>$</td>
</tr>
<tr>
<td>Childcare</td>
<td>$</td>
</tr>
<tr>
<td>Clothing</td>
<td>$</td>
</tr>
<tr>
<td>Contributions to charity</td>
<td>$</td>
</tr>
<tr>
<td>Debt payments (other than mortgage)</td>
<td>$</td>
</tr>
<tr>
<td>Education</td>
<td>$</td>
</tr>
<tr>
<td>Entertainment</td>
<td>$</td>
</tr>
<tr>
<td>Equipment</td>
<td>$</td>
</tr>
<tr>
<td>Food</td>
<td>$</td>
</tr>
<tr>
<td>Furnishings</td>
<td>$</td>
</tr>
<tr>
<td>Gifts</td>
<td>$</td>
</tr>
<tr>
<td>Housing</td>
<td>$</td>
</tr>
<tr>
<td>Care and maintenance</td>
<td>$</td>
</tr>
<tr>
<td>Mortgage</td>
<td>$</td>
</tr>
</tbody>
</table>

Page 53
<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td></td>
</tr>
<tr>
<td>Real estate taxes</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
</tr>
<tr>
<td>Interest (other than mortgage)</td>
<td></td>
</tr>
<tr>
<td>Laundry and dry cleaning</td>
<td></td>
</tr>
<tr>
<td>Life insurance premiums</td>
<td></td>
</tr>
<tr>
<td>Medical and dental care</td>
<td></td>
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<tr>
<td>Personal care</td>
<td></td>
</tr>
<tr>
<td>Personal gifts</td>
<td></td>
</tr>
<tr>
<td>Retirement plan contributions</td>
<td></td>
</tr>
<tr>
<td>Qualified plan (defined contribution [401(k)] and defined benefit)</td>
<td></td>
</tr>
<tr>
<td>Keogh</td>
<td></td>
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<tr>
<td>IRA</td>
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<tr>
<td>SEP plan</td>
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<tr>
<td>SIMPLE plan</td>
<td></td>
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<tr>
<td>Telephone/cell phone/computer lines</td>
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<tr>
<td>Tax liabilities</td>
<td></td>
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<tr>
<td>Television (cable, etc.)</td>
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<tr>
<td>Travel</td>
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<tr>
<td>Utilities</td>
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<tr>
<td>Vacation</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$</td>
</tr>
</tbody>
</table>
### ANNUAL INVESTMENTS

(Exclude principal payments on home, voluntary contributions to retirement plans)

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savings accounts</td>
<td>$</td>
</tr>
<tr>
<td>CDs</td>
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</tr>
<tr>
<td>Stocks</td>
<td></td>
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<tr>
<td>Bonds</td>
<td></td>
</tr>
<tr>
<td>Mutual funds</td>
<td></td>
</tr>
<tr>
<td>Municipals</td>
<td></td>
</tr>
<tr>
<td>Treasuries</td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
</tr>
<tr>
<td>Partnerships and LLCs</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$</td>
</tr>
</tbody>
</table>

### LIVING WILL AND MEDICAL DIRECTIVES

Do you or your family members, or both, wish to direct medical care or removal of medical care through the use of a living will, durable power of attorney, springing power of attorney, health care proxy, or other form of medical directives?

### ¶220 Planner’s Checklist

The financial planner takes the raw data from the questionnaire and supplements it with information gathered in personal interviews. The planner thereby hopes to touch all bases.

The following form (exhibit 2-2) is designed to fulfill this purpose. Here the planner can check off the documents that have been reviewed and obtain an overall picture of the client’s assets and liabilities, gift data, cash flow, and other pertinent data.
## Exhibit 2-2: Personal Financial Planning Questionnaire

**Client**

<table>
<thead>
<tr>
<th>Date of Interview</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

**Interviewed by**

### COPIES OF DOCUMENTS THAT MUST BE REVIEWED

<table>
<thead>
<tr>
<th></th>
<th>Obtained</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Existing wills of both spouses</td>
</tr>
<tr>
<td>2.</td>
<td>All gift tax returns ever filed by client or spouse, or both</td>
</tr>
<tr>
<td>3.</td>
<td>Individual income tax returns for the past five years</td>
</tr>
<tr>
<td>4.</td>
<td>Insurance policies in effect</td>
</tr>
<tr>
<td>5.</td>
<td>Existing pension, profit-sharing, stock bonus, Keogh, deferred compensation or similar type plans, traditional IRAs, Roth IRAs, SEP plans, and SIMPLE plans</td>
</tr>
<tr>
<td>6.</td>
<td>Real estate deeds and mortgages</td>
</tr>
<tr>
<td>7.</td>
<td>Trust instruments</td>
</tr>
<tr>
<td>8.</td>
<td>Personal and business financial statements for the past five years</td>
</tr>
<tr>
<td>9.</td>
<td>Business income tax returns for the past five years</td>
</tr>
<tr>
<td>10.</td>
<td>Buy/sell or stock redemption agreements</td>
</tr>
<tr>
<td>11.</td>
<td>Partnership, LLC, or joint venture agreements</td>
</tr>
<tr>
<td>12.</td>
<td>Powers of appointment</td>
</tr>
<tr>
<td>13.</td>
<td>Divorce, separation and premarital agreements</td>
</tr>
<tr>
<td>14.</td>
<td>Instruments showing basis of assets held</td>
</tr>
<tr>
<td>15.</td>
<td>Instruments creating spouses’ joint tenancies or tenancies by the entirety</td>
</tr>
<tr>
<td>16.</td>
<td>Living wills and medical directives</td>
</tr>
<tr>
<td>17.</td>
<td>Durable powers of attorney</td>
</tr>
</tbody>
</table>
GIFTS

Lifetime Use of Unified Estate and Gift Tax Credit; Use of GST Exemption

| Federal | Spouse 1 has used: | $ ___________
| Federal | Spouse 2 has used: | $ ___________

Gifts After 9/8/76 and Before 1/1/77

Aggregate amount allowed as specific exemption* | $ ___________

Cumulative Taxable Gifts Per Latest Gift Tax Returns

| Federal | State |
| Spouse 1: | $ ___________ | $ ___________ |
| Spouse 2: | $ ___________ | $ ___________ |

GIFT DATA

A. Trusts created (grantor, beneficiaries, powers and rights retained, value of gift, trustee, term, reversion, present value):


B. Existing custodial accounts under Uniform Gifts to Minors Act and Uniform Transfers to Minors Act (donor, date, custodian, minor (age), value of gift, present value):


C. Substantiation of value at time of gift:


D. Is the client a surviving spouse of a spouse that left a Deceased Spousal Unused Exclusion (DSUE) through use of the portability election? If so, how much?


*Unified credit is reduced by 20 percent of this amount to a maximum of $6,000.
### EMPLOYMENT (For Each Spouse)

<table>
<thead>
<tr>
<th>Current employer</th>
<th>Date employed</th>
<th>Annual compensation</th>
<th>Projected retirement date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### CASH FLOW

<table>
<thead>
<tr>
<th>Sources of cash:</th>
<th>Currently</th>
<th>Projected After Client’s Death</th>
<th>Projected for Retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compensation</td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash flow from rental property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalties</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Keogh</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Traditional IRA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roth IRA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIMPLE plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from installment sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business interests:</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Page 58
| Miscellaneous: |       |       |       |
|               |       |       |       |
| Trusts        |       |       |       |
|               |       |       |       |
|               |       |       |       |
| Annuities     |       |       |       |
|               |       |       |       |
| Pension benefits |     |       |       |
| Social Security |     |       |       |
| Other Income Sources | |       |       |
|               |       |       |       |
|               |       |       |       |
| Total         | $     |       |       |

<p>| Expenditures: |       |       |       |
| Auto         |       |       |       |
| Care and maintenance | |       |       |
| Insurance   |       |       |       |
| Payments    |       |       |       |
| Childcare   |       |       |       |
| Clothing    |       |       |       |
| Contributions to charity | |       |       |
| Debt payments (other than mortgage) | |       |       |
| Education   |       |       |       |
| Entertainment |     |       |       |
| Equipment   |       |       |       |</p>
<table>
<thead>
<tr>
<th>Category</th>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Furnishings</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gifts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Care and maintenance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgage; Home equity loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Principal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real estate taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Laundry and dry cleaning</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Life insurance premiums</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medical and dental care</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal care</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal gifts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retirement plan contributions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Qualified plan (defined contribution [401(k)] and defined benefit)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Keogh</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Traditional IRA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roth IRA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SEP plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIMPLE plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telephone/Computer lines</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Television
Travel
Utilities
Vacation
Other

Total $  
Excess (deficit) $  

CLOSELY HELD BUSINESS INTERESTS
(Use separate sheet for each business interest)

Name/Taxpayer Identification Number

Business Address

Type of entity:
  C Corporation
  Partnership
  Sole Proprietorship
  S Corporation
  Limited Liability Company

Material Participation
  Yes  No

Percentage of Ownership:
  Self:
  Spouse:
  Joint:
  Participation:
  Others:
  Children:
Buy/sell or redemption agreement?  
Yes ________  No ________

Details:

---

IRC Section 2703 compliance?  
Yes ________  Yes ________

Details:

---

Client’s wishes on disposition of interest

---

KEY-PERSON INSURANCE

<table>
<thead>
<tr>
<th>EMPLOYEE</th>
<th>FACE VALUE</th>
<th>CASH VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CLOSELY-HELD BUSINESS INTERESTS

---

Most recent transfer of ownership equity by any owner:

Price

Percentage or number of shares

Date of transfer

Corporate obligations guaranteed by client

Estimate of fair market value per your analysis

Estimate of fair market value per client

Basis of securities held

Date acquired

REMARKS

---
### TYPE OF BUSINESS RETIREMENT PLAN

<table>
<thead>
<tr>
<th>Stock Bonus</th>
<th>Pension*</th>
<th>Profit-Sharing*</th>
<th>Individual Retirement Account</th>
<th>Deferred Compensation</th>
</tr>
</thead>
</table>

Company**

<table>
<thead>
<tr>
<th>Retirement benefits</th>
</tr>
</thead>
</table>

Amount currently vested***

<table>
<thead>
<tr>
<th>Death benefits</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Disability benefits</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Beneficiary at death</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Alternate Beneficiaries</th>
</tr>
</thead>
</table>

Amount of insurance excludable under IRC Section 2042

<table>
<thead>
<tr>
<th>Employee contributions to date</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Name and address of plan administrator(s)</th>
</tr>
</thead>
</table>

*Indicate if either is a Keogh plan, SEP plan, or SIMPLE plan.

**If more than one, attach separate sheet.

***For many workers, vesting occurs after five years on the job.

### STOCK OPTIONS

<table>
<thead>
<tr>
<th>Date of Grant</th>
<th>Option Price</th>
<th>Number of Shares</th>
<th>Type of Option</th>
<th>Fair Market Value at Date of Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option 1</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 2</td>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expiration Date</td>
<td>How Long Exercisable by Estate</td>
<td>Present Fair Market Value</td>
<td>Value: Number of Shares (fair market value) Option Price</td>
<td></td>
</tr>
<tr>
<td>-----------------</td>
<td>-------------------------------</td>
<td>---------------------------</td>
<td>--------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td>Option 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Option 2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**RESTRICTED PROPERTY**

<table>
<thead>
<tr>
<th>Description of Property Subject to Restriction</th>
<th>Nature of Restriction</th>
<th>Expected Date Such Restriction Will Lapse</th>
<th>IRC Section 83(b) Election in Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**LOCATION OF ASSETS AND DOCUMENTS**

1. Safe deposit box (location of box, who has access, who has keys, in whose name is box registered):

   ____________________________________________

2. Original current wills:

   ____________________________________________

3. Life, health, and accident insurance policies:

   ____________________________________________
4. Long-term care insurance policies:

5. Securities:

6. Trust agreements:

7. Tax returns; years covered:

8. Contracts and business agreements:

9. Real estate and condominiums:
   a. Location and how owned:
   b. Deed and title policy:
   c. Mortgages:
   d. Leases:

10. Car titles:
11. Custody and other managed accounts:

12. Jewelry and other valuable tangibles:

13. Cancelled checks and stubs; periods covered:

14. Cemetery plot (location of plot and deed; care arrangements):

15. Birth certificates:

16. Death certificates:

17. Marriage certificates:

18. Divorce papers:

19. Employee benefit statements:

20. Employee benefit plan copies:
21. Military discharge papers:

22. Naturalization papers:

23. Passports:

24. Adoption papers:

25. General insurance policies:

26. Private safe (location, who has access):

27. Firearms and registration requirements:

28. Funeral directions:

29. Living wills:

30. Entitlements (Social Security, veterans, etc.):

31. POWERS OF ATTORNEY (outstanding, including bank accounts and safe deposit access and health care decisions. Give dates and names (obtain copies; show attorney in fact; address; description of power; date)):

32. Computer sites, user names and passwords:
MEDICAL, DISABILITY, AND LONG-TERM CARE INSURANCE

<table>
<thead>
<tr>
<th>Company</th>
<th>Benefits</th>
<th>Beneficiary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surgical</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hospital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term Care</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

225 Personal Financial Outlook

The financial planner may consider using the following personal financial outlook checklist (exhibit 2-3) as a starting point to summarize a client’s financial situation and identify important issues and opportunities for planning. Practitioners can include this checklist in their tax organizers or have new clients fill it out prior to working on a planning engagement.

Exhibit 2-3: Personal Financial Outlook Checklist

Copyright © 2016 by AICPA Personal Financial Planning Division

Note: When working with a married couple, both spouses should fill out individual checklists or be sure to answer only "Yes" or "No" when applicable for both spouses.

<table>
<thead>
<tr>
<th>Wills &amp; Living Trusts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you understand the importance of having a will and an estate plan?</td>
</tr>
<tr>
<td>Do you have a will?</td>
</tr>
<tr>
<td>Has it been updated since the last major life event (birth, death, marriage, divorce, move from another state, etc.)?</td>
</tr>
<tr>
<td>Have you appointed a guardian for your minor children?</td>
</tr>
<tr>
<td>Are you and your spouse U.S. citizens?</td>
</tr>
<tr>
<td>Have you created a living trust (or carefully considered and determined it wasn’t necessary)?</td>
</tr>
<tr>
<td>Have you transferred the appropriate assets into the trust?</td>
</tr>
<tr>
<td>Has anyone taken your present plan and charted the way your documents actually work and what your heirs will receive from your estate?</td>
</tr>
<tr>
<td>Do you understand the effects of a premature death on your assets and family lifestyle?</td>
</tr>
<tr>
<td>Do your executor and your beneficiaries know the location of these documents or the appropriate person to contact?</td>
</tr>
<tr>
<td>Do you understand how inheritance taxes affect your estate plan?</td>
</tr>
</tbody>
</table>
### Titling of Assets

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you properly designated beneficiaries on all retirement accounts and life insurance policies?</td>
<td></td>
</tr>
<tr>
<td>Have you used such designations on bank accounts, brokerage accounts, and automobile title documents?</td>
<td></td>
</tr>
<tr>
<td>Do the beneficiaries have copies of these designations so that they’ll be able to quickly transfer assets if needed?</td>
<td></td>
</tr>
<tr>
<td>Have you determined the appropriateness of joint designations on shared assets and considered the effect on community property rules, if applicable?</td>
<td></td>
</tr>
</tbody>
</table>

### Irrevocable Trusts

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you considered and, if appropriate, established credit shelter trusts, qualified personal residence trusts, grantor retained interest trusts, and special needs trusts?</td>
<td></td>
</tr>
</tbody>
</table>

### Advance Directives

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you considered and, if appropriate, prepared health care proxies, durable powers of attorney for financial decisions, HIPAA authorizations, and living wills?</td>
<td></td>
</tr>
<tr>
<td>Have you provided the appropriate people with documents needed to utilize these?</td>
<td></td>
</tr>
</tbody>
</table>

### Gifts & Charitable Planning

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Is it important for you to leave assets to your loved ones or charity, or both?</td>
<td></td>
</tr>
<tr>
<td>Have you considered your strategy for gifts to loved ones?</td>
<td></td>
</tr>
<tr>
<td>Have you executed it?</td>
<td></td>
</tr>
<tr>
<td>Have you considered your strategy for charitable contributions?</td>
<td></td>
</tr>
<tr>
<td>Have you executed it?</td>
<td></td>
</tr>
</tbody>
</table>

### Asset Allocation

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you identified the time frame within which you’ll need the funds from various investment accounts?</td>
<td></td>
</tr>
<tr>
<td>Have you determined your risk tolerance and the returns you’ll need to achieve your goals?</td>
<td></td>
</tr>
<tr>
<td>Have you determined the appropriate percentage of your assets to commit to equity investments?</td>
<td></td>
</tr>
<tr>
<td>Have you developed an overall investment strategy?</td>
<td></td>
</tr>
<tr>
<td>Have you executed the strategy?</td>
<td></td>
</tr>
<tr>
<td>Are you satisfied with your investment performance?</td>
<td></td>
</tr>
</tbody>
</table>

### Diversification

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you identified any concentration of investments that may be placing you at unnecessary risk?</td>
<td></td>
</tr>
<tr>
<td>Have you identified ways of diversifying to reduce that risk?</td>
<td></td>
</tr>
<tr>
<td>Question</td>
<td>Yes</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>-----</td>
</tr>
<tr>
<td>Have you considered hedging strategies?</td>
<td></td>
</tr>
<tr>
<td>Have you executed your diversification strategy?</td>
<td></td>
</tr>
<tr>
<td><strong>Benefits</strong></td>
<td></td>
</tr>
<tr>
<td>Do you fully understand the employee investment programs available to you?</td>
<td></td>
</tr>
<tr>
<td>Are you participating in your company 401(k) plan and taking advantage of employer matching contributions?</td>
<td></td>
</tr>
<tr>
<td>Have you determined the strategies for exercising and selling employee stock options, if applicable?</td>
<td></td>
</tr>
<tr>
<td>Have you identified all government benefits to which you may be entitled?</td>
<td></td>
</tr>
<tr>
<td>Are you executing strategies to take advantage of them?</td>
<td></td>
</tr>
<tr>
<td>Have you considered whether an annuity is a better strategy for you than a lump sum payout?</td>
<td></td>
</tr>
<tr>
<td>Would you prefer to take a single life annuity?</td>
<td></td>
</tr>
<tr>
<td>Would you prefer to take a joint life annuity, or other?</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Planning</strong></td>
<td></td>
</tr>
<tr>
<td>Have you determined the appropriate allocation of investments between taxable and tax-deferred accounts?</td>
<td></td>
</tr>
<tr>
<td>Have you identified strategies for transfer of investments to other family members?</td>
<td></td>
</tr>
<tr>
<td>Have you determined the funds that need to be set aside to cover upcoming tax obligations?</td>
<td></td>
</tr>
<tr>
<td>Have you considered the potential impact of the alternative minimum tax and the net investment income tax on your planning?</td>
<td></td>
</tr>
<tr>
<td>Do you have a strategy to withdraw funds in the most tax efficient manner?</td>
<td></td>
</tr>
<tr>
<td><strong>Cost Minimization</strong></td>
<td></td>
</tr>
<tr>
<td>Have you chosen cost-effective ways of making and holding investments?</td>
<td></td>
</tr>
<tr>
<td>Are you minimizing unnecessary turnover of investments?</td>
<td></td>
</tr>
<tr>
<td>Have you determined whether it is appropriate to acquire individual securities rather than mutual funds or ETFs?</td>
<td></td>
</tr>
<tr>
<td>Have you adopted strategies to minimize the tax cost of investments held in taxable accounts?</td>
<td></td>
</tr>
<tr>
<td><strong>Business &amp; Umbrella Coverage</strong></td>
<td></td>
</tr>
<tr>
<td>Have you determined the necessary business liability protection?</td>
<td></td>
</tr>
<tr>
<td>Have you obtained solid coverage from a reliable carrier?</td>
<td></td>
</tr>
<tr>
<td>Have you estimated the umbrella coverage needed for personal assets?</td>
<td></td>
</tr>
<tr>
<td>Have you obtained the necessary coverage?</td>
<td></td>
</tr>
</tbody>
</table>
### Life Insurance

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you determined the amount of life insurance coverage required for loved ones?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you determined the proper type of life insurance to acquire?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the life insurance policy owned by the correct person or entity?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you cancelled unnecessary and inappropriate forms of coverage?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you recently reviewed older policies to assess the policy performance, the strength of carrier, or if better alternatives exist?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are you familiar with the uses of life insurance plans beyond the death benefit?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you understand the Social Security Death Benefit?</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Property & Liability Insurance

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you have adequate replacement cost coverage of assets?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you have additional protection as needed for floods and earthquakes?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you properly covered valuable items such as artwork or jewelry?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you have an inventory of your assets for insurance purposes in a safe location?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you eliminated unneeded coverage and raised deductibles for losses you can afford to pay?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you consolidated various policies with one insurer to benefit from multi-policy discounts?</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Health Insurance

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Are all your family members covered for catastrophic health care costs to the extent possible?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you have coverage in the form you want from a reliable provider?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you raised deductibles on expenses you can afford to pay and/or considered a health savings account?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you exercise regularly?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Do you avoid smoking?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are you familiar with the eligibility requirements associated with Medicare?</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Disability & Long-Term Care Insurance

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Would your financial plan survive if you had a catastrophic event?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>What would happen to your lifestyle if you did not have adequate coverage?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you determined the need for income protection policies?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you obtained as much coverage as you can from a reliable provider?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Are you paying for disability coverage with after-tax dollars to ensure benefits are tax-free?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have you considered and, if appropriate, obtained long-term care insurance?</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Do you understand the costs associated with nursing home care and how the Medicaid program is administered?

<table>
<thead>
<tr>
<th>Saving Target</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you have a clear picture of your financial objectives and what you need to save to achieve your goals?</td>
<td></td>
</tr>
<tr>
<td>Have you determined a reasonable savings rate for the achievement of your financial goals?</td>
<td></td>
</tr>
<tr>
<td>Have you come to an agreement with your significant other so that you are both comfortable with this rate?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Emergency Reserve</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you calculated what your non-discretionary monthly expenses are?</td>
<td></td>
</tr>
<tr>
<td>Do you have 3 to 6 months of cash to cover expenses if you were to lose your job or another unexpected event occurred?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Budgeting</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you know how much you spend each month?</td>
<td></td>
</tr>
<tr>
<td>Have you identified expenditures that provide little real value?</td>
<td></td>
</tr>
<tr>
<td>Do you have strategies for purchasing needed items in bulk or at the right time to reduce costs?</td>
<td></td>
</tr>
<tr>
<td>Do you have a discretionary fund for each family member that doesn’t need to be accounted for?</td>
<td></td>
</tr>
<tr>
<td>Do both spouses understand the family finances and would both spouses be able to make decisions in the event of an emergency?</td>
<td></td>
</tr>
<tr>
<td>Have you considered costs of caring for elderly parents or for adult children?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liquidity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Are you holding the appropriate amount of cash needed to cover expected payments, allow maximum deductibles on insurance, take advantage of opportunities to purchase items at bargain prices, and sleep peacefully when investments are down?</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debt Management</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Have you eliminated non-deductible debt to the extent possible?</td>
<td></td>
</tr>
<tr>
<td>Have you reviewed interest rates on debts and taken steps to reduce them, if applicable?</td>
<td></td>
</tr>
<tr>
<td>Do you have available but unused lines of credit to satisfy liquidity needs?</td>
<td></td>
</tr>
<tr>
<td>Do you know your credit score and have you taken reasonable steps to keep it high?</td>
<td></td>
</tr>
<tr>
<td>Do you check your credit report regularly to make sure your identity has not been compromised?</td>
<td></td>
</tr>
</tbody>
</table>
### Retirement

Have you determined when or if you plan to retire?  
Have you calculated the capital you will need to fund retirement?  
Have you identified probable sources of retirement income other than investment earnings?  
Have you considered the availability of social security and the appropriate age to start receiving benefits? Are you aware of alternative social security strategies?  
Have you determined the appropriateness of annuities and reverse mortgages to finance retirement costs?  
Have you considered unexpected costs in retirement (e.g. health care or caring for a loved one)?  
Are you currently saving enough to meet your retirement needs after considering taxes and inflation?  
Do you have a specific distribution strategy for your retirement funds?

### College

Have you determined the extent to which you want to assist loved ones in financing the costs of education?  
Do you plan to pay for an in-state school or private institution?  
Have you considered the available savings vehicles?  
Are you funding those savings vehicles? Using 529 plans?  
Have you considered other vehicles in addition to 529 plans? Have you run the numbers for college aid?

### Home

Do you have plans to acquire a home (or a larger or second home)?  
Have you estimated a reasonable amount to pay for the home?  
Do you know what your mortgage options are?  
Have you determined the necessary cash down payment to purchase and furnish the home?  
Are you saving for the amount you’ve determined?  
Have you considered refinancing your existing mortgage(s)?

### Work

Are you in the line of work that you wish to be?  
Are you satisfied working for your present company?  
Are you taking appropriate education courses to improve your skills or to prepare for a career change?  
Are you saving what you need to prepare for a planned career change or sabbatical?

### Enjoying Now

Do you know when and where you will be taking your next vacation?  
Do you reserve time each week for those who are most important to you?
Have you identified those pleasures that you can afford right now without endangering your future?

Have you considered your spiritual and other needs and made sure they are not being crowded out by excessive focus on making money?

<table>
<thead>
<tr>
<th>LIFE EVENTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Graduating/Starting Out</td>
<td>Saving for College</td>
</tr>
<tr>
<td>Changing Jobs</td>
<td>Managing College Expenses</td>
</tr>
<tr>
<td>Receiving a Promotion</td>
<td>Planning/Saving for Retirement</td>
</tr>
<tr>
<td>Coping with Unemployment</td>
<td>Long-Term Care Planning</td>
</tr>
<tr>
<td>Getting Married</td>
<td>Planning an Estate</td>
</tr>
<tr>
<td>Getting Divorced</td>
<td>Planning for Business Succession</td>
</tr>
<tr>
<td>Starting a Family</td>
<td>Nearing Retirement/Retirement</td>
</tr>
<tr>
<td>Renting/Buying a Home</td>
<td>Caring for an Aging Parent</td>
</tr>
<tr>
<td>Refinancing a Home</td>
<td>Loss of Spouse</td>
</tr>
<tr>
<td>Selling a Home</td>
<td>Receiving an Inheritance/Financial Windfall</td>
</tr>
<tr>
<td>Starting a Business</td>
<td>Other: __________________</td>
</tr>
</tbody>
</table>

[Source: adapted from "Life Events" section of Broadridge Advisor]

<table>
<thead>
<tr>
<th>PLANNING INTERESTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate planning/organization</td>
<td>Charitable planning</td>
</tr>
<tr>
<td>Insurance review/planning</td>
<td>Budgeting, savings and accumulation</td>
</tr>
<tr>
<td>Retirement planning</td>
<td>Inflation/standard of living update</td>
</tr>
<tr>
<td>Investment planning</td>
<td>Business valuation/review</td>
</tr>
<tr>
<td>Education funding</td>
<td>Business continuation concerns</td>
</tr>
<tr>
<td>Tax planning</td>
<td>Other: ______________</td>
</tr>
</tbody>
</table>

[Source: adapted from "Life Events" section of Broadridge Advisor]
230 Constructing a Plan

The chapters that follow deal with taking the information and developing a plan that will carry out the client’s objectives in the most economical and effective way. To this end, the financial planner will consider forms of property ownership, lifetime personal and charitable giving, use of trusts, life insurance, and all other matters dealing with the general principles and techniques of financial and estate planning addressed in this guide. Special situations deal with planning for corporate executives, professionals, the owners of closely held businesses and others. Special situations, the ways and means of building the estate, and a discussion of making use of the planning aids are found later in this guide.
Chapter 3

The Co-ownership of Property

301 Overview

Individuals often become involved in the co-ownership of property without fully realizing what it means in terms of loss of freedom and control and the costs entailed. The cost is necessarily affected by tax considerations. The financial planner must take into account the direct and indirect effects of tax rules on the various forms of co-ownership.

Co-ownership may assume many different forms, some of which are beyond the scope of this chapter. The modern corporation, for example, is a form of co-ownership, as is a partnership, cooperative apartment, condominium, limited liability company, or even a trust. Co-ownership might also be deemed to include ownership by different persons of qualitatively different interests in the same property, such as ownership of a life or term interest by one party and a remainder interest by another party. This chapter does not address those forms of ownership. Rather, this chapter addresses the common forms of ownership in which individuals may hold their homes, bank accounts, securities, and other investments. Specifically, this chapter examines what is probably the most common form of co-ownership—joint ownership or joint tenancy, with a right of survivorship. Special attention is focused on the special rule (315.02) that permits one half of spouses’ jointly owned property to be excluded from the gross estate of the first to die, regardless of the amount of consideration furnished by each spouse.1 This chapter also considers a special form of joint ownership, also with a right of survivorship, between spouses, known as a tenancy by the entirety. In addition, this chapter examines tenancies in common, which provide no right of survivorship. Finally, this chapter addresses community property, which is a form of co-

1 Internal Revenue Code (IRC) Section 2040(b).
ownership for married couples in eight states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington). Wisconsin has adopted the Uniform Marital Property Act, which is similar to community property statutes. Alaska has certain optional community property rules as well.

Individuals who need planning services often wait until middle age to consult a financial planner. When they do come for help, the financial planner may be confronted with accomplished facts about the form of property ownership. Few individuals have property arrangements that are entirely satisfactory by estate planning tests. Assets and property rights will have been acquired in a more or less haphazard fashion, based on feelings, incomplete knowledge, custom, arrangements made by other family members, habit, and even chance. Although feelings, customs, and habits are not to be completely ignored, they do have to be recognized for what they are. The financial planner must help the client recognize any consequences that might result from prior arrangements. The togetherness that can be symbolized by joint ownership or another person’s fear of togetherness can exact a price in terms of hidden costs or loss of planning flexibility. Once aware of these factors, the owners might wish to modify their earlier plans after evaluating the cost of doing so.

The first job of the financial planner is to find out exactly what forms of ownership exist. The financial planner will also want to know what the cost basis of each asset is, and what changes, if any, are desirable. The financial planner can then determine the best way to recommend any changes in the form of ownership. The cost of making any changes should be compared to the benefits of the changes.

The checklist in ¶305 sets out the steps the financial planner should generally take. The chapter later addresses in detail what needs to be done and how to do it.

¶305 Evaluating Forms of Ownership of Property

The following steps should be taken by financial planners when evaluating forms of property ownership:

1. **Document check.** Check all bank accounts, government bonds, listed and unlisted securities, deeds, co-op shares, and other evidences of ownership to determine whether the particular property is held jointly with right of survivorship, as a tenancy by the entirety, as a tenancy in common, or as community property under applicable local law. Determine when the property was acquired.

2. **Mode of acquisition.** Was property acquired in any of the forms of co-ownership by purchase, gift, or inheritance?

3. **Contributions of co-tenants.** How much did each of the co-tenants contribute, if anything, to the acquisition?

4. **Income tax consequences.** What are the income tax consequences of co-ownership, taking into account applicable local law?

5. **Severance of interests—legal feasibility.** How may a severance of a joint interest be made under state law? Can it be done unilaterally or only by mutual consent?

6. **Tax consequences of severance.** What will be the effect of the severance and termination of joint tenancies, including tenancies by the entirety, in terms of estate tax, gift tax, and income tax consequences?
7. **Fractional interest rule for spouses’ jointly-owned property.** Under the Internal Revenue Code (IRC) Section 2040(b), only 50 percent of the value of jointly-owned personal and real property held by the spouses in joint tenancy with right of survivorship, or as tenants by the entirety, will be included in the gross estate of the first spouse to die, regardless of the consideration furnished by each spouse. However, the U.S. Court of Appeals for the Sixth Circuit has held that this rule does not apply to joint tenancies created before 1977 (¶315.02), providing instead that for such joint tenancies, the entire value of the property is attributed to the person who furnished the consideration for it.²

8. **Effect of joint and mutual will.** The financial planner should check any will to determine its effect in relation to jointly-owned property and the marital deduction in the light of applicable local law.

9. **Structure plan.** The financial planner should explain to the client the legal and tax consequences of the current forms of ownership and the costs and benefits of proposed changes. The client should decide whether or not he or she wants the revisions made.

### ¶310 Joint Ownership

Some use the term *joint ownership* to include tenancies in common, in which each tenant owns an undivided portion of the property that he or she may freely dispose of. A tenancy in common does not include property held with a right of survivorship. When financial planners use the term *joint ownership* they mean a form of ownership in which the entire property passes to the survivor on the death of the joint tenant. This chapter also uses the term “joint ownership” to include that special form of joint tenancies between spouses known as *tenancies by the entirety*. Although tenancies by the entirety are also characterized by a survivorship feature like that found in ordinary joint tenancies, they differ from the point of view of termination rules. This last point will be addressed in ¶315.02.

From a purely estate planning point of view, joint tenancies or tenancies by the entirety may often be undesirable. They are especially undesirable when the estate is substantial and potentially subject to a large estate tax. However, these joint tenancies can also create problems for smaller estates.

Anyone transferring property from sole ownership to joint ownership can expect to lose full control. With some types of property, an owner may be able to retain control by keeping evidence of joint ownership. However, by retaining control, the owner might make the transfer revocable or ineffective. Also, joint ownership usually involves a sharing of income from the property, which might not be desirable. Sharing the income is undesirable if the transferor needs the income. However, sharing the income might be desirable if the transferor truly wants to share it with the joint tenant, especially if the latter is in a lower income tax bracket. Joint ownership rules out any form of postmortem control by the person who created the joint ownership. The survivor will have control over the property. This circumstance might not be desirable if the survivor is not able to manage the property. For example, a survivor might have difficulty managing a business interest in which he or she lacks management experience or might suffer from some form of disability. Ordinarily, allowing the survivor to have control over the property is not considered advisable if he or she remarries, and the property passes out of the family.

Joint tenancies involve a variety of estate tax, gift tax, and income tax considerations, which will be addressed later in detail.

In addition, joint tenancy is somewhat like marriage, not only in the surrender and sharing of control and income, but also in its divorce and termination aspects. Modern divorce laws and procedures in some jurisdictions may make obtaining a divorce easier than unwinding joint ownership. The joint tenants must also consider state laws and any gift taxes that they must pay.

The idea that joint tenancies are a substitute for a will is a myth. No one can be certain that all of his or her property will be in joint ownership at the time of death. A last minute inheritance or a settlement, bonus, or other property bonanza always remains a possibility. Simultaneous death of the joint tenants is another possibility. The potential occurrence of any of these events makes having a will an estate planning necessity.

However, joint tenancies have their place in estate planning. They combine the survivorship principle with an avoidance of probate in a way that can make this form of ownership desirable from an estate planning point of view. For example, spouses with a modest joint checking or savings account should usually hold the account as joint tenants with a right of survivorship. The couple can use this form of ownership to provide the survivor with almost immediate cash for support, payment of funeral expenses, and other debts and costs demanding prompt payment. This scenario assumes that the survivor would not otherwise have such funds available. It also assumes that the amount in the joint accounts is kept large enough for the survivor’s reasonably anticipated needs for current cash.

Spouses might also desire to put their personal residence in joint tenancy or tenancy by the entirety for the reasons described in ¶315.02.

Although the idea of combining survivorship, avoidance of probate, and taking care of the survivor’s current cash needs via joint ownership is attractive, the financial planner should consider alternatives. Some alternatives might achieve the same goals without some of the disadvantages of joint ownership. A revocable trust, for example, can be set up to provide the survivorship feature, avoid probate, and supply the survivor with immediate cash. At the same time, the revocable trust allows the settlor (the creator of the trust) to retain control and have beneficial use of the property during his or her lifetime. However, a revocable trust is not always preferable. It carries its own limitations and disadvantages, including complying with the laws and requirements in forming it, titling property to it, and administering it (see ¶630 for a full discussion of the revocable trust).

The legal and tax consequences of joint ownership of property can vary depending on the character of the property involved and local law. Exhibit 3-1, which follows, is designed to give the reader a general view of the advantages and disadvantages of joint ownership compared with those of sole ownership. Following the chart, the estate tax, gift tax, income tax, termination problems, and the use of joint ownership in special properties are considered.

**Exhibit 3-1: General Comparison of Sole and Joint Ownership of Property**

<table>
<thead>
<tr>
<th>Point of Comparison</th>
<th>Sole Ownership</th>
<th>Joint Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lifetime control</td>
<td>Full</td>
<td>Divided</td>
</tr>
<tr>
<td>Postmortem control</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

Page 79
<table>
<thead>
<tr>
<th>Point of Comparison</th>
<th>Sole Ownership</th>
<th>Joint Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power to bequeath</td>
<td>Full</td>
<td>Shared</td>
</tr>
<tr>
<td>Income from property</td>
<td>All</td>
<td>Shared</td>
</tr>
<tr>
<td>Tax on creation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Generally</td>
<td>None</td>
<td>Possible gift tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Possible income tax</td>
</tr>
<tr>
<td>Inter-spousal</td>
<td>Not applicable</td>
<td>No gift tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Possible income tax</td>
</tr>
<tr>
<td>Tax on termination</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Generally</td>
<td>Possible gift tax</td>
<td>Possible gift tax</td>
</tr>
<tr>
<td></td>
<td>Possible income tax</td>
<td>Possible income tax</td>
</tr>
<tr>
<td>Inter-spousal</td>
<td>Not applicable</td>
<td>No gift tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>No income tax</td>
</tr>
<tr>
<td>Inclusion in gross estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Generally</td>
<td>All</td>
<td>All, unless survivor shows contribution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>One-half included in decedent’s estate</td>
</tr>
<tr>
<td>Inter-spousal</td>
<td>Not applicable</td>
<td>No gift tax</td>
</tr>
<tr>
<td>Tax on postmortem disposition</td>
<td>Full step-up in basis</td>
<td>No step-up for part not includible in decedent’s gross estate*</td>
</tr>
<tr>
<td>Tax on postmortem disposition for property acquired from a decedent who died in 2010 only (and an election was made to opt out of the federal estate tax)</td>
<td>Limited step-up in basis</td>
<td>Limited step-up in basis for part deemed owned by decedent only</td>
</tr>
<tr>
<td>Cash availability on death of owner</td>
<td>Delayed</td>
<td>Immediate or as soon as waiver of state tax lien obtained</td>
</tr>
<tr>
<td>Need for will</td>
<td>Yes, unless statutory disposition is OK</td>
<td>Same as sole ownership unless no other non-joint property interests</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>Included in computing expenses and fees</td>
<td>Generally not included in computation</td>
</tr>
<tr>
<td>Unwinding</td>
<td>No special problem</td>
<td>Legal problems on top of tax problems</td>
</tr>
<tr>
<td>Creditors’ claims</td>
<td>Fully subject to</td>
<td>Free of creditors under some state laws; subject to claims in others</td>
</tr>
</tbody>
</table>

*No step-up if joint tenancy acquired by decedent by gift from his or her joint tenant within one year of death (IRC Section 1014(e)).

**.01 Estate and Death Taxes**

Under IRC Section 2040(a), the full value of jointly-held property is includible in the gross estate of the first joint tenant to die, unless the executor shows that some part of the property belonged to the survivor before the joint tenancy was created or that the survivor contributed to the acquisition of the property or
its improvement. However, the requirement of a showing of contribution is not necessary in the case of a joint tenancy between spouses,\(^3\) as discussed in detail in \(^{315.02}\). Another exception to the full value inclusion of joint property rule applies if the property was acquired by gift, legacy, or inheritance. This exception will be addressed in "Joint property acquired by gift or inheritance," which follows.

Focusing first on the exception involving contributions by the survivor, the financial planner should note the consequences of proving survivor contributions. The amount excluded from the decedent’s gross estate is not merely the amount of the survivor’s contribution but, rather, a fractional part of the full value of the property at the time of death. The numerator of the fraction is the amount contributed by the survivor, and the denominator is the full value of the property at the time the contribution was made.

**Example 3.1.** Assume that a parcel of real estate is acquired for $30,000, with Donna Cline putting up $20,000 and Steve Henderson putting up $10,000. Years later, if Cline dies and the property is then worth $90,000, $30,000 ($90,000 \times $10,000/$30,000), not $10,000, would be excludible from Cline’s gross estate. Henderson is credited with contributing one-third of the value of the property.

The deceased joint tenant might have given the survivor money or other property before the jointly-held property was acquired. If that money or other property became the basis of the survivor’s contribution, it is not counted as an independent contribution by the survivor. This rule applies even though the gifted property appreciated in value between the time of the gift and the time of acquisition of the jointly held property.

**Example 3.2.** Alice Wilson gave Bob Jenkins real estate worth $20,000, and five years later (when the real estate was worth $40,000), Jenkins exchanged it for real estate worth $50,000, title being taken by Wilson and Jenkins as joint tenants. Jenkins would be considered to have made no contribution toward the acquisition of the new property. On the other hand, income earned from the property or money acquired by gift from persons other than the joint owner may be used as a basis for the survivor’s contribution. For example, if Jenkins used accumulated rents from the property received as a gift to acquire the new joint tenancy property, these rents would be considered a contribution by Jenkins.

If the jointly held property is mortgaged, difficult questions can arise. Is the amount of an assumed mortgage considered to be a contribution? A U.S. district court addressed this issue in a case involving an acquisition by a husband and wife. The husband put up all the cash, but both parties’ names were on the mortgage. The court held that the wife contributed to the purchase price to the extent of the value of the property attributable to one-half of the amount of the mortgage assumed and paid, even though the mortgage payments were made by the husband.\(^4\) However, that case was decided many years ago, and the value of that decision as precedent is doubtful. Obviously, it is an approach that permits estate taxes to be avoided. This makes sense if the joint liability on the mortgage is genuine at the time the mortgage is assumed or placed by the joint tenants. However, if the parties contemplate from the beginning that one or the other is to bear full responsibility and make the mortgage payments, the result could be dif-

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\(^3\) IRC Section 2040(b).

The IRS, in any case, will very likely want to take a close look at the transaction to determine whether it is real or a sham, particularly when a pattern exists in which one individual has made all the payments from his or her own funds. If the parties acquire property subject to an existing mortgage, the amount outstanding at the time of acquisition should have no effect in determining contributions. However, subsequent mortgage payments may affect the determination of contributions.

In all events, except for qualifying tenancies between spouses (¶315.02), the full value of jointly held property is presumptively includible in the gross estate of the first joint tenant to die. The burden is on the executor to show otherwise. This rule puts a premium on recordkeeping. One cannot predict who will die first. Both joint tenants should keep complete records of their own contributions, as well as those of their joint tenant.

During the planning stage, a financial planner might have to address an existing joint tenancy. If the client cannot prove past contributions to the financial planner’s satisfaction, the client will likely have difficulty proving them to the IRS on the death of the other joint tenant. Therefore, when computing the potential estate tax liabilities attributable to the property, the financial planner should not count the claimed but unproven contributions of one or the other joint tenants. If the individual who originally owned all the property and who created the joint tenancy paid a gift tax, the gift tax paid qualifies as a credit against any estate tax due.

**Joint property acquired by gift or inheritance.** If the joint tenants acquired the property from someone else by way of gift or inheritance, IRC Section 2040, and the regulations thereunder, provide that on the death of one of the joint tenants, only the value of his or her fractional interest in the property is includible in his or her gross estate. The fractional interest is that interest specified in the gift or fixed by law. If none is specified or fixed by law, the fractional interest is determined by dividing the value of the property by the number of the joint tenants. When dealing with a tenancy by the entirety of spouses, the only two tenants will be the spouses. As a general rule, only half of the value of the property is includible in the gross estate of the first married joint tenant to die (¶315.02). Other types of joint tenancies can have more than two tenants. An individual might, for example, make a testamentary transfer of property to four grandchildren. If the property will have more than two owners, using a tenancy in common rather than a joint ownership with survivorship is usually advisable.

Suppose one of the joint tenants acquired the property by gift or inheritance as a sole owner and subsequently converted the property to joint ownership. A court has held that the rule, calling for a fractional exclusion from the decedent’s estate of the total value of the property based on contributions of the survivor, does not apply to amounts contributed by the survivor for improvements. The cost of the improvements is considered only if the parties show that the improvements increased or decreased in value from the time made until the date of death.

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5 IRC Section 2040(b).
6 IRC Section 2040(a).
7 IRC Section 2040(b).
Simultaneous death of joint tenants. Simultaneous death of joint tenants does not occur frequently. However, the simultaneous death of joint tenants can produce unexpected estate tax results. The Uniform Simultaneous Death Act (the act) was promulgated in 1940 and adopted by 49 states. In 1991, the act was made part of the Uniform Probate Code Article II and the Uniform Act on Intestacy, Wills, and Donative Transfers. The act was amended in 1993. The 1993 version of the act has been adopted by the District of Columbia, the Virgin Islands, and the following states: Alaska, Arizona, Arkansas, Colorado, Hawaii, Kansas, Kentucky, Massachusetts, Montana, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, South Dakota, Utah, Virginia, and Wisconsin. Most of the other states still follow the 1940 version of the act or have incorporated the provisions of the act in their adoption of the Uniform Probate Code. The act creates a presumption of simultaneous death, absent a sufficient showing to the contrary. It also provides, in the case of a joint tenancy or tenancy by the entirety, that the property is to be distributed half to the distributees of each joint tenant. In effect, the joint tenancy is treated as though it were a tenancy in common without survivorship rights.

The IRS issued a contrary ruling for a situation involving the simultaneous death presumption for property held by husband and wife as tenants by the entirety. In that case, the husband had contributed the full consideration for acquiring the property. The IRS ruled that the full value of the property was includible in the husband’s gross estate because he had furnished the full consideration. Half the value of the property was then includible in the wife’s gross estate by reason of the Uniform Simultaneous Death Act. This half qualified for the marital deduction in the husband’s estate. Note that this ruling was issued prior to the enactment of the current IRC Section 2040(b). This approach the IRS used would not apply under IRC Section 2040(b). This section deals with spousal joint tenancies and provides that only one-half of the value of the jointly-held property generally is includible in the gross estate of each spouse.

What if the IRS followed the same approach with a joint tenancy between persons other than spouses in which one of the tenants furnished full consideration for the acquisition? One decedent’s gross estate would include the full value of the property without benefit of the marital deduction, and the other’s gross estate would include half the value of the property. Presumably, the estate tax paid by the estate required to include the full value would be allowed as a credit against the estate tax payable by the other tenant’s estate. However, no definitive ruling or case on point is available.

.02 Gift Taxes on the Creation of a Joint Tenancy

Creation of a joint tenancy generally gives rise to a taxable gift, unless the interest acquired by each joint tenant is equal to his or her contribution to the joint interest. The general rule does not apply, however, to joint tenancies or tenancies by the entirety between spouses as a result of the gift tax marital deduc-

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9 IRC Section 2056(a).
10 Revenue Ruling 66-60, 1966-1 CB 221, modified on other grounds in Revenue Ruling 76-303, 1976-2 CB 266.
11 IRC Section 2056(a) or IRC Section 2040(b).
12 Regulations Section 25.2511-1(h)(5).
tion. (¶315.02),\textsuperscript{13} or to purchases of U.S. savings bonds (¶315.03), and the creation of joint bank accounts (¶315.01), and joint brokerage accounts (¶315.05) under special circumstances.\textsuperscript{14}

Not all gifts result in tax. Consider the $14,000 (for 2017 and indexed annually for inflation) annual gift tax exclusion,\textsuperscript{15} the split-gift concept,\textsuperscript{16} the marital deduction,\textsuperscript{17} and the applicable estate and gift tax credit amount,\textsuperscript{18} all of which are addressed in chapter 4, "Lifetime Gifts to Individuals." The annual gift tax exclusion can only be adjusted in increments of $1,000. The IRS generally publishes notice of the adjustments in late September. A $14,000 annual gift tax exclusion became effective for 2013 and remained at $14,000 for 2014, 2015, 2016 and 2017 after the $13,000 exclusion amount had been in place for several years.

The financial planner should weigh the gift tax payment potential against other possibly favorable tax consequences flowing from the payment of gift taxes, such as the following:

- The gift tax paid may be excluded from the donor’s gross estate if the gift is not made within three years of death.\textsuperscript{19}
- The portion of the gift tax paid attributable to appreciation in the gift property increases the tax basis of the property,\textsuperscript{20} which can increase future depreciation deductions for depreciable property and reduce the tax liability on the sale proceeds if the property is later sold.

When an individual buys property with his or her own funds and title is taken in joint tenancy, the value of the gift to the joint tenant is one-half of the value of the jointly-held property.\textsuperscript{21} Special rules apply when the parties are married and the property is held in a tenancy by the entirety (¶315.02).\textsuperscript{22}

\section*{.03 Income Tax Consequences on Creation of Joint Tenancy}

Joint ownership generally permits a splitting of income. Each joint tenant reports his or her share of the income or gain on sale on his or her own separate tax return. This splitting of income can produce over-

\textsuperscript{13} IRC Section 2523(a) and Regulations Section 25.2511-1(h)(5).

\textsuperscript{14} Regulations Section 25.2511-1(h)(4).

\textsuperscript{15} IRC Section 2503(b).

\textsuperscript{16} IRC Section 2513.

\textsuperscript{17} IRC Section 2523(a).

\textsuperscript{18} IRC Sections 2010 and 2505.

\textsuperscript{19} IRC Section 2035(b).

\textsuperscript{20} IRC Section 1015(d)(6).

\textsuperscript{21} Regulations Section 25.2511-1(h)(5).

\textsuperscript{22} Regulations Section 25.2511-1(h)(5).
all tax savings. The shift of income from the creator of the joint tenancy reduces the creator’s tax liability and might cause the retained income taxable to the creator (if any) to be taxed at a lower rate. When the joint owners do not file a joint income tax return, the creation of a joint tenancy can reduce the combined tax paid on the income generated by the property.

Taking into account federal rates alone, the spread between the tax bracket of the creating joint tenant and the other tenant(s) might be substantial in view of the 39.6 percent top income tax rate for 2017. When state and local taxes are considered, along with the possible application of the net investment income tax of 3.8 percent, the spread might be even greater.

Creation of joint interests in appreciated property affords special income-splitting opportunities. On a subsequent sale of the property by the joint tenants, the gain is divided between or among the joint tenants according to their fractional interests. A possible exception to this rule could occur where the sale negotiations began before the creation of the joint interest. In that case, the IRS might want to attribute the entire gain to the creator of the joint tenancy under the step transaction doctrine and assignment of income doctrine. Substantial savings might be realized if the creator of the joint tenancy would be taxed at a 15-percent, 20-percent, or 23.8-percent marginal rate on any capital gain,\(^2\) and the other tenant would be taxed at a rate of possibly 0 percent.\(^3\)

These income tax benefits are not available with U.S. savings bonds (¶315.03) and many joint savings accounts (¶315.01) when one joint tenant makes the purchase or deposit because the purchase or deposit is not considered a completed gift by the purchaser.\(^4\)

Creation of a joint tenancy by a parent with a child may not produce any significant tax savings because the child may be taxed under the kiddie tax at the higher of his or her own tax rate or the parent’s tax rate on unearned income in excess of $2,100 (in 2017). This rule applies to a child who is under age 19 or who is under age 24 and a full-time student.\(^5\) Even if the creator of the joint tenancy with the child were a grandparent or other family member, the result would be the same. When the child attains the age of 19 or 24, as the case may be, the child’s unearned income will be taxable at the child’s own personal rate.

A joint tenancy with a spouse is not likely to be of much income tax benefit, at least on the federal income tax return, where income splitting is permitted on a joint return. However, some state income tax laws do not provide for income splitting on a joint return. In those states, splitting income between spouses through joint ownership may produce income tax savings.

In all cases, gift tax costs (¶310.02), if any, must be weighed against income tax savings.

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\(^2\) IRC Section 1(h)(1)(C); IRC Section 1411.

\(^3\) IRC Section 1(h)(1)(B).

\(^4\) Regulations Section 25.2511-1(h)(4).

\(^5\) IRC Section 1(g).
The joint tenants themselves can end the relationship while they are alive. Death, of course, ends it automatically. A joint tenant may terminate a regular joint tenancy unilaterally. Generally, a tenancy by the entirety may be ended only by mutual consent or by termination of the marital relationship.

**Lifetime terminations.** Termination during life is accomplished by dividing the property, selling it and dividing the proceeds, or by exchanging it for other property. Regardless of which method is used, gift tax liabilities are possible if the joint tenants are not married to each other.\(^{27}\) A gift of the property occurs if the property or the proceeds are divided to give one of the joint tenants less than the value of his or her fractional interest in the property.

**Example 3.3.** Assume that jointly-held property is sold for $100,000 and each of the joint tenants, Amy Jones and Bill Davis, has a one-half interest in the property. Jones receives $80,000 and Davis receives $20,000. Davis has made a gift of $30,000 to Jones. If each had received $50,000, no gift occurs, regardless of how much each contributed to set up the joint tenancy.

From this example, one might conclude that the thing to do is to give each tenant no more than his or her fractional interest. Doing so certainly avoids potential gift tax, but it overlooks two factors that the financial planner should keep in mind: (1) contributions to the acquisition and improvement of the property, and (2) survivorship value. The first factor is easy enough to handle. If the contributions have been unequal, the parties will presumably be aware of this fact. Once the financial planner calls it to their attention, they will have the opportunity to make adjustments for this factor effecting a division. The survivorship factor could be more troublesome and less obvious in most cases. It may be clear enough with respect to situations in which there is a wide disparity in the ages or health (or both) of the joint tenants. Nominal equality would not be true equality in such cases.

**Example 3.4.** Assume a situation in which a 90-year-old grandfather, Guy Long, owns a parcel of real estate with his 21-year-old grandson, Steve Jacobs. Measured by actuarial standards, the chances of Long receiving the whole of the property by survivorship are slight, and a 50-50 division would hardly reflect reality.

**Effect of estate taxes on terminations.** The parties should also consider estate taxes when ending a joint tenancy. The financial planner should consult three particular sections of the IRC when advising the client:

- (1) IRC Section 2035, concerned with transfers within three years of death, which, while no longer generally includible for estate tax purposes, are included in the estate for purposes of determining eligibility for special-use valuation of farm or business real estate, the 14-year extension for payment of estate taxes,\(^{28}\) and IRC Section 303 stock redemptions\(^ {29}\)

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\(^{27}\) IRC Section 2523(a).

\(^{28}\) IRC Section 6166.

\(^{29}\) IRC Section 2035(c).
• (2) IRC Section 2036, which requires inclusion in the estate the value of any interest transferred by a decedent in which he or she retains a life interest

• (3) IRC Section 2038, which deals with revocable transfers

Under IRC Section 2035, the creation of a joint tenancy will not generally result in the inclusion of the joint interest in the estate of the creator for estate tax purposes. However, if the donor is the owner of a closely held corporation, the creation of the joint tenancy could affect the ability of the donor’s estate to meet the test for an IRC Section 303 redemption of stock, or the test for an IRC Section 6166 extension of time to pay the federal estate tax. This situation could occur if the donor dies within three years after creating the joint tenancy. This test requires that the closely held business interest have a value of more than 35 percent of the gross estate. The creation of a joint interest in nonbusiness property, although removing the joint interest created for estate tax purposes, will not be effective in terms of enabling the estate to meet the 35-percent test, that is, the full amount of the joint property will be "counted" as owned by the decedent.30 Although a gift within three years of death is generally not includible in a decedent’s estate, any gift tax paid, or payable thereon, will be includible.31 The gross-up of gift tax rule continues to apply.

IRC Section 2036 requires inclusion in an individual’s gross estate of the value of any property that he or she has, at any time, transferred, in which he or she has retained a life interest. When jointly-held property is transferred in trust, with the joint tenants reserving a life interest in the trust during their joint lives and for the life of the survivor, IRC Section 2036 clearly applies. When one of the joint tenants dies, assuming it is the one who furnished the entire consideration for the acquisition of the property, how much of it is to be included in his or her gross estate? Only the portion representing the decedent’s fractional interest in the property transferred to the trust will be includible. Revenue Ruling 69-57732 states that when property held in a tenancy by the entirety is transferred to a trust under which each spouse reserves a joint and survivor life estate, only one-half of the value of the trust property is includible in the gross estate of each, even when the trust is irrevocable. Although the ruling dealt with spousal joint tenancies, the principle applies to other joint tenancies as well.

If the joint tenants transfer the property to a trust without retaining any life interest for themselves, whether the trust was revocable or irrevocable would make a difference. If revocable, IRC Section 2038 applies. The gross estate of the first joint tenant to die would include one half of the value of the trust property. If the trust is irrevocable, IRC Section 2038 would not apply.

Creating a trust that complies with the requirements of Revenue Ruling 69-577, referred to previously, might be one of the best ways of ending an unwanted joint tenancy. The trust must dispose of any property left in the trust after the two life interests have ended. The trustee should consider possible gift tax liabilities when making the disposal. The interest disposed of is called a remainder interest. The IRS has tables for determining the value of such interests. The values vary depending on the ages of the life tenants. If both life tenants are young, the remainder interest will have little value for gift tax purposes. If

30 IRC Section 2035(c).

31 IRC Section 2035(b).

32 1969-2 CB 173.
they are both old, the value of the remainder interest is high, and a gift tax liability is possible. The dimensions of it will vary depending on the value of the trust property and available transfer tax exemptions and exclusions. If the potential liability is significant, the settlor should reserve a limited power to appoint the remainder among the descendants of the settlor. In such a case, no completed gift will occur that would cause a gift tax liability.33

**Income tax consequences.** Income tax consequences must be considered when a joint tenancy is terminated. Each joint tenant, on termination of the joint tenancy during his or her life by a sale or exchange to an outsider, might realize taxable gain or loss on the transaction. Gain or loss is determined by the difference between what is received by each joint tenant in relation to the tax basis for the fractional interest in the property.34 Generally, when the property was acquired for consideration, the cost, less depreciation, if any, allocated to the joint tenants according to their respective fractional interests in the property, will determine their tax income tax basis.35 If the property was acquired by the joint tenants as a gift from a third party, the donor’s adjusted basis increased for any gift tax paid determines the donee’s basis.36 If the property was acquired from a decedent, the fair market value of the property includable in the decedent’s gross estate determines basis as a general rule.

**How the survivor is taxed.** When a joint tenancy in property is automatically terminated by death, the survivor becomes the sole owner of the property. From that time on, the survivor is taxable on all the income generated by the property. If the survivor sells or exchanges the property, special rules apply for computing the gain or loss. These rules depend on how the survivor’s tax basis is computed.

If the entire property is includible in the gross estate of the decedent, its basis is the fair market value at the date of the decedent’s death37 or six months later,38 if the executor elects the alternate valuation date.39 To the extent that the property was not includible in the deceased joint tenant’s gross estate, the survivor’s basis is the survivor’s cost if the survivor bought it or contributed to its purchase. Property acquired from a decedent who died in 2010 will not necessarily receive a basis equal to its fair market value on the date of the decedent’s death. Rather, such property may have a basis equal to the lower of the basis of the property in the hands of the decedent or the property’s fair market value on the date of the decedent’s death, depending on whether or not the decedent’s estate opted to elect out of the federal estate tax system. For such decedents, the executor may allocate a general increase in basis to the decedent’s property of up to $1,300,000.40 In addition, the law allows an additional basis increase of up to $3

33 Regulations Section 25.2511-2(b).
34 IRC Section 1001(a).
35 IRC Section 1011(a).
36 IRC Section 1015.
37 IRC Section 1014(a)(1).
38 IRC Section 1014(a)(2).
39 IRC Section 2032.
40 IRC Section 1022(b).
million for property that passed to a surviving spouse.\textsuperscript{41} See \textsuperscript{¶210} for additional details on the basis rules for property acquired from a decedent who died in 2010.

If depreciable property is involved and is includible in the gross estate of the deceased joint tenant, the survivor’s basis generally must be reduced by any depreciation deductions allowed the survivor (but not those allowed to the decedent) before the joint tenant’s death.\textsuperscript{42}

If the survivor keeps the property, it would be includible in the survivor’s gross estate. However, a special estate tax credit for property previously taxed may be available if the survivor dies within 10 years of the death of the former joint tenant in whose estate the property had been included and taxed.\textsuperscript{43}

Conversion to a tenancy in common. One of the ways in which the survivorship feature of a joint tenancy may be eliminated and the tenancy terminated is to have the tenants join in transferring the property to themselves as tenants in common, sometimes referred to as \textit{severing the joint tenancy}. No gain or loss will be recognized on such a transfer.\textsuperscript{44} As long as the proportional interests are not disturbed, the joint tenants making such a transfer will not incur any gift tax liability. If the joint tenancy is between spouses, the unlimited marital deduction\textsuperscript{45} avoids gift tax, regardless of whether the proportional interests are disturbed. In addition, no recognized sale between spouses occurs for income tax purposes.

\textbf{¶315 Use of Joint Ownership With Special Types of Property}

The rules dealing with joint tenancies can vary depending on the type of property held in joint ownership. The paragraphs that follow deal with these differences as they affect different types of property commonly encountered in financial and estate planning.

.01 Bank Accounts

Almost everyone has a joint bank account with another person, such as a spouse, child, sibling, parent, grandparent, or betrothed. Rarely will anybody call a lawyer to determine whether special factors should be considered in opening an account. The individual goes to a bank and says he or she wants to open a joint account. The person receives papers from a bank clerk to fill out, gives the bank some cash or a check, and receives a statement that may read "Pay to John or Jane or Survivor." If he is John, he is fairly sure that clause means that when Jane dies, he will receive what is in the account. However, he typically is not aware of what it means in terms of income tax, gift tax, and estate tax consequences.

Joint accounts can be very convenient, but they are also fraught with many potential dangers. What are the advantages of joint accounts? They are obviously very convenient for married couples. They also are convenient for an incapacitated senior family member who needs the assistance of a junior family mem-

\textsuperscript{41} IRC Section 1022(c).
\textsuperscript{42} IRC Section 1014(b)(9).
\textsuperscript{43} IRC Section 2013.
\textsuperscript{44} See Revenue Ruling 56-437, 1956-2 CB 507, involving a joint tenancy in stock.
\textsuperscript{45} IRC Section 2523(a).
ber to make withdrawals to pay for the senior’s living expenses. The survivorship feature offers the opportunity of avoiding probate. This advantage can assure a continued source of funds for a surviving spousal joint tenant following the death of the other spouse. Absent a joint account, the survivor could have limited access to the decedent’s funds pending settlement of the estate.

Joint accounts also have disadvantages. A spouse named as a joint tenant could withdraw funds from the account and place the withdrawn funds in his or her own account, consume them, or give them away. The incapacitated senior family member might not want the funds in the joint account to go exclusively to the child who is the named joint tenant but rather to be shared equally by that child and other children, who were not named as joint tenants. However, the funds go to the named joint tenant by operation of law. The discussion that follows examines the legal consequences of joint accounts.

Some states have laws spelling out the legal consequences of joint accounts. Most states leave it to the deposit agreement to define the rights of the joint holders of the account. The legal relationship can directly affect the various consequences. Although the legal relationship can vary, depending on state law and deposit agreement variations, joint accounts generally fall into one of three basic categories:

1. **Joint tenancy with immediate vesting.** Each joint owner, on the creation of the account, acquires an interest in one-half of the funds deposited and cannot withdraw more than his or her half without accounting to the other.

2. **Revocable account.** Each joint account holder may withdraw the full amount on deposit without accounting to the other.

3. **Convenience account.** One individual deposits all the funds and has the sole right to the funds while both joint tenants are alive. The other individual may make deposits and withdrawals only as the agent for the depositor.

All three types of joint accounts provide for survivorship. In the case of the convenience account, the individual supplying the funds receives the funds if he or she is the survivor. If the other non-contributing account holder survives, whether he or she receives the funds depends on the deposit agreement and local law.

Personal checking accounts are not likely to be of great concern to the financial planner because the amount in the account at any one time is typically not much more than one month’s bills or living expenses. Savings accounts are likely to be more significant. Time deposits, certificates of deposit, and money market accounts might be even more important. In a climate of economic uncertainty, the desire for security lures money into bank deposits, even when rates are low. The deposits can be sizable, and the income tax, gift tax, and estate tax consequences equally large.

**Income tax consequences.** With respect to the vested-rights type of account, because each account holder owns half the amount on deposit, each account holder is entitled to, and should report, half the interest income. Income tax savings are possible if one joint tenant is in a lower bracket than the one furnishing the funds. However, bear in mind that unearned income of a child subject to the so-called "kiddie tax" is taxable at the higher of the child’s tax rate or the parents’ top tax rate.46 (See ¶3205.) Moreo-

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46 IRC Section 1(g).
ver, if the depositors are spouses, and they file a joint return, they will receive no income-splitting advantage.

With respect to the two other types of accounts, direct authority is scarce. The income would seem to be reportable on the basis of the amount earned by the funds contributed by each contributor. If one furnishes all the deposits, he or she is chargeable with all the income. However, the bank will report all the interest income on a Form 1099-INT to the person whose Social Security number is on the account. If a taxpayer receives a Form 1099-INT that includes an amount received as a nominee for the other joint tenant, the taxpayer who received the Form 1099-INT must report the full amount shown as interest on the Form 1099-INT on his or her income tax return. The taxpayer then shows a subtotal of all interest income. Below that subtotal, the taxpayer should write "Nominee Distribution" and the amount that belongs to the other joint tenant. The taxpayer then subtracts that amount from the interest income subtotal. The taxpayer must also file a Form 1099-INT, along with a Form 1096, for the interest earned by the other joint tenant. The joint tenant who received the interest as a nominee must give the other joint tenant a copy of Form 1099-INT. The joint tenant who received the interest income as a nominee should be listed as the payer and the other joint tenant as the recipient. If the other joint tenant is the taxpayer’s spouse, the taxpayer does not have to file an additional Form 1099-INT for interest received as a nominee for his or her spouse.47

Ordinarily, the Social Security number of any one of the joint tenants is sufficient. However, if the choice is between an adult and a minor, the adult’s number should be used. For a joint account of spouses, when determining the number to be used, primary consideration should be given to who owns the funds in the account. If the funds are mixed, the Social Security number of either spouse may be used.48

**Gift tax consequences.** When one owner funds a vested-rights joint account, a gift occurs of one-half of the deposit on the opening of the account. A gift could also occur on withdrawal if one joint tenant withdraws more than his or her half, unless the withdrawal is for the benefit of the other joint tenant.

With a revocable account, no gift occurs on opening the account, but a gift occurs when the joint tenant who did not contribute funds withdraws funds.49 With a convenience account, no gift occurs on opening the account or when withdrawals are made as the agent of the joint tenant who made the deposit. However, a gift occurs if the agent withdraws funds and uses them for his or her own purpose, even with the consent of the principal.

If there is a gift, the $14,000 (for 2017 and indexed annually for inflation) annual gift tax exclusion,50 applicable credit amount (unified credit),51 and the marital deduction52 can reduce or eliminate actual li-

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47 IRS Publication 550 "Investment Income and Expenses."

48 Revenue Procedure 77-28, 1977-2 CB 537.

49 Reg. Section 25.2511-1(h)(4).

50 IRC Section 2503(b).

51 IRC Section 2010 and 2505.

52 IRC Section 2523(a).
ability. For 2005–2010, the applicable credit amount for gift tax purposes exempted $1 million from gift tax. (In 2011, the gift tax exclusion was $5 million; in 2012, it was $5,120,000; in 2013, it was $5,250,000; in 2014, it was $5,340,000; in 2015, it was $5,430,000; in 2016, it was $5,450,000; and it is $5,490,000 in 2017.)

**Estate tax consequences.** The pertinent estate tax regulation provides that a decedent’s gross estate presumptively includes, under IRC Section 2040(a), the value of property held jointly at the time of the decedent’s death by the decedent and another person(s) with the right of survivorship. It then defines property held jointly as including a deposit of money in the name of the decedent and any other person and payable to either or survivor. Thus, with respect to a bank deposit that meets precisely the definition in that regulation, the entire balance in the account at the time of the death of one of the joint tenants will be includible in his or her gross estate. This result holds true unless the executor is able to prove that some or all of the account is attributable to deposits the survivor made. Authority is lacking on the type of account that gives each joint tenant a vested right in half the balance. Against the bank, either joint tenant may be able to withdraw the full amount. However, between the parties themselves, if one withdraws more than his or her share, that joint tenant would be accountable to the other joint tenant. One could argue that if under state law and the deposit agreement only one-half of such account belongs to each joint tenant, then only one-half should be includible in the gross estate of the first to die.

With a convenience account, the full amount in the account should be includible in the gross estate of the principal and none in the gross estate of the agent. However, a financial planner should exercise caution. Determining the ownership of the funds depends on the facts and circumstances of each case and applicable local law.

Estate tax consequences regarding joint accounts of spouses are addressed in ¶315.02.

When the death of one joint tenant appears imminent, a planning tactic is to withdraw the funds in anticipation of death. Although the other joint tenant could withdraw the entire amount, the more common approach is for the one who is ill to sign a withdrawal slip and deliver it to the other joint tenant. As a general rule, IRC Section 2035 no longer requires inclusion in the gross estate of transfers made within three years of death. (Or, if the amount involved does not exceed the $14,000 [for 2017 and indexed annually for inflation] annual gift tax exclusion, no taxable gift has occurred.)

IRC Section 2040, as noted under the regulation, refers to joint property held at the time of death. If the account is closed out by the survivor-to-be before the death of the other joint tenant, the amount will likely not be included in the decedent’s gross estate. However, the U.S. Tax Court has held that if the account is not terminated under state law, the move is ineffective.

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53 Regulations Section 20.2040-1.

54 IRC Section 2040(a).

55 IRC Section 2503(b).

56 *H.W. Grant Est.*, 1 T.C. 731 (1943).
**Recordkeeping.** Recordkeeping is important if substantial sums are to be maintained in bank accounts of individuals whose estates are expected to be subject to estate taxes. One way to make a record is to note on check stubs or other records who deposited what amount and who withdrew what amount. Alternatively, the parties might open two joint accounts.

**Example 3.5.** Don James and Sandra Smith open two joint accounts with a written arrangement that James is to make deposits and withdrawals only in account A, and Smith is to do so only in account B. They preserve the record of the agreement and comply with its terms.

**.02 Property Owned by Married Couples**

One-half of the value of any property held by spouses as joint tenants with a right of survivorship, or as tenants by the entirety, is includible in the gross estate of the first to die, regardless of which spouse furnished the original consideration. However, the U.S. Court of Appeals for the Sixth Circuit has held that this rule does not apply to joint tenancies created before 1977. See the discussion that follows under the heading "Estate tax consequences."

**Planning considerations.** In many cases, an individual should not create a joint interest in property with a spouse. If the individual wishes, he or she can transfer the property by will to the spouse, rather than creating a joint tenancy, and do so with the assurance that the unlimited marital deduction will exclude the entire value from estate tax. In the meantime, control of the property is retained for life. Joint ownership does have the advantage of avoiding probate, which might be an important consideration in certain jurisdictions.

The couple should also consider the income tax consequences in addition to eliminating probate as an advantage or disadvantage of joint ownership.

If sole ownership is retained and transferred to the surviving spouse at death, the surviving spouse will have a basis equal to the fair market value of the property at death (or six months later if the alternate valuation date is elected). If this results in an increased basis, this benefit could be worth more than the probate savings of joint ownership.

**Example 3.6.** Janet and Ted Hansen are married. Janet buys a home, which the couple will occupy as their principal residence, for $150,000 in September 1980. She takes title in joint names with a right of survivorship. On Janet’s death in 2013, the home has a fair market value of $1 million. On a sale by Ted at that price in 2017, his tax basis for computing gain would be $500,000 as to the half passing to him by reason of survivorship and $75,000 as to the half which he acquired by gift when the property was placed in both names in 1980. Thus, he would

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57 IRC Section 2040(b).

58 IRC Section 2056(a).

59 IRC Section 1014(a).

60 IRC Section 1014(a).

61 IRC Section 1015.
realize a taxable gain of $175,000 ($1,000,000 – $575,000 [basis] – $250,000 [amount excluded as sales proceeds from a residence under IRC Section 121]) (¶2820). If Janet and Ted owned the home as community property, the residence would receive a full step-up in basis on Janet’s death.62

If Janet had taken title in her own name and devised the property to Ted on her death, the basis of the property in Ted’s hands would be $1 million, and no gain would be realized on a sale at that price. The savings in income taxes would need to be weighed against possible administration costs resulting from sole ownership.

The stepped-up basis rules apply for decedents who died in 2010, unless the estate elected to opt out of the federal estate tax. If the opt out election was made (see IRS Form 8939) the stepped-up basis rules are replaced by rules that allow the executor to increase the decedent’s basis of estate property (or its value on the decedent’s date of death) by up to $1,300,00063 and up to an additional $3 million for property passing to a surviving spouse.64

Life expectancy factors, the relative size of the estates, and other factors should also be considered before placing property in joint tenancy or in the name of only one of the spouses.

In many cases in which joint tenancies between spouses exist, the couple should consider terminating an existing joint interest and vesting the entire ownership in one of the spouses. Such a termination could provide income tax benefits on the death of the spouse who owns the property. The unlimited marital deduction65 allows a termination of a joint interest without considering gift tax consequences.

However, placing property in joint tenancy could have important beneficial side effects when an individual owns a closely held business. The estate must meet ownership percentage tests if the estate of the first joint tenant to die includes a closely held business, and the benefits of any of the following provisions are sought: (1) Special use valuation under IRC Section 2032A; (2) an extension of time to pay estate taxes attributable to the closely held business under IRC Section 6166; or (3) a redemption of corporate stock under IRC Section 303 (with respect to a closely held business owned in corporate form).

A business owner can remove one-half of the value of nonbusiness property from his or her gross estate by placing it in joint tenancy. This reduction in value can help meet the ownership percentage tests in order to qualify for a relief provision, such as the opportunity to pay the federal estate tax attributable to a closely held business interest over 14 years, if the transfer occurs more than three years before death.66 However, placing the business interest itself in joint tenancy would likely be a mistake. Doing so would

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62 IRC Sections 1014(a) and 1014(b)(6).
63 IRC Section 1022(b).
64 IRC Section 1022(e).
65 IRC Section 2523(a).
66 IRC Section 2035(c).
reduce the amount of the business interest in the owner’s eventual estate and make satisfying the ownership percentage tests for this special provision more difficult.

**Example 3.7.** John Cooper owns stock in a closely held corporation with a fair market value of $3 million. His gross estate is $10,300,000, all of which is held in his own name. His adjusted gross estate is estimated to be $10 million. He wishes to give $3 million to his wife, Sara, and the residue, after payment of taxes, to a trust for the benefit of children of a prior marriage. Under these circumstances, if he were to make such disposition by will, his estate would not qualify for the benefits of either the IRC Section 6166 extension of time to pay estate tax or an IRC Section 303 redemption. If, however, more than three years before his death he placed $3 million of non-business property in joint ownership with his wife, his adjusted gross estate would be reduced to $8,500,000 ($10,000,000 – [$3,000,000 × 1/2]), and the value of the closely held business would meet the 35-percent-of-the-value-of-the-adjusted-gross-estate test for purposes of IRC Sections 303 and 6166.

If the property placed in joint tenancy increases significantly in value at a pace greater than that shown by the other assets in the estate, the estate might have a problem satisfying the percentage tests. Thus, the selection of property with relatively low appreciation potential is a factor the financial planner should consider.

**Income tax consequences.** Income tax considerations are usually of little importance in connection with a personal residence, which ordinarily produces no income. However, income tax considerations might assume significance if the parties file separate returns, and one spouse pays all the real estate taxes and mortgage interest and is entitled to the corresponding deductions. Even with income-producing property, income taxes will ordinarily be of no consequence if the parties file a joint return. If separate returns are filed, income-splitting and the splitting of deductions might produce some current income tax savings. Alternatively, the filing of separate returns by married persons could increase the couple’s overall tax liability as the result of the compression of the income tax brackets.

On the sale or exchange of property held by spouses as joint tenants or tenants by the entirety, the gain or loss of each is determined by the difference between the tax basis of each spouse and his or her share of the proceeds or property received in exchange.

**Gift tax consequences.** The creation of a joint interest between spouses either by one spouse acting alone or both spouses together is free of gift tax consequences by reason of IRC Section 2523(d), which qualifies the transfer for the marital deduction. However, the financial planner should check state tax consequences because not all states have similar provisions. As of spring 2017, the only state with a gift tax is Connecticut, Minnesota having repealed its short-lived gift tax statute.

Termination of joint ownership of property between spouses by sale, exchange, or otherwise is without gift or income tax consequences no matter how the property or the proceeds are divided. IRC Section 1041.

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67 IRC Sections 163 and 164.

68 IRC Section 1001(a).
Transfer of a jointly held interest in property from one spouse to another in a divorce settlement may escape gift tax either by reason of the marital deduction69 (if the transfer takes place before termination of the marriage by divorce), or, if the transfer is incident to the divorce, it is deemed made for consideration of money or money’s worth. The latter occurs if the transfer is made

- under a written agreement in settlement of marital or support rights, and the divorce takes place within the three-year period beginning one year before the agreement is entered into; or70
- under a divorce decree settling property rights subject to court jurisdiction if required by state law;71 or
- in consideration of relinquishment of support rights;72 or
- for property or cash of equal value.

Without a transfer, a joint tenancy (or a tenancy by the entirety) between spouses will be converted into a tenancy in common on divorce. (See ¶310.04 for treatment of such conversion; see chapter 24, “Planning for Marriage, Divorce, or Separation,” on the subject of divorce in terms of financial planning.)

**Estate tax consequences.** Regarding joint tenancies and tenancies by the entirety, only one-half of the value of the jointly held property is includible in the gross estate of the first spouse to die, regardless of contribution by either spouse to acquisition costs.73

To the extent that property held by spouses as joint tenants or as tenants by the entirety is includible in the gross estate of the first to die, it qualifies for the estate tax marital deduction.74

The U.S. Court of Appeals for the Sixth Circuit has held that the one-half inclusion rule of IRC Section 2040(b) does not apply to joint tenancies created before 1977.75 Under the court’s view, such joint tenancies are subject to the general rule of IRC Section 2040(a), under which the full value of the property is included in the decedent’s gross estate if the survivor made no contribution. The *M. Gallenstein* deci-

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69 IRC Section 2523(a).
70 IRC Section 2516.
73 IRC Section 2040(b).
74 IRC Section 2056(a).
75 *M. Gallenstein*, 975 F.2d 286 (6th Cir. 1992).
sion has been followed by the Fourth Circuit. The Tax Court also cited the *Gallenstein* decision as support for a decision that was appealable to the Ninth Circuit.

The IRS acquiesced to the Tax Court’s decision in *T. Hahn*, so the IRS will no longer argue that IRC Section 2040(b)(1) applies to joint interests created before January 1, 1977, when the deceased joint tenant died after December 31, 1981. Rather, these joint tenancies will be subject to the contribution rule of IRC Section 2040(a) as it stood before the amendments to IRC Section 2040(b) in 1981. Therefore, a surviving spouse who did not contribute toward the purchase of the jointly held property will receive a basis equal to the full value of the property.

*Gallenstein* is a landmark decision. Surviving joint tenants who made no contributions can receive substantial income tax savings through a step-up in basis to the fair market value of the jointly held property at the date of the decedent’s death. Such individual would wind up with a stepped-up basis in 100 percent of the property, rather than a step-up in only 50 percent of the property. The surviving spouse receives a stepped-up basis for 100 percent of the property held as community property. If an election was made to opt out of the estate tax for 2010, the step-up in basis for property passing from an individual who died in 2010 is subject to an aggregate limit of $1,300,000 and an additional $3 million for property passing to a surviving spouse.

In situations in which the *Gallenstein* rule applies, the higher inclusion in the decedent’s gross estate should not increase the decedent’s estate tax because of the unlimited marital deduction.

The court’s decision could also have an effect on an estate’s qualification for special use valuation, deferral of tax on closely held business interests, and redemptions to pay death taxes.

**Special considerations involving the residence.** Joint ownership of the personal residence frequently involves nontax considerations. Joint ownership might be influenced by psychological and emotional

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76 *J. Patten*, 116 F.3d 1029 (4th Cir. 1997).


78 IRC Sections 1014(a) and 2040(a).

79 IRC Sections 1014(a) and 2040(b).

80 IRC Sections 1014(a) and 1014(b)(6).

81 IRC Section 1022(b).

82 IRC Section 1022(c).

83 IRC Section 2056(a).

84 IRC Section 2032A.

85 IRC Section 6166.

86 IRC Section 303.
factors having to do with each spouse’s contribution to the maintenance of the home. The couple will usually want the surviving spouse to have continued occupancy of the residence. Family tradition and community custom of joint ownership can play a part. Also, joint ownership may, depending on state law, serve to insulate this important asset from the claims of creditors of either spouse. Nontax factors such as these can result in placing the residence in joint ownership despite possible adverse tax consequences. The $250,000 exclusion from gain on the sale of a principal residence by individuals ($500,000 for joint return filers),\(^87\) can help diminish or eliminate the effect of the loss of a step-up in basis of one-half of property held in joint ownership on the death of the first joint tenant to die (¶2820).

.03 U.S. Savings Bonds

An asset found in estates of all sizes is the U.S. savings bond. Electronic Series EE bonds are purchased at face value from Treasury Direct (www.treasurydirect.gov). The Series E bond, issued before January 1, 1980, was originally issued at 75 percent of face value. In all other respects, the E and EE bonds are identical.

Series I bonds are issued at face value and accrue interest based on the rate of inflation. Interest is compounded semiannually. Series I bonds issued in January 2003 or earlier may be cashed in at any time after 6 months of issue. Series I bonds issued in February 2003 or later may be cashed in at any time after 12 months from the date of issue.

EE bonds issued in May 2005 and after earn a fixed rate of interest. Rates for new issues are adjusted each May 1 and November 1, with each new rate effective for all bonds issued in the 6 months following the adjustment. EE Bonds purchased May 1997 through April 2005 earn interest based on 5-year U.S. Treasury security yields. The rate for EE bonds is 90 percent of the average yields on 5-year securities for the preceding 6 months.

The bonds are issued in one simple form of co-ownership: "A or B," which means that the Treasury will pay either A or B on presentation of the bond. If either A or B dies, the survivor is the sole owner.

U.S. Savings Bonds are also issued in beneficiary form. This form reads, "A payable on death to B." This form means that during A’s life, the government will pay only A. On A’s death, the government will pay only B, unless A, during his or her lifetime, has substituted another as beneficiary. Thus, the interest of the beneficiary resembles a contingent future interest more than a present co-ownership interest.

**Income tax consequences.** Taxation of the interest on Series H and HH bonds is straightforward. It is taxable to the co-owners on a cash basis when received. The taxation of Series E, Series EE, and Series I bonds is more complicated.

The owners of Series E, Series EE, and Series I bonds do not have to report the annual appreciation in their value until the bonds are redeemed or they have matured, unless the owners elect to report the appreciation on an annual basis.

\(^87\) IRC Section 121.
The election to report the appreciation, once made, applies to all Series E, Series EE, and Series I bonds owned, as well as to any subsequently acquired and any other similar obligations sold on a discount basis.

The appreciation or interest is taxable to the co-owner of the bond who furnished the consideration, even though he or she permits the other co-owner to redeem the bonds (whether at or before their maturity) and retain the entire proceeds. If the noncontributing co-owner surrenders the bond for reissue in his or her own name, the contributing co-owner must include the appreciation to the date of reissue in his or her gross income. However, if the bond is reissued in the sole name of the contributing co-owner, that co-owner need not include the appreciation in his or her gross income in the year of reissue.

Savings bonds are an attractive investment for children who are otherwise subject to payment of the kiddie tax. By having a child purchase Series EE or Series I bonds that mature after the child reaches age 19 (or, if a full-time student, age 24), the rule that taxes a child’s unearned income at the higher of the child’s rate or the parent’s top rate is avoided. When the bonds mature, the interest will be taxed at the child’s tax rate.

Savings bonds can also be a tax-free way to pay for a child’s college education. The interest on EE bonds issued after 1989 and on Series I bonds might escape tax altogether under IRC Section 135 if the taxpayer pays for qualified higher education expenses (for the taxpayer, his or her spouse, or his or her dependents) in the year the bonds are redeemed, and the taxpayer’s modified adjusted gross income does not exceed certain limits that are annually adjusted for inflation. The 2016 phase-out range was $116,300–$146,300 for joint filers and $77,550–$92,550 for all other returns. The 2017 phase-out range is $117,250–$147,250 for joint filers, and $78,150–$93,150 for all other returns. The bond purchaser must be at least 24 years old before the date the bonds are issued. These bonds may be purchased in sole ownership form or in co-ownership form with a spouse.

Effective January 4, 2012, the annual (calendar year) purchase limit applying to electronic Series EE and Series I savings bonds is $10,000 for each series. The limit is applied per Social Security Number (SSN) or Taxpayer Identification Number (TIN). For paper Series I Savings Bonds purchased through IRS tax refunds, the purchase limit is $5,000 per SSN. The limit applies to the SSN of the first-named registrant of a savings bond. This registrant is considered the primary owner of the bond, whether it is issued in paper or electronic form. The second-named registrant may purchase additional securities, up to the annual limit, if that registrant is the primary owner of the additional bonds. The limit applies only to bonds purchased in a single calendar year. There is no limit on the total value of savings bonds that can be held by an individual or entity. All limits are based on the issue price of the securities.

U.S. savings bonds are exempt from state and local income taxes.

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88 Revenue Ruling 54-143, 1954-1 CB 12.
89 Revenue Ruling 55-278, 1955-1 CB 471.
90 Revenue Ruling 68-61, 1968-1 CB 346.
91 IRC Section 1(g) and Revenue Procedure 2002-70, IRB 2002-46, 845 (November 18, 2002).
**Planning Pointer.**

Series E savings bonds issued on or before November 1965 reached their final maturity after 40 years. Series E savings bonds issued on or after December 1965 reached their final maturity after 30 years. If the taxpayer has elected to defer reporting the interest, the entire amount of accrued interest becomes taxable in the year of maturity. Series EE bonds reach their final maturity in 30 years.

**Gift tax consequences.** The creation of co-ownership in savings bonds is free of gift tax. When a bond is bought in co-ownership form, the purchaser can always cash in the bond and recover his or her money. Therefore, a completed gift has not occurred. The gift occurs when the noncontributing owner cashes the bond without obligation to account to his or her benefactor or when the bond is reissued in the sole name of the non-contributor. The $14,000 (for 2017 and indexed annually for inflation) annual gift tax exclusion is available for such gifts of present interests. If the co-owners are married, the unlimited marital deduction is available. Only one way of giving away a U.S. savings bond will be recognized for federal transfer tax purposes. The bond must be reissued in the name of the donee. Mere delivery to the donee is not sufficient.

**Estate tax consequences.** The bond’s redemption value at the estate tax valuation date will be includible in the gross estate of the first co-owner to die, except to the extent the decedent’s executor is able to show that the survivor contributed to the purchase or the co-owners were married. In the latter case, only one-half of the value generally is includible in the gross estate of the first to die, and that half qualifies for the estate tax marital deduction. Savings bonds do not get a step up in basis when the owner dies. The bonds are considered income in respect of a decedent (IRD) assets. The obligation to pay unpaid income taxes passes to the recipient of the bond, unless the income taxes on the bond interest have already been paid by the decedent.

It is possible for the representative of the decedent’s estate to elect to include all of the unpaid tax on the interest earned through the decedent’s date of death on the decedent’s final Form 1040. This can be a particularly useful election where a decedent has otherwise “wasted” deductions in the year of death (such as large medical expenses). Reporting the income absorbs the deductions and results in the income earned on the bonds through the date of death (but not beyond) having been reported. Consequently, this

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92 Revenue Ruling 55-278, 1955-1 CB 471.
93 IRC Section 2503(b).
94 IRC Section 2523(a).
96 IRC Section 2040(a).
97 IRC Section 2040(b).
98 IRC Section 2056(a).
income does not need to be reported by the recipient of the bonds when that person cashes in the bonds in the future.99

.04 Safe Deposit Boxes

Many individuals hold safe deposit boxes in joint ownership or at least as joint lessees. A joint safe deposit box does not transform sole ownership of the contents into joint ownership. All that is involved in a joint safe deposit box is joint access to the contents. If joint ownership is desired, the owner of each item must transfer it into joint ownership in a way that satisfies the legal requirements of local law. Generally, one can do so by a written transfer specifying who is transferring what to whom, in what form of ownership, and for how much, if anything. The transferor must deliver the instrument, or copy, to the co-owner. The co-owner must accept the transfer. The parties should also check to see if they must comply with any special local law requirements.

.05 Securities

Joint ownership of securities (stocks and bonds) involves special legal factors, which differ from those involved in joint ownership of other types of property. The differences flow primarily from variations in local law. Superimposed on local law are the stock exchange and brokerage house rules, some of which may stem from federal securities laws. In addition, the formal account agreements between brokerage houses and their customers might affect ownership rights. No special tax rules apply to joint ownership of securities.

A special issue involving joint ownership of securities may arise out of joint brokerage accounts. The issue usually concerns the formal agreement between the co-owners of the securities in the account and the broker. Such agreement often provides for survivorship. In some cases, the securities themselves will be registered in the names of the co-owners. For example, "A and B as joint tenants, with right of survivorship, and not as tenants in common," is one of the most common forms of registration. Often the securities in the account will be registered in street name, that is, the name of a person designated by the broker. A street name account can involve legal risks for the customers if the brokerage house should go out of business or declare bankruptcy.

The Securities Investor Protection Corporation offers significant insurance protection in such instances. In any event, with the ordinary street name registration, either of the co-owners may deal with the broker as though he or she were the sole owner, which is not always possible if securities are registered in joint names.

**Income tax consequences.** If the securities are registered in joint names, interest, dividends, and capital gains and losses from the securities are generally allocable to each joint owner, proportionate to his or her fractional interest under local law. If a parent buys stock and has it registered in the parent’s name and the child’s name as joint tenants, the dividends and capital gains and losses are split between them. This approach can achieve the tax savings possible in income splitting between senior family members and junior family members in lower brackets, without a complete transfer of the income-producing  

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99 IRC Section 454.
property, but, as a result of the kiddie tax, only if the child is 19 or older or, if a full-time student, 24 or older.\textsuperscript{100}

The same income tax consequences should apply when securities are registered in a street name if, under local law, each co-owner is entitled to an equal share of income. The IRS has not issued a ruling directly on the point, but a ruling on gift tax consequences might create some insight. In general, the gift tax ruling provides that the creation of a street name account by a party who furnishes all the money results in no gift to the other co-owner.\textsuperscript{101} Accordingly, if no gift occurs, the other owner’s right to income would be called into question.

No income-splitting advantage typically accrues to married couples holding securities in joint ownership because they normally file joint income tax returns. In those states having income tax laws that do not permit married couples to file joint state income tax returns, joint ownership might produce state income tax savings.

**Gift tax consequences.** The general rules relating to gift taxes on creation and termination of joint ownership apply to securities transactions except for street name accounts. With the latter type of account, the IRS has adopted the position that no gift occurs when one of the co-owners of the account contributes cash or securities to the account.\textsuperscript{102} A gift occurs only when the noncontributing co-owner takes cash or securities out of the account for his or her own benefit. If the contributing co-owner withdraws everything that is in the account and closes it and has the securities transferred to his or her own name, no gift occurs. If the account is closed and the noncontributing co-owner receives something, to that extent, a gift occurs.

If the co-owners contemplate that they will make contributions to a joint street name account, the determination of whether a gift occurs on termination can prove to be most troublesome. Part of the difficulty is that income and capital charges attributable to the contributions of each owner would apparently not enter into valuation of the gift. Furthermore, separating these items might be difficult. The better way to handle the situation might be to set up two separate joint accounts, preferably with different brokerage houses. Each person would limit his or her contributions to one of the accounts.

In accordance with the general rules governing joint ownership between spouses, the creation and termination of joint ownership of securities between spouses is without gift tax consequences.\textsuperscript{103}

**Estate tax consequences.** The general estate tax rules are fully applicable to joint ownership of securities. The practical aspects of recordkeeping can take on an added dimension if a person with a joint brokerage account has been actively trading over the years, and the other joint tenant has been a frequent contributor. Tracing and allocation can be most difficult, if not impossible without complete records.

\textsuperscript{100} IRC Section 1(g).

\textsuperscript{101} Revenue Ruling 69-148, 1969-1 CB 226.

\textsuperscript{102} Revenue Ruling 69-148, 1969-1 CB 226.

\textsuperscript{103} IRC Section 2523.
In a tenancy in common, each tenant or co-owner owns an undivided interest in the property. The size of that interest, measured as a fractional part of the whole, can vary from slightly above 0 percent to slightly below 100 percent. In most cases, the ownership interest will be proportional to the number of co-tenants. For example, two co-tenants will usually each have a 50-percent undivided interest. Each co-tenant is entitled to a proportionate share of the income, if any. Each co-tenant may sell that portion, give it away, or dispose of it by will. (If there is no will, it will pass to the deceased co-tenant’s heirs by operation of law.)

For tax purposes, each co-tenant’s share of the property is generally treated as though it were owned by him or her separately. A tenancy in common can be used for intra-family income-splitting purposes. A father could, for example, put an apartment house that he owns into a tenancy in common with his children. He might wish to undertake this transaction when he has exhausted depreciation deductions. At that point, the tax shelter is gone, and he is beginning to be taxed on the income at a higher rate. However, if the property is income-producing, income-shifting will not be achieved if the co-tenant is under the age of 19 or, if a full-time student, under the age of 24. That is because the unearned income of a minor in these age groups in excess of $2,100 a year (for 2017) is taxed at the higher of the child’s tax rate or the parents’ tax rate.104

A gift will occur on the creation of a tenancy in common to the extent that tenants who have not contributed anything receive something or to the extent that those who have contributed something receive a greater share than their contributions warrant. A discount from fair market value may be allowed because of the donee’s partially locked-in position.105 A gift could also occur on termination of the tenancy. For example, if the entire property is sold and one co-tenant receives more than his or her proportionate share of the proceeds, a gift occurs for the difference. The unlimited marital deduction permits creation and termination of tenancies in common between spouses without gift tax.106

When a tenant in common sells his or her interest, the seller will ordinarily realize gain or loss as though the property was held in separate ownership.107 Tenants in common generally have a right, through appropriate procedures, to bring about a partition sale. At such a sale, the property may be purchased by those tenants who prefer to remain with the property. The IRS has ruled that in a situation in which property owned by six tenants in common was sold at a partition sale and then repurchased by five of them, no sale occurred by the five, but the sixth did make a sale.108

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104 IRC Section 1(g) and Revenue Procedure 2002-70, IRB 2002-46, 845 (November 18, 2002).
105 J. Propstra, 680 F.2d 1248 (9th Cir. 1982). Ludwick v. Commissioner, TCM 2010-104
106 IRC Section 2523.
107 IRC Section 1001(a).
When a co-tenant dies, the fair market value of the decedent’s interest will be includible in the decedent’s gross estate.\(^{109}\) Here, as under *Ludwick* and *Propstra*,\(^ {110}\) a discount should be allowable for the partially locked-in position of the interest. A partition sale may be held to unlock the interest, but a sale under those circumstances is not likely to command a fair market value price.

### 325 Community Property

Eight states—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington—have a form of co-ownership of property known as community property. Wisconsin has adopted the Uniform Marital Property Act, which is similar to community property statutes. Alaska has an elective community property system. Although the details of the community property system vary from state to state with certain common exceptions, all property acquired by spouses during their marriage, while they are domiciled in one of the community property states, is community property. It belongs to each of the marriage partners, share and share alike. They share not only in the physical property acquired but also in the income from the property. They also share their salaries, wages, and other compensation for services.

At the same time, each spouse might still have separate property. They may also hold property between them in joint tenancy. Generally, they may adjust their property interests between their community and separate property. A financial planner should understand these basic factors about community property rules.

#### 01 In General

In general, community property assets retain that character even after the parties have moved to a non-community property state. However, they may adjust their property rights between themselves. Thus, couples living in a community property state might have acquired a community property bank account. When they move into a separate property state and take the proceeds of the account with them, the money still retains its character as community property. If they invest it in real estate in their new state, the real estate may be viewed as community property.\(^ {111}\)

When a couple moves from a separate property state to a community property state, the personal property they acquired in the former state, whether tangible (such as cars, furniture, jewelry, and so on) or intangible (such as stocks and bonds), retains its character as separate, joint, or other form of ownership from the previous state. Any real estate acquired in a separate property state will retain the form of ownership assigned to it.

The distinction between what is his, hers, and theirs for any couple who has been domiciled in a community property state becomes very important from a tax standpoint. These basic general rules will afford some help in drawing the distinction:

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\(^{109}\) IRC Section 2033.

\(^{110}\) TCM 2010-104; 680 F.2d 1248 (9th Cir. 1982).

\(^{111}\) Revenue Ruling 72-443, 1972-2 CB 531.
• Property acquired before marriage or before becoming domiciled in a community property state retains the form of ownership it had when acquired—separate, joint, or other.

• Property acquired during the marriage by gift or inheritance by one of the parties retains the character in which it was acquired.

• Earnings of the spouses during marriage are community property.

• Property purchased with community property is community property, and property purchased with separate property is separate property.

• Property purchased with commingled community and separate property, so that the two cannot be separated, is community property.

• Compensation for personal injuries is generally treated as separate property.

**Estate tax considerations.** Married couples domiciled in a community property state may each have their own separate property in addition to their community property. They may also own property as joint tenants with right of survivorship or as tenants in common. Their non-community property for estate tax purposes will receive the same treatment in community property states that it does in separate property states.

Community property calls for special treatment and rules. Community property is includible in the gross estate of the first to die only to the extent of the decedent’s interest. This interest is ordinarily one-half of its value, but a discount may be allowed because of the lock-in effect. See *J. Propstra*, 112 in which a 15-percent discount was allowed in valuing real estate. This rule applies even though the survivor earned all the income used to acquire the community property. Community property transferred to a surviving spouse qualifies for the estate tax marital deduction. 113

Community property includible in a decedent’s gross estate may be offset only by expenses, claims, and deductions applicable to that particular property.

One of the basic choices that the financial planner and his or her clients have in a community property state is whether to hold property jointly or in community property form. With joint property or community property, only one-half is includible in the gross estate of the first to die, 114 where it can be sheltered by the marital deduction. 115 Jointly held property is not subject to probate, whereas community property is subject to probate. However, this advantage might be more than offset by basis considerations. In the case of community property, the surviving spouse receives a full step-up in basis in the entire property if

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112 680 F.2d 1248 (9th Cir. 1982).
113 IRC Section 2056(a).
114 IRC Section 2040(b).
115 IRC Section 2056(a).
at least one-half of the whole property is includible in the deceased spouse’s gross estate.\textsuperscript{116} By contrast, with joint property, only one-half of the property gets a stepped-up basis.\textsuperscript{117} What happens when the survivor dies? With community property, the first spouse might have placed his or her share of the community property in a trust for the benefit of the survivor for life. The trust might allow the surviving spouse limited access to the principal of the trust if such access became necessary.\textsuperscript{118} Thus, the surviving spouse might have essentially the same financial security that would have been possible had the survivor owned the property outright. On the survivor’s death, planning could allow the remainder of the estate to pass to the couple’s children or other beneficiaries without being taxed as part of the survivor’s estate. If the couple used joint ownership, the future value of whatever was left of the property at the time of the survivor’s death would be includible in the survivor’s gross estate.

The provision for the special use valuation of real estate used in farming or other closely held business provides for equal treatment of community and individually owned realty.\textsuperscript{119}

The financial planner should consider other factors. State inheritance or estate taxes could be a factor. The financial planner should also consider the unified credit against the estate tax.\textsuperscript{120} For example, if what is left in the estate of the surviving spouse after administration expenses and other deductions is less than the amount that the available unified credit will offset, the second tax potential with jointly-held property would be of no real consequence. Alternatively, if this amount will not be offset by the unified credit, the financial planner and his or her clients should give serious thought to community property estate planning. The planning implications of the significantly increased federal estate tax exclusion and the availability of the portability election at the death of the first spouse should also be taken into consideration.

\textbf{Gift tax considerations.} No gift occurs when property earned or acquired by one spouse becomes community property. Even if a gift occurred, the unlimited marital deduction would bar a gift tax.\textsuperscript{121} Although a conversion of separate property to community property might be a gift, it will be tax free. In addition, if community property is converted into separate or joint property, the conversion will be free of gift tax consequences.

If both spouses join in making a gift of community property to someone else, the gift is deemed by law to be split, and both spouses would be subject to gift tax liability on the gift of their half interests. Each spouse is allowed the $14,000 (for 2017 and indexed annually for inflation) annual gift tax exclusion,\textsuperscript{122} as well as the $5.49 million (for 2017 and indexed annually for inflation) lifetime gift exclusion.

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\textsuperscript{116} IRC Sections 1014(a) and 1014(b)(6).
\textsuperscript{117} IRC Section 1014(a).
\textsuperscript{118} IRC Section 2041(b)(1)(A).
\textsuperscript{119} IRC Section 2032A(e)(10).
\textsuperscript{120} IRC Section 2010.
\textsuperscript{121} IRC Section 2523(a).
\textsuperscript{122} IRC Section 2503(b).
.02 Interest in Qualified Plan

In a community property state, does an employee’s spouse have a community interest in the employee’s participation in a qualified employee benefit plan? The U.S. Supreme Court addressed this issue in *Boggs v. Boggs*. The court held that the Employee Retirement Income Security Act of 1974 (ERISA) pre-empts state law that allowed a nonparticipant spouse to make a testamentary transfer of her rights in a joint and survivor annuity to her sons. The court also ruled that ERISA pre-empted a state law claim by the sons to an IRA and an employee stock ownership plan transferred to them by their mother in the testamentary transfer. The court stated that ERISA conferred pension plan beneficiary status on a nonparticipant spouse only to the extent that a covered plan required a survivor’s annuity or when a qualified domestic relations order awards the spouse an interest in a participant’s benefits. The court’s ruling is contrary to the usual rule that state law determines property rights. However, when the state law conflicts with federal law, under ERISA, the federal law will control. Thus, nothing should be included in a nonparticipant spouse’s gross estate for his or her interest in undistributed pension benefits covered by ERISA. If the nonparticipant spouse has an interest in a pension not covered by ERISA, the nonparticipant spouse’s interest in the account, as defined by local law, would be included in his or her gross estate.

.03 Life Insurance

Life insurance in community property situations merits special attention. Life insurance involves complex rules that are not the same in all community property states. Different questions can arise about whether the proceeds are to be treated as separate property or as community property under a state’s community property laws. The answer might depend on when, where, and how the policy was acquired; who paid the premiums and when; along with other factors. Once these questions are answered under state law, federal estate tax law determines the extent to which the proceeds are includible in the gross estate and, if includible, whether the marital deduction is available.

If the policy was purchased in a community property state and premiums were paid with community property, the couple was, at all times, domiciled in a community property state, the insured retained incidents of ownership in the policy, and the policy proceeds are subject to the community property claim of the surviving spouse, only the decedent’s community property share, one-half of the proceeds, is included in his or her gross estate.

If the policy, at its inception, was not subject to community property rules, conflicting views exist. Texas holds that if the policy was not community property at inception, it will not be converted to community property by the fact that later premiums are paid with community property. However, the proceeds are

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123 520 U.S. 833 (1997), rev’g 82 F.3d 90.
124 29 USC Section1001 et seq.
125 IRC Section 2033.
126 IRC Section 2056(a).
127 Regulations Section 20.2042-1(b)(2).
subject to the community estate’s right of reimbursement for the return of community funds used to pay premiums. If the insured retains incidents of ownership, the full value of the proceeds will be includible in the insured’s estate, less one-half the amount of premiums paid out of community funds. California follows a different rule, under which the percentages of premiums paid with community property funds and those paid with separate property funds are computed. The policy proceeds are then divided up into community and separate property in accordance with those percentages.

To avoid this type of complication, the policy owner should consider assigning the policy and all incidents of ownership to the beneficiary, usually the spouse. When drawing the assignment, the attorney should use precise language to indicate clearly that the policy owner intends to make a transfer of full ownership and all incidents thereof, including all community property rights.

§330 Time-sharing of Property

Multiple ownership or use of property, or both, are what is involved in time-sharing. Time-sharing has been applied to condominiums, townhouses, hotels, motels, single family detached homes, campgrounds, and even boats and yachts. It may be used with new construction or with respect to conversion of existing structures. It can exist in projects devoted solely to time-sharing, as well as those with both time-sharing and nontime-sharing properties.

Usually, a vacation home sits idle much of the time. Yet taxes, mortgage payments, insurance, and maintenance costs continue full-time. The time-share purchaser has all these costs prorated. The purchaser buys an interest or a right to use the property, but pays only for a specified time. Further, the time-sharing facility might have recreational amenities infrequently found in single family vacation homes.

Time-sharing permits individuals to enjoy vacation facilities that they might not otherwise be able to afford. If affordable, owning all the property might be considered uneconomical in terms of its projected limited use.

From a legal standpoint, four different types of time-sharing arrangements are available:

1. **Time-span ownership.** Each purchaser receives a deed to an undivided interest in a parcel of real estate as a tenant in common with all other purchasers. At common law, a tenant in common has the right to partition the property. Therefore, the deed or agreement accompanying it should contain an enforceable waiver of the right of partition because partition could destroy the time-sharing arrangement.

2. **Interval estate.** A purchaser receives a deed for an estate for years in a particular unit over a recurring period and also receives a vested remainder in fee. Thus, the purchaser has an undivided interest in the unit in fee as a tenant in common with all other purchasers. To avoid merger of the estate for years and the remainder, because the purchaser owns both, the time-sharing declaration must contain an express statement that it is the intent of the parties that the two estates remain separate and not merge.

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3. **Statutory.** Statutes in some states create time-sharing arrangements that allow ownership of a particular week or weeks in perpetuity.

4. **Licensing.** The licensor retains fee title and the purchaser or licensee has a bare right to use the property under specified terms.

The purchaser’s title under the first three forms is insurable, as is the mortgagee’s title under these arrangements.

Time-sharing is an area where a need for consumer protection exists. The states of Massachusetts, Rhode Island, and Wisconsin have adopted the Model Real Estate Time-Share Act. It has also influenced legislation in other states. Most states have a consumer protection statute modeled after this act. Time-shares are specifically regulated by Colorado, Florida, New Hampshire, South Carolina, and Utah.

The Federal Trade Commission has two rules applicable to right-to-use plans but not to ownership time-sharing. One gives the purchaser the right to assert claims and defenses against the holder in due course of notes given on an installment sale that the purchaser could assert against the seller. The other provides for a cooling-off period on door-to-door sales, which gives the purchaser a three-day rescission right.

The concerns that purchasers express about time-shares include the annual maintenance fees that are imposed and the difficulty of selling a time-share if it is no longer wanted. In addition, because the time-share is typically a personal use property and not an investment property, a sale of the time-share at a loss is not a deductible loss. If the taxpayer can prove the time-share was used for business (such as for entertaining clients on a regular basis or if the time-share was provided to employees as a benefit), there is a chance that a loss on the sale of the time-share is deductible, but the burden of proof is on the taxpayer to overcome the skepticism that would likely be raised by the IRS if a time-share loss is claimed.
Chapter 4

Lifetime Gifts to Individuals

¶401 Overview

The financial planner should consider whether a program of lifetime gifts to individuals is advisable for the client. Planned gifts can provide income tax and estate tax savings.

However, no one should give away money or other property that might be needed in case of a disaster or for normal living expenses. The ability to afford the gift should be the number one consideration. Especially in times of low interest rates, prospective donors and their financial advisers should make certain that the comfort of the donor is taken into account before any substantial gifting is considered.

The financial planner should consider the donor’s needs and desires. What satisfaction does the donor seek from the gift? Is the objective to escape from the management of the property? Does the donor hope to see the property used and enjoyed as he or she thinks it should be? Does the donor seek the privacy that might be possible with a lifetime gift but impossible with a bequest by will? Does the donor hope that the gift will promote in the donee a sense of financial maturity, or, in some other way, help in the donee’s personal growth? The donor should consider what the real needs of the donee are, what the donee’s level of maturity and responsibility is, and many other factors. These factors have very little, if anything, to do with tax savings. Nevertheless, they are important, perhaps even more important than tax factors.

Gifts do not have to be made outright. Gifts in trust can allow the donor to transfer property without giving the donee full management and control of the transferred property. The donor can achieve tax savings and provide asset protection with a transfer in trust.
Lifetime gifts are also a way of avoiding probate and eliminating the costs of bequests. Therefore, gifts help to conserve the estate over and above possible tax savings.

Gifts can flow from mixed motives. The motives are not always altruistic, kindly, and beneficent. Sometimes the purpose might be to put the given property beyond the reach of current or future creditors. The donor must be sure that the gift does not violate the laws against fraudulent conveyances if the objective is to place the donated property beyond the reach of current creditors. Sometimes, the motive could be a desire to bend the donee to the will of the donor. At other times, the motive could be a peace offering or fulfilling a perceived social or business obligation or expected political gain. Gifts based primarily on such motives are not likely to be influenced by tax or estate planning considerations.

When the donor is motivated primarily by benevolence, tax considerations and estate planning considerations are likely to assume importance. When a client comes to appreciate the tax benefits that can be realized by planned giving, the client understands that tax-saving considerations and strategies permit greater beneficence than would otherwise be possible. How and under what circumstances these tax savings are possible is the subject matter of the rest of this chapter.

¶405 Tax Factors

.01 In General

Once the donor has considered the practical realities of giving and has found good reason for making a gift or a series of gifts, the financial planner should help the donor evaluate the tax factors. The goal is to save estate taxes and income taxes at either minimal or no gift tax cost. The financial planner must also consider the generation-skipping transfer tax, which is discussed in detail in chapter 27, "Planning for Generation-Skipping Transfers," for any gifts a client makes to grandchildren or other skip persons. Few roadblocks impede the goal of achieving estate tax savings by making lifetime gifts. Individuals may reduce their estates and save estate taxes by making lifetime transfers gift tax free under the $14,000 (for 2017 and indexed annually for inflation) per donee annual gift tax exclusion.¹

The goal of saving income taxes, on the other hand, has been marked by many obstacles.

The basis of property transferred by a donor to a donee is the carryover basis from the donor (IRC Section 1015). Accordingly, donors should be wary of giving away low basis appreciated property, especially if they are elderly or ill, when the basis of property transferred at death is the fair market value of property as of the donor/decedent’s date of death (IRC Section 1014). If property has declined in value from the donor’s original cost, the donor should sell the property, claim the loss, and give away the cash.

Any trust property that can revert to the donor or the donor’s spouse is treated as owned by the donor, and all of its income is included in the donor’s gross income.

¹ Internal Revenue Code Section 2503(b).
The "kiddie tax" has also been an obstacle to achieving income tax savings. The kiddie tax provides that a child is taxed on the higher of the child’s rate or his or her parents’ tax rate on unearned income in excess of a dollar threshold.\(^2\) For 2017, the kiddie tax generally applies to a child if

- the child
  - has not reached the age of 19 by the close of the tax year or
  - has not reached age 24 by the close of the year and is a full-time student, if either of the child’s parents is alive at such time;

- the child’s unearned income exceeds $2,100; and

- the child does not file a joint return.

The kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.\(^3\)

If the child is above the kiddie tax age limit, unearned income is taxed at the child’s income tax rate, starting at 10 percent.\(^4\) With the top income tax bracket of 39.6 percent in effect for 2017 and beyond, a large spread separates the lowest 10-percent bracket from the highest bracket of 39.6 percent. State and local taxes can widen the spread considerably. The net investment income tax of 3.8 percent can widen the spread still further, as can the higher tax rates effective for 2017 on ordinary income (39.6 percent), qualified dividends (20 percent) and long-term capital gains (20 percent) when a person’s taxable income passes the thresholds established by ATRA as indexed for inflation. In addition, the parents’ income might be taxed at a marginal rate even higher than the nominal top rate due to the phase-out of the deduction for personal and dependency exemptions\(^5\) and the limitation on itemized deductions.\(^6\) Income tax planning to shift income tax liability from high bracket to lower bracket taxpayers will certainly be a major focus for financial planners in the years to come.

Even if the child is subject to the kiddie tax, parents can use strategies to reduce the effect of the kiddie tax. For example, parents could place funds in investments that are designed to produce no more than $2,100 (for 2017) of current unearned income, $1,050 of which would be received tax free by the child, and the balance of which would be taxed to the child at the child’s income tax rate. The parents could place the balance of the funds in growth stocks, Series EE bonds, Series I Bonds, or other assets that do not produce current income. After the child is no longer subject to the kiddie tax, the investments can be converted to income-producing assets, so that the child could gain full advantage from a low tax bracket.

\(^2\) IRC Section 1(g).

\(^3\) IRC Section 1(g)(2) as amended by the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28).

\(^4\) IRC Section 1(c).

\(^5\) IRC Section 151(d)(3).

\(^6\) IRC Section 68. (The so-called “Pease limitation,” named after the Congressman who came up with this idea.)
Of course, parents should consider the investment aspects in addition to tax savings when making and changing the investments.

The income tax brackets of estates and trusts are highly compressed and the least favorable of all income tax rates. This rate compression has a negative impact on use of trusts as gift-giving vehicles. Trusts and estates reach the top income tax bracket of 39.6 percent at only $12,500 of taxable income for 2017.

The $14,000 (for 2017 and indexed annually for inflation) annual gift tax exclusion is allowed only for gifts of present interests. However, IRC Section 2503(c) provides that minors’ trusts and custodial gifts are considered to meet the present interest requirement even if the trustee or the custodian does not have to distribute the income until the child reaches age 21. Income from custodial gifts is taxed directly to the child, whereas income from an IRC Section 2503(c) trust is taxed to the trust if accumulated and to the child if distributed. Because these vehicles generally are used to accumulate income, the more compressed brackets clearly favor custodianships over IRC Section 2503(c) trusts. In some cases, custodianships are favored over IRC Section 2503(c) trusts even if the child is subject to the kiddie tax.

**Imputed interest on loans with interest rates below the market rate.** A lender is deemed to have made a gift to a borrower on a gift loan with an interest rate that is below the market rate. The deemed interest is equal to the principal of the loan, multiplied by the difference between the stated interest rate, if any, and the applicable federal rate. A *gift loan* is one in which the foregoing of interest occurs because of donative intent. On a gift loan, the lender is deemed to have paid the foregone interest to the borrower. The interest deemed paid is considered a gift, which is subject to the gift tax. The deemed gift is eligible for the $14,000 (for 2017 and indexed annually for inflation) annual exclusion. The borrower is deemed to have received a gift, and then the borrower is deemed to have paid the interest to the lender. The borrower receives a deduction for the interest deemed paid only if it qualifies as deductible under IRC Section 163. Generally, IRC Section 163 disallows a deduction for personal interest. The lender must recognize the imputed interest income in his or her gross income. The interest deemed to have been retransferred from the borrower to the lender may not exceed the borrower’s net investment income for the year. However, the net investment income limitation does not apply if the loan has as

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7 IRC Section 2503(b).
8 IRC Sections 661 and 662.
9 IRC §Section1(g).
10 IRC Sections 1274(d) and 7872(f).
11 IRC Section 7872(f)(3).
12 IRC Section 2503(b).
13 IRC Section 7872(a).
14 IRC Section 163(h).
15 IRC Section 61(a).
16 IRC Section 7872(d)(1)(A).
one of its principal purposes the avoidance of any federal tax\textsuperscript{17} or for any day in which the total outstanding loans between the individuals is more than $100,000.\textsuperscript{18} A \textit{de minimis} exception provides that gift loans of $10,000 or less are not subject to the imputed interest rules unless the borrower uses the loan to purchase or carry income-producing assets.\textsuperscript{19} Given the exceptionally low published federal interest rates in 2016 and 2017, the environment for making interest-bearing loans to family members at the current rates has seldom been more attractive—all without the risk or concern of imputed interest.

**Valuation tables.** IRC Section 7520 provides tables for valuing annuities, life estates, terms for years, remainders, and reversions for purposes of federal income and estate and gift taxation. These tables use an interest factor based on 120 percent of the federal midterm rate for the month in which the valuation date occurs. Whether or not to make a gift currently or later depends on the trend of interest rates and the kind of property interest being valued for gift tax purposes. For example, when interest rates are low, the value of life estates and term interests will be high, and the value of future interests will be low. This environment is very conducive to making gifts involving retained and remainder interests, (such as grantor retained annuity trusts), so that the taxable portion of the gift (the remainder interest) will receive a relatively low valuation. If interest rates are high, the value of life estates and term interests will decrease, and the value of future interests will increase, resulting in a greater value for the gifted (and potentially taxable) portion of a transfer with a retained interest by the grantor.

**Undervaluation penalty.** Undervaluing property for estate and gift tax purposes may result in an accuracy-related penalty.\textsuperscript{20} The penalty may range from 20 percent to 40 percent of the unpaid tax, depending on the magnitude of the undervaluation.

**Special rules for spouses who are not U.S. citizens.** The gift tax marital deduction does not protect gifts made to spouses who are not U.S. citizens. However, a special $100,000-per-year gift tax exclusion applies for gifts made to such spouses.\textsuperscript{21} This $100,000 exclusion is allowed only for transfers that would qualify for the marital deduction if the donee spouse were a U.S. citizen. This $100,000 statutory exclusion is indexed for inflation. The exclusion for 2016 was $148,000. The exclusion for 2017 is $149,000.

**Note:** This chapter’s analysis of lifetime giving to a spouse assumes that both the donor and the donee are U.S. citizens.

For a discussion of the estate tax treatment of surviving spouses who are not U.S. citizens, see ¶1230.

\textsuperscript{17} IRC Section 7872(d)(1)(B).

\textsuperscript{18} IRC Section 7872(d)(1)(D).

\textsuperscript{19} IRC Section 7872(c)(2).

\textsuperscript{20} IRC Section 6662.

\textsuperscript{21} IRC Section 2523(i).
A single unified rate schedule exists with respect to gifts and estates of decedents. There are additional considerations when a gift is made to a related person two or more generations younger than the donor or an unrelated person more than 37.5 years younger than the donor. These rules relating to the generation-skipping transfer tax are further discussed in chapter 27, "Planning for Generation-Skipping Transfers."

ATRA made the lifetime gift exclusion permanent at $5 million, indexed annually for inflation after 2011. The tax rate on taxable gifts is now 40 percent, also made permanent by ATRA. The inflation-adjusted exclusion available for 2017 is $5,490,000.

**How the amount of gift tax is computed.** The amount of gift tax payable for any calendar year is determined by applying the unified rate schedule to the cumulative lifetime transfers for all past taxable periods and the current calendar year and then subtracting the taxes payable on all taxable gifts made in preceding calendar years and quarters. Prior gifts are computed under the unified rate schedule even when the gifts were made before 1977.

When required, the donor must file a gift tax return on Form 709.

### Gift Tax Rate Table for 2017 Gifts

<table>
<thead>
<tr>
<th>Size of Taxable Estate or Aggregate Taxable Gifts*</th>
<th>Tax on Amount in Column I</th>
<th>Tax Rate on Excess Over Column I</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 0 to $ 10,000</td>
<td>$ 0</td>
<td>18%</td>
</tr>
<tr>
<td>10,000 to 20,000</td>
<td>1,800</td>
<td>20%</td>
</tr>
<tr>
<td>20,000 to 40,000</td>
<td>3,800</td>
<td>22%</td>
</tr>
<tr>
<td>40,000 to 60,000</td>
<td>8,200</td>
<td>24%</td>
</tr>
<tr>
<td>60,000 to 80,000</td>
<td>13,000</td>
<td>26%</td>
</tr>
<tr>
<td>80,000 to 100,000</td>
<td>18,200</td>
<td>28%</td>
</tr>
<tr>
<td>100,000 to 150,000</td>
<td>23,800</td>
<td>30%</td>
</tr>
<tr>
<td>150,000 to 250,000</td>
<td>38,800</td>
<td>32%</td>
</tr>
<tr>
<td>250,000 to 500,000</td>
<td>70,800</td>
<td>34%</td>
</tr>
<tr>
<td>500,000 to 750,000</td>
<td>155,800</td>
<td>37%</td>
</tr>
</tbody>
</table>

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22 IRC Section 2502(a).

23 IRC Section 6019.
Table 4-1: Phase-in of Applicable Exclusion Amounts for the Gift and Estate Tax

<table>
<thead>
<tr>
<th>Year</th>
<th>Applicable Exclusion Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006, 2007, 2008</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>2009</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>2010–2011</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>2012</td>
<td>$5,120,000</td>
</tr>
<tr>
<td>2013</td>
<td>$5,250,000</td>
</tr>
<tr>
<td>2014</td>
<td>$5,340,000</td>
</tr>
<tr>
<td>2015</td>
<td>$5,430,000</td>
</tr>
<tr>
<td>2016</td>
<td>$5,450,000</td>
</tr>
<tr>
<td>2017</td>
<td>$5,490,000</td>
</tr>
</tbody>
</table>

The unified credit amount that translated to a $5,450,000 exclusion in 2016 was $2,125,800. The unified credit that translates to a $5,490,000 exclusion in 2017 is $2,141,800.

A significant difference in the method of calculating the gift tax and the estate tax operates to favor lifetime giving over testamentary transfers, if transfer tax savings are the prime consideration. These savings occur because the gift tax is tax exclusive, whereas the estate tax is tax inclusive. The reunification of the gift tax exclusion with the estate tax exclusion for 2017 and thereafter reinforces the gift tax advantage.

The savings of a lifetime gift over a testamentary transfer is demonstrated in the following example, which ignores both the annual gift tax exclusion\(^24\) and gift splitting\(^25\).

**Example 4.1.** Peter Collins has made gifts sufficient to have exhausted his applicable credit amount (unified credit) and put him in the 40-percent transfer tax bracket. He has $101,500 to give to his adult son, Todd. Peter wants the gift tax paid out of the $101,500, which brings the net gift down to $72,500 ($101,500/\[100\% + 40\%\])], on which the gift tax is (at the rate of 40 percent of the net gift) $29,000. A $101,500 transfer at death (assuming the decedent’s estate

\(^{24}\) IRC Section 2503(b).

\(^{25}\) IRC Section 2513.
remained in the 40-percent bracket) would cost $40,600 in transfer taxes. Todd has $72,500 left from the lifetime gift. A legatee of a testamentary bequest would be left with $60,900.

Making gifts of property with appreciation potential also excludes future appreciation from transfer tax, even if the donor dies within three years of making the transfer.\(^\text{26}\) Lifetime gifts can produce savings and benefits for the donor and the donor’s family in a number of ways:

- If the donor dies within three years of the gift, any gift taxes paid on such gifts will be included in the donor’s gross estate. However, if the gift occurs more than three years before the donor’s death, any gift taxes paid will be excluded from the donor’s gross estate.\(^\text{27}\)

- Administration expenses associated with a decedent will not be incurred on either the gift taxes paid or the gifted property itself.

- If the gift is to a family member in a lower income tax bracket than the donor and the gift is of income-producing property, the gift will cause a reduction in family income taxes. This tax benefit will be sharply reduced or eliminated if the recipient is subject to the kiddie tax.\(^\text{28}\)

- The income earned on the gifted property, after tax, will be excluded from the donor’s gross estate.

- State death taxes, if applicable, will be reduced.

- If the property is of a kind that generates tax preference income\(^\text{29}\) and causes the donor to incur alternative minimum tax liability,\(^\text{30}\) the transfer may relieve the donor of such liability.

In addition, the $14,000 (for 2017) annual gift tax exclusion (indexed annually for inflation),\(^\text{31}\) combined with gift splitting,\(^\text{32}\) can remove up to $28,000 per year per donee from the donor’s gross estate without gift tax. The amount of the annual exclusion will be adjusted periodically for inflation, which can increase the amounts that a donor will be able to give tax free during his or her lifetime.\(^\text{33}\)

\(^{26}\) IRC Section 2035.

\(^{27}\) IRC Section 2035.

\(^{28}\) IRC Section 1(g).

\(^{29}\) IRC Section 57.

\(^{30}\) IRC Section 55.

\(^{31}\) IRC Section 2503(b).

\(^{32}\) IRC Section 2513.

\(^{33}\) IRC Section 2503(b)(2).
Lifetime gifts with appreciation potential may also be encouraged in the sense that the applicable exclusion amount allows the prospective donor to make substantial gifts without incurring gift tax and without donating needed assets. The applicable exclusion amount for gift tax purposes is $5,490,000 for 2017. At the same time, gifting may remove asset appreciation that would otherwise generate estate tax liability.

However, lifetime interspousal gifts usually do not provide any transfer tax savings because of the unlimited marital deduction. The unlimited marital deduction allows a transfer during lifetime between spouses with no income tax cost and at death without incurring estate tax cost. It has the effect of deferring the possible transfer tax consequences to the second death. Thus, the prospective donor spouse might prefer to retain property during life rather than giving it to his or her spouse. Among other things, retaining property, rather than making an interspousal gift, would guard against the possibility that a later divorce would cause the donor to regret having made the gift.

Basis concerns. A countervailing consideration to suggestions of aggressive gifting, however, is the issue of income tax basis. Because gifting involves a carryover basis to the donee under IRC Section 1015, it may be a good idea to refrain from giving away low basis assets, especially when the donor is not likely to be an estate tax payer at death. Retaining assets without concern for estate tax liability is likely to deliver a higher basis to heirs at death where property is appreciating in accordance with the date of death (or alternate valuation date) rules of IRC Section 1014.

Revaluation of lifetime gifts for estate tax purposes. In F. Smith Est. 94 T.C. 872 (1990), the U.S. Tax Court held that the statute of limitations provision of IRC Section 2504(c) applies only to prevent revaluation of lifetime gifts for gift tax purposes. It does not bar the revaluation of lifetime gifts for estate tax purposes. This result was overturned by the Taxpayer Relief Act of 1997, effective for gifts made after August 5, 1997. However, in order for protection from revaluation of gifts at death to apply, the gift in question must have been "adequately disclosed." Accordingly, the gift tax statute of limitations will not run with respect to a gift that is not adequately disclosed, even if a gift tax return was filed for that and other transfers in the same year. The rules for adequate disclosure suggest utilizing a reputable appraisal or providing the IRS with significant financial disclosures and information.

The annual exclusion. In 2017, the first $14,000 in gifts (other than future interests) made by a donor to any one person during the calendar year is not taxable. In other words, one $14,000 exclusion per donee per year is allowed to an unlimited number of donees. The number of exclusions is not determined by the number of gifts, but by the number of donees.

Example 4.2. Assume that Dan Young gives the maximum excludible amount every year to each of his four children. He could make a total of $56,000 in gifts in 2017 to the four of them without incurring gift tax. If Dan’s wife, Eve, consents to gift splitting, these amounts could be doubled.

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34 IRC Sections 2505 and 2010(c).
35 IRC Section 2056(a).
36 Regulation 301.6501-1(f)(2).
37 IRC Section 2503(b).
What if the couple started an ongoing gift program extending over the five-year period beginning in 2012 (when the annual exclusion was $13,000) and ending in the year of Dan’s death in 2017? $612,000 ($52,000 × 2 donors × 1 year 2012, and $56,000 × 2 donors for five years 2013–2017) in gifts could be passed tax free to the children. These tax-free gifts reduce Dan’s gross estate considerably. In addition, Dan has removed the appreciation of the gifted assets from his gross estate. The larger the estate, the larger the estate tax savings. On a taxable estate that would otherwise be $6 million, taking advantage of the annual exclusions totaling $612,000 saves $244,800 ($612,000 × 40%).

Dan could have made additional tax-free gifts. Using the same assumptions as mentioned previously, Dan might be able to reduce the size of his gross estate even further. How? If the four children are married and their spouses are included as donees, the number of annual exclusions is doubled. For 2012, with Eve consenting to gift splitting, $26,000 ($13,000 × 2), tax free, could have been given each year to each of the four children and their spouses, and for 2013–2017, $28,000 ($14,000 × 2), tax free, could have been given each year to each of the four children and their spouses:

A gift to two or more persons as joint tenants, tenants by the entirety (joint tenancy between spouses not severable by either acting unilaterally), or tenants in common is considered as a gift to each tenant in proportion to his or her interest in the tenancy. The rule would similarly govern a gift to spouses as community property if they were living in a community property state.

Basically, as long as the donor makes outright gifts, the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion usually presents no serious problems. However, a problem could arise if a question exists about whether the gift is of a future interest.

IRC Section 2503(b) establishes the annual gift tax present interest exclusion and the exception denying the exclusion for future interests. In this context, a future interest means any interest that is to commence in possession and enjoyment at some future time. Whether the future interest is vested (the individual holding it, or his or her heirs, are certain to come into possession and enjoyment) or contingent (possession or enjoyment depends on the occurrence or nonoccurrence of certain events) does not matter. In either case, the annual exclusion is not available.

Congress’s stated reasons for enacting the future interest exception were to eliminate the difficulty of ascertaining who the eventual donees would be and the number of exclusions available. In addition, the restriction reduces the difficulty of determining the value of their individual gifts.

If a spouse gives the family residence to his or her spouse for life, and upon the second death the house goes to the children, the gift to the children is a gift of a future interest. Therefore, the annual gift tax exclusion would not be available for the gift to the children.

If an individual donates income-producing property and the gift is restricted in any way that would effectively deny the immediate commencement of an income flow to the donee, or an opportunity for the donee to transfer the property, the donee would be treated as having been given a future interest. In that case, the annual exclusion is not available.

However, these situations are not the most troublesome situations involving the future interest issue. The most troublesome situation occurs when a donor transfers full title to property with strings attached. When the gift is made through a trust with restrictions on the income interest, or when the property transferred is non-income-producing, the future interest rule may present special problems. An examination of the problems arising when gifting using a trust is presented in connection with the discussion of
trusts, generally, in ¶660. There, the use of a Crummey power, affording a limited power of withdrawal of income or corpus by the beneficiary, is discussed. This power is a means of making the annual exclusion available in cases in which the trust does not provide for the mandatory distribution of income at least annually and is not a trust for a minor satisfying the requirements of IRC Section 2503(c) (¶425.04).

**Unlimited exclusion for tuition and medical care payments.** An unlimited gift tax exclusion applies to qualifying payments of tuition or medical care expenses.\(^38\) This exclusion is in addition to the annual or lifetime gift tax exclusion.\(^39\) The unlimited exclusion for tuition and medical care expenses is permitted without regard to the relationship between the donor and the donee.\(^40\)

The exclusion for tuition is limited to direct tuition costs and does not include payments for books, supplies, dormitory fees, and so on.\(^41\) The tuition exclusion applies to any level of education when payments are made directly to a recognized educational institution.

The exclusion for medical care is not allowed for amounts reimbursed by insurance. Medical expenses are limited to those defined in IRC Section 213(d) (that is, those for diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body).\(^42\)

For these exclusions to be applicable, the payment must be made directly to the education provider or the medical care provider, not to the student or patient for delivery to the provider. Form over substance is very important here.

**Planning Pointer.**

Use of the unlimited tuition exclusion merits consideration by an individual with grandchildren enrolled in college or postgraduate training. The parents would likely pay for their children’s tuition. Thus, this exclusion effectively allows the grandparents to transfer funds indirectly to the parents without transfer tax cost. At the same time, this move reduces the donor’s estate over and above the means afforded by the use of the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion.

The IRS has ruled privately that the tuition exclusion is available for prepayments of tuition (for example, prepaying 12 years’ worth of tuition for elementary and secondary education) if the prepayments are nonrefundable and become the sole property of the school.\(^43\) Prepayment may be an attractive option, for

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\(^38\) IRC Section 2503(e).

\(^39\) IRC Section 2503(b).

\(^40\) Regulations Section 25.2503-6(a).

\(^41\) Regulations Section 25.2503-6(b)(2).

\(^42\) Regulations Section 25.2503-6(b)(3).

\(^43\) PLR 20060200.
example, if grandparents may not survive through a grandchild’s school years. By prepaying tuition, the grandparents can effectively transfer a substantial sum to their heirs free of transfer tax without utilizing any of their other transfer tax exclusions.

Caution. One way of prepaying a child’s college tuition is through contributions to an IRC Section 529 plan. However, IRC Section 529(c)(2)(A)(ii) specifically provides that a Section 529 plan contribution is not a qualified transfer eligible for the unlimited gift tax exclusion. IRC Section 529(a)(2)(A)(i) does provide that a Section 529 plan contribution is a completed present interest gift and not a gift of a future interest. Consequently, the annual gift tax exclusion is available for such contributions. A special rule allows a donor to fund five years’ worth of Section 529 plan contributions (that is, the available present interest exclusion for the donee times five in that year) in a single tax year without adverse gift tax consequences. That amount of the present interest exclusion for that donee is then considered to have been used for the year of the gift and the next four tax years. If the present interest exclusion is increased in the subsequent four years, the increased amount may be given to the donee of the prepaid Section 529 plan.

The medical expense exclusion might be of particular value when providing care for an aged parent. If the parent is elderly or seriously ill and not covered by insurance or only inadequately covered, he or she could incur enormous charges. Even if the parent has sufficient assets to pay the charges incurred, the parent might have to sell low basis, highly appreciated assets at a substantial income tax cost to do so. Thus, the heir-apparent might pay for medical care, with the informal assurance that the appreciated assets would pass to him or her on the death of the parent. Hence, the heir-apparent would receive a stepped-up basis in the property,44 and the parent would avoid any income tax on the appreciation up to the time of death.

Of course, such calculations and planning require considerable emotional detachment and might not always be feasible. However, IRC Section 2503(e) allows the possibility.

The marital deduction. An unlimited marital deduction applies to lifetime gifts45 and testamentary transfers to a spouse.46 For a gift by one spouse to the other to qualify for the gift tax marital deduction, the following requirements must be satisfied:

- The parties must be legally married at the time the gift is made. No marital deduction is available for a prenuptial gift.
- The donee spouse must be a U.S. citizen.47
- The gift usually cannot be a terminable interest,48 but an exception applies for transfers of qualified terminable interest property (QTIPs).49

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44 IRC Section 1014(a).
45 IRC Section 2523(a).
46 IRC Section 2056(a).
47 IRC Section 2523(i).
Although gifts to noncitizen spouses do not qualify for a lifetime marital deduction, such gifts may qualify for a $149,000 annual exclusion for gifts made in calendar year 2017 (see previous discussion in ¶405 under the heading "Special rules for spouses who are not citizens"). The $149,000 exclusion for gifts made in calendar year 2017 is the statutory $100,000 exclusion adjusted annually for inflation after calendar year 1998. It is allowed only for transfers that would qualify for the marital deduction if the donee spouse were a U.S. citizen.

A gift of a life estate to one’s spouse with a general power of appointment vested in the donee spouse will qualify for the unlimited marital deduction under the following conditions:

- The spouse must have the right to receive all the income from the entire interest, or specific portion thereof, for life, payable at least annually.

- The donee spouse must have the power to appoint the entire interest or a specific portion thereof to himself or herself or to the donee’s estate.

- The power must be exercisable by the donee spouse alone and in all events during life or at death.

- The interest or the specific portion thereof subject to the power may not be subject to a power in any other person to appoint any part of the property to any person other than the donee spouse.

- In general, transfers of terminable interests may be considered QTIPs if the donor so elects, and the spouse receives a qualifying interest for life. The QTIP interest must meet these conditions:
  
  — The spouse must be entitled for a period measured solely by his or her life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals.

  — There must not be a power in any other person (including the spouse) to appoint any of the property subject to the qualifying interest to any person other than the spouse during the spouse’s life.

48 IRC Section 2523(b).
49 IRC Section 2523(f).
50 IRC Sections 2503(b) and 2523(i)(2).
51 IRC Sections 2503(b) and 2523(i)(2).
52 IRC Section 2523(i).
53 IRC Section 2523(e).
54 IRC Sections 2523(f) and 2056(b)(7)(B).
Annuities qualify as income interests.\textsuperscript{55} Also, a spousal joint and survivor annuity qualifies for QTIP treatment, as long as only the spouses have the right to receive any payments before the death of the surviving spouse.\textsuperscript{56} QTIP treatment applies automatically to such annuities, but the donor may elect out of QTIP treatment.\textsuperscript{57} Whereas annuities qualify for QTIP treatment, income interests for a term of years or life estates subject to termination on remarriage or the occurrence of a specified event do not qualify for the marital deduction.\textsuperscript{58} A Louisiana usufruct interest for life qualifies.\textsuperscript{59}

Property for which a QTIP election has been made is subject to transfer taxes at the earlier of (1) the date on which the donee spouse disposes (either by gift, sale, or otherwise) of any part of the qualifying income interest\textsuperscript{60} or (2) the date of the donee spouse’s death.\textsuperscript{61}

A transfer by the donee of any part of the income interest will trigger a transfer tax on the value of the entire remainder interest in the trust without benefit of the annual exclusion.\textsuperscript{62} The transfer of the life income interest qualifies for the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion.\textsuperscript{63}

If the property is not disposed of before the death of the donee spouse, the fair market value of the property as of the date of the donee spouse’s death or the alternate valuation date,\textsuperscript{64} if elected, will be includible in the donee spouse’s gross estate under IRC Section 2044. The beneficiaries of the trust will receive a basis equal to the fair market value of the QTIP property as of the donee spouse’s date of death under IRC Section 1014.

The additional estate taxes attributable to the taxation of the qualified terminable interest property at the death of the surviving spouse are borne by that property.\textsuperscript{65} Unless the surviving spouse directs otherwise,\textsuperscript{66} the surviving spouse or the surviving spouse’s estate is granted a right to recover the gift tax paid

\textsuperscript{55} IRC Section 2523(f)(2)(B) and Regulations Section 25.2523(f)-1(c)(3)(ii).

\textsuperscript{56} IRC Section 2523(f)(6)(A).

\textsuperscript{57} IRC Section 2523(f)(6)(B).

\textsuperscript{58} Regulations Section 25.2523(f)-1(c)(1)(i).

\textsuperscript{59} IRC Sections 2523(f)(3) and 2056(b)(7)(B)(ii).

\textsuperscript{60} IRC Section 2519.

\textsuperscript{61} IRC Section 2044.

\textsuperscript{62} IRC Sections 2519 and 2503(b).

\textsuperscript{63} IRC Section 2503(b).

\textsuperscript{64} IRC Section 2032(a).

\textsuperscript{65} IRC Section 2207A(a)(1).

\textsuperscript{66} IRC Section 2207A(a)(2).
on the remainder interest as a result of a lifetime transfer of the qualifying interest\textsuperscript{67} or the estate tax paid as a result of including such property in the surviving spouse’s gross estate.\textsuperscript{68} The surviving spouse is also entitled to recover any penalties or interest paid that is attributable to the additional gift or estate tax.\textsuperscript{69} However, the surviving spouse cannot recover from the remaindermen any unified credit used to offset the tax on the transfer.

The QTIP exception does not otherwise change the terminable interest rules.

IRC Section 2523(b)(1) provides that the marital deduction is not to be allowed if the donor retains or transfers or has transferred (for less than adequate and full consideration in money or money’s worth) to any person other than the donee spouse (or the estate of such spouse) an interest in the gifted property such that the donor or such person (or their heirs or assigns) may possess or enjoy any part of such property after termination of the interest of the donee spouse. Thus, if a donor is considering giving a 15-year term interest in property to his or her spouse and selling the interest after that term to a third party (that is, a real estate developer), the donor should first sell the interest following the term to the third party for adequate and full consideration in money or money’s worth and then give his or her spouse the term interest that has been retained. This procedure is preferable to the reverse procedure of making a gift to the spouse of a 15-year term interest, retaining the remainder interest, and then selling it to the third party.

If the donor follows the latter course, when making a gift of the term interest to the spouse, the donor retains a remainder or a reversionary interest. Thus, the donor would come within the terms of IRC Section 2523(b)(1). However, if the donor first disposes of the remainder interest to a third party for adequate and full consideration in money or money’s worth, the consideration takes the donor outside the terms of the provision. When the donor later transfers the full term interest to his or her spouse, the donor retains no interest. Therefore, the donor would fall outside the terms of the retained interest portion of IRC Section 2523(b)(1).

Another type of nondeductible terminable interest occurs if the donor, instead of retaining an interest in the property itself, retains a power to appoint someone other than the spouse to possess or enjoy any part of the property after the spouse’s interest terminates.\textsuperscript{70} The power need not be a general power of appointment.

A special rule deals with tainted assets. This rule applies to a situation in which a donor gives a spouse an interest in a group of assets that includes a particular asset that would be nondeductible if it passed directly from the donor. In this case, the donor must reduce the marital deduction by the value of the nondeductible asset or assets.\textsuperscript{71}

\textsuperscript{67} IRC Section 2207A(b).
\textsuperscript{68} IRC Section 2207A(a)(1).
\textsuperscript{69} IRC Section 2207A(d).
\textsuperscript{70} IRC Section 2523(b)(2).
\textsuperscript{71} IRC Section 2523(c).
A full life interest given to the spouse, plus a power of appointment over the remainder that is exercisable in favor of the donee spouse or his or her estate, will qualify for the marital deduction. However, it must meet the requirements of IRC Section 2523(e) and the related regulations. The applicable gift tax regulations in this connection closely follow the estate tax marital deduction regulations.

The financial planner and his or her client face two basic questions in connection with the unlimited marital deduction insofar as it relates to lifetime gifts:

1. To what extent is the marital deduction to be used, if at all?
2. If it is to be used, should the QTIP election be made?

Lifetime use of the unlimited marital deduction affords no greater transfer tax savings than if used at death. However, using the unlimited marital deduction for lifetime gifts saves administration expenses and avoids probate of the gifted assets. The donor realizes no income tax benefits, assuming the property is income-producing, and the couple files a joint return. A gift could provide some intangible psychological benefits. If the marriage fails, however, the donor spouse might regret having made the gift. There may be an asset protection opportunity here if the donor spouse is engaged in an activity that bears a high liability risk. Transferring property to the donee spouse may succeed in removing the property from the potential claims of creditors of the donor spouse.

The possibility exists that the donee spouse might predecease the donor spouse. In that case, the estate tax marital deduction would not be available for the donor spouse. This factor might possibly serve as an incentive to procure life insurance for the surviving spouse. It might also encourage lifetime use of the marital deduction, at least in amounts which, together with the value of any property held by either spouse as separate property, would allow full use of the unified credit available to the estate of the first spouse to die. A lifetime transfer could save taxes for the donor spouse’s estate if the donee spouse predeceased the donor, and the benefits of the estate tax marital deduction were lost. However, consider whether the availability of the portability election at the death of the first spouse may mitigate this concern. Lifetime use of the unlimited marital deduction would permit the donee spouse to make a tax-free transfer to the children or other objects of bounty that the donor and donee might agree on. However, it would not guarantee that result, as would a QTIP.

The loss of family benefit could be great if the spouse squanders an outright gift. Therefore, the donor might want to consider ways and means of reducing or avoiding this risk of loss.

A QTIP trust is one way of reducing the risk of loss. A QTIP trust limits the possible loss to the value of a life-income interest while guaranteeing the interest of the children or other remaindemen. However, a QTIP is not the only way of minimizing the risk of loss. A life insurance policy on the life of the donor spouse might be a way of providing the children with some protection at a smaller cost than providing the donee spouse with a QTIP interest. The children (or preferably an irrevocable trust created for their benefit) should own the policy and be its beneficiaries.

One might ask what effect, if any, the unlimited marital deduction might have on the disposition of life insurance policies owned by the insured. If the insured is to use the unlimited marital deduction, whether

\[72 \text{ IRC Section 2056(a).}\]
the insurance proceeds are includible in his or her gross estate will not matter greatly, except that their inclusion might add somewhat to administration costs. Further, if the donee spouse should predecease the donor spouse, and if the donor spouse has retained the policy and names his or her estate as beneficiary, the policy proceeds at the donor’s death might help to alleviate any liquidity problems the donor’s estate might have. Also, retention of a cash value policy might be important in aiding the donor’s own financial security during the donor’s lifetime, should withdrawal of the cash value be necessary or desirable. The loan value of the policy, on its own, could be an important asset, especially because state law often protects life insurance policies from creditors.

Under some circumstances, the donor might want to make a lifetime transfer of a policy and all incidents of ownership to his or her spouse. If the donor makes such a transfer, the donee spouse will be in a position to transfer the policy to the children or others by will if the donee predeceases the insured. Although the value of the policy at the time of death of the donee spouse would be includible the donee’s gross estate, the proceeds payable on the death of the donor spouse would not be includible in the gross estate of the donee or in the gross estate of the insured on the insured’s death. The course to be followed in any given situation will depend on an analysis of the facts and goals. Another possibility is to transfer the policy to an irrevocable life insurance trust. If the grantor (insured) survives for three years following the transfer, the policy proceeds would not be included in the grantor’s gross estate at the time of death. If a new life insurance policy is acquired and owned by an irrevocable life insurance trust from inception, the three year look back rule does not apply, and the policy will not be considered includable in the estate of the grantor-insured.

As to the QTIP exception, the donor spouse must decide whether the interest qualifies for the marital deduction. The choice is in the form of an election made after a life-income interest has been created in trust (or other qualifying) form, which gives the donee spouse a right to income payable at least annually and with no right to appoint the property to anyone other than the spouse during his or her lifetime. Although the donor (or the donor’s legal representative) makes the formal choice by an election after the fact, sound planning dictates that the donor give careful thought to the matter before creating the trust.

Although there are good reasons for the creation of a life-income interest as part of a testamentary plan, justifying the creation of such interests as part of a lifetime gift plan is more difficult. An individual who is in business or who, for other reasons, does not wish to expose all of his or her assets to the claims of creditors and who has no fears about marriage stability might wish to give his or her spouse a life-income interest in some portion of his or her assets. Also, if an individual believes a spouse has only a short time to live and is fearful of estate tax consequences (with the resulting loss of the marital deduction), the transfer of a QTIP interest to the spouse might serve a very good estate planning purpose in some cases. It might enable the spouse’s estate to take advantage of the available unified credit to make tax-free transfers to the children or others. Otherwise, the unified credit might be wasted.
Note, however, that the portability of the use of the applicable exclusion might serve to avoid the loss of
the unified credit at the death of the first spouse to die, making the transfer suggested above unnec-
sary.

Under both the QTIP and general power exceptions to the terminable interest rule, if the life-income in-
terest is made terminable on remarriage or on the occurrence of some other specified event, the transfer
is not eligible for the marital deduction.\footnote{IRC Section 2523(b)(1) and Regulations Section 25.2523(b)-1.}

Whether the QTIP exception to the terminable interest rule is to be elected in connection with a lifetime
transfer of an interest or whether the donor-settlor decides not to make the election will generally depend
on the amount of unified credit available\footnote{IRC Sections 2010 and 2505.} to the donor and the availability of portability (see ¶410.03
covering portability).

**Example 4.3.** Hal Irving has an estate of $8 million in 2017. He has available an applicable exclusion amount of $5,490,000. For business reasons, he has decided to transfer $1,500,000 to an irrevocable trust to pay the income, at least annually, to his spouse Linda, with the remainder to their children. He decides not to elect the life-income marital deduction exception to the termi-
nable interest rule. Use of the exclusion avoids actual payment of gift tax. On Linda’s death, the
property will pass to the children tax free without being included in her gross estate. If Hal dies
in 2017, by use of the unlimited marital deduction, he will be able to transfer his estate to Linda
tax free. He will still have available the applicable exclusion amount of $3,990,000 ($5,490,000
minus $1,500,000) of unused exclusion, permitting him to make a tax-free transfer to the chil-
dren or others in that amount.

If he had made the QTIP election, the transfer to the trust would be tax free by reason of the un-
limited marital deduction. He would be assured that the trust corpus would pass to the children.
However, the transfer to the children might be a taxable event and could result in actual payment
of transfer taxes on Linda’s death, assuming the balance of Hal’s $8 million estate passed to her
at Hal’s death and remained intact. The unified credit available to Linda might not be sufficient
to avoid payment of tax. This depends on a number of issues with respect to which the law is
presently uncertain, including the following:

- What will be the amount of the available exclusion in the year of Linda’s death?
- Has Linda previously used her own exclusion?
- Will the portability rules remain "permanently" extended to allow Linda’s estate to use
  Hal’s unused unified credit at his death?

The result, illustrated by the preceding example, is that a donor should not make the QTIP election
without careful calculation of the ultimate tax cost. The donor should take into account the use, or loss
of use, of the applicable credit amount (unified credit) and the availability of portability, as well as the
ultimate disposition of the property involved.
Filing of gift tax returns. An individual who makes gifts other than gifts qualifying for the marital deduction that do not require a lifetime QTIP election,78 the charitable deduction (other than for split-interest gifts, or unless other reportable gifts are made),79 the $14,000 (for 2017, indexed annually for inflation) annual exclusion, or the exclusion for tuition or medical care80 during a calendar year must file an annual gift tax return (Form 709).81 As a general rule, the return must be filed by April 15 of the calendar year following the calendar year in which the gift or gifts were made.82 However, an extension of time to file the donor’s federal income tax return (file Form 4868) also acts to extend the time for filing the donor’s gift tax return.83 It is also possible to obtain an automatic six-month extension of time to file Form 709, even if the filing time for Form 1040 is not extended. In this case, Form 8892 should be filed to obtain the extension of time to file Form 709. Another rule provides that the gift tax return for the calendar year in which the donor dies must be filed no later than the due date for filing the donor’s estate tax return (including extensions).84 In the case of split gifts, a return must be filed even though a gift tax liability does not result (that is, when the gift is not in excess of the annual exclusions available to the donor-spouse and the consenting spouse).85 Even if a gift falls under the $14,000 annual exclusion amount (for 2017, indexed annually for inflation), an individual may consider filing a gift tax return to start the running of the statute of limitations (especially in instances in which valuation of transferred assets, such as closely held stock or partnership interests, include valuation discounts or otherwise may be open to challenge from the IRS).

Savings clauses. Savings clauses attempt to place a ceiling on gift tax liability in the event the IRS or a court places a higher value on the gift than was reported. That result may be achieved in a variety of ways. The question with such clauses is whether the courts will respect them or declare them void as against public policy. If the savings clause attempts to revoke the gift, it probably will be voided.86 Alternatively, if the transfer is for consideration, and the clause calls for an increase in the sales price in the event of an IRS determination that the consideration was inadequate, the courts might uphold a savings clause as valid, as was the case in J. King 545 F.2d 700 (10th Cir. 1976).

The U.S. Tax Court held a clause void as against public policy that called for a downward adjustment in the number of shares gifted, if the value of the shares was determined to exceed the valuation placed upon them by the donor. The court held the clause void even though it also called for an upward adjust-
The IRS noted that the latter was unenforceable by the donee as unsupported by consideration. More recently, the cases of Christiansen v. Commissioner, 130 T.C. 1 (2008), aff’d 586 F.3d 1061 (8th Cir. 2009); Petter v. Commissioner, T.C. Memo 2009-280, aff’d 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Commissioner, T.C. Memo 2011-133; and Wandry v. Commissioner, T.C. Memo 2012-88, have held in the taxpayers’ favor and permitted the use of appropriately drafted defined value clauses. Practitioners are using the Wandry case to protect valuations from IRS challenges. The IRS has nonacquiesced in the Wandry case (A.O.D. IRB 2012-46) but did not appeal the result. The Christiansen, Petter, and Hendrix cases all provided that if there was a valuation adjustment required, the adjustment would be made in the favor of a charity. Wandry provided that such an adjustment would be made in favor of the taxpayer.

.03 Portability

The portability rules allow married spouses to benefit from the unused portion of the applicable exclusion when the death of the first spouse occurs after 2010. A timely filed Form 706 is required to elect portability, even if the estate is below the applicable exclusion amount, and no tax is due. If the return is not filed, any available exclusion not used by the deceased spouse is lost forever and is unavailable to be used at the death of the surviving spouse. To avoid this problem, practitioners should have a discussion with their clients and recommend filing the federal estate tax return for the first deceased spouse, even if no tax is due. The IRS issued Revenue Procedure 2014-18 that permitted a late portability election to be made for deaths occurring between January 1, 2011 and December 31, 2013 as long as Form 706 was filed by December 31, 2014. No further automatic extensions of the late election opportunity have been announced.

An extension of time to file can be obtained by applying for a private letter ruling from the IRS. As long as the interests of the IRS have not been “prejudiced” (i.e., no unpaid tax is involved in the extension request), the requested extension should be granted. However, the user fee that must be paid when the request is made is now $10,000.

**How to elect portability.** To elect portability when the first spouse dies, the executor must file a timely Form 706. The form is due nine months from the date of death of the deceased spouse. The form must be filed to elect portability, even if it is not otherwise required. An automatic six-month extension may be obtained to file Form 706 by filing the extension form (Form 4768) on or before the 9 months from the date of death filing deadline for Form 706. The IRS will issue private letter rulings granting extension of time to file Form 706 to elect portability, but a $10,000 user fee must be paid. (See, for example, PLRs 201714009, 201714022, 201714023 (April 7, 2017) and many others.)

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88 Revenue Ruling 86-41, 1986-1 CB 300.

89 IRC Section 2010(c)(5).

90 Notice 2011-82.
The IRS has issued final regulations\(^9\) governing portability. The regulations provide that the estate, in most cases, need not report the exact value of property that qualifies for the marital or charitable deduction. However, the value of the gross estate must be estimated on the return. The return will show ranges of dollar values, and the estate will have to identify the range within which it estimates the gross estate falls. The executor will have to determine the value of most assets passing to the surviving spouse in order to determine the basis of the assets and may have to do so for state estate tax purposes or for other reasons in connection with the administration of the estate.

The regulations go on to say that in certain cases, the estate may be required to report the value of property qualifying for the marital or charitable deduction in a number of specific situations, including if the value relates to, affects, or is needed to determine the value of property passing to another recipient; if the value is needed to determine eligibility for alternate valuation, special use valuation, or installment payment of the estate tax; if less than the entire value of an interest in property includible in the estate is marital or charitable deduction property; or if a partial disclaimer or partial QTIP election is made with respect to a bequest, devise, or transfer part of which is marital or charitable deduction property. The Form 706 issued by the IRS for deaths occurring in 2013 and beyond reflects these rules, and remains the correct Form 706 to be used.

**Who is responsible for making the portability election?** The executor is authorized to file the return to elect portability. This raises several fiduciary issues. Must the executor file a return and elect portability if the surviving spouse so requests? Who pays the cost of preparing the return, the estate or the surviving spouse? Can the surviving spouse be appointed as a special executor or administrator for the limited purpose of preparing and filing the return to elect portability if the executor does not want to do so? This is similar to the procedure in some states for the appointment of a special executor or administrator when an estate has a claim against the executor. The regulations do not permit the spouse to act independently of the executor.

**How is the DSUE determined?** The regulations provide that the deceased spouse’s unused exclusion (DSUE) is the lesser of the decedent’s basic applicable exclusion amount, or the excess of the basic exclusion amount of the surviving spouse’s last deceased spouse over the amount with respect to which the tentative tax was determined with respect to such deceased spouse’s estate.

The regulations clarify that if the surviving spouse remarries, the DSUE will still be available to the surviving spouse, as long as his or her new spouse is living. Therefore, a surviving spouse who remarries may want to use the available DSUE quickly to protect against losing it upon the death of the new spouse. However, if the surviving spouse remarries and divorces, the death of the new spouse will not destroy the DSUE from the first deceased spouse because the second spouse, not being married to the surviving spouse at death, is not the last deceased spouse.

If a surviving spouse who has a DSUE makes a taxable gift, the DSUE is applied first, before using the surviving spouse’s own basic exclusion amount. This facilitates the use of the DSUE by a surviving spouse who remarries and risks losing it if the new spouse predeceases him or her.

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9 T.D. 9725.
Extended statute of limitations. The statute of limitations for the deceased spouse’s estate tax return remains open indefinitely for purposes of determining the allowable DSUE, even if it has otherwise expired, for purposes of assessing estate tax with respect to the surviving spouse’s estate or gift tax with respect to gifts made by the deceased spouse. Accordingly, it may remain open until the death of the surviving spouse and the determination of the available exclusion for that spouse because the surviving spouse’s exclusion may be derived from the return filed for the first spouse to die.

Chapter 37 in this guide will address portability in greater detail.

.04 The Split Gift

When a married person makes a gift of property to a third person, if his or her spouse consents, that gift will be treated for gift tax purposes as though each spouse made one-half of the gift. A split gift allows the gift to be taxed at a lower rate, and if the gift is not taxable, a split gift uses less of the donor’s lifetime exclusion than if it is treated as a gift given by one spouse. Gifts of community property are automatically treated as split gifts.

Important tax savings or applicable credit amount (unified credit) savings, or both, are available through the use of the split gift. For example, the amount of unified credit used on a gift of $100,000 for a donor who had made no prior taxable gifts would be $23,800, but the unified credit used on two gifts of $50,000 each would be $21,200, for a unified credit savings of $2,600. These amounts do not take into account the annual gift tax exclusion. They focus only on the unified credit savings and assume that the donors have already used the annual exclusion by making previous gifts to the donee.

Equally important, the $14,000 annual gift tax exclusion available for 2017, indexed annually for inflation, and the unified credit available to each spouse can be applied jointly. The annual exclusion for 2017 per donee then amounts to $28,000 instead of $14,000. If neither spouse has used his or her applicable exclusion amount, the couple theoretically could give $10,980,000 plus $28,000 to a single donee in 2017 without having to pay gift tax.

Each spouse may use his or her applicable credit amount (unified credit) against only that portion of the gift that is treated as his or hers. No joint gift tax returns are permitted to be filed. Every donor must file his or her own gift tax return reporting his or her share of all gifts.

Gift splitting is allowed under IRC Section 2513(a) only under the following conditions:

- Each spouse was a citizen or resident of the United States at the time the gift was made.
- The parties are married at the time of the gift and, if divorced or widowed after the gift was made, do not remarry during the remainder of the calendar year in which the gift was made.
- Both spouses agree to split all their gifts to third parties for the calendar year.

Only gifts to persons other than the donor’s spouse qualify for gift splitting. If an individual makes a gift of property in part to a spouse and in part to others, gift splitting will be permitted for the gift to others, provided that the gift is severable, and its value is ascertainable.

Both spouses must consent to gift splitting and must do so within a specific period spelled out in IRC Section 2513(b)(2). Generally, the consents must be filed after the year in which the gifts are made and on or before the 15th day of April of the year after the gifts were made. The IRS has ruled that once one
of the spouses has filed a timely return, and the due date for filing the return has passed, the spouses may not correct a failure to treat a gift as a split gift.92

The actual donor must file the gift tax return. The consenting spouse, who is only a constructive donor, need not file a gift tax return if his or her portion of the gift is of a present interest and is valued at $14,000 (in 2017) or less. The consenting spouse should file a gift tax return if his or her gift might be valued at more than $14,000 or might be viewed as a gift of a future interest, thus, barring use of the annual exclusion.

Either spouse may revoke the consent to gift split at any time up to the time the gift tax return is due, but not afterward. Consent is irrevocable if given after the due date (for example, on an extended return).93 Gift splitting, then, is not something to be entered into lightly. For example, if the marriage is in trouble and a divorce or separation is possible, the consenting spouse must somehow be protected against this joint and several liability for the gift tax on this constructive gift. Even if the consenting spouse has no gift tax liability, the consenting spouse should consider the effect of losing some of his or her unified credit.

Gift splitting can be helpful in a marriage where one spouse has substantial assets and the other does not. The wealthier spouse will use less of his or her applicable exclusion through gifting, and the less wealthy spouse may approach, but not ever reach, the threshold for taxable transfers.

.05 Estate Tax Savings in Giving

One can save estate taxes by giving away money or property during one’s lifetime. Exceptions and qualifications do apply. If an individual makes a gift but retains an interest or rights in the gifted property, the property may be included in the individual’s gross estate.95 Also, if an individual owns a life insurance policy and makes a gift of it within three years of his or her death, the proceeds of the policy will be included in the policy owner’s gross estate.96

Apart from these broad-based exceptions, gift giving is generally an effective way of saving estate taxes. Although a donor should consider the gift tax costs, one may make gifts under the umbrella of the annual exclusion and spousal gift splitting without incurring a gift tax liability. Further, the use of the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion97 can serve to reduce the gift tax liability on gifts to an individual donee otherwise in excess of the amount of the applicable exclusion.

93 IRC Section 2513(c).
94 IRC Section 2513(d).
95 IRC Sections 2036-2038.
96 IRC Sections 2035(a) and 2042.
97 IRC Section 2503(b).
As previously noted, an annual, well-managed gifting program involving multiple donees will, over time, permit large wealth transfers that reduce or eliminate the estate tax with no gift tax cost.

If the donated property has high appreciation potential, the estate tax savings are also higher. Even if the gift is taxable and the donor uses up the applicable credit amount to avoid the tax or actually pays gift tax after the applicable credit amount (unified credit) has been exhausted, the donor ordinarily will be better off. If the donor makes the gift more than three years before his or her death, any gift taxes paid will be excluded from the donor’s gross estate, along with any future appreciation of the transferred property.98

The applicable exclusion amount for gift tax purposes is $5,490,000 for 2017. The applicable exclusion amount for estate tax purposes is also $5,490,000 in 2017.

Assets that an individual owns might appreciate in value, if not in real terms, then in nominal dollars, as time goes on. Clients who are now out of reach of the estate tax could be subject to the estate tax in the future, although their wealth has not increased in value in real terms. The top gift and estate tax rate is permanently set by ATRA at 40 percent for 2013 and thereafter.

Consequently, individuals who face the prospect of having a substantial portion of their estates taxed at their death, own assets with high appreciation potential, and are able to make gifts to family members will find that lifetime giving is an effective way to save estate taxes. This potential savings should be compared with the income tax consequences to the donees if low basis assets are transferred to the donees with a carryover basis from the donor, and the donees later sell the property. If the donor would be subject to estate tax, gifting is advisable, paying attention to the basis of the assets to be transferred. If the donor is not likely to be subjected to the estate tax, basis may become a more important tax consideration.

.06 Income Tax Savings in Giving

Gifts can be an effective source of income tax savings. Savings will be generated if the donor is in a higher tax bracket than the donee. Currently, there is a very large point spread between the top income tax rate and the bottom income tax rate. The spreads between the income tax rate brackets provide a strong incentive for making gifts to children (other than those subject to the kiddie tax, who are under age 19 or under age 24 if a full-time student) and other relatives (such as parents) in low tax brackets to utilize the 10-percent and 15-percent rates fully.

Planning tactics are available for the financial planner to use in assisting the client to help children and parents in low tax brackets and to enjoy income tax savings.

Grantor trust rules. IRC Section 673 provides that for trusts created by transfers after March 1, 1986, the grantor of a trust is treated as the owner (and is taxable on the income) of any portion of the trust in which he or she has a reversionary interest in either the corpus or income, if, as of the inception of that portion, the value of the interest exceeds 5 percent of the value of such portion. However, this rule has one narrow exception: The grantor will not be taxable if he or she retains a reversionary interest that takes effect only on the death of a lineal descendant beneficiary under age 21. This exception, along

98 IRC Section 2035(b).
with trusts for minors generally, is discussed subsequently. In addition, a remainder interest in the grantor’s spouse is treated as being held by the grantor, giving the grantor the equivalent of a reversionary interest.

As noted previously, for the grantor to be taxed on the trust income, his or her reversionary interest must exceed 5 percent of the value of the trust or trust portion at inception. This value is computed using IRS tables under IRC Section 7520. The interest factor under these tables changes monthly. This reversion rule always had been of little practical value, but it is of even less value when interest rates are low. Low interest rates make it nearly impossible to avoid having almost any interest in the trust retained by the grantor to be valued at less than five percent. Thus, the rule appears to be useful only with very young beneficiaries, if market interest rates increase.

The lineal descendant exception permits the grantor to retain a reversionary interest without being taxed as the grantor if the trust is for the benefit of a lineal descendant (child, grandchild, great-grandchild), and the reversion is to take place only on the death of the beneficiary before age 21.99 This exception would seem to be of little practical value in the normal course of events, when the beneficiary is likely to live long enough to attain age 21.

What about a beneficiary who suffers from a terminal illness but has not reached the stage when death is imminent? The exception could be of significant tax-saving value in such a case, especially if the grantor is in a combined federal, state, and local tax bracket that is 20 percentage points or more above the beneficiary’s bracket. This situation would be the case for grantors in the highest income tax brackets.

Consider creating a reversionary trust to be funded with tax-exempt income to help a family member in need.

Example 4.4. Brian and Susan Taylor are married and file a joint return. Their taxable income puts them in the 35-percent marginal tax bracket for 2017. The Taylors also have $50,000 of income that is exempt from federal, state, and local tax. The Taylors have a net worth, not including residences, of over $1 million. Susan’s sister, Brenda Doyle, is a widow with two minor children. Doyle claims head-of-household status, and her taxable income places her in a marginal bracket of 15 percent. The Taylors wish to provide Doyle with some financial assistance, at least until the children cease to be dependent. The Taylors set up a reversionary trust for a term of 10 years, funding it at the rate of $28,000 annually with gift splitting, strategically timed at the end of one year and the beginning of the next year so that $56,000 is working for Brenda within the first week of the trust, using tax-exempt bonds that yield 4 percent. When the trust is fully funded with $140,000 after 4 years and one week, the tax-exempt income generates $5,600 ($140,000 × 4%) annually, the equivalent of a taxable yield of $6,440 in her tax bracket.

The Taylors could retain the tax-exempt bonds themselves and make an annual gift of the yield to Susan’s sister. However, the trust provides a measure of security for the sister, a commitment which would survive the death of the Taylors. At the same time, the trust funds may provide a measure of security for the Taylors to the extent that the income and corpus may be placed beyond the reach of their creditors.

99 IRC Section 673(b).
An individual in a low tax bracket may, nevertheless, have substantial wealth and be in a position to help other family members financially through the use of a reversionary trust of short duration. The individuals to be helped might be in a higher tax bracket.

A young adult with significant assets might want to establish a trust to contribute to the support of his or her grandparents, whom his or her parents have been supporting, with a resulting net savings to the family as a unit. This situation might occur when the young adult’s parents are in the highest marginal bracket, while his or her tax rate is 15 percent. To the extent of every dollar of support furnished by the child for the grandparents, his or her parents would be relieved of a dollar of support.

**Kiddie tax.** Despite popular (mis)conceptions to the contrary, one can still achieve significant intra-family savings by shifting income-producing assets to children, even if the income is subject to the kiddie tax.\(^{100}\) The kiddie tax applies to children who are under age 19 or who are full-time students under age 24. The tax applies only to children whose earned income does not exceed one-half of the amount of their support.\(^ {101}\)

The kiddie tax separates a child’s unearned income into three parts. For 2017, assuming the child has no earned income and no itemized deductions, the breakdown is as follows:

\begin{itemize}
  \item \textit{100 percent tax-free income:} Unearned income up to $1,050, sheltered by child’s special $1,050 standard deduction
  \item \textit{Income subject to tax at the 10 percent rate:} $1,050
  \item \textit{Net unearned income subject to tax at parental rate:} Unearned income over $2,100
\end{itemize}

At low investment return rates, a fairly large gift of assets can be made without coming close to the $2,100 income limit.

If the child’s unearned income already is substantially above the net unearned income limit, a parent can still possibly reduce overall family income taxes by making gifts of property designed to produce income or profit in the future, after the child is free of the kiddie tax. Such gifts include the following:

\begin{itemize}
  \item Growth stock or growth mutual funds that have low current dividends but that are expected to increase in value (and dividend yield) over the long term
  \item Stock in the family business, which the business can redeem after the child is free of the kiddie tax
\end{itemize}

\(^{100}\) IRC Section 1(g).

\(^{101}\) IRC Section 1(g)(2) as amended by the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28).
• Assets that produce no income currently but that can result in substantial gains in the future (for example, prime raw land)

• Series EE bonds or Series I bonds, on which the tax on accruing interest may be deferred until the bonds are redeemed

Parents may elect to include directly on their return the income of certain children who are subject to the kiddie tax. A child subject to the kiddie tax is not required to file a return if parents elect to include the child’s gross income on the parents’ return. The election can be made only if the child’s income is more than $1,050 and less than $10,000 and consists of only interest, dividends, and Alaska Permanent Fund dividends; if the child has not made estimated tax payments; and is not subject to backup withholding (see the instructions to IRS Form 8814 for additional requirements). In addition to being taxed on the child’s income, parents who make this election must pay an amount equal to the lesser of $105 ($1,050 × 10%) (2017) or 10 percent of the excess of the child’s income over $1,050 (2017). These amounts are indexed for inflation. The parents must also treat any tax-exempt interest from specified private activity bonds owned by the child as a tax preference item of the parents when computing the alternative minimum tax.

Planning Pointer.

Electing to include the child’s income on the parents’ return simplifies tax filing chores, but it may not be a wise move. The parents’ adjusted gross income will increase, which could cost the parents’ deductions and loss of other tax breaks under various adjusted gross income-based phase-outs. In addition, the election may increase the family’s state income tax and subject the parents to the net investment income tax. While the kiddie tax may force some of the child’s unearned income to be taxed at the parents’ regular income tax rate, each person, including a child subject to the kiddie tax, has his or her own threshold for purposes of the net investment income tax—another good reason to keep the child’s income reported independently from his or her parents.

Planning Pointer.

Although it may not produce the lowest overall family tax expense, a grantor may find it appealing to make a completed gift (via a grantor trust) but retain the income tax burden on the transferred assets. By doing so, the grantor allows the trust assets to grow income-tax free and, at the same time, reduces his or her taxable estate. The IRS has ruled that the payment of these income taxes by the trust grantor does not result in an additional gift to the trust or its beneficiaries. (Revenue Ruling 2004-64).

.07 Incomplete Gifts

No gift, no income splitting, and no gift tax occur unless the gift is complete and bona fide. The general rules for determining this require the following:

102 IRC Section 1(g)(7).
103 IRC Section 1(g)(7)(B)(ii)(II).
104 IRC Section 57(a)(5).
• A competent donor and donee
• A clear intent to make a gift
• An irrevocable transfer of legal title barring further control by the donor
• A delivery to the donee of the gift or of evidence of title, such as a deed or stock certificate
• Acceptance of the gift by the donee105

Gifts in which the donor reserves some interest in or power over the property, which result in the gifts being treated as incomplete, occur mostly in connection with transfers in trust (discussed in ¶420). However, the principles examined there usually apply to other types of gifts as well. One must be careful of gifts in which the donor retains a right to revoke the gift without the donee or anybody else having any say about it. No completed gift occurs in such a case.

A gift is not necessarily considered incomplete, however, if the donor reserves the right to reacquire the property if the donee predeceases the donor. That type of transaction is called a possibility of reverter, which reduces the gift’s value, but does not necessarily make it incomplete.

Similarly, if the donor retains a life estate in the property and gives only a remainder interest, the gift of the remainder interest may be complete if the qualified interest requirements of IRC Section 2702 are satisfied. The value of the gift of such remainder interest, for gift tax purposes, would be computed by consulting IRS valuation tables under IRC Section 7520. If the donor transfers property but retains a limited power of appointment over the transferred property, the gift will be considered incomplete.

Promise of a gift. In the case of a promise that is legally enforceable under state law to transfer property for less than adequate and full consideration in money or money’s worth, the promisor makes a completed gift on the date when the promise is binding and determinable in value rather than when the promised payment is actually made.106

Gifts by check or note. The IRS has always maintained that a gift of the donor’s own check to a non-charitable donee is not complete until it is paid, certified, accepted by the donee, or negotiated to a third party for value. Until such time, the gift is revocable.107 A gift of a check made in December of one year that was deposited in that year but that did not clear until January 2 of the following year has been treated as made in the earlier year. The taxpayer established the intent to make a gift, made an unconditional delivery of the check, and presented the check for payment within the earlier year and within a reasonable time of issuance in the case of Metzger.108 Based on its defeat in the Fourth Circuit, the IRS has conceded the application of the relation-back doctrine to noncharitable gifts under the circumstances of the

105 See R.W. Hite, Sr., Est., 49 T.C. 580 (1968), spelling out bona fide gift requirements.
106 Revenue Ruling 84-25, 1984-1 CB 191.
107 Revenue Ruling 67-396, 1967-2 CB 351; D.F. McCarthy, 806 F.2d 129 (7th Cir. 1986); J.M. Gagliardi Est., 89 T.C. 1207 (1987).
108 A.F. Metzger Est., CA-4, 94-2 USTC ¶60,179.
Metzger decision. However, in *Estate of Newman*, the U.S. Court of Appeals for the District of Columbia ruled that checks written by the decedent’s attorney-in-fact before the decedent’s death, but paid to noncharitable donees after the decedent’s death, were included in the decedent’s gross estate. The court reasoned that the checks were not completed gifts because the decedent had the power to revoke the gifts before the bank paid the checks. The key difference between the decisions in Metzger and Newman is that the donor was still alive at the time the bank paid the checks in Metzger but was deceased at the time the bank paid the checks in Newman.

A gift of the donor’s own unenforceable note is not complete until it is paid or transferred for value. This result has been upheld even when a note is secured by a real estate mortgage. However, this particular ruling seems open to question. A gift of a donor’s own note that is legally enforceable under state law when given is complete on the date when the promise to pay is binding and determinable in value, rather than when the note is paid.

### §410 Basic Strategies in Lifetime Giving

A number of factors involved in lifetime giving suggest the existence of basic strategies. These strategies concern whether or not a gift, made under specific circumstances, would be economically wise; how the applicable credit amount, annual exclusion, marital deduction, and gift splitting may be used to their maximum advantage; and whether a gift of cash or a gift of income-producing property should be made. This section focuses on these and other factors.

Lifetime gifts may be drawn into the donor’s gross estate if the donor retains a life income interest in the gifted property—an interest that does not, in fact, end before the donor’s death—or if the donor disposes of such a retained interest within three years of death, as discussed in ¶1005.

One of the basic factors to be considered by a donor is the income tax cost of making a gift in cash as compared to a gift of income-producing property yielding the same amount as the cash gift, assuming no income tax liability on the part of the donee. The income tax cost will vary with the income tax bracket


112 Revenue Ruling 84-25, 1984-1 CB 191.

113 IRC Sections 2010 and 2505.

114 IRC Section 2503(b).

115 IRC Section 2523(a).

116 IRC Section 2513(a).

117 IRC Section 2036(a).

118 IRC Section 2035(a).
of the donor. The following table (exhibit 4-1) compares the income tax cost of a yearly gift of $1,000 with that of a yearly gift of property yielding $1,000, assuming no income tax liability for the donee. However, if the donee is subject to the kiddie tax, the first $1,050 of the unearned income would be tax-free; the next $1,050 (2017) of the unearned income would be taxable at 10 percent; and the child’s unearned income in excess of $2,100 (2017) would be taxable at his or her parents’ top rate.119 These amounts are indexed to inflation.

The table assumes that the donor possesses income-producing property with a high enough yield to provide sufficient income after taxes in the donor’s particular bracket to enable the donor to make a gift of $1,000. Alternatively, the donor, instead of making a gift of cash, gives the donee enough income-producing property to provide the donee with $1,000 in income.

**Exhibit 4-1: Comparison of Cash Gift With Gift of Income Property for Income Tax Purposes**

<table>
<thead>
<tr>
<th>Donor’s Top Tax Rate</th>
<th>Income Needed to Net $1,000 After Taxes</th>
<th>Income From Gift Property</th>
<th>Income Kept by Donor</th>
<th>Donor’s After-Tax Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$1,111</td>
<td>$1,000</td>
<td>$111</td>
<td>$100</td>
</tr>
<tr>
<td>15%</td>
<td>$1,176</td>
<td>$1,000</td>
<td>$176</td>
<td>$150</td>
</tr>
<tr>
<td>25%</td>
<td>$1,333</td>
<td>$1,000</td>
<td>$333</td>
<td>$250</td>
</tr>
<tr>
<td>28%</td>
<td>$1,389</td>
<td>$1,000</td>
<td>$389</td>
<td>$280</td>
</tr>
<tr>
<td>33%</td>
<td>$1,493</td>
<td>$1,000</td>
<td>$493</td>
<td>$330</td>
</tr>
<tr>
<td>35%</td>
<td>$1,538</td>
<td>$1,000</td>
<td>$538</td>
<td>$350</td>
</tr>
<tr>
<td>39.6%</td>
<td>$1,656</td>
<td>$1,000</td>
<td>$656</td>
<td>$396</td>
</tr>
</tbody>
</table>

This table illustrates that, in all tax brackets, a gift of income-producing property is better than a gift of cash from the donor’s standpoint in that the donor avoids the income tax on the income from the property.

Keep in mind, however, that a cash gift of $1,000 (and, indeed, a gift of as much as $14,000 or $28,000 with gift splitting120) may be made without any gift tax consequence in 2017,121 whereas a gift of a future interest in property sufficient to produce an annual yield of $1,000 might result in gift tax liability if the donor’s applicable exclusion has been exhausted. Assuming a yield of less than 7.14 percent, a gift of more than $14,000 would be required. With gift splitting, there would be no tax unless the yield were less than 3.57 ($1,000/$28,000) percent.

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119 IRC Section 1(g).

120 IRC Section 2513(a).

121 IRC Section 2503(b).
What Types of Property to Give

Selecting the right property for the gift is an important part of any planned gift strategy. Listing the categories of property with gift possibilities is often helpful:

- **Personal property.** Art objects, business interests, cash, certificates of deposit, contract rights, copyrights, estate and trust interests, jewelry, joint property interests, mortgages (on real estate and personal property), notes, patents, receivables, securities (stocks, bonds, mutual fund shares, investment contracts, and limited partnership interests), trademarks, personal effects, autos, and other types of tangible property.

- **Real estate.** Income-producing property, joint tenancies, leases, residences (condominiums and interests in cooperative apartments included), vacant land, vacation homes, and various rights in real estate, including easements of access, light, and air.

- **Life insurance and annuities.** Cash values, refunds, and remainders.

When selecting gift property, the following are the major general considerations:

- **Low gift tax value—high estate tax value.** Usually, a financial planner wants to help the client reduce estate taxes at minimum gift tax cost. Thus, the client should select property that will probably have low current gift tax value and high future estate tax value. Property with a low present value and a high appreciation potential meets this test.

- **Appreciated property.** A gift of appreciated property from an individual in a high tax bracket to a family member in a lower tax bracket can reduce the effective cost of a gift. For example, assume that an individual owns ordinary income property that has a cost basis of $4,000 and is worth $14,000. If the donor is in the 39.6 percent tax bracket and sells the property, the tax on the transaction would be at least $3,960 (not including the net investment income tax and any applicable state income tax). Assume that the donor gives that property to his or her parents, who are in the 15 percent bracket. If they sell the property, they will not have any income tax liability (they are in the 0 percent bracket for capital gains), which results in a net income tax savings of $3,960. However, sometimes retaining appreciated property until death to get a stepped-up basis might be a better strategy when there will not be any estate tax liability on the donors, and the decedent’s heirs will avoid or reduce future income taxes.

- **Property with growth potential.** The client should consider giving property that is most likely to appreciate and cause estate tax problems if retained.

- **Assets not likely to be sold.** If the gift property is not likely to be sold by the donee at any foreseeable time, even though the property may have appreciated in value, a stepped-up basis on the death of the owner may be of little or no importance. This may make the property a better choice for a lifetime gift.

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122 IRC Section 1014(a).
• **High income-producing property.** Usually, a financial planner will want to recommend that a client in a high tax bracket select a gift of high income-producing property to give to a family member in a lower bracket, as long as the donee is older than age 19 and not a full-time student under age 24. However, if the donee is in a higher bracket than the donor (such as a gift from a retired parent to a middle-aged child), a gift of low-yield growth-type property might be better.

• **Property not readily subject to controlled testamentary disposition.** Property that might present problems for the executor or trustee of an estate, such as property that is difficult to value, sell, or divide up, may be good for gifting.

• **Shrinking or wasting assets.** Assets that shrink in value with the passage of time, such as copyrights, patents, leaseholds, and mineral rights, are not usually good choices to give as gifts.

These, and other factors, affect the selection of specific types of property:

• **Art objects, antiques, and jewelry.** These objects are likely to be good for lifetime giving because they fall within the scope of one of the major general considerations listed previously. They can present problems of valuation. Also, they raise questions about whether they are to be sold or retained and, if retained, to whom they should be given if not the subject of a specific legacy.

• **Business interests.** Minority interests in a closely held business can usually be given away without adversely affecting the donor’s control. Income-splitting and valuation discount benefits may be achieved, especially if the business is in partnership or corporate form. Stock in an S corporation is especially good for giving because it causes corporate income to be passed through to the donees. Likewise, gifts of interests in a family limited partnership or limited liability company taxed as a partnership would cause income to be passed through to the donees. These suggestions assume, of course, that the donor is comfortable parting with income.

• **Family residence.** A lifetime gift of the family residence to one’s spouse may afford a means of enabling the donee to take advantage of the applicable exclusion amount when making subsequent gifts to children, if cash or cash equivalents are not available. A lifetime gift of the residence to a spouse may be contraindicated if the owner-spouse has a low basis, is elderly, expects to predecease the other spouse, and has a sizable amount of appreciation in the house. Upon death of the owner spouse, the residence would receive a stepped-up basis (absent an election having been made to opt out of the federal estate tax for a person who died in 2010)\(^{123}\) that would eliminate all income tax liability on the decedent’s share of the house for appreciation up to the time of death. Both gifts and a devise of the property through a will would qualify for the marital deduction\(^ {124}\) and could enable the donee spouse to take advantage of the $250,000 ($500,000 for married couples filing a joint return) gain exclusion for sales of principal residences (¶2815).\(^ {125}\)

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\(^{123}\) IRC Section 1014(a).

\(^{124}\) IRC Sections 2056(a) and 2523(a).

\(^{125}\) IRC Section 121.
• **Joint property.** Interests in jointly-held property held by persons who are not married might make good gifts by the older joint tenant to the younger one. Under the general rule of IRC Section 2040(a), the entire value of jointly-held property is included in the gross estate of the first joint tenant to die unless the survivor is able to demonstrate the proportionate share of his or her contributions to the property’s acquisition. Such a determination might be difficult to establish. When property is held jointly by spouses, only one-half of the value of the jointly held property is includible in the gross estate of the first to die.\(^{126}\)

• **Life insurance.** With the exception of policies (for example, single premium) treated as modified endowment contracts, cash value life insurance receives favorable income tax treatment. Life insurance proceeds are excluded from the decedent’s gross estate if the policy is not payable to the estate, and the decedent has not held any incidents of ownership in the policy in the three years before the decedent’s death.\(^{127}\) An irrevocable life insurance trust or transfer of all incidents of ownership to junior family members will ensure that the client’s gross estate is not unnecessarily increased by life insurance proceeds (¶430). Given a choice between transferring property such as securities of a given value and a paid-up insurance policy of the same stated value at death, the life insurance policy generally could be given at a lower gift tax cost and would be an asset a donor may be much more comfortable giving away.

• **Non-income-producing property.** If a donor transfers nonmarketable and non-income-producing property in trust to the trust beneficiaries, the gift may not qualify for the annual exclusion because it may be treated as a gift of a future interest.\(^{128}\)

• **Remainder interests.** Remainder interests are interests that grow in value as the preceding estate nears termination. Some remainder interests are, therefore, suitable for lifetime giving, whether the interest is deemed vested or contingent. However, the annual exclusion is not available for those gifts because they are gifts of future interests.\(^{129}\) Also, if the donor retains a life-income interest, a gift of merely a remainder interest is not advisable because the full value of the property would be included in his or her gross estate.\(^{130}\)

• **Securities.** Good growth stocks make good gifts, particularly during the lower valuation periods in a bear market.

\(^{126}\) IRC Section 2040(b).

\(^{127}\) IRC Sections 2035(a) and 2042.

\(^{128}\) IRC Section 2503(b) and *F.A. Berzon*, 63 T.C. 601 (1975), *aff'd* by 534 F.2d 528 (2d Cir. 1976), involving a gift of closely held stock with a history of nonpayment of dividends. See also *Hackl v. Commissioner*, 118 T.C. 279 (2002); *aff'd* 335 F.3d 664 (7th Cir. 2004) involving a gift of interests in a limited liability company; but see also *Wimmer v. Commissioner*, T.C. Memo 2012-157 distinguishing the *Hackl* case.

\(^{129}\) IRC Section 2503(b).

\(^{130}\) IRC Section 2036(a).
• **Zero coupon bonds.** A gift of a zero coupon bond may be effected at low gift tax cost relative to its value at maturity but exposes the donee to inclusion of interest in gross income before maturity, unless the bond is tax exempt.

• **U.S. savings bonds.** Savings bonds make good gifts, but they should be purchased so that only the donee’s name appears as the owner. If the donor’s name appears as co-owner, the bonds may be includible in the donor’s gross estate under IRC Section 2040. An exclusion from gross income may apply to the interest on Series EE and Series I bonds issued after 1989 and redeemed to pay for college tuition. However, in a twist on the usual family income-shifting strategy of giving away property, unless the bonds are bought and held in the parents’ name, the special interest tuition exclusion will not be available. The tuition exclusion is subject to a phase-out for taxpayers with high modified adjusted gross income.

**.02 Income Tax Basis Rules**

*Basis,* for income tax purposes, is a broad term that marks the point of departure for computing a property owner’s gain or loss on the sale of the property or for computing allowable depreciation. One of the most important estate planning factors to weigh when deciding between lifetime gifts and testamentary transfers is the potential step-up to date of death value in the federal income tax basis that a decedent’s estate or beneficiaries receive. They take as their basis the fair market value of the property for estate tax purposes (that is, the value at the decedent’s date of death or six months later if the estate is eligible for the alternate valuation date, and the executor elects it). Thus, any unrealized appreciation up to the time of the estate tax valuation date never becomes subject to federal income taxation.

(Note: For decedents who passed away in 2010 whose estates opted out of the federal estate tax, the step up in basis for testamentary transfers under IRC Section 1014 is replaced with a modified carryover basis at death rule under IRC Section 1022.)

Property acquired by lifetime gift is not so favorably treated. The donee’s basis is the same as the donor’s basis, (a carryover basis) with an adjustment for any gift tax paid. The adjustment for gift tax paid is limited to the amount allocable to the net appreciation element in the gift.

When the donor’s basis is higher than the fair market value of the property at the time of the gift, for the purpose of determining a loss, the donee takes the fair market value as the donee’s basis. (However, a spousal donee takes the spousal donor’s basis under IRC Section 1041.) The result is that the donee, on the sale of the property, will not be able to take advantage of the full amount of the donor’s paper loss.

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131 IRC Section 135(a).

132 IRC Section 135(c)(1).

133 IRC Section 135(b)(2).

134 IRC Sections 1014(a) and 2032.

135 IRC Section 1015.

136 IRC Section 1015(a).
Thus, the donor should consider selling the property to recognize the loss and then give the proceeds to the donee.

Generally, highly appreciated property might not be a good choice for a gift if the owner can easily hold it until his or her death. Assuming no changes in the law, the property would then receive a step-up in basis (except as previously described for certain decedents that passed away in 2010), and the beneficiary could avoid income tax on the appreciation that occurred before the owner’s death. However, the financial planner should evaluate the tradeoff between income tax savings for the donee or beneficiary and the possible estate tax on the property if it appreciates and the owner holds it until his or her death. If long-term capital gain property is involved (¶3101), the reduced tax rate on net capital gains might make the lifetime gift alternative more attractive than holding the property until death, unless the donor expects to have an estate that falls under the estate tax threshold.

The adjusted gross income and the income tax brackets of the parties must be taken into account in light of the net investment income tax and the higher income tax brackets for wealthy individuals. High income tax basis and stepped-up basis are very desirable in light of these income tax issues.

Additional advantages of a lifetime gift are explained in ¶405. Also, if a sale of appreciated property is necessary to meet a family member’s expenses (a child’s college expenses, for example), usually the owner should transfer the property to the family member as a gift (but only if the family member is of an age and status to avoid being subject to the kiddie tax) and let the donee sell it. The gain would then be taxable at the donee’s presumably lower tax rate.

If the donee can show capital losses on his or her income tax return that can be used to offset capital gains, the donee’s losses might be a factor in the decision to transfer appreciated property. This strategy might be particularly desirable if the donor can make the gift at a low or no cost in gift taxes. Given the high gift tax exclusion, gift tax liability can be avoided by most taxpayers.

At one time, one could give appreciated property to a dying person, who would then bequeath the property back to the donor or the donor’s spouse. As a result, the property would receive a stepped-up basis equal to its fair market value for estate tax purposes. All income tax liability for appreciation up to that point would be eliminated. However, IRC Section 1014(e) provides that if one gives property to an individual who dies within one year of the gift and the donee bequeaths the property back to the donor or the donor’s spouse, the “new” basis of the property in the hands of the original donor or his or her spouse will be the basis of the property in the hands of the decedent immediately before death. The fair market value at death rule will not be applied here. This rule applies whether the decedent was terminally ill or died unexpectedly.

The provision leaves open the possibility of obtaining a stepped-up basis by having the decedent-donee live beyond the one year period or effect a testamentary transfer to persons other than the donor or his or her spouse. For example, suppose one spouse is dying and the other spouse gives the dying spouse appreciated property. The dying spouse bequeaths the property to the couple’s children. The children receive a stepped-up basis. In this case, the decedent had to have owned the property for only one day. In this example, the gift to the dying spouse can be made without gift tax cost by reason of the unlimited

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137 IRC Section 1014(a).
marital deduction. The bequest to the children may be tax free to the dying spouse’s estate to the extent that unused applicable exclusion amounts are available.\textsuperscript{138} If the applicable exclusion amount is exhausted, amounts may be transferred to the surviving spouse tax free under the umbrella of the unlimited marital deduction,\textsuperscript{139} and if other appreciated property (not transferred to the dying spouse by the other spouse within one year of death) is included in the decedent’s estate, the surviving spouse will get a stepped-up basis. Also consider the possibility of having the donor spouse make the gift to the donee spouse, and have the donee “return” it at death in a QTIP trust for the benefit of the donor. Arguably, the QTIP form of ownership is not a return of the same property with the same rights to the donor, and the stepped-up basis should apply even if the donee spouse fails to live one year.

.03 Gifts Between Spouses

Interspousal gifts generally do not result in federal income tax savings. Interspousal gifts are, however, useful in achieving estate tax savings, unless portability makes such savings unnecessary. The estate tax liability may be lowered by the unlimited gift tax marital deduction,\textsuperscript{140} the unified credit,\textsuperscript{141} and the fractional interest rule\textsuperscript{142} for property jointly owned by spouses, each of which is discussed in ¶405.02. Thus, lifetime gifts to a spouse might be indicated for these reasons:

- The unlimited gift tax marital deduction protects a gift of any amount without dilution of the applicable credit amount (unified credit).
- The gift reduces the donor’s gross estate.
- The gift may enable the donee-spouse to make use of the applicable credit amount (unified credit).
- The gift operates as a hedge against the loss of the marital deduction if the donee should predecease the donor.
- The gift may, to some extent, serve the purpose of equalizing the estates of the spouses to reduce the tax burden on each of their estates, although if the portability opportunity is available and utilized, gifting may not be required to accomplish this goal.

Equalization may be accomplished by an equalization clause in a marital deduction bequest or by such a clause contained in a living trust.\textsuperscript{143}

\begin{footnotes}
\footnotetext[138]{IRC Section 2010.}
\footnotetext[139]{IRC Section 2056(a).}
\footnotetext[140]{IRC Section 2523(a).}
\footnotetext[141]{IRC Sections 2010 and 2505.}
\footnotetext[142]{IRC Section 2040(b).}
\footnotetext[143]{See \textit{C.W. Smith, Est.}, 66 T.C. 415 (1976), aff’d per curiam, 565 F.2d 455 (7th Cir. 1977); see also \textit{F.L. Meeske Est.}, 72 T.C. 73 (1979) and \textit{V.S. Laurin Est.}, 38 T.C.M. 644 (1979).}
\end{footnotes}
Equalization of this type is normally only resorted to when each spouse has rather substantial holdings of property. However, a couple might also move toward equalization to avoid wasting the applicable credit amount (unified credit)\(^{144}\) to which each spouse is entitled. Again, keep in mind that the portability of the applicable exclusion, now permanently available to the estates of spouses who die after 2010, may protect against the wasting of the unified credit over two deaths without requiring spouses’ property to be divided equally between them.

\.04 An Ongoing Program

A planned, ongoing gift program offers the greatest opportunity for reducing estate taxes at minimal gift tax cost. This type of program is designed to take maximum advantage of the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion.\(^{145}\) A donor should engage in an ongoing gift program only when the donor’s financial needs and those of the donor’s spouse, if married, are met. The gifts should not jeopardize their welfare.

In that situation, the donor could make substantial gifts to children or others well in excess of the amount permitted by the annual exclusion.\(^{146}\) However, the donor should consider the wisdom of such a course of action on a variety of grounds. The donor should weigh the following considerations:

- The applicable credit amount\(^{147}\) and the unlimited estate and gift tax marital deduction\(^{148}\) might make an ongoing gift-giving program with the primary emphasis on reducing estate taxes less urgent for many estates. This consideration is especially important because the applicable exclusion amount under the unified gift and estate tax system for lifetime gifts is $5,490,000 for 2017, and the applicable exclusion amount for estate tax purposes is also $5,490,000 for 2017—both exclusions permanently indexed for inflation. A prospective donor who is married might plan to make use of the marital deduction and the applicable credit amount (unified credit) to avoid estate tax. Nevertheless, in appropriate circumstances, the prospective donor might wish to undertake an ongoing gift program with a view to reducing estate taxes of the surviving spouse’s estate.

- An unmarried individual whose estate is large enough to generate estate tax liability might wish to consider making lifetime gifts, unless doing so would unduly reduce the individual’s current economic well-being.

- The donor might question whether the donee has sufficient maturity to handle substantial amounts of money or property. Although a donor could use a trust to make up for the donee’s

\(^{144}\) IRC Section 2010.

\(^{145}\) IRC Section 2503(b).

\(^{146}\) IRC Section 2503(b).

\(^{147}\) IRC Section 2010.

\(^{148}\) IRC Sections 2056(a) and 2523(a).
lack of maturity, the cost and other administrative complications of a trust might act as a deter-
rent.

- If the donor questions the donee’s maturity, the donor might want to make annual gifts in rela-
tively small amounts as a form of test.

- Gifts in excess of the annual $14,000 (for 2017) exclusion\(^{149}\) use up the applicable credit amount
  (unified credit)\(^{150}\) and require payment of the gift tax when the credit is exhausted. This, in turn,
imposes a further drain on the donor unless the gift is given in the form of a net gift. A net gift is
one in which the donee agrees to pay the gift tax. The gift tax liability assumed by the donee re-
duces the amount of the taxable gift made by the donor.\(^{151}\)

However, a net gift may involve income tax problems as discussed in ¶410.07. Also, under the
unified estate and gift tax system, taxable lifetime gifts are “adjusted taxable gifts” and may af-
fect the estate tax calculation, possibly pushing the estate into becoming a taxable estate.\(^{152}\)
Again, consider the generous transfer tax exclusions available for 2017 and beyond.

- Unearned income of a child in excess of $2,100 (2017) is taxed at the greater of the child’s or
parents’ top rate if the child is under age 19 or under age 24 and a full-time student.\(^{153}\) When
making gifts to children, the donor should consider transfers of property that will generate little
or no taxable income until the child reaches age 19 or 24, as the case may be.

For these reasons, if the financial situation of the client is strong enough, the financial planner should
consider recommending a planned, ongoing gift program that makes use of at least the $14,000 (for
2017, indexed annually for inflation) annual exclusion\(^{154}\) and gift splitting.\(^{155}\) Also, take advantage of the
unlimited gift tax exclusion that applies for direct payment to the service providers of tuition and medi-
cal expenses (¶405.02).\(^{156}\)

\(^{149}\) IRC Section 2503(b).

\(^{150}\) IRC Sections 2010 and 2505.

\(^{151}\) Revenue Ruling 75-72, 1975-1 CB 310.

\(^{152}\) IRC Section 2001(c).

\(^{153}\) IRC Section 1(g).

\(^{154}\) IRC Section 2503(b).

\(^{155}\) IRC Section 2513(a).

\(^{156}\) IRC Section 2503(e).
The risk of a spouse with substantial property dying before completion of the ongoing gift program may be reduced by a gift to the other spouse. The unlimited marital deduction (assuming the donee spouse is a U.S. citizen) bars a gift tax.\textsuperscript{157} Portability may also be useful in this situation.

The financial planner should give some consideration to recommending insurance on the life of the donor to

- pay for the increased estate tax liability that would result from non-completion of the gifting program and
- provide any additional liquidity that the estate might need.

The loss of gift splitting and the unlimited marital deduction on the death of the spouse engaging in the ongoing gift program might be a factor warranting insurance on the life of the other spouse.

\textbf{.05 Timing Strategies}

Timing is important when developing a gift strategy. The following are some key factors to consider:

**Stock market low points.** If gifts of securities are contemplated, the donor should make the gift at low points in the market to minimize the gift tax liability or use of the applicable credit amount.

**Year-end.** The law does not allow a carryover for an unused annual gift tax exclusion. Therefore, as year-end approaches, the gift situation requires review. The annual exclusion is “use it or lose it” for each year.

**Deathbed of donor.** As a general rule, deathbed gifts are not includible in the donor’s gross estate. However, deathbed gifts of interests in property otherwise included in the value of the gross estate under IRC Sections 2036, 2037, 2038, or 2042 (or those gifts which would have been included if the interest had been retained by the decedent) are includible.\textsuperscript{158} Be careful giving low basis property as deathbed gifts; generally this is not advisable because the donor’s basis in the property will pass to the donee.

In addition, all transfers within three years of death (other than those eligible for the annual exclusion) will be included for the purpose of determining the estate’s qualification for special corporate stock redemption,\textsuperscript{159} special use valuation,\textsuperscript{160} deferral of estate tax payments,\textsuperscript{161} and for the purpose of determining property subject to estate tax liens.\textsuperscript{162}

\textsuperscript{157} IRC Section 2523(a).
\textsuperscript{158} IRC Section 2035(a).
\textsuperscript{159} IRC Section 303.
\textsuperscript{160} IRC Section 2032A.
\textsuperscript{161} IRC Section 6166.
\textsuperscript{162} IRC Section 2035(c).
Dealthbed gifts in unlimited amounts may be made to the donor’s spouse without estate or gift tax consequences under the unlimited marital deduction.\textsuperscript{163} Gift splitting\textsuperscript{164} by married persons of gifts to third parties may be used to take advantage of the annual exclusion. Gift splitting allows gifts of $28,000 per donee in 2017\textsuperscript{165} without use of the unified credit. See ¶430 for a more detailed discussion of gifts made within three years of the donor’s death. Again, be mindful of the distinction between carryover basis gifts and stepped-up basis gifts.

**Death of consenting spouse.** Generally, gifts made within three years of death are not included in the decedent’s gross estate. However, under IRC Section 2035(b), any gift tax paid on gifts made by the decedent within three years of death is includible in the gross estate of the decedent.

As a result, deathbed consents to gifts by a donor’s spouse can reduce the amount of the gift tax on gifts in excess of $28,000 in 2017 and will eliminate the gift tax on gifts of less than that amount. Although no part of the gifts consented to would be includible in the consenting spouse’s gross estate, the consenting spouse’s share of any taxable gifts would be treated as part of the consenting spouse’s adjusted taxable gifts for estate tax calculation purposes and would reduce the decedent’s applicable exclusion for purposes of portability (¶1005).

.06 The Bargain Sale Gift

A donor may own a piece of property that a prospective donee could put to good use. However, the property could be worth a lot more than the donor would like to give. The donor has several options in such circumstances. For one, the donor could transfer only a joint interest in the property. The donor would still have responsibility with respect to the property while limiting the prospective donee’s rights. These are two results the donor might not have intended. Another idea is to make a gift of only a fractional share of the property to the donee. Another idea would be to sell the property for less than its fair market value (a bargain sale) to the donee.

For gift tax purposes, a bargain sale may be treated as a gift to the extent of the bargain (that is, the amount by which the property’s fair market value exceeds the price paid by the donee).\textsuperscript{166} Obviously, in the business world, a person selling at a price that could be considered a bargain is not going to incur a gift tax. There is no gift when a price is arrived at through arm’s-length negotiation by unrelated parties. However, a gift occurs when the transferor has donative intent, the purchaser is a natural object of the transferor’s bounty, and the sale is not an arm’s-length transaction.

Even when a situation resembling gifting exists, for many types of property, different individuals could have many honest differences of opinion about what constitutes fair market value. A transaction is not necessarily a gift merely because the price is not fixed in the upper ranges of estimates of market value.

\textsuperscript{163} IRC Section 2523(a).

\textsuperscript{164} IRC Section 2513(a).

\textsuperscript{165} IRC Section 2503(b).

\textsuperscript{166} IRC Section 2512(b).
Of course, if listed securities, mutual funds, or a life insurance policy is involved, the parties will have less room for differences of opinion about fair market value at the time the transaction occurs.

The part-sale, part-gift transaction results in gain or loss to the seller to the extent that the sales proceeds exceed the portion of the adjusted basis of the property allocated to the sale portion.\textsuperscript{167} IRC Section 267 disallows a loss deduction on transactions between certain closely related family members and some other related parties, such as controlled business entities or trusts and estates and their beneficiaries. The buyer-donee takes the donor’s basis for the gift portion, plus an adjustment for gift tax the donor pays, if any, based on the appreciation of the property,\textsuperscript{168} and would add to that the amount, if any, paid to acquire the property to complete the donee’s basis calculation.\textsuperscript{169}

\textbf{.07 The Net Gift Technique}

The \textit{net gift technique} essentially involves a gift made on condition that the donee pay the gift tax. A definitive revenue ruling, a U.S. Supreme Court decision, and a U.S. Tax Court decision now limit the technique’s usefulness and value:

- Under the revenue ruling, the donor must first exhaust his or her unified credit (applicable credit amount) before any gift tax is payable by the donee.\textsuperscript{170}

- Under the U.S. Supreme Court decision, when a donor makes a gift and the donee pays the federal gift tax due, the donor has taxable income to the extent, if any, that the gift tax paid exceeds the donor’s adjusted basis in the gifted property.\textsuperscript{171}

The \textit{Diedrich} rule might adversely affect the use of the net gift technique when it might otherwise be useful. However, with appropriate tax planning, donors can reduce the impact of \textit{Diedrich} through selection of the gift property, using property when any gift tax to be paid by the donee will not exceed the donor’s basis and, if this is not possible, by taking steps to offset any income tax liability that the donor might incur.

- Under the U.S. Tax Court decision, a decedent’s gross estate includes the amount of gift tax paid by donees on net gifts made by the decedent within three years of death.\textsuperscript{172}

Only Connecticut presently imposes a gift tax outside of the federal government. In that jurisdiction, the donee’s agreement to pay the gift tax raises the following federal and state income and gift tax issues:

\textsuperscript{167} IRC Section 1001.
\textsuperscript{168} IRC Section 1015.
\textsuperscript{169} IRC Section 1012.
\textsuperscript{170} Revenue Ruling 81-223, 1981-2 CB 189.
\textsuperscript{171} \textit{V.P. Diedrich}, 457 U.S. 191 (1982).
\textsuperscript{172} \textit{S.C. Sachs Est.}, 88 T.C. 769 (1987), \textit{aff’d}, 856 F.2d 1158 (8th Cir. 1988).
• Federal income tax. Under the part-sale, part-gift approach of Diedrich, the donee’s agreement to pay the state gift tax should serve to increase the donor’s gain. If both the donor and donee are jointly and severally liable for the state gift tax, only one-half of the gift tax liability increases the donor’s gain.

• Federal gift tax. The amount of the gift tax paid by the donee reduces the value of the gift for federal gift tax purposes. However, if the donor and donee under state law are jointly and severally liable for the gift tax, only one-half of the gift tax paid by the donee will reduce the value of the gift.

• State income tax. In a state with an income tax, the law would likely apply the principle of Diedrich to tax the donor on gain resulting from the donee’s assumption of gift tax liability unless the state law otherwise provides.

• State gift tax. The donee’s assumption of state gift tax liability should serve to reduce the value of the gift for state gift tax purposes absent any state law provision for credit against gift tax liability. In the latter case, the state might adopt a requirement of exhaustion of the credit as under federal law. A state law providing that the donee’s payment or agreement to pay the state gift tax is not consideration for the gift will not reduce the value of the gift.

The Tax Court has determined that it will no longer follow its decision in McCord v. Commissioner, 120 T.C. 358 (2003), a case in which it held that a couple had improperly reduced their gross gift value by the actuarial value of the donees' obligation to pay any potential estate taxes that might result under IRC Section 2035(b) if the couple was to die within three years of the gift.

In Steinberg v. Commissioner, 141 T.C. 258 (2013) and 145 T.C. No. 7 (2015), the taxpayer gifted securities and cash to her daughters and, in exchange, the daughters agreed to assume and pay, among other things, any estate tax liability imposed under IRC Section 2035(b) as a result of the gifts if the donor died within three years—a so-called "net net gift." The Tax Court rejected the IRS's request for summary judgment and held that, because the value of the obligation assumed by the daughters was not barred as a matter of law from being consideration in money or money’s worth, the fair market value of mother's taxable gift could possibly be reduced by the daughters' assumption of the potential IRC Section 2035(b) estate tax liability.

¶415 Direct and Indirect Gifts

The gift tax has been given a very broad reading by the U.S. Supreme Court. It applies to both direct and indirect gifts. A direct gift may be made by the creation of a trust, the forgiveness of a debt, the as-

173 Revenue Ruling 76-49, 1976-1 CB 294 (N.Y.); Revenue Ruling 76-57, 1976-1 CB 297 (N.C.); and Revenue Ruling 76-104, 1976-1 CB 301 (Calif.).


175 Revenue Ruling 76-104, 1976-1 CB 301 (Calif.).

assignment of a judgment, the assignment of the benefits of an insurance policy, or the transfer of cash, stock, real estate, certificates of deposit, or federal or municipal bonds. An indirect gift may be made by the payment of another person’s expenses, except when a legal obligation exists to pay the expenses (for example, a parent providing support for a minor child or where a specific gift tax exclusion applies, such as payment of another’s tuition or medical care directly to the education or medical service provider). An interest-free loan is considered a gift. A gift can be made by a transfer from a donor to a second person to benefit a donee. For example, if A makes a transfer to B in return for B’s promise to pay C an annuity, a gift from A to C would occur if the annuity is equal to the value of the transfer from A to B. If B’s promise to C is worthless, then A has made a gift to B.

Creation and transfer of a family partnership interest might constitute a gift, as might a renunciation or disclaimer of a bequest or devise. Regulation Section 25.2511-1(c) contains detailed provisions dealing with the gift tax consequences of such renunciations or disclaimers, but makes reference to IRC Section 2518 for rules relating to qualified disclaimers, which can avoid characterization as gifts.

The broad reading given the gift tax by Dickman has, in effect, given the IRS a license to explore the outer reaches of the federal gift tax.

The IRS has ruled, for example, that the failure of a controlling shareholder who owns preferred stock to have the corporation declare a preferred stock dividend constitutes a gift to younger generation shareholders of the corporation to the extent of the preferred dividends foregone. The ramifications of the U.S. Supreme Court’s broad reading might be to bring a variety of intra-family transactions within the gift tax net.

In fact, non-action has been deemed to constitute a gift. In E.W. Snyder, the U.S. Tax Court held that a taxpayer, by failing to convert noncumulative preferred stock into cumulative preferred stock, which would have entitled the taxpayer to accumulated dividends, made an indirect gift to the common shareholders.

This chapter is not intended to offer an encyclopedic treatment of the subject of indirect gifts but simply to call attention to the basic fact that anytime someone transfers property for less than adequate and full consideration in money or money’s worth, a potentially taxable gift occurs.

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177 Regulations Section 25.2511-1(a).
178 IRC Section 2503(e).
179 Dickman, supra.
180 Regulations Section 25.2511-1(h)(2) and (3).
¶420 Gifts in Trust

Lifetime giving can spring from many motives. In a family, income splitting might be among such motives. Under the assignment of income doctrine, one may not separate the dividend from the stock, the interest from the bond, the "fruit from the tree," as it were. If shifting income is the goal, one must transfer the underlying property producing the income. The potential donor might not be ready to make such an outright transfer. The donee might also not be ready for the property with all of its responsibilities. If the donee is a minor, the donor could use one or more of the approaches discussed in ¶425 to accomplish the purpose of the transfer, including the special types of trusts more suitable for gifts to minors.

If the donee is not a minor, some other form of trust may be the most efficient way of splitting income and satisfying the needs of both the donor and the donee. Not all trust forms effectively shift income. Some trusts, in addition to shifting income, are effective in reducing the estate taxes of their creators. Some gifts in trust qualify for the annual gift tax present interest exclusion. However, other gifts in trust are deemed to be gifts of future interests and, thus, ineligible for the annual exclusion.

Chapter 6, "The Use of Trusts," discusses the ramifications of trusts in much greater depth. However, one point is worth noting here. Because the income tax brackets of trusts are highly compressed, trusts that accumulate income are far more costly than custodianships. The latter can accumulate income until a minor reaches the age of majority, but the income is taxed directly to the minor, possibly subject to the kiddie tax at the parents’ tax rate. The accumulation of income is treated much less favorably for a trust. For example, for tax years beginning in 2017, the 15-percent rate applies to a trust’s taxable income up to $2,550; the 25-percent rate applies to taxable income between $2,550 and $6,000; the 28-percent rate applies to taxable income between $6,000 and $9,150; the 33-percent rate applies to taxable income between $9,150 and $12,500; and the 39.6 percent rate applies to taxable income over $12,500. A single person who has attained age 19 and is not a full-time student, on the other hand, is taxed in 2017 at a rate of 10 percent on taxable income up to $9,325; at 15 percent for taxable income between $9,325 and $37,950; and at 25 percent between $37,950 and $91,900. Higher rates apply on taxable income above that amount.

¶425 Gifts to Minors

Gifts from parents to children and from grandparents to grandchildren are the most common lifetime gifts.

Many of these gifts will be to minors. Many gifts will be made without any particular thought to legal or tax consequences, which is fine if the gifts are small. As the gifts increase in size, the donors should consider the tax and legal factors more carefully. The kiddie tax has an especially severe impact on gifts to minors (¶405.05).

The tax laws are concerned with taxing gifts at every opportunity, subject to available exclusions. A gift made to a newborn infant is clearly taxable unless it falls within the $14,000 (for 2017, indexed annually for inflation) annual exclusion. State laws, however, are concerned with the legal capacity of an infant.

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183 IRC Section 1(g).

184 IRC Section 2503(b).
to possess and own property, take care of it, and sell and transfer it. They are also concerned with the protection of the rights of the infant.

These state law concerns are responsible for laws barring registration of securities in a minor’s name; providing for the appointment of judicially supervised guardians of the property (and person) of minors; limitations on the power of a minor to contract; and many other restrictions and limitations. All of these restrictions complicate making gifts to minors and bring into play trusts, custodianships, and guardianships as vehicles for gifts to minors to help protect their interests. Each of these vehicles differs from the others in one or more respects.

Exhibit 4-2 (¶425.04) compares outright gifts, custodianships, guardianships, and four different types of trusts that may be used as vehicles for gifts to minors. The comparison is in terms of a variety of different legal, tax, and practical factors, all of which are developed in the more detailed discussion of each vehicle in the numbered paragraphs following exhibit 4-2.

.01 Factors to Consider When Choosing a Planning Vehicle

When considering these different vehicles, the financial planner should keep the following factors in mind:

Income shifting. A family can realize limited income tax savings when a parent transfers income-producing property or money to an account in the name of a minor child or to a custodial account, guardian, or trust for the child. Unless the child is age 19 or older, or, if a full-time student, age 24 or older, the child’s unearned income in excess of $2,100 (for 2017) is taxed at the greater of the child’s tax rate or the parent’s top rate.\(^{185}\) When the child reaches age 19 or 24, as the case may be, the income will no longer be taxed at the parent’s rate, but the child will be without the benefit of a personal exemption and will have only a $1,050 standard deduction to shield unearned income (assuming the child can still be claimed as a dependent). Thus, for 2017, the child will be taxable at a 10-percent rate on unearned income over $1,050 up to taxable income of $9,325 and at higher rates for earned income above that level. For example, a single person’s taxable income between $9,325 and $37,950 is taxed at 15 percent for 2017. The rate rises to 25 percent for taxable income between $37,950 and $91,900. The maximum rate of 39.6 percent applies to taxable income over $418,400.

The potential 29.6 (39.6 percent rate − 10 percent rate) point spread makes for considerable interest in income splitting once the child reaches age 19. The spread can be even further heightened for taxpayers caught by the 3.8 percent tax on net investment income, as well as progressive state and local income taxes.

Consider this simple example, showing family tax savings by a transfer of $1,000 in income from a parent at various tax bracket levels to a minor child without other taxable income.

\(^{185}\) IRC Section 1(g).
**Highly compressed income tax brackets of trusts.** The income tax brackets of trusts are highly compressed when compared to the brackets of other categories of taxpayers. For example, for tax years beginning in 2017, the 15-percent rate applies to a trust’s taxable income up to $2,550; the 25-percent rate applies to taxable income between $2,550 and $6,000; the 28-percent rate applies to taxable income between $6,000 and $9,150; the 33-percent rate applies to taxable income between $9,150 and $12,500; and the 39.6 percent rate applies to taxable income over $12,500.

This rate structure obviously affects the use of trusts as income-shifting vehicles. In many cases, custodial accounts may be preferable to IRC Section 2503(c) minors’ trusts. With a custodial account, the income is taxed directly to the child (subject to the kiddie tax rules) even though it is accumulated until the child reaches the age of majority. Income accumulated in a trust would be subject to the highly compressed brackets described previously.

**Income used for support.** Income of a trust actually applied or distributed to the support or maintenance of a beneficiary whom the grantor of the trust is legally obligated to support or maintain is taxable to the grantor under IRC Section 677(b). The IRS has ruled that the same rule applies to custodial accounts.186 In addition, a guardianship may be held to be a trust under state law so that IRC Section 677(b) would be brought into play.187

The amount taxable to a person obligated to support a minor is limited to the extent of his or her legal obligations under local law.188

This area is one in which the financial planner must watch state law developments closely. Under some circumstances, private school expenses have been considered support obligations.189 Further, college education and, indeed, graduate school education, might be deemed to be within the ambit of parental support obligations, although the child may have attained adulthood.190

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<thead>
<tr>
<th>Parent’s Top Tax Bracket</th>
<th>Family Tax Savings</th>
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<tbody>
<tr>
<td>25%</td>
<td>$250</td>
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<tr>
<td>28%</td>
<td>$280</td>
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<tr>
<td>33%</td>
<td>$333</td>
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<tr>
<td>35%</td>
<td>$350</td>
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<tr>
<td>39.6%</td>
<td>$396</td>
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</tbody>
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186 Revenue Ruling 59-357, 1959-2 CB 212.
187 C.P. Brooke, 468 F.2d 1155 (9th Cir. 1972).
188 Revenue Ruling 56-484, 1956-2 CB 23.
Braun was decided under New Jersey law. In New Jersey, the support obligation rests on the parents’ financial circumstances, education, attitudes toward education, and other factors. The cautious financial planner in other states will want to take Braun and Stone into account.

**Planning Pointer.**

- The financial planner should consider the following as a means of avoiding or cushioning the concerns posed by these cases: Discuss the cases and the risks with the client.
- Provide for payment of income to adult beneficiaries.
- Provide in the trust that income is not to be applied to any item judicially or legislatively determined to be a support obligation.
- When possible, have grandparents fund the trusts because they would have no support obligation for the child’s higher education.
- If grandparents lack the resources, consider gifts from the parents to the grandparents, who would then have funds to set up the trust. Of course, the parties must implement this plan in such a way to avoid the IRS reclassifying the transactions as gifts from parents under the step transaction doctrine.

One should also be aware of the reach of IRC Section 677(a). Under this provision, the grantor of a trust may be taxed on trust income used to satisfy a grantor’s express or implied legal and contractual obligations. This provision may also apply to guardianships that, under state law, are regarded as trusts. Under this section, although a parent might not have an obligation of support, trust income may be taxable to the parent-grantor if it is used to discharge an express or implied obligation of the grantor.191 From this perspective, a parent who has assumed express (or implied) liability for his or her child’s college tuition might be held taxable on trust income used to pay tuition. This result could occur, although a college education, under local law, might not be within the parent’s support obligation.

.02 Custodianships

All states have special laws that make gifts to minors easier and safer. The Uniform Gifts to Minors Act (UGMA) came to be adopted in almost all states. More recently, it has been superseded in many states by the Uniform Transfers to Minors Act (UTMA), which significantly broadens the UGMA. For example, UTMA places no limitations on the types of property transferable. Real estate, limited partnership interests, patents, tangible personal property, and other forms of property may be transferred. In addition, custodians have all powers over custodial property that unmarried adult owners have over their own property, subject to fiduciary obligations. This allows UTMA custodians to enter into a broad range of business transactions.

To advise a client on making a gift to a minor under either Uniform Act, the financial planner should check the exact language to be used under local law because some variations might exist in the Uniform Acts from state to state. The financial planner should also check local law about the custodian’s respon-

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sibilities and duties. The Uniform Acts originally set the age of majority at 21, but the age of majority has since been lowered in many states.

Both Uniform Acts provide for paying over the custodial property on attaining a specified age. UTMA sets the age at 21 for gift property and at 18 or other state statutory age for other property. UGMA age has been lowered in some states. The financial planner should check applicable state law.

**Income tax aspects.** When a custodial account is created for a child subject to the kiddie tax, any unearned income over $2,100 (2017) is taxed to the child at the greater of the child’s rate or the parent’s marginal tax rate\(^{192}\) without the benefit of a personal exemption, provided that the child is eligible to be claimed as a dependent by the parents. After making use of the benefit of a $1,050 standard deduction, another $1,050 of the child’s unearned income will be taxed at the child’s rate.

When the child reaches age 19 or, in the case of a full-time student, age 24, the income from the account will no longer be taxable at the parents’ rate, but the child will still be without the benefit of a personal exemption (assuming the child is still a dependent). However, the $1,050 standard deduction may still be used to shield unearned income. Thus, for 2017, the child will be taxable at a 10-percent rate on unearned income over the $1,050 covered by the standard deduction up to $9,325 and at higher rates for earned income above that level. For example, a single person’s taxable income between $9,325 and $37,950 is taxed at 15 percent for 2017. The rate rises to 25 percent for taxable income between $37,950 and $91,900. The maximum rate of 39.6 percent applies to taxable income over $418,400.

If the income from the gift is used to discharge someone else’s obligation, the income is taxable to that individual. If the income is used to satisfy a duty of support, it is taxable to the parent or the person under a legal duty of support, regardless of whether or not he or she made the gift or is the custodian.\(^{193}\)

### Planning Pointer.

The income tax brackets of trusts are greatly compressed, which serves to make custodial accounts far better than trusts in saving family income taxes. For example, for tax year beginning in 2017, the 15-percent rate applies to a trust’s taxable income up to $2,550; the 25-percent rate applies to taxable income between $2,550 and $6,000; the 28-percent rate applies to taxable income between $6,000 and $9,150; the 33-percent rate applies to taxable income between $9,150 and $12,500; and the 39.6 percent rate applies to taxable income over $12,500.

### Estate tax aspects.** If the minor dies before the funds in the account are distributed, the amount in the fund is includible in the minor’s gross estate. It is not includible in the donor’s gross estate unless the donor is also the custodian and dies before the minor attains the age of majority. This result, as applied to UGMA transfers, follows from federal estate tax law and should be the same with respect to UTMA transfers. A gift may not, as a general rule, be includible in the gross estate of the donor even though made within three years of the donor’s death, unless it is a gift of an insurance policy or otherwise falls under IRC Section 2035 (¶430).

\(^{192}\) IRC Section 1(g).

\(^{193}\) Revenue Ruling 56-484, 1956-2 CB 23.
Except when insignificant amounts are involved, having the donor serve as custodian is not prudent and runs the risk of having the custodial funds included in the donor’s gross estate. The next logical candidate for the job might be the donor’s spouse, the other parent of the minor beneficiary. However, IRC Section 2041 might pose a problem. If the parent-custodian dies before the child attains the age of majority, the IRS might contend that he or she possessed a general power of appointment in that the property could be used to discharge the parent-custodian’s obligation of support. Of course, in many states, a parent cannot use a minor child’s money to discharge a legal obligation, and anyone living in a state where this is true would be safe in naming the non-donor spouse and parent of the minor as custodian. Reciprocal gifts made by the spouses at the same time and in the same amounts, each naming the other as custodian, run the risk of being treated as each naming himself or herself as custodian. Generally, if a trustworthy aunt, uncle, or other relative is willing to serve as custodian, naming that person as custodian would be safer.

Gift tax aspects. Gifts made under either UGMA or UTMA qualify for the annual gift tax exclusion of $14,000 (for 2017 and indexed annually for inflation), or double that amount if the donor’s spouse consents. Both UGMA and UTMA, of course, were carefully framed to ensure this result under the provisions of IRC Section 2503(b) and (c). Just as there is an estate tax danger if a parent serves as custodian, a possible gift tax danger also exists. The danger arises because IRC Section 2514 provides that the release or lapse of a general power of appointment is a gift. Under a somewhat strained interpretation of that section, the IRS might maintain that when a parent-custodian turns over the funds to the beneficiary when the beneficiary attains the age of majority, the parent-custodian releases a general power of appointment to use the custodial funds for support. However, such power may be negated by local law requirements. Still, this possibility offers another reason for not having a parent with a duty of support serve as custodian, whether or not the parent is the donor.

.03 Guardianships

A legal guardian may be made the recipient of a gift to a minor. The guardian has custody and management of the minor’s property and has fiduciary responsibilities akin to those of a trustee. However, the guardian does not hold legal title to the property as does a trustee. Courts have held that a court-administered guardianship may be considered a trust for the purpose of IRC Section 677(b). Under that provision, the trust grantor is taxable on trust income used to discharge a support obligation. For example, when the father of minor children is appointed their legal guardian, he may be taxable on income used for their support, as defined by local law.

Unearned income of a child in excess of $2,100 (2017) is taxed at the greater of the child’s rate or the parent’s marginal tax rate, if the child is under the age of 19, or under the age of 24 if the child is a full-time student. Once the child reaches age 19 or 24, as the case may be, income held in a guardianship
is taxable to the child even though it is accumulated and not paid to him or her or currently used for his or her benefit, aside from amounts used for support that may possibly be taxed to a parent. The guardian is obligated to file the minor’s income tax return. The property given is removed from the donor’s gross estate. The gift is treated as a gift of a present interest, for which the $14,000 (for 2017 and indexed annually for inflation) annual exclusion is available.199

A guardianship assures the minor of greater protection of his or her property rights than either a trust or custodial account. Guardianships require accountings, bonding, and court supervision, the form and content varying with local law. However, a guardianship involves higher costs in the form of initial legal fees, bonding costs, guardian fees (unless the appointed family member is willing to waive fees), and the costs of accounting and terminating the guardianship. Termination at age 21, or at an earlier age of majority, may be another negative factor when compared to trusts of possibly longer duration. Another factor meriting consideration is that when a gift is made to a guardian, one cannot provide that if the minor dies before the guardianship ends, the interest passes to a contingent beneficiary, as one can with a trust. Hence, if the minor lacks the capacity to make a will (as is the case in many states), upon death, the property might revert to the parent-donor. The result would be that the parent might lose the income tax and estate tax savings sought in the first instance, at least until the parent makes some further disposition of the property.

Still, a court-appointed parent-guardian would not likely be vulnerable to the arguments made in connection with custodial accounts. These include the argument that the custodial property would be includible in the gross estate of the parent-custodian predeceasing the minor or the contention that turning over the property to the minor at the end of the guardianship could amount to the release of a general power of appointment.

.04 Trusts for Minors

The financial planner might think of a trust for a minor as something that the financial planner is basically free to design. The trust may provide what is to be done with the trust income, whether it is to be distributed to the minor or accumulated, or both; how long the trust will last; who will serve as trustee (and how a successor will be selected, if that should become necessary); when and how the principal of the trust will be distributed; and many other details. However, the settlor should not think that once the trust is created, the settlor is then free to do with it as desired. If the settlor does so, he or she will be treated as the owner for income and estate tax purposes. Still, if substantial gifts are involved, the benefits of a trust might outweigh its costs. The greatest flexibility is found in a broad, general type of trust suitable for adult beneficiaries, as well as for minors. This broad, general type of trust is discussed in ¶420 of this chapter. Here, the focus is on two special types of trusts that are widely used as vehicles for gifts to minors. The IRC Section 2503(c) trust deals with the availability of the $14,000 (for 2017, indexed annually for inflation) annual gift tax exclusion for transfers for the benefit of minors. The other is the offspring of IRC Section 2503(b), which makes the annual exclusion available only for gifts of present interests and so mandates current income distributions from the trust if that requirement is to be satisfied.

These two different types of trusts are examined in greater detail in the following paragraphs. The essential difference lies in how the trusts distribute income and principal (corpus). The Section 2503(c) type

199 IRC Section 2503(b).
trust does not require the current distribution of income but does require the possible distribution of the "property and the income therefrom," a phrase discussed subsequently, which may possibly require distribution of principal on the minor’s attaining age 21. The Section 2503(b) type trust requires current distribution of income but does not require distribution of principal on the minor’s attaining age 21. Trusts that accumulate income are far more costly from a tax standpoint because of the highly compressed income tax rates applicable to trusts. The financial planner should keep this rate structure in mind when choosing between an IRC Section 2503(b) trust, which pays out income, and an IRC Section 2503(c) trust, which may accumulate income. Likewise, the financial planner should consider income tax rates when considering a custodianship, which may accumulate income that is taxed directly to the minor on whose behalf the account is established.

Section 2503(c) trust to last during minority. IRC Section 2503(c) gave rise to the Section 2503(c) trust. The section itself says nothing about trusts. It merely describes a specific form of transfer for the minor’s benefit that will qualify as a gift of a present interest to make the $14,000 (for 2017, indexed annually for inflation) annual exclusion available.

IRC Section 2503(c) provides that a gift to an individual who is not yet 21 will not be considered a gift of a future interest (that is, it will be considered a gift of a present interest) if the gift "property and the income therefrom" (1) may be expended by, or for the benefit of, the donee before attaining the age of 21 years and (2), to the extent not so expended, will be paid to the donee upon reaching 21 or, if the donee dies before then, will be paid to the donee’s estate or to such persons as the donee appoints under a general power of appointment. Although legal restrictions on a minor’s ability to exercise the power do not affect the annual gift tax exclusion, the donor will lose the benefit of the annual exclusion if a provision in the document regarding the exercise of the power is more restrictive than the applicable state law.

An important point to note is that the IRC section does not require that "the property and the income therefrom" be used for the minor’s benefit during minority in order for the gift to be regarded as a gift of a present interest, only that it may be. Thus, these trusts do not require the current distribution of income. However, the financial planner should remember that income actually accumulated in the trust will be taxed at the highly compressed brackets that apply for trusts, as discussed previously.

Another important point is that the IRC section uses the phrase "the property and the income therefrom." It does not refer to principal or corpus. A gift may be separated into component parts, one of which may qualify as a present interest under the statute. Accordingly, courts have held that a gift of income only may satisfy the statute and qualify as a gift of a present interest. Further, such interest will not fail to qualify because it is coupled with other interests that are future interests. Thus, courts have held that a trust that provided all income up to the age of majority must be paid to the beneficiary or expended for the beneficiary’s benefit before the age of majority, or be paid over to the beneficiary at age 21 or to the beneficiary’s estate or appointee in the event of death prior to 21, qualified for the annual gift tax exclusion, even though the trust also provided for further payments of income after the beneficiary attained age 21 until age 30 and did not allow the trust principal to be paid over to the trust beneficiary until age

200 Regulations Section 25.2503-4(b).

201 G. Gall, 521 F.2d 878 (5th Cir. 1975), aff’g D.C. Tex., 75-1 USTC ¶13,067.
The IRS goes along with the determination that a gift of trust income to a minor satisfies the requirements of IRC Section 2503(c), even though the beneficiary has no interest in the corpus at age 21. Herr provides an important planning tool that makes the $14,000 (for 2017, indexed annually for inflation) annual exclusion available, although corpus is not required to be distributed at age 21.

Further, Revenue Ruling 74-43 provides that, if the beneficiary, upon attaining age 21, is given a right for a limited period to require immediate distribution of the trust corpus by giving written notice to the trustee, the annual exclusion will be available. Upon the beneficiary’s failing to do so, the trust may be drafted to continue automatically for whatever period the donor provided when setting up the trust. Because the ruling does not address the question of whether the trustee is required to notify the beneficiary of this right, the settlor might be wise to deal with a notice provision in the trust. When fixing the time within which the beneficiary is to act, a reasonable time to reflect on the choice and to act should be allowed (for example, 60 days were found to be reasonable in IRS Letter Ruling 8507017).

Although a trust may delay distribution of corpus, as shown previously, the trust may also provide for the distribution of corpus and income before age 21 if that should be desired. The IRS has ruled that age 21, as referred to in IRC Section 2503(c), is the maximum age at which the turnover must be made, not the minimum age. If the sums involved are not too large, a distribution at age 18 (as a beneficiary is about to enter college, for example) might be thought appropriate.

In any event, the price to be paid for the present interest concession is that the "property and the income therefrom" must generally be payable to the donee upon turning 21 at the latest, if not sooner. If large sums are to be paid over, this requirement can be a serious, practical limitation on the use of this type of trust.

If the sums involved are not too large, the donor might want to mark the donee’s coming of age by distributing the trust funds. On the other hand, the donor might feel more comfortable if the trust were to continue until age 25 or some other age. The donor may do so either by the technique used in Herr or pursuant to Revenue Ruling 74-43, both of which are discussed previously.

Many planners use a Crumney trust when planning for minor beneficiaries. The trust includes a power of withdrawal to protect the grantor’s annual exclusion gift as a present interest (typically addressed and declined by the minor’s parents) and extends the permitted distribution period to the minor beneficiary to any age the grantor desires, possibly for the lifetime of the minor to provide asset protection and to avoid inclusion of the trust property in the minor’s future estate.

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201 A.I. Herr, 35 T.C. 732 (1961), aff’d, 303 F.2d 780 (3d Cir. 1962).


203 1974-1 CB 285.

204 November 19, 1984.

**Income and estate tax aspects.** An IRC Section 2503(c) trust is a separate taxable entity. To the extent that income is accumulated, it is taxable to the trust. For example, for tax years beginning in 2017, the 15-percent rate applies to a trust’s taxable income up to $2,550; the 25-percent rate applies to taxable income between $2,550 and $6,000; the 28-percent rate applies to taxable income between $6,000 and $9,150; the 33-percent rate applies to taxable income between $9,150 and $12,500; and the 39.6 percent rate applies to taxable income over $12,500. Thus, accumulating income in trusts can be extremely costly. A custodial account may accumulate income at far less tax cost.

Another concern of Section 2503(c) trusts is IRC Section 677(b), under which income applied to or distributed for the support of a beneficiary whom the grantor is legally obligated to support will be taxable to the grantor. A lowered age of majority, relieving the parent-grantor of the obligation of support earlier, might help here, as well as distributions used for purposes not falling within the support obligation under local law (¶425). Consider inserting language in the trust prohibiting the use of the trust for the support of the beneficiary.

Generally, the trust property is not includable in the donor’s gross estate.

The availability of the $14,000 (for 2017) annual exclusion for Section 2503(c) trusts has already been discussed. However, gift splitting\(^\text{207}\) is also available, making possible gifts of as much as $28,000 (for 2017) per year per donee. Transfers to a Section 2503(c) trust are permitted at annual intervals. Thus, the annual exclusion and gift splitting will, over a period of years, permit a substantial fund to be accumulated. For example, based on the current annual exclusion, the fund could have $280,000 plus accumulated interest and principal appreciation over a period of 10 years.

---

**Exhibit 4-2: Comparison of Basic Forms of Gifts to Minors**

<table>
<thead>
<tr>
<th>Item of Comparison</th>
<th>Outright Gift</th>
<th>Custodianship</th>
<th>Guardianship</th>
<th>Regular</th>
</tr>
</thead>
<tbody>
<tr>
<td>Use of income for minor</td>
<td>Generally, no</td>
<td>Yes</td>
<td>Yes</td>
<td>Trust controls</td>
</tr>
<tr>
<td>Use of principal for minor</td>
<td>Generally, no</td>
<td>Yes</td>
<td>Yes</td>
<td>Trust controls</td>
</tr>
<tr>
<td>Judicial close supervision</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Fiduciary qualifications</td>
<td>No</td>
<td>Any adult or trust company</td>
<td>Court-approved</td>
<td>Donor-imposed</td>
</tr>
<tr>
<td>Risk in donor as fiduciary</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Possibly</td>
</tr>
<tr>
<td>Bonding required</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Only if the donor requires bonding</td>
</tr>
<tr>
<td>Accounting</td>
<td>No</td>
<td>Records kept; possible accounting</td>
<td>Yes</td>
<td>Generally, only private records need be kept</td>
</tr>
</tbody>
</table>

---

\(^{207}\) IRC Section 2513(a).
<table>
<thead>
<tr>
<th>Investments</th>
<th>Unlimited</th>
<th>Limited</th>
<th>Generally, unlimited</th>
<th>Generally, unlimited within donor’s control</th>
<th>Generally, unlimited</th>
<th>Generally, unlimited</th>
</tr>
</thead>
<tbody>
<tr>
<td>When minor gets title</td>
<td>Immediately</td>
<td>Immediately</td>
<td>Immediately</td>
<td>On termination or earlier distribution of income or principal</td>
<td>Possibly age 21; Trust controls</td>
<td>At age 21</td>
</tr>
<tr>
<td>When minor gets possession</td>
<td>Immediately</td>
<td>Age of majority</td>
<td>Age of majority</td>
<td>Trust controls</td>
<td>Trust controls</td>
<td>Generally, age of majority</td>
</tr>
<tr>
<td>Fiduciary’s death</td>
<td>No fiduciary</td>
<td>Inclusion of fund in estate possible</td>
<td>No effect except on successor appointment</td>
<td>No effect, generally, if trust is irrevocable and settlor retains no interest, otherwise includible in settlor’s estate</td>
<td>No effect</td>
<td>No effect</td>
</tr>
<tr>
<td>Minor’s death</td>
<td>Heirs of minor take unless minor has will effective under local law</td>
<td>Trust controls</td>
<td>Trust controls</td>
<td>Estate of minor or appointees</td>
<td>Minor’s estate</td>
<td>Minor’s estate</td>
</tr>
<tr>
<td>Tax liability for distributed income</td>
<td>Minor</td>
<td>Minor is generally taxable except as it is used to discharge parents’ obligation of support and is taxable to parents</td>
<td>Minor</td>
<td>Minor</td>
<td>Minor</td>
<td>Minor</td>
</tr>
<tr>
<td>Tax liability for undistributed Income Kiddie tax may apply</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>If present income interest</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gift tax annual exclusion</td>
<td>Yes</td>
<td>Yes, except if donor-custodian dies</td>
<td>Yes</td>
<td>Yes, except if settlor dies possessing forbidden powers or rights</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Exclusion of gift from estate of donor</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Cost</td>
<td>Generally, none or nominal</td>
<td>Generally, none or nominal</td>
<td>Legal fees and bonding costs and possible guardian’s fees</td>
<td>Legal fees varying with complexity, size of trust and other factors, and possible trustee fees</td>
<td>Legal fees to create trust; possible trustee fees; Annual tax returns</td>
<td>Legal fees to create trust; possible trustee fees; Annual tax returns</td>
</tr>
</tbody>
</table>

*Unearned income of child subject to the kiddie tax is taxed at the parent’s top rate, assuming the parents’ rate is higher than that of the child (IRC Section 1(g)).

If accumulated income and corpus are to be turned over to the minor at age 21, the settlor might not want to make contributions as large as those permitted to be made tax free through use of the full annual exclusion and gift splitting. If, however, the trust is to provide for distribution of income only at age 21 and retention of the corpus until a later age or for life, then the settlor might want to contribute larger sums. In such a case, separate computations would be required for the income interest and the gift of
corpus, using the IRC Section 7520 actuarial tables for the valuation of the respective interests (¶405). The gift of corpus would ordinarily be treated as a gift of a future interest for which the annual exclusion would not be available, unless the trust contained a Crummey right of withdrawal.\textsuperscript{208}

**Section 2503(b) current income trusts.** If a trust requires mandatory distribution of income to the trust beneficiary, at least annually, gifts to it will qualify as gifts of present interest and so become eligible for the $14,000 (for 2017, indexed annually) annual gift tax exclusion under IRC Section 2503(b). Such trusts are known as Section 2503(b) trusts. Except insofar as they require mandatory distribution of income, they permit much more flexibility in structuring than either the previously discussed Section 2503(c) trust or custodianships. Although one may structure a Section 2503(c) trust so that principal need not be distributed to the beneficiary, as discussed previously, a custodianship requires distribution of principal and unexpended income no later than age 21. The Section 2503(b) trust has no such requirement. It may last for a lifetime or any shorter fixed term. The principal need never pass to the income beneficiary but may go to other persons the donor-settlor designated or whom the income beneficiary may have been authorized to designate.

A Section 2503(b) trust created for a child under the age of 19 or, in the case of a full-time student, age 24, results in income in excess of $2,100 (2017) being taxed to the child at the greater of the child’s rate or the parents’ top rate.\textsuperscript{209} After the child reaches age 19 or age 24, as the case may be if the child is still a dependent, unearned income in excess of $1,050 (2017) will be taxed at the child’s rate, starting at 10 percent, except as the trust income may be taxed to the settlor-parent as having been used to discharge a parental obligation of support, as discussed in ¶425. These amounts are indexed annually to inflation.

The value of the entire trust property is treated as a gift. The gift has two parts: an income portion and a principal or remainder portion. Only the income portion qualifies for the gift tax annual exclusion. The other portion is a future interest and does not qualify.\textsuperscript{210} The value of the income portion for gift tax purposes is determined on the basis of IRS tables issued monthly pursuant to IRC Section 7520. The value varies depending on the duration of the income interest and the federal midterm rate for the month in which the valuation occurs (¶405).

The gift tax annual exclusion (doubled with gift splitting under IRC Section 2513(a)) makes possible a substantial build-up of trust funds through an ongoing program of annual gifts without incurring any gift tax liability. The future interest portion of the gift, however, would be subject to gift tax without the benefit of the annual exclusion. The allocation of a portion of the gift to a future interest would reduce the donor’s lifetime exclusion if the donor has exclusion available.

Under IRC Section 2503(b), the present income portion retains its status as such, even though the income portion may be reduced by a power given to the trustee to use principal. However, the power must be used for the income beneficiary and not for some other person.

\textsuperscript{208} IRC Section 2503(b).

\textsuperscript{209} IRC Section 1(g).

\textsuperscript{210} IRC Section 2503(b).
In Revenue Ruling 69-344, the IRS took the position that the annual exclusion is not allowable for a gift of property in trust that provides that all income must be paid to the beneficiary but also permits principal to be invested in non-income-producing property and life insurance policies. The IRS declared that the income interest had no value. Caution dictates that the trust instrument should specifically deny such power to the trustee.

430 Gifts Within Three Years of Death

Generally, the value of gifts made within three years of the donor’s death is not includible in the gross estate of the donor, and any post-gift appreciation will not be subject to transfer tax. Accordingly, such property will not be considered to pass from the decedent, and the stepped-up basis of IRC Section 1014 will not apply. The carry over basis rules of IRC Section 1015, which deals with the basis of gift property in the hands of the donee, will apply.

However, certain exceptions apply. Gifts of interests in property that would otherwise have been included in the gross estate under IRC Sections 2036 (retained life estate), 2037 (transfers taking effect at death), 2038 (revocable transfers), or 2042 (life insurance) or that "would have been included under any of such Code sections if such interest had been retained by the decedent" are included in the gross estate if transferred within three years of death.

The quoted language is from the IRC provision. It is intended to mean that if the decedent, within three years of death, releases or transfers an interest that would have been included in his or her gross estate under any of the cited sections, if it was retained until death (which is the operative fact under those sections), it will be included in the decedent’s gross estate under the exception to IRC Section 2035. Such interests are included in the transferor’s gross estate regardless of whether a gift tax return was required.

The value of property transferred to a donee from a decedent’s revocable trust within three years of the decedent’s death, and the value of property in such a trust with respect to which the decedent’s power to revoke is relinquished more than three years before death, is not includible in the decedent’s gross estate. This provision codifies the holdings of H. McNeely and E. Kisling Est.

All transfers within three years of death (other than gifts eligible for the annual gift tax exclusion) will be included for purposes of determining the estate’s qualification for special corporate stock redemption, determining property subject to the estate tax liens, and for special valuation and payment deferral purposes (under IRC Sections 303, 2032A, and 6166).

211 1969-1 CB 225.
212 IRC Section 2035(a).
213 IRC Section 2035(e).
214 16 F.3d 303 (8th Cir. 1994).
216 IRC Section 2035(c).
Assume the owner of a business interest wants to meet the percentage requirements that will enable the owner’s estate to take advantage of the previously cited IRC sections. The owner might make gifts of nonbusiness property to increase the value of the remaining business interest as a percentage of his or her adjusted gross estate. To be effective, the owner will have to make such gifts more than three years before his or her death.

IRC Section 2035(b), the so-called “gross-up provision,” continues to apply to all estates so that gift taxes paid on gifts made within three years of death are includible in the donor’s gross estate.

.01 Pros and Cons of Gifts Under the Three-Year Rule

The rule applicable to gifts made by decedents within three years of death offers these advantages:

- Any post-gift appreciation is not subject to transfer tax, so that property with such appreciation potential may be a proper subject for a gift.
- State gift taxes, if any, paid or payable, may be excluded from the gross estate.
- The value of the gift is not includible in the decedent’s probate estate so that all the advantages of avoiding probate attach, including savings in administration costs and the avoidance of delay and publicity.
- The unlimited marital deduction\(^{217}\) permits a married individual to make a lifetime gift to his or her U.S. citizen spouse in an unlimited amount without incurring gift tax. The individual also may do so at death,\(^{218}\) but at the price of including the bequest in the probate estate.
- If the gift is of income-producing property, post-gift income will not be includible in the donor’s gross estate.
- If the donee is in a lower tax bracket than the donor, post-gift income will be taxable at a lower rate. If the donee is the donor’s spouse and they file a joint return, this advantage would not be applicable.

One disadvantage is the gross-up rule on any gift tax paid by the donor within three years of death,\(^{219}\) which may not be a problem if the donor’s estate is not subject to the federal estate tax. A serious disadvantage (if no federal estate tax is due on the donor-decedent’s estate) is that the lifetime gift will also result in the loss of a step-up in basis at death if the property has appreciated (the step-up in basis is not available for decedents that passed away in 2010 when the estate opted out of the federal estate tax).\(^{220}\)

\(^{217}\) IRC Section 2523(a).

\(^{218}\) IRC Section 2056(a).

\(^{219}\) IRC Section 2035(b).

\(^{220}\) IRC Section 1014(a).
long-term capital gain property is involved (¶3101), the reduced tax rates on net capital gains\(^{221}\) might make this loss of stepped-up basis more palatable if the donee heir is in a low tax bracket; but when no estate tax is due, the better plan is to hold assets and receive a basis increase to the heirs, and avoid any capital gain tax on the appreciation realized by the decedent.

If the gift is property that, at the time the gift is made, has a fair market value in excess of the donor’s adjusted basis in the property, the donee’s basis will be the donor’s adjusted basis increased by the gift tax paid, if any, on the net appreciation.\(^{222}\) If the gift property further appreciates after the date of the gift, no additional gift tax is due on the appreciation, and the law allows no further increase in basis.

In any case, when deciding whether to make a gift at a time when death is likely to occur within three years, all of the previously mentioned factors should be taken into account. An estimate should be made of the transfer costs if a gift is not made, and the property is includible in the gross estate of the deceased owner. Inclusion of the property in the owner’s gross estate can result in federal estate taxes, state death taxes, additional probate costs, and other disadvantages. These negative factors might be offset, in whole or in part, by the benefit of receiving a stepped-up basis for appreciated property acquired from the decedent at death (the basis increase is limited for those decedents who passed away in 2010 and whose estates opted out of the federal estate tax system).\(^{223}\)

**Use of durable power of attorney.** In view of the advantages offered by gifts made within three years of death, a client could have incentives for deathbed giving. Once the prospective donor lapses into a state of incompetency, the estate planning opportunity will usually be lost. However, a possibility exists that the prospective donor may retain the planning opportunity through the use of a durable power of attorney.

All states now recognize durable powers of attorney. If the principal so desires, the durable power of attorney should specifically authorize the agent to make gifts in the event of the principal’s disability or incapacity. The financial planner should check applicable state law to ensure that the durable power of attorney meets all necessary state requirements, especially the gifting provision.

Authorized gifts can be broadly stated, including to all family members and others with no limitation on amounts, or they may be limited to specified family members and specific financial requirements, such as not exceeding the applicable annual exclusion or the applicable lifetime exclusion. Gifts to charity may be allowed, if desired, in excess of the annual exclusion limitations.

**Gifts of group-term life insurance.** A gift of a group-term life insurance policy might be viewed as the basis for a series of annual transfers, in which case, an individual could not make a gift that would be outside the three-year rule of IRC Section 2035. This rule draws gifts of life insurance policies made within three years of death into the donor’s gross estate. However, in Revenue Ruling 80-289,\(^{224}\) the IRS

\(^{221}\) IRC Section 1(h).

\(^{222}\) IRC Section 1015.

\(^{223}\) IRC Section 1014(a); IRC Section 1022.

\(^{224}\) 980-2 CB 270.
held that when the employee made an assignment of his group term life insurance policy more than three years before he died, and the employer terminated the old policy and entered into an arrangement with a new insurer within three years of death, and the employee then made an assignment of the new policy to the assignee of the old policy, the policy proceeds were not includible in the decedent’s gross estate.

This ruling seems to indicate that the IRS is not disposed to view group-term life insurance as annually renewable term insurance. If the IRS did so, the policy proceeds would be includible in the decedent’s gross estate, in any case, under the theory that each year marked the commencement of a new three-year period.225

Planning Pointer.

When dealing with an employee assignment of a group-term life insurance policy, the assignment form should contain language such as the following:

"This assignment is intended to be effective with respect to all group-term life insurance policies that the employer may later use as a replacement for the current policy."

.02 Limits of the Gross-Up Rule

The gross-up rule of IRC Section 2035(b) is limited to federal gift taxes. Thus, in those states that impose gift taxes (only Connecticut in 2017, Minnesota having repealed its gift tax in 2014), deathbed gifts can serve the purpose of excluding the state gift tax paid from the decedent’s gross estate.

Finally, the gross-up rule does not apply to gift taxes paid on gifts made more than three years before death. Also, it does not apply to any generation-skipping transfer taxes paid within three years of death.

225 IRC Sections 2035(a) and 2042.
Chapter 5

Charitable Giving

¶501 Overview

An individual who gives to charity can benefit himself or herself, family members, and selected charities. Generally, no one should make major gifts to charity until the individual’s own financial security, and the financial security of family members, are on firm ground.

The affordability of a gift depends not on the immediate cost in property or money but, rather, it depends on the after-tax cost. The major factors in determining the after-tax cost are the donor’s filing status, taxable income, and overall tax rate (federal, state, and local). The 2017 capital gains rates on the wealthiest taxpayers and the net investment income tax may generate enthusiasm for donations of appreciated property.

The significant gift and estate tax savings possible through charitable giving is another important consideration.

.01 Checklist of Charitable Contribution Issues for the Financial Planner to Consider

Charitable giving creates many opportunities for rewarding planning. In addition to the satisfaction of benefitting an organization important to the client, there are also potential income, gift, and estate tax savings for the client. In order to secure the tax benefits of charitable giving, it is necessary to observe a series of formal and sometimes complex rules and regulations. It takes more than just a desire and effort
to "do good"—compliance issues must be addressed. Here, the financial planner can make a difference by making certain that the well-intentioned client can gain all the appropriate tax advantages that his or her generosity makes available. The following is a checklist of the highlights of charitable giving that must be observed in order for contributions to charity to receive the desired tax treatment:

1. To get the charitable contribution deduction, the organization must be a "qualified charity." Check for its listing in IRS Publication 78 on the IRS website, www.irs.gov.

2. The donor must itemize deductions to claim an income tax benefit for a charitable contribution.

3. For income tax purposes, the amount of a deductible contribution is subject to limits based on the adjusted gross income of the donor, the type of property given to the charity, and the tax-exempt status of the charity. For gift and estate tax purposes, there are no limits on the amount of the deduction for charitable contributions. These issues are described in the material that follows in this chapter.

4. Maintain adequate records of all gifts to charity—cancelled checks, credit card receipts, and so on.

5. Get a contemporaneous acknowledgement of the gift from the charity. “Substantiation” of the donation is a key requirement. Be sure it addresses whether the charity provided any goods or services in exchange for the gift. If the charity did, the amount of the deduction must be reduced by the value of any benefit received.

6. If the donation to charity is property (other than cash) valued at $500 or more, Form 8283 must be completed and attached to the donor’s federal income tax return.

7. If the donation to charity is noncash property valued in excess of $5,000, Section B of Form 8283 must be completed and attached to the donor’s federal income tax return. For gifts of artwork, collectibles, and other property (but not publicly traded stock), an appraisal of the donated property should be provided.

8. A pledge to charity is not deductible until it is actually paid.

9. A charitable contribution charged on a credit card is deductible in the year the charge is made, even if the payment of the credit card bill is made in a later year.

10. Useful IRS Publications include the following:
    
    Publication 526—Charitable Contributions
    
    Publication 561—Determining the Value of Donated Property
    
    Publication 78—Cumulative List of Charitable Organizations
.02 Various Techniques for Charitable Giving

If an individual is not ready to make an outright gift, he or she can use various techniques to make a charitable contribution while retaining an interest in the property to be contributed. Yet, the donor is able to obtain a current income tax charitable deduction.¹ These techniques include the following:

- A charitable remainder trust in which an income interest is retained (¶515.01).
- A gift of a remainder interest in a personal residence or farm (¶515.03).
- A gift of a lease on, an option to purchase, or an easement or remainder interest in real estate for conservation purposes (¶535).
- A bargain sale to charity (¶505.10).
- A transfer of property to charity in exchange for an annuity (¶520).
- A gift of life insurance to a charity (¶525).
- A gift of an interest to charity through a charitable lead trust (¶530).

Many techniques exist for charitable giving. These techniques, and the special tax and practical considerations for each, are developed separately in the subsequent paragraphs.

.03 Valuation Tables

The tables in Internal Revenue Code (IRC) Section 7520 for valuing annuities, life estates, terms for years, remainders, and reversions for purposes of federal income, estate, and gift taxation use an interest factor that is based on 120 percent of the federal midterm rate for the month in which the valuation takes place. However, for purposes of computing the value of an income, gift, or estate tax charitable deduction, the taxpayer has another option. The taxpayer may base the valuation on 120 percent of the federal midterm rate for either of the two months preceding the month in which the transfer to charity takes place.²

.04 Indications Your Client May Need Help with Charitable Planning

1. Clients have appreciated assets they could have donated, but instead wrote checks or donated by credit card.
2. Clients need to pay significant capital gains taxes that may have been avoided or minimized had they donated those assets to charity.
3. Clients can’t find tax-receipt letters from the charities or don’t recall whether they contributed by check, credit card, cash, or other means. Clients are frustrated by the process of keeping track of these, or it takes them a long time to provide these to their CPAs. Even then, the list is incomplete.

¹ Internal Revenue Code (IRC) Section 170(a).
² IRC Section 7520(a)(2).
4. Clients wait until the end of the year to make all of their donations, even though this could have been done much earlier. These late donations often add extra stress to the donors who feel rushed to make decisions, their wealth advisers who may have to rush to donate stock at the last minute, and charities that are hoping to receive the donations before year-end.

5. Clients donate significantly different amounts every year.

6. Clients donate to different charities every year.

7. Clients make many donations to the same charities throughout the year.

8. Clients are frustrated with the process, the paperwork, the responsibility, the frequent solicitations from charities, and whether their donations are appreciated or if they are having an impact.

9. Clients try to deduct contributions for which they are not entitled such as entire amounts for tables, tickets or items at galas, golf outings, or auctions.

10. Clients have private foundations but do not follow the rules or are overwhelmed by the reporting and operating requirements. Donor-advised funds may be a much simpler solution that would still enable clients to achieve their charitable goals and mission.

11. Clients are getting ready to sell a business or other asset and could greatly benefit by making a donation of the entire asset or a portion of it before the sale, rather than paying the taxes and then contributing the after-tax remainder.

12. Clients are generous in their donations, but accountants can see when preparing returns that their children, who sometimes work in the same family business, are not. Parents wonder how to instill their children with similar philanthropic values.

§505 Income Tax Deduction for Charitable Contributions

A taxpayer who itemizes deductions on Schedule A of Form 1040 may deduct contributions to organizations operated for religious, charitable, educational, scientific, or literary purposes, or to prevent cruelty to animals or children.\(^3\) The higher the taxpayer’s marginal rate, the greater the tax savings. If a contribution is also deductible under a state or local income tax regime, or both, the value of the deduction is increased.

When preparing Form 1040, questions can arise, such as whether the taxpayer is entitled to a deduction for buying benefit, raffle, or bingo tickets; incurring out-of-pocket expenses when doing volunteer work; and making donations of old clothes. Generally, this chapter does not address these everyday questions. Rather, this chapter addresses situations in which clients plan charitable giving with a goal of realizing important estate and gift tax savings. A financial planner cannot find the answers to these questions about planned giving in the Form 1040 instructions.

Clients making everyday charitable contributions might overlook the details. A taxpayer may not deduct any contribution of $250 or more unless the taxpayer has contemporaneous written substantiation from the charity of the contribution, including a good faith estimate of the value of any goods or services that have been provided to the donor in exchange for making the gift.\(^4\) No deduction is allowed for any contribution of cash, a check, or other monetary gift—regardless of the amount—unless the taxpayer has a record to back up the contribution, such as a bank record or a written communication from the donee.

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\(^3\) IRC Sections 170(a) and 170(c)(2)(B).

\(^4\) IRC Section 170(f)(8).
showing the amount and date of the contribution. The IRS strictly enforces this substantiation rule. Under another long-standing rule, charities that solicit or receive *quid pro quo* contributions in excess of $75 (that is, payments that are partly contributions and partly consideration for goods or services from the charity, such as a compact disc supplied by a listener-sponsored television station) must supply the donor with a written statement that essentially makes a good faith estimate of the deductible portion of the payment. The law provides a *de minimis* exception for contributions of $75 or less and an exception for receipt of an intangible religious benefit. Charities that fail to comply are subject to penalties. These rules are discussed in greater detail under the heading "Substantiation Requirements" that follows.

The first thing to do when planning a substantial gift to an organization whose exact charitable status is not known is to ask whether it is on the Treasury list of approved charities. The financial planner should check the list. A potential donor might also want to check for possible violations of civil rights or other laws with respect to its exempt purpose because such violations may deny the organization its charitable status.

The next step is to make sure the amount or value of the gift does not violate the percentage limitations on current income tax deductions for charitable gifts. These percentage limitations vary, depending on whether the contribution is to a public, semipublic, or private charity; consists of cash or property; is a gift for the use of one of these charities; or is a gift of certain types of capital gain property. Any charitable contribution that is not currently deductible because of the percentage limitations may be carried over for up to five years. An understanding of the different categories of charitable beneficiaries should prove helpful.

.01 Categories

**Public charities.** These charities are the types of organizations listed in IRC Section 170(b)(1)(A). They generally include churches, temples, nonprofit colleges, universities and other schools, hospitals and medical research organizations, government units, private operating foundations, private distributing foundations, and private foundations maintaining a common fund. They also include a broad range of organizations not meeting specific criteria for public charities that have, over a four-year period, received a substantial amount of public support, normally one-third, excluding amounts received from their exempt function or activities.

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5 IRC Section 170(f)(17).
6 IRC Section 6115(a).
7 IRC Section 6115(a).
8 IRC Section 6115(b).
9 IRC Section 6714.
10 IRC Section 170(d)(1)(A).
11 Regulations Section 1.170A-9(e).
Exhibit 5-1: Checklist of Income Tax Contribution Deduction Rules

<table>
<thead>
<tr>
<th>Form of Contribution</th>
<th>Amount Deductible</th>
<th>Maximum Deduction as Percent of Adjusted Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or Check</td>
<td>100%</td>
<td>50% to public charities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>30% to other charities</td>
</tr>
<tr>
<td>Appreciated Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term capital gain, generally (1) 100% of value or (2) by election, basis</td>
<td>(1) 30% public charities 20% other charities</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(2) 50% public charities 20% other charities</td>
</tr>
<tr>
<td>Short-term assets</td>
<td>Basis</td>
<td>Same as for cash</td>
</tr>
<tr>
<td>Inventory</td>
<td>Basis</td>
<td>Same as for cash</td>
</tr>
<tr>
<td>Tangible personal property (long-term), that is, art, antiques, jewels, and so on</td>
<td>100% of value if donee’s use related to charity, if not, basis</td>
<td>Same as for cash</td>
</tr>
<tr>
<td>Life insurance</td>
<td>Lesser of 100% of value or basis</td>
<td>Generally, same as for cash</td>
</tr>
<tr>
<td>Intellectual property</td>
<td>Lesser of 100% of value or basis; see ¶505.11</td>
<td>Same as for cash</td>
</tr>
<tr>
<td>To certain private foundations</td>
<td>Basis</td>
<td>20%</td>
</tr>
<tr>
<td>Bargain Sale of Appreciated Property</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term, generally</td>
<td>100% bargain element, appreciation partly taxed</td>
<td>30% public charities</td>
</tr>
<tr>
<td>Short-term, generally</td>
<td>None, if sold at basis</td>
<td>20% other charities</td>
</tr>
<tr>
<td>Future interests</td>
<td>See ¶515</td>
<td></td>
</tr>
<tr>
<td>Income interests</td>
<td>See ¶530</td>
<td></td>
</tr>
<tr>
<td>Qualified conservation contributions</td>
<td>See ¶535</td>
<td></td>
</tr>
</tbody>
</table>

Semipublic charities. These organizations do not fall within the public charity category and include veterans’ organizations,12 fraternal organizations operated under a lodge system,13 and nonprofit cemetery associations.14

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12 IRC Section 170(c)(3).

13 IRC Section 170(c)(4).

14 IRC Section 170(c)(5).
Private charities. These charities are private foundations that are not operating or distributing foundations or those not maintaining a common fund.\(^{15}\)

Contributions for the use of a charity. These contributions are limited to 30 percent of adjusted gross income, as will be noted.\(^{16}\) A contribution of an income interest in property, regardless of whether it is in trust, is considered as made for the use of the charity, rather than to the charity.\(^{17}\) Gifts of remainder interests are generally considered as made to the charity (see ¶515 for a discussion of charitable remainders).

Capital gain property. Discussed in ¶505.09 under contributions of appreciated property.

Donor-advised funds. Some charities offer accounts known as donor-advised funds to which donors can make contributions and subsequently provide advice or recommendations on fund distributions or investments. Although having a say over the use of the contributions may sound appealing, a donor should tread carefully when making contributions to donor-advised funds. The Pension Protection Act of 2006 imposed new rules that (1) deny deductions for contributions to donor-advised funds maintained by certain supporting organizations and (2) impose new substantiation requirements for deductible contributions to other donor-advised funds.\(^{18}\) Under the substantiation requirements, a deduction for a contribution to a donor-advised fund is only allowed if the donor gets a contemporaneous written acknowledgment from the sponsoring organization that the organization has exclusive legal control over the assets contributed. This requirement is in addition to the general substantiation requirements for charitable contributions. All of that said, however, properly organized and operated donor-advised funds have become a popular vehicle for charitable giving.

.02 Percentage Limitations

The various percentage limitations on charitable contributions are as follows:

The 50-percent limit. Generally, an individual’s charitable contribution deduction for the year is limited to 50 percent of his or her adjusted gross income computed without regard to any net operating loss carryback.\(^{19}\) Adjusted gross income means gross income less the deductions listed in IRC Section 62. This is referred to as the “contribution base.” When applying the limitation, contributions to public charities are applied first. If the 50-percent limit is used up on these contributions, no deductions are available for contributions to semipublic or private charitable organizations or contributions for the use of any charitable organization.\(^{20}\) Contributions to public charities in excess of the 50-percent limit are treated as

\(^{15}\) IRC Sections 170(b)(1)(E) and 509(a).

\(^{16}\) IRC Section 170(b)(1)(B).

\(^{17}\) Regulations Section 1.170A-8(a)(2).

\(^{18}\) IRC Section 170(f)(18), as amended by P.L. 109-280.

\(^{19}\) IRC Sections 170(b)(1)(A) and 170(b)(1)(F).

\(^{20}\) IRC Section 170(b)(1)(B).
contributions to public charities and may be carried forward by the donor to each of the five succeeding taxable years.\textsuperscript{21}

**The 30-percent limit for certain contributions to private charities and contributions for the use of charities.** Contributions of cash and ordinary income property to semipublic and private charities and contributions of appreciated property for the use of any charitable organization are limited to 30 percent of the contributor’s adjusted gross income. This 30-percent limit is further reduced by the amount by which contributions to public charities exceed 20 percent of the contribution base. Thus, a taxpayer who contributes 25 percent of his or her adjusted gross income to public charities is limited to 25 percent of adjusted gross income for the 30-percent charities.\textsuperscript{22} Excess contributions are eligible for a 5-year carryover.\textsuperscript{23}

**The 20-percent limit.** Contributions of capital gain property to semipublic and private charities are limited to 20 percent of the contributor’s contribution base.\textsuperscript{24} This 20 percent is further reduced by the amount by which contributions of certain capital gain property to public charities exceed 10 percent of the contribution base.\textsuperscript{25} Thus, for example, if such contributions equaled 18 percent of the contribution base, contributions of capital gain property to semipublic and private charities would be limited to 12 percent. Excess contributions are eligible for a 5-year carryover.\textsuperscript{26}

**The special 30-percent limit.** A special 30-percent limitation applies to contributions of certain capital gain property.\textsuperscript{27} This limitation will be discussed in greater detail in \textsuperscript{\footnotesize[505.09]}. An individual contributing only this type of property to a public charity is generally limited to a deduction equal to 30 percent of his or her adjusted gross income. If the taxpayer contributes the property to a 20-percent charity, the limit is 20 percent of his or her adjusted gross income.\textsuperscript{28} Again, contributions to public charities come first. Thus, if a taxpayer uses all of the 30-percent limitation in contributions to public charities, nothing will be left for contributions to 20-percent charities, and then the 5-year carry forward will apply.\textsuperscript{29}

\footnotesize

\textsuperscript{21} IRC Section 170(d)(1).

\textsuperscript{22} IRC Section 170(b)(1)(B).

\textsuperscript{23} IRC Sections 170(b)(1)(B) and 170(d)(1).

\textsuperscript{24} IRC Section 170(b)(1)(D)(i).

\textsuperscript{25} IRC Section 170(b)(1)(D)(i).

\textsuperscript{26} IRC Sections 170(b)(1)(D)(ii) and 170(d)(1).

\textsuperscript{27} IRC Section 170(b)(1)(C)(i).

\textsuperscript{28} IRC Section 170(b)(1)(D)(i).

\textsuperscript{29} IRC Section 170(b)(1)(D)(i).
A charitable deduction for a property contribution is measured by the fair market value of the property at the time of contribution, subject to the possible reduction in the case of contributions of appreciated property, as discussed in ¶505.09. In addition, special limitations apply to certain types of property contributions, as discussed in ¶505.11.

Listed securities present no serious valuation problem; the value is the average between the high and low value for the day of the contribution. Accordingly, the taxpayer will receive a larger deduction by donating the securities on a day in which the price is high. The stock market success formula of "buy low and sell high" could be modified slightly for charitable contribution purposes. The formula would be "give high and hold low."

Determining the fair market value of property when no public market exists is more difficult. The fair market value in these situations is generally defined as the price at which the property would change hands between a willing seller and a willing buyer, the buyer being under no compulsion to buy and having reasonable knowledge of the relevant facts. If a financial planner is dealing with an item like a collection of stamps, sales of comparable stamp collections within a reasonable time before or after the contribution might be a fair measure of value, but obtaining an appraisal is always the best advice for a financial planner to give a client.

A financial planner must be cautious in advising clients about contributions of unique items, such as art objects and antiques, whose value determination is more difficult. The French grid system of valuation derives the value of relatively minor works of an artist from the sales of the artist’s major works. Appraisals are strongly urged here.

The value of real estate or a business interest are among the most difficult assets to calculate. For contributions of property over $5,000, a taxpayer must attach a qualified appraisal to the federal income tax return. The appraisal must be prepared by a qualified appraiser who has earned a designation from a qualified appraiser organization. The rules relating to how to determine fair market value are addressed in IRS Publication 561, "Determining the Value of Donated Property."

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30 Regulations Section 1.170A-1(c).
31 IRC Section 170(e).
32 Regulations Section 20.2031-2(b).
33 Regulations Section 1.170A-1(c)(2).
34 Regulations Section 1.170A-13(c).
.04 Substantiation Requirements

No deduction is allowed for *any* contribution of cash, a check, or other monetary gift—regardless of the amount—unless the taxpayer has a record to back up the contribution, such as a bank record or a written communication from the donee showing the amount and date of the contribution. In the case of contributions by payroll deduction, a pay stub or W-2 form showing the contribution amount, along with the donee organization’s pledge card or other acknowledgement, will meet the substantiation requirement. In the case of a contribution to a combined fund organization, such as the United Way, which distributes contributed funds to other charities, a written communication from the organization must identify the donee organizations that are the ultimate recipients of the contribution. Under proposed regulations issued in 2008, the requirement to obtain a bank record or written communication would not apply to transfers to certain trusts, including charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). However, the requirement would apply to transfers to pooled income funds.

No charitable deduction is allowed for any contribution of clothing or a household item unless the clothing or household item is in "good used condition or better." However, a deduction may be allowed for donations of items whose claimed value exceeds $500, if in certain required situations the donor includes a qualified appraisal of the item with the return.

Moreover, under IRC Section 170(f)(8), a taxpayer who makes a contribution of $250 or more may not deduct it unless the gift is substantiated by a contemporaneous written acknowledgment from the charity. A canceled check is not considered proof. *Contemporaneous* means on or before the earlier of the date the taxpayer files a return for the year in which the contribution is made or the due date plus extensions for the return. From a practical standpoint, a donor should obtain written acknowledgment from the charity as soon as the donor makes each affected contribution.

The Tax Court has handed down harsh results in several cases involving taxpayers who clearly donated the claimed funds to charity. In one case, the taxpayer submitted his own appraisal, thereby violating the independent appraiser rule (*Mohamed, Sr. v. Commissioner*, TC Memo 2012-152). In another case, the taxpayer failed to obtain a contemporaneous acknowledgement from the donee charity that no goods and services were received in exchange for the gift and the charitable deduction was denied, despite the taxpayer’s cancelled checks and a subsequent confirming letter from the charity. (*Durden v. Commissioner*, TC Memo 2012-140). Even the courts were apologetic in these cases when they enforced the harsh "letter of the law" required by the IRS rules.

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38 Notice 2006-110.


42 IRC Section 170(f)(16)(C); Prop. Reg. Section 1.170A-18(b).

43 IRC Section 170(f)(8)(C).
The disallowance rule for unsubstantiated gifts of $250 or more applies separately to each gift.\textsuperscript{44} Although gifts generally are not aggregated, the IRS warns that it is authorized to issue anti-abuse rules to prevent avoidance "by taxpayers writing separate smaller checks on the same date."

No prescribed charitable gift acknowledgment form exists. However, the charity’s statement must indicate the donor’s name (the donor’s Social Security number or taxpayer identification number is not necessary) and provide sufficient information to substantiate the amount of the contribution along with a statement that goods or services were exchanged or received for the donation. Separate acknowledgments for each $250 contribution are not necessary; the charity may furnish periodic statements substantiating such contributions.

The information that the donor must obtain from the charity depends on the type of donation:

- For gratuitous contributions of $250 or more in cash, the charity indicates the amount given and that the donor received nothing in return.

- For gratuitous contributions of $250 or more in property (or cash and property), the charity must describe, but need not value, the property and also must state that the donor received nothing in return. A charity may use an agent to solicit and process contributions of property, such as used automobiles. The agent may provide the taxpayer with the contemporaneous written acknowledgement of the contribution.\textsuperscript{45}

- For contributions of $250 or more, when the donor receives intangible religious benefits in exchange, the acknowledgment requirements generally are the same as for gratuitous contributions. However, the charity must state that the donor received an intangible religious benefit, although it need not value or describe it. An intangible religious benefit is one provided by an organization structured exclusively for religious purposes and of a type that is not generally sold outside the donative context. An example of such an intangible religious benefit is a payment for admission to a religious ceremony.\textsuperscript{46}

Goods or services that have insubstantial value as determined under the annually indexed IRS guidelines need not be taken into account by the charity for purposes of the $250 rule. In addition, a taxpayer does not have to take into account certain annual membership benefits received from a charity for an annual payment of $75 or less.\textsuperscript{47} Also, the cited regulations address contributions by payroll deduction and provide that for purposes of the $250 threshold, each paycheck is treated as a separate contribution.

Additional substantiation requirements must be met for large gifts of property. A taxpayer must obtain a qualified appraisal by a qualified appraiser and attach a summary of it (Section B, Form 8283) to the tax return claiming the deduction if the claimed value of donated property (other than publicly traded secur-

\begin{itemize}
\item \textsuperscript{44} Regulations Section 1.170A-13(f)(1).
\item \textsuperscript{45} Revenue Ruling 2002-67, IRB 2002-47 (November 6, 2002).
\item \textsuperscript{46} Regulations Section 1.170A-13(f)(2).
\item \textsuperscript{47} Regulations Section 1.170A-13(f)(8).
\end{itemize}
ties) is over $5,000 ($10,000 in the case of non-publicly traded stock) but not more than $500,000. If the value is more than $500,000, the taxpayer must attach a signed copy of a qualified appraisal to the return in most cases. Statutory definitions of the terms qualified appraisal and qualified appraiser are provided.48

An appraisal will be treated as a qualified appraisal if it is conducted by a qualified appraiser in accordance with generally accepted appraisal standards.49 The qualified appraisal must describe the property, give the date of the appraisal, the date of the contribution, and any special conditions attached to it (for example, restrictions on donee’s use), identify the appraiser and his or her qualifications, the appraised value of the property, and how that value was arrived at.50 The appraisal must be signed by the appraiser. The IRS has provided guidance on requesting a statement of value from the IRS for art appraised at $50,000 or more.51 If the IRS audits a return that claims a deduction of $20,000 or more per item of artwork, the revenue agent must refer the claimed deduction to Art Appraisal Services for review by the Commissioner’s Art Advisory Panel.52

The appraisal must be performed no earlier than 60 days before the contribution is made and no later than the date it must be received by the donor (due date, including extensions, of the return on which the contribution is claimed).53

The appraiser must be qualified to make appraisals of the type of property donated and must not be the donor, the donee, a party to the transaction in which the donor acquired the property, a person employed by, or related to, any of the foregoing, a spouse of such a related party, or any person whose relationship to the donor would cause a reasonable person to question the independence of the appraisal.54 The appraisal fee must not be based on a percentage of the appraised value.55 However, this prohibition does not apply to fees based on a sliding scale paid to a generally recognized appraisers’ association. The Tax Court has made clear the importance of using a certified appraiser in valuation matters, such as the Accredited in Business Valuation (ABV) credential, by asserting penalties when the rejected appraisal was submitted by a person who had credentials as an experienced accountant but who was not a certified appraiser.56

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49 Notice 2006-96; see also Prop. Reg. Section 1.170A-17.

50 Regulations Section 1.170A-13(c)(5) as amended by P.L. 109-280; Notice 2006-96.

51 Revenue Procedure. 96-15, 1996-1 CB 627.

52 Internal Revenue Manual 4.48.2 and 8.18.1.3.

53 Regulations Section 1.170A-13(c).

54 Regulations Section 1.170A-13(c)(5).

55 Regulations Section 1.170A-13(c)(6).

A qualified appraiser is an individual who has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements under IRS regulations, regularly performs appraisals for compensation, and meets any other requirements prescribed by the IRS. An individual will not be considered a qualified appraiser for any specific appraisal unless he or she demonstrates verifiable education and experience in valuing the type of property subject to the appraisal and has not been prohibited from practicing before the IRS at any time during the three-year period ending on date of the appraisal.\(^57\)

An appraiser is treated as having earned an appraisal designation from a recognized professional appraiser organization if such a designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed. An appraiser is treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal if he or she makes a declaration in the appraisal that, because of the appraiser’s background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.\(^58\)

No deduction is allowed unless these requirements are met.\(^59\)

**.05 Overvaluation Penalty**

Significant overvaluation of donated property can result in a deficiency assessment and a penalty under IRC Section 6662. If the claimed value is 200 percent or more of the correct value,\(^60\) the penalty is imposed at a rate of 20 percent of the underpayment of tax attributable to the overvaluation.\(^61\) The penalty is doubled when the claimed value is 400 percent or more of the correct value.\(^62\) The penalty does not apply unless the underpayment of tax exceeds $5,000.\(^63\) Moreover, the penalty does not apply if all the following requirements are met:

- The taxpayer proves that he or she had reasonable cause for the underpayment, and the taxpayer acted in good faith.\(^64\)
- The claimed value of the property was based on a qualified appraisal by a qualified appraiser.\(^65\)


\(^{58}\) Notice 2006-96.

\(^{59}\) Regulations Section 1.170A-13(c)(2).

\(^{60}\) IRC Section 6662(e)(1)(A).

\(^{61}\) IRC Section 6662(a).

\(^{62}\) IRC Section 6662(h).

\(^{63}\) IRC Section 6662(e)(2).

\(^{64}\) IRC Section 6664(c)(1).

\(^{65}\) IRC Section 6664(c)(2)(A).
• The taxpayer made a good faith investigation of the value of the property.\textsuperscript{66}

\textit{Qualified appraisal} and \textit{qualified appraiser} have the same meanings as they do in connection with income tax charitable contribution substantiation requirements, as discussed previously.\textsuperscript{67}

\textbf{.06 When the Taxpayer May Deduct the Contribution}

The charitable contribution is deductible in the year made.\textsuperscript{68} However, questions can arise about the proper year for deduction of certain gifts.

The fact that a contribution fulfills a pledge or subscription is of no consequence, even though the obligation might be legally enforceable. When the taxpayer makes the payment is what counts. Payment by check is effective as of the date of delivery or the date of mailing, provided the check clears the bank, and delivery is unconditional.\textsuperscript{69} Contributions made by credit card are deductible in the year charged to the credit card, regardless of the year in which the taxpayer pays the credit card bill.\textsuperscript{70}

With a gift of stock, an unconditional delivery or mailing of a properly endorsed certificate is effective as of the date of delivery or mailing, provided that the certificate is received in the ordinary course of the mail.\textsuperscript{71} Hand delivery of the certificate is the best way of ensuring the deduction. Delivery of the stock certificate to the donor’s bank or broker for transfer of the stock on the corporate books is also risky at year-end because the contribution will be effective only when the transfer of the stock is made on the corporate books. The last event could take place after year-end and cause the gift to be deductible in the following year.

A contribution in the form of a promissory note is deductible only when the note is paid, not when it is delivered, even if the note is adequately secured. Attempts on the donor’s part to restrict the charity’s use of the contributed property or attach conditions to the contribution can only result in questions about whether the taxpayer has made a completed, deductible contribution. Even if those questions are answered satisfactorily, they will raise further questions about the timing and value of the contributions.

\textsuperscript{66} IRC Section 6664(c)(2)(B).
\textsuperscript{67} IRC Section 6664(c)(3).
\textsuperscript{68} IRC Section 170(a)(1).
\textsuperscript{69} Regulations Section 1.170A-1(b).
\textsuperscript{70} Revenue Ruling 78-38, 1978-1 CB 67.
\textsuperscript{71} Regulations Section 1.170A-1(b).
.07 Loss Property

Generally, a taxpayer should not contribute property that has a fair market value that is less than his or her basis in the property. The charitable contribution deduction will be limited to the fair market value of the property on the date of the gift without the benefit of any loss deduction.\(^{72}\)

Instead, the taxpayer should sell the property, donate the proceeds of the sale to a charity, and take a loss deduction on the sale of the property. Even if the donor incurs a sales commission, the tax savings from the loss deduction will usually exceed the sales commission.

.08 Applications and Permutations of the Rules

The following paragraphs (§505.09 and §505.10) address applications and permutations of the basic income tax rules as applied to contributions of appreciated property and bargain sales of appreciated property. The dominant motivation for transactions of this type is often income tax savings. This chapter later examines the estate tax considerations of contributions of appreciated property and the income tax and estate tax aspects of contributions of other types of property and different methods of charitable giving.

.09 Contributions of Appreciated Property

Contributions of appreciated property are deductible, based on the property’s fair market value at the time of the contribution.\(^{73}\) However, such contributions are subject to special rules affecting the amount of the deduction.\(^{74}\) The rules vary with the type of property (real or personal, intangible or tangible), the holding period, the kind of charity, and how the property is to be used.

**Capital gain property.** Contributions of appreciated property held by the donor for more than one year are generally given favorable tax treatment. Such property qualifies as long-term capital gain property. With certain exceptions, and subject to contribution limits that will be discussed, the donor receives a deduction for the property’s fair market value and escapes income tax on the appreciation.\(^{75}\)

Three different basic rules affect the contribution of the following appreciated property held long term (that is, for more than one year) by the donor:

1. Real estate and intangible personal property (that is, securities, insurance policies, and other contract rights)
2. Tangible personal property (such as works of art, rare books, cars and antique furniture)
3. Any property contributed to certain private foundations

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\(^{72}\) *L.M. Withers*, 69 T.C. 900 (1978).

\(^{73}\) Regulations Section 1.170A-1(c)(1).

\(^{74}\) IRC Section 170(e).

\(^{75}\) IRC Section 170(e)(1)(A) and Reg. Section 1.170A-1(c)(1).
As for real estate and intangible personal property, the donor is entitled to a deduction based on the property’s fair market value at the time of the contribution. However, unless the donor makes a special election, discussed in the following text, the deduction is generally limited to 30 percent of the donor’s adjusted gross income if the donor makes the contribution to a public charity (an organization listed in IRC Section 170(b)(1)(A)(i)(viii) and discussed in ¶505). If the donor makes the contribution to a semi-private or private charity (a 20-percent charity), the upper limit of the deduction is 20 percent of adjusted gross income. The 30-percent limit is applied first. Thus, if the taxpayer exhausts the 30-percent limit by gifts to public charities, he or she has no room for additional deductions for contributions to 20-percent charities. However, excess gifts to 20-percent charities qualify for a 5-year carryover.\(^\text{76}\)

Notwithstanding the general 30-percent limitation on contributions of appreciated property, the donor may deduct contributions of appreciated property up to the 50-percent ceiling if the donor elects to reduce the value of the contribution by the amount of the appreciation of the contributed property. Whether a taxpayer should make this election depends on two factors:

1. The amount of appreciation
2. If the appreciation is large enough, the importance to the donor of receiving a current deduction for more than the 30-percent limit otherwise available

The top income tax rate for most long-term capital gains is 15 percent for most individuals. In 2017, the top rate for long-term capital gains reached 20 percent for single persons with taxable income over $418,400 and married persons filing jointly with taxable income over $470,700. In 2017, the net investment income tax of 3.8 percent is imposed on capital gains (among other forms of net investment income) of single persons with adjusted gross income over $200,000 and married persons filing joint returns with adjusted gross income over $250,000. Individuals in the 10-percent and 15-percent tax brackets are subject to a 0-percent rate on their long-term capital gains.

The 25-percent rate still applies to the recapture of depreciation on depreciable real estate under IRC Section 1250. In addition, the 28-percent rate still applies to capital gains on the sale or exchange of collectibles and the portion of any IRC Section 1202 gain that is subject to tax. The tax savings from avoiding the recognition of long-term capital gains are equal to the appreciation in the property multiplied by the taxpayer’s appropriate tax rate on long-term capital gains.

**Charitable bailout of closely held stock.** What if a taxpayer wants to make a significant contribution to his or her favorite charity but is short on cash? The taxpayer has a strategy available if he or she holds stock in a closely held corporation, perhaps a controlling interest. If the taxpayer cannot, or will not, sell the stock, the taxpayer might be able to work out an informal agreement with the charity. Under the agreement, the taxpayer will give the charity some portion of the corporate stock. The charity then presents the stock to the corporation for redemption. The corporation agrees, and the charity receives cash for the stock. The shareholder received a deduction for the fair market value of the stock, and the cash moves from the corporation to the charity. The IRS accepts the U.S. Tax Court holding in *D.D. Palmer* 62 T.C. 684 (1974), *aff’d*, 523 F.2d 1308 (8th Cir. 1975) to the effect that, so long as the charity is not legally bound to go through with the redemption at the time it receives the shares, the transaction is to be

\(^{76}\) IRC Section 170(d)(1).
treated according to its form. Thus, IRS Revenue Ruling 78-197 provides that the plan will work, even though the parties had a prearranged (but not legally binding) plan of redemption. The IRS argued in *G.A. Rauenhorst*77 that it was not bound by Revenue Ruling 78-197. However, the IRS has not withdrawn or modified that ruling. The U.S. Tax Court held for the taxpayer and ruled that Revenue Ruling 78-197 was a concession by the IRS.

As long as the charity is not legally bound to redeem the shares and cannot be compelled to redeem them, a risk exists that it will not redeem them. The charity might attempt to sell the shares to others to realize cash, or the charity could retain the shares as a minority shareholder. As a practical matter, the likelihood that the charity will not redeem the shares is low. The charity is dependent on the donor and others for future contributions and will be eager to retain their goodwill. Also, the charity will be eager to realize cash. The charity does not want to retain an interest in a business and run afoul of the unrelated business taxable income rules. The redemption is an easier and quicker way of acting than attempting to find a buyer for closely held stock at a price that will match the offered redemption price.

**Planning Pointer.**

Consider combining this charitable "bailout" technique with a gift of a portion of the client’s business interest to the client’s children. After the redemption, the children may own a significant interest in the business based on the fact that the interest gifted to them may constitute a large portion of the post-redemption outstanding shares.

**Contribution of tangible personal property qualifying for long-term gain.** Contributions of items of tangible property, the sale of which would result in a long-term capital gain, are subject to different charitable contribution rules. The tax treatment depends on the use the charity plans to make of the property. If the use is unrelated to the charity’s purpose or function or the source of its tax-exempt status, the donor must reduce the amount of the deduction by the amount of gain that would have been long-term capital gain if the donor had sold the property for its fair market value at the time of the contribution.78

The Treasury regulations, in discussing related and unrelated use, offer this example:

If a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use.79

If the donor claims that the use is related and, therefore, there is no need to reduce the deduction, the donor must be able to show the following:

- That the property was not, in fact, put to an unrelated use

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77 119 T.C. 157 (2002).

78 IRC Section 170(e)(1)(B).

79 Regulations Section 1.170A-4(b)(3)(i).
• That anticipating that the property would not be put to an unrelated use was reasonable\textsuperscript{80}

A written statement made by the charity of an intended use that is related to its exempt functions and activities, if made in good faith, should give the donor a reasonable basis for anticipation of related use treatment.

If the donee organization prematurely disposes of property for which a full deduction was claimed, the deduction may be reduced or recaptured.

If the disposition takes place in the year of the contribution, the deduction is generally limited to the donor’s basis, rather than the fair market value of the contributed property. That is, the deduction is reduced as if the property were originally put to an unrelated use.\textsuperscript{81}

If the disposition takes place after the contribution year but within three years of the date of the contribution, the donor’s income for the year of the disposition must be increased by the excess of (1) the amount of the original deduction over (2) the donor’s basis of the property at the time of the contribution.\textsuperscript{82}

Reduction, or recapture of the deduction, is not required if the donee organization certifies that the donated property was put to a related use or that the property was intended to be put to a related use that has become impossible or not feasible to implement.

**Contributions to certain foundations.** The deduction for any capital gain property contributed to certain private foundations is limited to the donor’s adjusted basis in the property. A private foundation subject to this rule includes a foundation that is not a private operating foundation or a community foundation. However, the private foundation will be exempt from the special rule if within two and one-half months after the year it receives the contribution it makes a qualifying distribution equal to the amount of the contribution.\textsuperscript{83} In addition, a donor may deduct the fair market value of stock given to a private foundation if price quotations for the stock are readily available on an established securities market.\textsuperscript{84} The rules governing foundations are extremely complex and technical, and this guide covers them lightly.

**Ordinary income property.** The deduction for property that, if sold by the donor at fair market value would give rise to ordinary income, is limited to its adjusted basis.\textsuperscript{85} Obviously, a donor would usually not select this type of appreciated property for a gift to charity. Included in this category of property are items of real and personal property, tangible and intangible, held short-term; business inventory items;

\textsuperscript{80} Regulations Section 1.170A-4(b)(3)(ii).

\textsuperscript{81} IRC Section 170(e)(1)(B)(i)(II) as added by P.L. 109-280.

\textsuperscript{82} IRC Section 170(e)(7) as added by P.L. 109-280.

\textsuperscript{83} IRC Sections 170(b)(1)(E) and 170(e)(1)(B).

\textsuperscript{84} IRC Sections 170(e)(1)(B)(ii) and 170(e)(5).

\textsuperscript{85} IRC Section 170(e)(1)(A).
and crops. Works created by the donor, such as paintings, sculpture, books, letters, and memoranda are in this category. In the case of a painting, for example, the deduction would be limited to the artist’s cost of the canvas and paints. Conceivably, the property could be worth less than it cost to produce it, in which case, the fair market value of the property would be used to limit the deduction.

**Property with both capital gain and ordinary income potential.** When a person makes a charitable contribution of property that, if sold, would result in the realization of both capital gain and ordinary income, both the capital gain and the ordinary income rules discussed previously would come into play. An example would be when the contribution was of income-producing real estate placed in service before 1987 and on which the taxpayer claimed accelerated depreciation deductions. IRC Section 1250 calls for the recapture as ordinary income of accelerated depreciation over what straight-line depreciation would have been on real estate. Similar rules apply to depreciable personal property under the recapture provisions of IRC Section 1245.

**Alternative minimum tax.** There is no alternative minimum tax preference for charitable contributions of appreciated property, whether real, personal, or intangible.

### .10 Bargain Sales of Appreciated Property

Sometimes a charitable-minded individual might have a piece of appreciated property he or she would like to contribute to charity. However, the property is worth more than the individual wants to give, and the property is not divisible. For example, a potential donor might want to recover his or her investment in the property and give away only what amounts to the appreciation. A donor can achieve this result with a bargain sale to the charity.

A donor who makes a bargain sale to a charity faces income tax liability. The transaction would be split in two under IRC Section 1011(b), a sale portion and a contribution portion, with the sale portion being taxable. To figure the capital gain on the sale portion, an allocation of the tax basis of the property must be made between the sale portion and the contribution portion. Follow these steps:

1. Take the tax basis of the property
2. Multiply it by a fraction, where the numerator is the sale proceeds and the denominator is the property’s fair market value
3. Subtract the result in (2) from the sale proceeds

The remainder is the taxable gain on the sale portion.

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86 IRC Section 170(e)(1).
Example 5.1. Jean Freer sells her college a piece of real estate for $48,000, which is her tax basis for the property. The property is worth $80,000 at current values. On the bargain sale, she makes a donation of $32,000 to her college but will have realized capital gains, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Tax basis of property</td>
<td>$48,000</td>
</tr>
<tr>
<td>2</td>
<td>Less: Basis allocable to sale portion</td>
<td>$28,800</td>
</tr>
<tr>
<td></td>
<td>Basis</td>
<td>$48,000 \times \frac{48,000}{80,000} = $32,000</td>
</tr>
<tr>
<td>3</td>
<td>Taxable gain</td>
<td>$19,200</td>
</tr>
</tbody>
</table>

If she had sold the property for $80,000, she would have realized a capital gain of $32,000 ($80,000 – $48,000). The bargain sale saves the tax on $12,800 ($32,000 – $19,200), as well as the selling expenses. Brokerage commissions at 6 percent would have amounted to $4,800 ($80,000 \times 6\%).

The contribution portion, consisting of appreciated property, is subject to the rules discussed in ¶505.09, dealing with gifts of appreciated property, generally.

If the property sold is subject to a mortgage, the amount of the debt, regardless of whether the charity assumes the mortgage, is included as part of the amount realized for income tax purposes.\(^8\) This rule not only decreases the size of the charitable contribution but also leaves the donor in a position in which the donor is still liable for the mortgage. Most likely, if the donor were eventually called upon to pay the mortgage, this might be considered as a further contribution to the charity. However, it would generally be an unplanned, if not coerced, form of contribution, which hardly commends itself to an estate and financial planning approach.

The bargain sale rules apply to real estate, tangible personal property that the charity can use, and intangible personal property, such as stocks and bonds. However, bargain sales of securities or other forms of property that are fungible or readily divisible seldom make sense. In the case of listed stocks, for example, the donor who wants to recoup his or her investment in a block of stock can do so by selling off enough shares to become whole. Thus, the individual would be in a position to contribute the balance of the shares to charity without having to go through a bargain sale. Still, if the individual has other holdings in the stock and feels that a sale to recoup the investment might adversely affect the market, a bargain sale might be advisable. The financial planner and the client will have to look at the total picture before deciding which way to go.

.11 Other Special Rules

Special tax law rules apply to charitable donations of certain types of property. Examples follow.

**Intellectual property donations.** A taxpayer’s deduction for the donation of "qualified intellectual property" is limited to the lesser of the donor’s basis or the property’s fair market value at the time of the

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\(^8\) Regulations Section 1.1011-2(a)(3).
However, subject to certain limitations, the donor can take additional deductions in the year of contribution, and in succeeding years, based on a sliding-scale percentage (from 100 percent to 10 percent, depending on the year after the initial contribution) of the "qualified donee income" that the charitable donee receives or accrues from the contributed intellectual property. An additional deduction is allowed in any year only to the extent that the aggregate of the specified percentages of qualified donee income exceeds the initial deduction claimed by the donor for the intellectual property.

This charitable contribution limitation and additional deductions apply to the contribution of the following:

- Patent
- Copyright (other than a copyright held by the creator of the property or a transferee whose basis is determined by reference to the creator’s basis)
- Trademark
- Trade name
- Trade secret
- Know-how
- Software (other than software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified)
- Similar property or applications or registrations of such property

However, the additional deductions are not allowed for contributions to or for the use of a private foundation.

Qualified donee income eligible for additional deductions is any net income properly allocable to the qualified intellectual property (as opposed to the activity in which the intellectual property is used) that is received by, or accrued to, the donee organization during a year. Qualified donee income does not include any income received by, or accrued to, the donee organization after the earlier of the tenth anniversary of the date of the contribution or the expiration of the legal life of the qualified intellectual property.

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88 IRC Section 170(e)(1)(B).
89 IRC Section 170(m).
90 IRC Section 170(m)(2).
91 IRC Section 170(e)(10)(B)(iii).
92 IRC Section 170(m)(9).
To qualify for the additional deductions, a donor must notify the donee at the time of the contribution that the donor intends to treat the contribution as a qualified intellectual property contribution.\textsuperscript{93} According to an IRS notice, a donor will satisfy the notification requirement if the donor delivers or mails to the donee, at the time of the contribution, a written statement containing the following information:

- The name, address, and taxpayer identification number of the donor
- A description with sufficient detail to identify the qualified intellectual property received by the donee
- The date of the contribution to the donee
- A statement that the donor intends to treat the contribution as a qualified intellectual property contribution for purposes of IRC Section 170(m) and Section 6050L\textsuperscript{94}

A donee that receives such notification must file a return with respect to a qualified intellectual property contribution for each taxable year showing the amount of any qualified donee income and must provide a copy of the return to the donor.\textsuperscript{95} The amount of net income taken into account by the donor when computing the additional deductions cannot exceed the amount of income reported by the donee.

\textbf{Contributions of vehicles, boats, and airplanes.} A donor’s deduction for a charitable contribution of a highway vehicle, boat, or airplane that is valued at more than $500 may be limited, depending on the use of the qualified vehicle by the donee organization. No deduction is allowed unless the donor obtains a contemporaneous written acknowledgment from the donee organization and includes the acknowledgment with the tax return on which the deduction is claimed.\textsuperscript{96}

For these vehicles, the acknowledgment rules replace the substantiation rules that generally apply for donations of more than $250.

If the donee organization sells the vehicle, the donor’s deduction is generally limited to the gross proceeds received from the sale, even if that amount is less than the fair market value of the vehicle. However, there are three exceptions: The gross proceeds limitation does not apply:

1. When there has been "significant intervening use" of the vehicle by the donee organization before the sale
2. When the donee organization makes "material improvements" to the vehicle

\textsuperscript{93} IRC Section 170(m)(8).
\textsuperscript{94} Notice 2005-41, IRB 2005-23 (May 20, 2005).
\textsuperscript{95} IRC Section 6050L; Reg. Section 1.6050L-2T.
\textsuperscript{96} IRC Section 170(f)(12).
3. When there is a bargain sale or a gift of the vehicle by the donee organization to a needy individual\textsuperscript{97}

A significant intervening use means that a donee organization must actually use the donated vehicle to substantially further the organization’s regularly conducted activities, and the use must be significant. Incidental use by an organization is not a significant intervening use.

A material improvement includes a major repair or improvement that significantly increases the value of the vehicle. Cleaning, minor repairs, and routine maintenance are not considered material improvements. In addition, services such as the application of paint or other types of finishes (for example, rust proofing or wax), removal of dents and scratches, cleaning or repair of upholstery, and installation of theft deterrent devices are not considered material improvements. To be a material improvement, an improvement may not be funded by an additional payment to the charity from the vehicle’s donor.

In the case of a bargain sale or gift of a vehicle by a donee organization, the sale or gift must directly advance a charitable purpose of the organization to help the poor, distressed, or underprivileged in need of a means of transportation. Note that this exception is not available if the organization sells the vehicle to a non-needy individual and merely applies the proceeds to the use of needy individuals.

If one of the exceptions to the gross proceeds limitations applies, the donor may deduct the fair market value of the vehicle. A qualified appraisal is required for a deduction in excess of $5,000.

If a donor donates a vehicle valued at more than $500 that is subsequently sold for $500 or less and none of the three exceptions is available, a special rule applies. The donor may deduct the lesser of (1) $500 or (2) the fair market value of the vehicle at the time of the donation. If the fair market value is $250 or more, a written acknowledgment must be obtained.

The special rules and gross proceeds limit do not apply to deductions for vehicles valued at $500 or less. However, if the donated vehicle has a claimed value of more than $250, the donor must obtain the same contemporaneous written acknowledgment that is required for all property donations of more than $250.

Acknowledgment requirements. All acknowledgments required for vehicle deductions over $500 must include the following information:

- The name and taxpayer identification number of the donor
- The vehicle identification number of the donated vehicle
- The date of the donation

Additional information is required depending on what happens after the vehicle is donated.

If the vehicle is sold by the donee organization and none of the three exceptions applies, the acknowledgment also must contain

- the date the qualified vehicle was sold;
- a certification that the qualified vehicle was sold in an arm’s length transaction between unrelated parties;
- a statement of the gross proceeds from the sale; and
- a statement that the deductible amount by the donor may not exceed the amount of the gross proceeds.

If the vehicle is to be sold after significant intervening use or material improvement, the acknowledgment must contain:

- a certification and detailed description of
  - the intended significant intervening use and the intended duration of the use or
  - the intended material improvement and
- a certification that the qualified vehicle will not be sold before completion of the use or improvement.

If the vehicle is sold and the needy individual exception applies, the acknowledgment also must contain:

- certification that the donee organization will sell the qualified vehicle to a needy individual at a price significantly below fair market value (or, if applicable, that the organization will give the vehicle to a needy individual), and
- certification that the sale (or gift transfer) will be in direct furtherance of the organization’s charitable purpose of relieving the poor and distressed or the underprivileged who are in need of a means of transportation.

If a donated vehicle is sold by the donee organization, an acknowledgement will be considered contemporaneous if it is received no later than 30 days after the date of the sale. In other cases, an acknowledgement must be received within 30 days of the date of the donation.

§510 Estate Tax Deduction for Charitable Contributions

Charitable contributions can generate not only income tax deductions, but also estate tax deductions. The estate tax rate in 2017 is 40 percent. A charitable contribution made during the donor’s lifetime can generate both an income tax deduction and an estate tax deduction. Both deductions can occur if the

98 IRC Section 2055(a).
property is includible in the donor’s gross estate by reason of the donor’s retention of a lifetime interest\textsuperscript{99} or powers over it\textsuperscript{100} or because, in the case of a gift of a life insurance policy, it was made within three years of death.\textsuperscript{101} If the client makes a bequest to a charity at death, only an estate tax deduction may be taken.

In many (but not all) ways, the estate tax rules parallel the income tax rules. The rules are generally the same with respect to qualified recipients, governing gifts of charitable remainders, and valuation of gifts. However, a significant difference is that the estate tax rules do not contain the percentage limitations on the amount of the allowable deduction found in the income tax rules. The estate tax rules allow an unlimited charitable deduction. Another difference is that the charity does not have to be a domestic charity to gain an estate tax deduction. A contribution to a foreign charity is deductible when computing the donor-decedent’s taxable estate.\textsuperscript{102}

The IRS privately ruled that a decedent’s estate was entitled to an estate tax charitable deduction for a bequest to a foreign charitable organization that was equal to the fair market value of the bequest. The decedent was a citizen and resident of the United States on the date of her death. Her will instructed that property situated in a foreign country was to be distributed to the foreign organization if the bequest would qualify for the charitable deduction under IRC Section 2055(a). The organization’s mission was to improve the quality of life of the handicapped and elderly. The organization was funded with assets from its founders, none of whom were U.S. citizens or residents. The organization never had any U.S. investments, engaged in trade or business in the U.S., or received funds from U.S. donors.

The IRS noted that the organization’s exclusive purpose was to improve the lives of handicapped and elderly people and the organization operated properly to fulfill its mission. The organization’s bylaws prohibited it from using any part of the net earnings for the benefit of any private stockholder or individual. In addition, the organization was not permitted to engage in or use its assets for lobbying, attempting to influence legislation, or any other political activities. In consideration of these factors, the IRS concluded that the decedent’s bequest was made to an organization described in IRC Section 2055(a)(2). Because the organization received all of its support from non-U.S. sources, had not engaged in any prohibited transactions, and had not been notified that it had engaged in any such prohibited transaction, the IRS ruled that IRC Section 2055(e)(1) was inapplicable. Therefore, the estate was entitled to a charitable deduction equal to the fair market value of the property that was includible in the decedent’s gross estate and passed to the organization. See IRS Letter Ruling 201702004.

The deduction is limited to the amount actually available for the charity’s use. If the contribution is burdened with transmission expenses or death taxes, the deduction would be reduced accordingly.\textsuperscript{103} The charitable deduction is not reduced by estate management expenses attributable to, and paid from, the

\textsuperscript{99} IRC Section 2036.

\textsuperscript{100} IRC Section 2041.

\textsuperscript{101} IRC Sections 2035(a) and 2042.

\textsuperscript{102} IRC Section 2055(a)(2) and Reg. Section 20.2055-1(a).

\textsuperscript{103} IRC Section 2055(c) and Reg. Section 20.2055-3(b)(2).
charitable share. However, the charitable deduction is reduced for management expenses attributable to property other than the charitable share but paid from the charitable share. Management expenses are expenses incurred to manage the estate’s assets, such as brokerage commissions, investment adviser fees, and interest. Transmission expenses are expenses other than management expenses. Examples of transmission expenses are executor’s commissions, attorney and accountant’s fees, and probate fees. Whether the contribution is to be burdened with these charges is basically something the contributor should decide in his or her will, trust or deed of gift. If the contributor fails to do so, local law will make the determination. A deductible charitable contribution might add to administration expenses, which will normally be deductible. If a charitable bequest is payable out of the residue of the decedent’s estate, and the residue is chargeable with death taxes, a difficult mathematical problem arises. Every dollar of estate tax charged to the charitable share reduces the charitable donation, which increases the estate tax and so on. Regulations Section 20.2055-3(a)(2) explains that the required circular computation can be made by the use of an algebraic formula or by trial and error. See also the instructions for Form 706, the federal estate tax return.

.01 The Estate Tax Deduction

Anyone with a strong aversion to paying income taxes or having his or her estate pay estate taxes can avoid them in one very simple, direct way. A person can put money into tax-exempt bonds, marry someone who is likely to live longer, and leave his or her spouse any amount desired, or not be married and leave non-spouse beneficiaries an amount equal to the decedent’s available transfer tax exclusion and the rest to charity. This plan will result in no income taxes in life and no estate taxes in death. Because of the availability of the unlimited charitable deduction, the estate tax has been called a “voluntary” tax.

.02 The Marital Deduction

A split gift to one’s spouse and charity may qualify for both the marital deduction and the charitable contribution deduction. This may take the form of a qualified charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) with the spouse as beneficiary, as discussed in ¶515.01, or a pooled income fund with the spouse as beneficiary, as discussed in ¶515.02.

¶515 Gifts of Charitable Remainders

An individual may be thinking of giving money or property to a charity at some future time but might not be ready to make the gift now. The individual can make a bequest to a charity in his or her will. A bequest may be designed to take effect sooner or later after the decedent’s death. A bequest would take effect later if the testator left his or her spouse or other family member the benefit of the money or property immediately after his or her death, with the charitable interest to follow the beneficiary’s death. A

104 Reg. Section 20.2055-3(b)(3).
105 Reg. Section 20.2055-3(b)(4).
106 Reg. Section 20.2055-3(b)(1)(i).
107 Reg. Section 20.2055-3(b)(1)(ii).
bequest would take effect sooner if the testator makes a gift to a charity during his or her life, or the gift passes outright to charity immediately upon death.

The individual can make a present gift of a remainder interest to the charity. If the individual wants to give money, he or she can do so through a trust. Alternatively, one can give a charity a remainder interest in property without using a trust. In either case, the remainder interest may be set up to take effect at the end of a term of years, on the donor’s death, on the death of the donor’s spouse, or on the deaths of some other persons, such as the donor’s parents or children. The longer the period before the charity comes into possession of its remainder interest, and the larger the benefit available for the noncharitable beneficiary, the smaller the income tax charitable deduction.

The deduction for a gift of a remainder interest is strictly limited. If the gift is to be made through a charitable remainder trust, it must comply with rigorous Internal Revenue Code guidelines and either be a CRAT, CRUT (both discussed in ¶515.01), or a pooled income fund (discussed in ¶515.02).108

If the gift is not to be made in trust, and if it is a gift of a charitable remainder interest in a personal residence or a farm, the special rules discussed in ¶515.03, must be observed.109 These rules are relatively simple. A special limited dispensation exists for contributions of partial interests in real estate for conservation purposes (¶535).110 If it is not a gift of a residence or farm or for conservation purposes, then the only way a deduction for a remainder interest may be obtained is by following the complex rules applicable to CRATs, CRUTs, and pooled income funds.111 Special considerations apply to remainder interests in tangible personal property (¶515.04).

.01 Charitable Remainder Trusts: Annuity Trust and Unitrust

An income, estate, or gift tax deduction for a contribution to a charitable remainder trust that has one or more noncharitable income beneficiaries is limited. The trust must qualify as either a CRAT or CRUT to sustain a deduction.

A CRAT provides a fixed annuity to its income beneficiaries, whereas a CRUT provides a form of variable annuity. These trusts may be set up during a person’s lifetime or by will. Both require that their creator set aside certain assets, with specified amounts payable either for a term of years (no more than 20) or for the life of the settlor, the settlor’s spouse, or other persons named by the settlor as beneficiaries, with the remainder to go to a qualified charity.112 Both require that the named beneficiaries are living at the time of the creation of the trust (unless a specific number of years is chosen for the trust), that pay-

108 IRC Section 2055(e)(2); IRC Section 664.
111 IRC Section 170(f)(3)(A).
112 IRC Section 664(d).
ments be made to the beneficiaries at least annually, and that the principal not be used for the beneficiar-
ies, except to satisfy the specific payout requirement of the trust.113

Both forms of trust require an annual rate of return to the beneficiaries of no less than 5 percent. Moreo-
ver, the trust cannot have a maximum payout percentage in excess of 50 percent of the trust’s value. In
addition, to sustain a charitable contribution deduction, the value of the charitable remainder interest
must be at least 10 percent of the value of the property transferred to the trust.114

Although a CRAT and a CRUT are subject to similar rules, they do have their differences. With a
CRAT, the return must be of a fixed or determinable amount and the no-less-than-5 percent return is
calculated on the initial net fair market value of the assets transferred to the trust.115 With a CRUT, the
return is calculated on the value of the trust assets, as determined annually.116 Accordingly, the benefi-
ciary of a CRUT has what amounts to a variable annuity. If the trust assets are in stocks or bonds, the
annuitant’s payments have a fixed percentage but will fluctuate with annual portfolio values.

With a CRAT, the annuitant must be paid out of principal if the trust income is insufficient to meet the
payout requirement. However, a CRUT may (but need not) provide that, if the income is insufficient, no
payment will be made out of principal and that only income realized must be paid. This trust is referred
to as a “NICRUT” (net income charitable remainder unitrust). However, the trust may further provide
that any deficit be made up in later years in which the trust has more than enough income to meet payout
requirements. Such a trust is sometimes referred to as a net income makeup charitable remainder
unitrust, or a NIMCRUT.

One other important difference between a CRAT and a CRUT concerns additional contributions. Once a
CRAT is set up, the law allows no further contributions to it.117 However, with a CRUT, additional con-
tributions may be made on specified terms and conditions.118 The additional contributions may be made
during the settlor’s life or by will.119 The IRS has issued sample forms of both types of trusts that should
prove useful.

113 IRC Section 664(d).
114 IRC Section 664(d).
115 IRC Section 664(d)(1)(A).
116 IRC Section 664(d)(2)(A).
117 Regulations Section 1.664-2(b).
118 Regulations Section 1.664-3(b).
119 Revenue Ruling 74-149, 1974-1 CB 157.
Sample provisions for charitable remainder annuity trusts are set forth in the following:

- Revenue Procedure 2003-53 (inter vivos annuity trust providing for payments for one measuring life)
- Revenue Procedure 2003-54 (inter vivos annuity trust providing for payments for a term of years)
- Revenue Procedure 2003-55 (inter vivos annuity trust providing payments consecutively for two measuring lives)
- Revenue Procedure 2003-56 (inter vivos annuity trust providing payments currently and consecutively for two measuring lives)
- Revenue Procedure 2003-58 (a testamentary annuity trust providing for payments for a term of years)
- Revenue Procedure 2003-59 (a testamentary annuity trust providing payments consecutively for two measuring lives)
- Revenue Procedure 2003-60 (a testamentary annuity trust providing payments currently and consecutively for two measuring lives)\(^{120}\)

Sample provisions for charitable remainder unitrusts are set out in the following:

- Revenue Procedure 2005-52 (inter vivos unitrust for one measuring life)
- Revenue Procedure 2005-53 (inter vivos unitrust for a term of years)
- Revenue Procedure 2005-54 (inter vivos unitrust providing payments consecutively for two measuring lives)
- Revenue Procedure 2005-55 (inter vivos unitrust for payments payable currently and consecutively for two measuring lives)
- Revenue Procedure 2005-56 (testamentary unitrust for one measuring life)
- Revenue Procedure 2005-57 (testamentary unitrust for a term of years)
- Revenue Procedure 2005-58 (testamentary unitrust providing payments consecutively for two measuring lives)
- Revenue Procedure 2005-59 (unitrust for payments payable currently and consecutively for two measuring lives)\(^{121}\)

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Restrictions on investments—tax-exempt securities. Regulations Section 1.664-1(a)(3) states that a trust is not a charitable remainder trust if the trust restricts the trustee from investing in a manner "which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets."

To restrict a trustee to investments in tax-exempt securities might be deemed to violate the regulation. First, the IRS could question whether such investments restrict realization of a "reasonable amount of income," taking into account the fact that the yield of tax-exempt securities may be less than the yield on taxable securities of equal quality. Because the trust is not taxable in any case, the charity might object to investments in tax-exempt securities. Mandatory investment in tax-exempt securities might also violate the gain portion of the quoted regulation. Of course, if tax-exempt securities are bought below par, their value is likely to increase over time. Thus, the trust would have a possibility of realizing gain. However, restricting the trustee to investment in tax-exempt securities or any other types of investments that might be in violation of the regulation would not be wise.

IRS sample trusts include a provision that states that nothing in the trust instrument is to be construed to restrict the trustee from investing in a manner that results in the annual realization of a reasonable amount of income or gain.

If the trust contains such a provision and specifically authorizes the trustee to invest in tax-exempt securities, an investment in tax-exempt securities would seem not to jeopardize the status of the trust. However, as a matter of prudence, the trustee should limit such investments, especially when their yield falls short of meeting the required payout to the income beneficiaries.

Investments in real estate or growth securities would not seem to present any special problems under the regulation. Still, the trust should include the sample provision cited and provide specific authority to invest in real estate or growth-type securities. A possible issue with such investments is their ability to produce sufficient income to meet the annual payment requirements.

Split gifts to spouse and charity. A special rule applies for interests in the same property transferred to a spouse and a charity. If an individual creates a qualified charitable remainder annuity or unitrust and the donor and his or her spouse are the only noncharitable beneficiaries, the spouse’s interest will not be a nondeductible terminable interest. The donor or his or her estate receives an estate or gift tax charitable contribution deduction for the charity’s interest and an estate or gift tax marital deduction for the spouse’s interest.

IRC Section 664(d)(3) makes provision for a modified form of unitrust, sometimes referred to as an income-only option. Such a trust may provide that the trustee must pay the income beneficiary only the amount of the trust income if the income amount is below the otherwise required fixed percentage

122 IRC Section 2056(b)(8).
123 IRC Section 2055(a).
124 IRC Section 2056(a).
yield. Such a trust is sometimes referred to as a NICRUT. If this income-only approach is used, the
trust instrument may further contain a restoration provision. This provision allows the trust to pay any
income that exceeds the amount that the specified percentage of trust assets would yield to the benefi-
ciary to the extent that the aggregate amount paid in prior years fell short of the aggregate amount de-
termined under the specified percentage method. Such a trust with a make-up provision is sometimes
referred to as a NIMCRUT.

The PATH Act addressed the calculation of the charitable deduction for the value of the remainder in-
terest in the event of the early termination of a NICRUT or NIMCRUT. Prior to the PATH Act, there
had been no rule governing the valuation of interests in a charitable remainder trust in the event of the
early termination of the trust. Section 344 of the PATH Act clarifies that the remainder interest is to be
computed on the basis that an amount equal to 5 percent of the net fair market value of the trust assets
(or a greater amount, if required by the terms of the trust instrument) is to be distributed each year, with
the net income limit being disregarded.

**Spouse’s right of election.** Most states prevent an individual from disinheriting a spouse by giving the
spouse the statutory right to take an elective share of the individual’s estate. As a general rule, a spouse’s
elective share is based solely on the individual’s probate estate. However, in some states, property trans-
ferred during life, including a charitable remainder trust established during a grantor’s life, may be in-
cluded in the calculation of a spouse’s elective share.

The tax law also provides that no amount other than annuity payments, in the case of a CRAT, or
unitrust payments, in the case of a CRUT, can be paid to or for the use of any person other than a quali-
fied charity. Accordingly, the IRS says that the mere possibility that charitable remainder trust assets
could be used to satisfy a spouse’s elective share technically disqualifies the trust’s tax exemption from
the start, even if the spouse never makes an election. Disqualification of the trust technically will cause
loss of income, gift, and estate tax deductions for the value of the charity’s remainder interest.

The IRS initially took a relatively hard line on this problem. In a revenue procedure issued in 2005, the
IRS announced that it would not disqualify a trust created before June 28, 2005, merely because of the
existence of a spousal right of election. However, if the spouse actually exercised the right of election,
the trust would be treated as failing to qualify as of its creation. By contrast, a new trust created on or af-
fter June 28, 2005, would escape disqualification only if the spouse irrevocably waived the right to make
the election.

In response to many negative comments, the IRS subsequently announced that it is reconsidering the
problem. Until further guidance is published regarding the effect of a spousal right of election on a

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125 IRC Section 664(d)(3)(A).
126 IRC Section 664(d)(3)(B).
127 IRC Section 664(d).
trust’s qualification as a CRAT or CRUT, the IRS will disregard the existence of such a right of election, even without a waiver—but only if the surviving spouse does not exercise the right of election.130

Thus, at least until further guidance is issued, the IRS will not disqualify a trust merely because the grantor’s spouse failed to waive the right of election. However, if the spouse actually exercises the right of election, the trust will be treated as failing to qualify for the charitable deduction as of its creation. Because of this risk, a waiver should be considered for all trusts subject to a spouse’s right of election. A waiver will provide certainty that the right of election cannot be made with respect to the charitable remainder trust and, therefore, could not disqualify the trust.

**Income, estate, and gift tax consequences.** Charitable remainder trusts offer several tax advantages. The transfer of appreciated property to a charitable remainder trust allows the donor to avoid the recognition of taxable gains. In addition, the transfer results in an income tax deduction for the actuarially determined present value of the remainder interest.131 The transfer to the charity is deductible in arriving at the donor’s amount of taxable gifts132 and removes the property, and any future appreciation in the property, from the donor’s gross estate.

Planning with charitable remainder trusts has become increasingly important in light of the 3.8 percent tax on net investment income. Transferring appreciated property to a charitable remainder trust (CRT) and having the trust sell the property and realize the gain will allow a taxpayer to obtain a charitable deduction and avoid the imposition of the net investment income tax on the gain. The annual payments from the CRT to the donor can stretch the benefit of the delayed realization of the gain to the taxpayer over a number of years.

The annual distributions from the CRT to the beneficiary will likely be considered net investment income subject to the net investment income tax as paid; however, as they are paid over time, they will not have the effect of causing a large increase in the adjusted gross income of the donor as would have occurred had the donor sold the property without the use of the CRT. The payout over time may also keep the donor’s income under the threshold for the net investment income tax.

A special rule applies to gains realized by a CRT on or before December 31, 2012. When these realized gains are distributed, they are not considered to be net investment income to the trust beneficiary; consequently, these gains are not subjected to the net investment income tax.

Another reason why the CRT is likely to become more attractive arises from the tax rates applicable to wealthier taxpayers. When the taxable income threshold of $470,700 (married filing jointly), $418,400 (single filer), or $235,350 (married filing separately) is passed, short term capital gains are taxed at the rate of 39.6 percent and long term capital gains are taxed at the rate of 20 percent. The net investment income tax is then imposed on top of these rates. Spreading out the receipt of income through the CRT may serve to keep the taxpayer below these thresholds, or at least not as far above them as would be the

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131 IRC Section 170.

132 IRC Section 2522.
case if the taxpayer sold the property and reported all of the gains on his or her personal income tax return.

The value of a remainder interest under an annuity trust for income, estate, and gift tax purposes is the net fair market value of the property placed in trust, less the present value of the annuity, computed under IRC Section 7520 tables. The interest factor under these tables is based on 120 percent of the federal midterm rate, and that rate changes monthly. For charitable transfers, the interest factor for the month of the transfer or for either of the two prior months may be used. Thus, if interest rates change within this three-month time period, a taxpayer will be in a position to choose the rate that produces the maximum deduction (a lower interest rate reduces the deduction for a CRAT). If two or more lives are involved, computations are based on the life contingencies of each individual.

The following example, adapted from the regulations and making use of an assumed 6-percent IRC Section 7520 rate, and the tables contained in IRS Publication 1458, illustrates the process:

**Example 5.2.** Al Hamlin, who was 50 years old on April 15, 2017 (age at nearest birthday is used), transferred $100,000 to a charitable remainder unitrust on January 1, 2017. The trust is required to pay Hamlin at the end of each year 6 percent of the fair market value of the assets as of the beginning of the tax year of the trust. The present value of the remainder interest is $22,250, computed as follows.

The adjusted payout is 5.660 percent (6% × 943396 [the present value of $1.00 payable at the end of a year using a 6% assumed IRS discount factor]). Table U(1), set out in IRS Publication 1458, shows the present worth of a remainder interest in a charitable remainder unitrust having various adjusted payout rates in which the remainder follows a single life. The table does not show a value of 5.660 percent. It shows a value for adjusted payout rates of 5.6 percent and 5.8 percent. To compute the value of a remainder interest with an adjusted payout rate of 5.660 percent, one must interpolate as follows:

| The factor in the table at 5.6% for age 50 | .22552 |
| The factor for 5.8% is                     | .21547 |
| Difference                                  | .01005 |
| Interpolation adjustment                   |        |

\[
\frac{5.660\% - 5.6\%}{5.8\% - 5.6\%} \times 0.01005 = 0.00302
\]

Factor at 5.6% at age 50                      .22552
Less: Interpolation adjustment               .00302

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133 Regulations Sections 170A-6(b)(2) and 1.664-2(c).

134 IRC Section 7520(a)(2).

135 IRC Section 7520(a)(2).
With the annuity trust, the federal midterm rate affects valuation. With the unitrust, the rate of return to be paid to the noncharitable beneficiary fixed in the trust instrument also affects valuation. The higher the rate to be paid, the more the life interest is worth, the less the remainder is worth, and the smaller the charitable deduction.

A unitrust involves annual valuations of trust assets, and the payout is determined by the relationship between the required percentage payout and these annual valuations. Therefore, unless the trust has assets with established market values, a possible danger is that the trustee might manipulate the values to favor income beneficiaries. For this reason, the IRS could disallow a tax deduction on the transfer of assets with no readily ascertainable value. These assets include stock in a closely held corporation or real estate, unless the trust has an independent trustee, whom the settlor may not replace (or only be permitted to replace with another independent trustee) to determine values.

If the grantor of the unitrust is also the trustee, and if the trust assets consist of publicly traded stocks, the trustee may determine the value. If other assets are placed in the unitrust, the annual valuations of non-publicly traded assets must be made by independent appraisers.

If an individual contributes appreciated property to a charitable remainder trust of either type (CRAT or CRUT), the rules governing deductions for contributions of appreciated property generally apply, including the 30-percent adjusted gross income limitation, unless the donor makes the special election to reduce the amount of the contribution to the adjusted basis in the property.

Both types of trusts are expressly exempt from income taxes, even though they may have undistributed income, unless they have unrelated business taxable income. If unrelated business taxable income is present in a charitable remainder trust, it is taxed at the rate of 100 percent.

Trust beneficiaries of both types of trusts (annuity and unitrusts) are taxed on distributions to them under a “tier system” described in IRC Section 664(b), as follows:

- First, as ordinary income to the extent of the trust’s ordinary income for the year, and undistributed ordinary income for prior years
- Second, as capital gains to the extent of the trust’s undistributed capital gains (short-term before long-term)

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136 IRC Section 170(b)(1)(C).
137 Revenue Ruling 74-53, 1974-1 CB 60.
138 IRC Section 664(c).
• Third, as other income (including income exempt from tax) to the extent of such income

• Fourth, as distribution of trust principal (corpus)

Complex issues and elections should be considered here with respect to the relationship between income distributed from a charitable remainder trust to a taxable beneficiary and the net investment income tax. Should an exact method be used to track the type of income distributed following the tier system, or should a "simplified" method be used to assume certain relationships between income distributed and net investment income? See the instructions to Form 5227 for further explanation of these issues.  

For estate tax purposes, if the settlor-donor is the sole income beneficiary, the trust property’s full value will be includible in the donor’s gross estate because of the retained life interest, but it will be fully offset by a charitable contribution deduction when computing the decedent’s taxable estate. If there are other individual beneficiaries, and they survive, the full value of the trust assets will be includible in the settlor’s gross estate, but the charitable contribution deduction will be reduced by the value of the remaining (surviving) noncharitable beneficiaries’ interests.

Accelerated charitable remainder trusts. At one time, a literal reading of the charitable remainder trust provisions led some tax practitioners to advocate the use of accelerated charitable remainder trusts. These trusts were designed to convert appreciated assets into cash while avoiding most of the tax on the appreciation. For example, some taxpayers created charitable remainder unitrusts with an annual payout rate of 80 percent and funded them with highly appreciated assets that produced no income. Additionally, the trust would make no distribution in year 1, but would sell all the trust assets at the beginning of year 2. The proceeds from the sale would then be used to pay the required distribution for the previous year. These taxpayers treated this distribution of 80 percent of the trust assets as a nontaxable distribution of corpus under the ordering rule because the trust did not realize any income during its first year.

Current law contains two rules designed to curb accelerated charitable remainder trusts. The first rule is a percentage payout limitation, and the second rule is a minimum charitable benefit:

• **Percentage payout limitation.** A trust will not qualify as a charitable remainder trust if the annual payout exceeds 50 percent. In the case of a CRAT, this means that the annual payout may not exceed 50 percent of the initial fair market value of the trust’s assets. In the case of a charitable remainder unitrust, it means that the annual payout cannot exceed 50 percent of the fair market value of the trust assets determined annually. Trusts that fail the 50-percent test will be

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139 The AICPA believes that the elective simplified method should be retained as an election, but because it is not necessarily simpler (for example, it requires two sets of books), it should be renamed the “elective alternative method.” See AICPA comment letter on the proposed regulations, REG-130843-13.

140 IRC Section 2036(a).

141 IRC Section 2055(a).

142 IRC Section 2037(a).

143 IRC Section 664(d)(1)(A).

144 IRC Section 664(d)(2)(A).
treated as complex trusts rather than charitable remainder trusts. The result will be that all of their income will be taxed to the trust or its beneficiaries, depending on distributions.  

- **Minimum charitable benefit.** A 10-percent minimum value charitable interest requirement is also imposed on charitable remainder trusts. In the case of a charitable remainder annuity trust, the value of the remainder interest must be at least 10-percent of the initial fair market value of all property placed in the trust.  

  With a charitable remainder unitrust, the 10-percent minimum applies with respect to each contribution of property to the trust. Trusts not meeting the 10-percent test may qualify for relief provisions, which allow for voiding the trust or reforming it to comply with the 10-percent rule. Otherwise, no charitable deduction will be allowed.  

- **“5% Exhaustion Test.”** This test requires that the annuity payable to the non-charitable beneficiary cannot be so great that there is a more than 5 percent chance that the corpus will be exhausted before the charity receives its interest. This rule sets an upper limit on the amount of possible annuity distributions. If there is a more than 5 percent chance that the assets of the CRAT will be exhausted by the payment of the annuity, the result that the charitable remainder beneficiaries will receive nothing at the termination of the trust, no charitable contribution deduction is allowed. Developments in 2016 have changed the way the 5 percent test is addressed.

  Under Rev. Ruling 77-374, a CRAT must meet the “5% Probability Test.” This applies only to CRATs designed to make annuity payments over a duration of one or more individual’s lifespans. The purpose of this test is to ensure the charity receives its remainder interest. Any chance of this not occurring such that the possibility that the trust corpus will be exhausted before the charity receives its interest must be so remote as to be negligible. If there is a greater than a 5 percent probability that the trust assets will run out, the possibility of exhaustion is not negligible. Failing this test will lead to the assumption that the CRAT will fail to make any distribution to the charitable remainder beneficiary. As a result, the donor will not receive a charitable deduction.

  In practical terms, this usually means that the prevailing interest rates used to conduct this test must be equal to or in excess of the payout rate (minimum of 5 percent) on the income stream. If the payout rate is higher than the annualized earning rate under the Section 7520 applicable federal rate (AFR), then the trust corpus may be diminished over time to zero. This is because principal may be invaded to make the annual income payouts.

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145 IRC Section 662(a).
146 IRC Section 664(d)(1)(D).
147 IRC Section 664(d)(2)(D).
148 IRC Section 2055(e)(3)(J).
While the probability of exhaustion isn’t typically an issue in a high interest rate environment, passing the test becomes difficult when rates are low—and interest rates have been at historic lows. These low rates make it very difficult to create a CRAT, even if it passes all the other requirements. In particular, it makes it impossible to create a CRAT using the lifespan of a younger person because the longer the trust corpus needs to be invaded to make the annual income payments, the more likely it will be CRAT exhausted.

- **Revenue Procedure 2016-42 and the Qualified Contingency Provision.** Recently, Rev. Proc. 2016-42 was released to provide relief from the 5% Probability Test. Its guidance will allow CRATs with a time period based on one or more measuring lives to be an option for donors as long as all other requirements are met. The relief is derived from Section 664(f), which permits certain qualified contingencies to basically shorten the duration of the CRAT. If the CRAT terms contain a provision identifying “the happening of a contingency” and the contingency occurs, then the trust terminates and the remainder goes to the charitable beneficiary. Meanwhile, the donor’s charitable deduction is maintained and the trust’s status as a CRAT is not threatened.

Rev. Proc. 2016-42 effectively allows the 5% Probability Test to be disregarded if language is provided in the CRAT identifying that the trust will terminate if, at a later point in time, it fails the requirement that the charity receive at least 10 percent of the CRAT’s initial value as its remainder interest.

Each year after the creation of the CRAT, the trustee of the CRAT will be required to calculate whether the value of the trust corpus, reduced by that year’s impending annuity payment, would be less than 10 percent of the value of the initial trust corpus. If the amount is less than 10 percent, than the CRAT is terminated. However, it has still qualified as a CRAT and the charitable deduction is intact. The risk of losing the deduction and CRAT status is removed. Meanwhile, the charity receives its remainder interest and the donor’s philanthropic intent is fulfilled.

.02 Pooled Income Funds

An individual might want to help a charity with a gift of income-producing property, securities, or other types of property, but cannot afford to part with all the income for the rest of his or her life. There may be a desire to provide income during a spouse’s life or the life of some other person. The charitable remainder trust, either the annuity trust or the unitrust, discussed in ¶515.01, offers one solution. The pooled income fund offers another solution. The pooled income fund was created with the idea of affording a vehicle for charitable contributions that would meet donor needs and provide a tax deduction. The pooled income fund also provides guidelines and safeguards to permit the valuation of contributions and the protection of the government and the charity.

Pooled income funds involve the pooling of the contributions of several contributors to benefit both the charity and the individuals concerned. The charitable remainder trust can provide a measure of investment diversification for someone who has been locked into an investment by reluctance to pay the capital gain tax. The pooled income fund should do a better job of diversification because of the larger

150 IRC Section 642(c)(5).

151 IRC Section 170(f)(2)(A).
amount of money it has to invest and because it is typically managed by institutional investors, rather than by individual trustees.

Within limits, the pooled income funds themselves can set up their own rules governing the types of property or securities that they will accept. The donor, in exchange for a contribution, receives participation units based on the value of his or her contribution and the value of units of the fund outstanding at the time.

In essence, the pooled income fund is a trust formed to pay income to noncharitable beneficiaries. If contributions to it are to qualify for income tax deductions, the trust must meet these conditions: 152

- The donor must retain a life income interest for himself or herself or one or more noncharitable beneficiaries.
- The charities must have irrevocable remainder interests for which contributions are eligible for the 50-percent adjusted gross income limitation for income tax purposes (¶505).
- All property of all donors must be commingled.
- The trust must be maintained or controlled by the charity to which the remainder interests are contributed; however, the charity need not be a trustee.
- The trust may not receive or invest in tax-exempt securities.
- Neither the donor nor a noncharitable beneficiary of the fund may serve as trustee.
- For each year in which a noncharitable beneficiary is entitled to receive income, he or she must receive an amount determined by the trust rate of return for that year.
- On termination of the life interest, the remainder interest must be severed from the trust and paid to, or retained for, the charity’s use.
- A pooled income fund that is created after February 15, 1991, or that accepts donations after that date, must either prohibit the fund from accepting or investing in depreciable or depletable property, or require that the trustee establish a depreciation or depletion reserve in accordance with generally accepted accounting principles. 153

Obviously, donors who contemplate this type of gift should evaluate the qualification of the trust. They will also want to examine the trust’s current rate of return over a span of years because that might indicate the return they could expect in the future. It could also be the key to the size of the available income tax deduction.

152 IRC Section 642(c)(5).
Relationship to marital deduction. If the donor’s spouse is named the sole income beneficiary of a pooled income fund, a marital deduction may be allowed for the entire value of the property as qualified terminable interest property (QTIP) property, if a proper election is made.154 Neither the donor spouse nor the donor spouse’s estate will be allowed a double deduction (that is, a marital deduction for the full value of the QTIP and a charitable deduction for the remainder interest).155 However, assuming the QTIP election was made, the future estate of the donee spouse will be entitled to the charitable contribution deduction when the donee spouse dies.156

How the deduction is figured. The charitable contribution income tax deduction is based on the present value of the remainder interest passing to the charity.157 This value is determined by subtracting the actuarial value of the life interest or interests reserved from the value of the property contributed. If the pooled income fund has existed for at least three tax years immediately preceding the tax year in which the contribution is made, the value of the life interest or interests is to be computed on the basis of the highest rate of return earned by the fund in any one of the three years preceding the year of the contribution.158 If a fund has been in existence less than three taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return shall be deemed to be one percentage point less than the highest annual average of the monthly rates (as prescribed by IRC Section 7520(a)(2)) for the three calendar years immediately preceding the year in which the fund is created (rounded to the nearest two tenths of one percent).159

Other tax factors. In general, the donor recognizes no gain or loss on a transfer of property to a pooled income fund. However, if the donor receives property from the fund, in addition to the life interest or interests, the donor will recognize gain. In addition, if the property transferred to the fund is subject to a mortgage in an amount in excess of the donor’s adjusted basis in the property, the donor will recognize gain. In the latter case, whether or not the mortgage debt is assumed, the transfer will be taxable in accordance with the bargain sale rules.160

The trust itself and its beneficiaries are taxable in accordance with the IRC provisions applicable to estates, trusts, and beneficiaries, generally (Subchapter J of the IRC). However, the rules applicable to grantor trusts161 do not apply.162 Pooled income funds are subjected to the net investment income tax.

154 IRC Section 2056(b)(7).
155 IRC Sections 2056(b)(9) and 2523(h).
156 IRC Section 2044(c).
157 IRC Section 170(f)(2)(A).
158 Regulations Section 1.642(c)-6(e)(3)(ii).
159 Regulations Section 1.642(c)-6(e)(4).
160 Regulations Section 1.642(c)-5(a)(3).
161 IRC Sections 671-677.
162 Regulations Section 1.642(c)-5(a)(2).
Practical factors. The way in which the remainder interest is valued for the purposes of an income tax deduction might place a potential contributor in something of a dilemma. The donor would like to have both a large deduction and the prospect of a high-income yield. If past performance is any indication of future performance, however, the donor cannot have both. The fund showing the highest rate of return to the non-charitable beneficiary would provide the smallest income tax charitable deduction. The fundamental quandary is for the client, not the financial planner, to resolve. Nevertheless, the financial planner can help with the arithmetic and provide advice to the client.

The donor may not exit from the pooled income fund. The donor or the donor’s beneficiaries, or both, are stuck for life in that remainder trust. Thus, the financial planner should encourage the client to diversify his or her investments.

.03 Charitable Remainder in a Personal Residence or Farm

As a general rule, one may not obtain a charitable contribution deduction for a gift of a future interest in property except through a charitable remainder trust of either the annuity or unitrust type, discussed in ¶515.01, or a pooled income fund discussed in ¶515.02.163 One exception to the general rule is the gift of a remainder interest in a personal residence or farm.164 An individual may contribute a personal residence or farm to a charity without setting up a trust and reserve the right to live in it or use it for the rest of his or her life (and the life of his or her spouse) or for a term of years. The donor will obtain an income tax deduction for the contribution of the remainder interest. The gift must be irrevocable.

A personal residence for this purpose is not limited to one’s principal residence but also includes vacation homes and stock in a cooperative apartment used as a residence.165

A farm includes land and improvements used by the donor or the donor’s tenant to produce crops, fruits, or other agricultural products or livestock or poultry.166 The IRC, however, provides that, when determining the value of the remainder interest in the real estate, depreciation (computed on the straight-line method) and depletion of the property are to be taken into account. The value is discounted at a six-percent annual rate, except as the Treasury might set a different rate.167 Pursuant to this authority, the Treasury Department has indicated that rates that are adjusted monthly apply to transfers made after April 30, 1989.168

An allocation must be made between the depreciable and non-depreciable portions of the property. The value of the non-depreciable portion will generally be computed like any other remainder interest. The value of the depreciable portion (a personal residence is not considered depreciable for other purposes if

163 IRC Section 170(f)(2)(A).
164 IRC Section 170(f)(3)(B).
165 Regulations Section 1.170A-7(b)(3).
166 Regulations Section 1.170A-7(f)(4).
167 IRC Section 170(f)(4).
168 Notice 89-24, 1989-1 CB 660.
It is owner-occupied) is computed under a special formula that makes use of a table containing certain factors to be taken into account, including a depreciation adjustment factor.\textsuperscript{169}

If a substantial part of the value lies in the depreciable portion, the depreciation factor would seriously reduce the amount of the charitable contribution deduction if the donor or his or her spouse has anything but short life expectancies. Land itself is not depreciable. However, if it is mineral land, or land that can be used as a sand or gravel pit, then depletion must be considered.\textsuperscript{170}

Use of these types of properties as charitable contributions might be indicated when the depreciation or depletion factor does not loom large; when a stepped-up basis on death\textsuperscript{171} is not a major factor; when the donor expects to outlive the mortality table’s life expectancy; and when the donor does expect the property to appreciate substantially in value by the time the charity comes into possession. Use of this planning technique may be discouraged when the preceding factors do not exist.

Special consideration should be given to IRC Section 121, which excludes up to $250,000 ($500,000 for certain married couples and surviving spouses) of gain on the sale of one’s principal residence if certain holding and use requirements are met (¶2820).

Under this provision, a principal residence with $250,000/$500,000 or more in appreciation is worth considerably more to the taxpayer or a surviving spouse if sold during life than it would be worth if the gain were fully taxable. This factor might provide an incentive for a lifetime sale, accompanied by other arrangements for a charitable contribution.

.04 Contributions of Future Interests in Tangible Personal Property, Such as Art and Paintings

A person owning a painting or any other kind of tangible personal property cannot generally receive a current tax deduction for a charitable contribution of a future interest in the property.\textsuperscript{172} A future interest is an interest that is to begin in use, possession, or enjoyment at some future time.

A person cannot obtain an income tax deduction by sending a deed to a painting to a museum if the deed states that the museum is to receive the painting on the death of the donor or after a certain number of years. A donor can, however, receive a deduction when he or she gives up the right of possession and enjoyment of the painting to the museum. When the donor gives up the right to possession of the painting, the donor receives a deduction based on the gift’s then fair market value.

These rules are contained in Regulations Section 1.170A-5(a)(2) and call attention to a form of co-ownership of paintings and other works of art that might offer some interesting planning possibilities. The regulation addresses a situation in which four individuals each have an undivided one-quarter interest in a painting, and each owner is entitled to three months’ possession in each year. Each co-owner can

\textsuperscript{169} Regulations Sections 1.170A-12(c) and 25.2512-5.

\textsuperscript{170} Regulations Section 1.170A-12(c).

\textsuperscript{171} IRC Section 1014(a).

\textsuperscript{172} IRC Section 170(f)(3)(A).
receive a deduction on receipt by the charity of a formally executed and acknowledged deed of the gift, provided that the charitable donee’s period of initial possession is not deferred more than a year.

One of the illustrations set out in Regulation Section 170A-5(b), example 5, suggests an interesting twist. A man gives a museum a remainder interest in a painting, reserving a life interest to himself. He then transfers his interest to his son. Because of the relationship, the transfer does not operate to give him a deduction for the remainder interest. However, when the son transfers his interest to the museum, father and son each receive a charitable contribution deduction. Of course, the amounts deductible by each will be different. This technique offers a means of deduction splitting within a family that might produce worthwhile family income tax savings in the right circumstances.

§520 Charitable Gift Annuities

Many established charities promote what are known as charitable gift annuities. In substance, money or property is exchanged for the charity’s promise to pay an annuity, usually in connection with a lifetime transfer. An individual might set up one of these annuities through a will on behalf of another person or persons. In that case, the individual receives no income tax deduction, but his or her estate may claim an estate tax deduction.

The difference between the value of the annuity to be paid to the noncharitable beneficiaries and the value of the property contributed to the charity is the amount allowed as a charitable deduction. The value of the annuity is determined under the tables issued under IRC Section 7520. The interest factor under these tables is based on 120 percent of the federal midterm rate, which changes monthly. For charitable transfers, the interest factor for the month of the transfer or for either of the two prior months may be used. Thus, if interest rates change within this three-month time period, a taxpayer will be in a position to choose the rate that produces the maximum deduction.

The annuity can provide for immediate or deferred payments. Most charities follow the recommended schedule of gift annuity rates of the American Council on Gift Annuities. Effective January 1, 2012, and unchanged as of November 7, 2016, the most recently issued suggested rate for a single life annuity for an individual who is age 65 is 4.7 percent. The rates, of course, vary with age. The rates are revised periodically. The most current rates are available at the council’s website at www.acga-web.org. The annuity payments are favorably taxed. A portion of each payment is nontaxable income to the recipient. The exclusion is computed by multiplying the amount received annually by a fraction representing the investment in the contract over the expected return over the life of the contract. Once the investment in the contract is fully recovered, no further exclusion is allowed. If death occurs before full recovery, the unrecovered amount is allowed as a deduction on the decedent’s return for his or her last taxable year.

173 IRC Section 7520(a)(2).
174 IRC Section 72(b)(1).
175 IRC Section 72(b)(2).
176 IRC Section 72(b)(3).
Unlike transfers to charitable remainder trusts or pooled income funds, a transfer of appreciated property in exchange for an annuity gives rise to tax liability. The gain must be specifically allocated between the charitable gift part of the contract and the annuity. The gain is taxable to the annuitant, pro rata, over his or her life expectancy. If the annuitant dies prematurely, that ends the income tax liability if the annuitant is the sole annuitant. If the annuity is a joint and survivor annuity, the survivor would assume the remaining income tax liability.\textsuperscript{177}

When determining the amount to be paid on a deferred annuity, the charity will take into account its use of the money or property before annuity payments start.

If the annuity is a two-life annuity, with the donor as the first life annuitant, a gift is made to the survivor of the right to receive future payments. Because it is a future interest, the annual gift tax exclusion ($14,000 for 2017, indexed annually for inflation) is not available.\textsuperscript{178} If the donor retains a right to revoke the survivor’s annuity, no gift tax liability would occur, because the gift to the survivor is not a completed transfer.\textsuperscript{179} If the donor dies before the other annuitant, the annuity’s value to the survivor would be includable in the donor-decedent’s gross estate.\textsuperscript{180} The value would be based on what it would cost to buy a comparable commercial annuity for the survivor.\textsuperscript{181}

A spousal joint and survivor annuity automatically qualifies for the estate and gift tax marital deduction, as long as only the spouses have the right to receive any payments before the death of the last spouse to die.\textsuperscript{182}

If the donor buys a single life annuity for someone else, it is considered a gift to the other individual in the amount of the annuity’s value. The annuity has no estate tax consequences for the donor when the donor dies.

\section*{525 Gifts of Life Insurance to Charity}

Gifts of life insurance on the donor’s life offer many tax, legal, and practical advantages to both donor and charity. Some of the key legal and practical advantages to the donor are as follows:

\begin{itemize}
  \item \textbf{Avoidance of publicity.} A charitable bequest is exposed to public view. A gift of life insurance can be kept secret and avoid possible family arguments.
\end{itemize}

\begin{footnotes}
\item\textsuperscript{177} IRC Section 691(a).
\item\textsuperscript{178} IRC Section 2503(b).
\item\textsuperscript{179} Regulations Section 25.2511-2(c).
\item\textsuperscript{180} IRC Sections 2038(a) and 2039(a).
\item\textsuperscript{181} Regulations Section 20.2031-8(a).
\item\textsuperscript{182} IRC Sections 2056(a), 2056(b)(7)(A), and 2056(b)(7)(C).
\end{footnotes}
• Avoidance of legal challenge. Some state laws limit the percentage of a person’s estate that may be contributed to charity by will. These restrictions appear to be inapplicable to insurance proceeds payable to a charity.

• Simplicity. An individual can give a life insurance policy without the legal expenses attending the drafting of a will or codicil.

• No loss of current income. Unlike a gift of income-producing property, with this form of gift, the donor incurs no loss of income.

• Possible increase in cash flow. If the donor is relieved of paying premiums, the donor will experience increased cash flow. (If the donor pays the premium once the policy is gifted, the donor receives an income tax deduction for a charitable contribution.)

The charity receives the following advantages from a gift of life insurance over a legacy or a lifetime gift of other types of property:

• Cash equivalent. The charity, if given ownership of a cash value policy, can cash it in and use the proceeds for its purposes before the donor’s death.

• Potential gain. Life insurance can produce instant substantial benefits for the charity, especially in cases when the insured dies prematurely. In addition, if the insured dies as the result of an accident and the policy contains a double indemnity rider, the charity will receive double the face value of the policy.

• Avoidance of probate. The charity can receive the proceeds on proof of death without the delays attending probate.

• Loan value. If the charity owns the policy, it can borrow against the policy’s cash surrender value at low interest rates, without any obligation to repay the loan (but there will be a corresponding reduction in the available death benefit). The charity may borrow against the policy to pay premiums or for other purposes. Universal and variable life products may permit the charity to finance insurance without borrowing from the policy’s cash value.

• Conversion privileges. As owner of the policy, the charity may convert it to a paid-up life policy for a reduced amount, with no further premiums payable. It may convert the policy to an extended term policy for the same amount to last for a predetermined time, also without further premium payments.

.01 Income Tax Consequences

Generally speaking, charitable contributions of life insurance policies on the donor’s life are subject to the same rules of deductibility governing charitable contributions of other types of property.183

183 IRC Section 170.
In general terms, IRC Section 170(f)(3) denies a charitable contribution deduction for partial interests in personal property, except when the contribution is of a fractional interest in the property, or the transfer is made in trust and is subject to certain strict limitations. Under this section, an outright charitable contribution of a life insurance policy in which the insured reserves significant rights amounting to a partial interest would not qualify for an income tax deduction.

An income tax deduction will also be disallowed if, in connection with a transfer, the charity directly or indirectly pays premiums on any "personal benefit contract" under which the transferor, a family member, or a person designated by the transferor is a direct or indirect beneficiary.\(^{184}\) This deduction prohibition is intended to crack down on so-called "charitable split-dollar life insurance arrangements" in which a donor transfers funds to a charity, and the charity uses the funds to purchase a cash value life insurance policy that benefits both taxpayer and the charity.\(^{185}\)

The valuation of gifts of life insurance also presents special problems. The Treasury has no income tax regulations on the subject, but the IRS has ruled that the applicable Treasury estate and gift tax regulations may properly be used for income tax purposes.\(^ {186}\)

Under the gift and estate tax regulations, the policy’s value is to be determined on the basis of the sale of the particular contract by the company or sales of comparable contracts sold by the company. If the contract has been in force for some time and further premiums are to be paid, the policy’s value is the interpolated terminal reserve value on the date of gift, which is an amount somewhat greater than the cash surrender value of the policy, plus a proportionate part of the gross premium last paid before the gift, and extending for a period thereafter.

Gifts of life insurance policies are valued under Regulations Section 25.2512-6. There is not a great deal of guidance in the cases or rulings that have interpreted this regulation. What little law there is suggests that if there is a “comparable contract value,” that value can be used to value a life insurance policy. If not, the interpolated terminal reserve (ITR) is used—which is described as “the reserve which the insurance company enters on its books against its liability on the contracts.” Unfortunately, that can be a very subjective valuation by the insurance company that may not bear a direct correlation to the premiums paid, cash surrender value, or any possible surrender charges.

If no further premiums are to be paid on the policy (that is, it is a single premium or paid-up policy), the policy value is the amount the company would charge for a single premium contract of the same amount on the life of a person of the age of the insured.\(^ {187}\)

When valuing payments payable on a person’s death for estate and gift tax purposes, the IRS actuarial tables must generally be used. Regulations Section 25.7520-3(b)(2)(iii) provides that the standard factor under IRC Section 7520 may not be used to value a remainder or reversionary interest unless the effect

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\(^{184}\) IRC Section 170(f)(10)(A).

\(^{185}\) Notice 99-36, 1999-1 CB 1284 (June 15, 1999).

\(^{186}\) Revenue Ruling 59-195, 1959-1 CB 18.

\(^{187}\) Regulations Sections 20.2031-8 and 25.2512-6.
of the interest will allow the beneficiary the beneficial enjoyment of the property that the law of trusts affords. An example of a case in which the donor may not use the standard factor is the funding of a trust with unproductive property. Regulations Section 25.7520-3(b)(3) provides that transfers of limited property interests are not allowed to be valued using the mortality component of the tables under IRC Section 7520 for an individual who is terminally ill at the time of the gift. Rather, gifts made by individuals who are terminally ill must be valued using a mortality factor that reflects the individual’s actual life expectancy.\(^\text{188}\) An individual is considered to be terminally ill if he or she has an incurable illness or other deteriorating physical condition and has at least a 50-percent probability of dying within one year. If the individual survives for at least 18 months after the date of the gift, he or she will generally be presumed not to have been terminally ill at the time of the gift. This presumption may be rebutted with clear and convincing evidence.\(^\text{189}\)

If this same rule were to be applied to determine value for purposes of the income tax deduction, a donor whose death appears imminent and who would be able to use the income tax deduction might want to make a charitable contribution of the policy. Perhaps the IRS would apply the rule that the value of the transfer increases as death becomes imminent only to support higher gift and estate tax valuations. The IRS might not allow the higher valuation for purposes of income tax deductions. Gifts of life insurance policies also offer possible estate tax benefits, as discussed in the following text.

Premiums paid by the donor, after having transferred the policy to the charity, are deductible as charitable contributions.\(^\text{190}\)

.02 Estate Tax Consequences

Life insurance proceeds payable to a named charitable beneficiary might be includible in the insured’s gross estate under several provisions of the estate tax law:

- **IRC Section 2035—transfer within three years of death.** If the insured dies within three years of the policy’s transfer, the proceeds will be includible in the insured’s gross estate.

- **IRC Section 2042—retained incidents of ownership or reversionary interest.** The proceeds will be includible in the insured’s gross estate under IRC Section 2042 if the insured, at the time of his or her death, possessed any incidents of ownership in the policy, or if the insured held a reversionary interest in the policy or in the proceeds, and the value of the reversionary interest immediately before the insured’s death exceeded 5 percent of the value of the policy.\(^\text{191}\)

- **Policies placed in a trust.** Life insurance policies placed in a trust for the benefit of a named charity may be includible in the insured’s gross estate if the trust is revocable\(^\text{192}\) or the insured re-

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\(^\text{188}\) Regulations Sections 25.7520-3(b)(4).

\(^\text{189}\) Regulations Section 25.7520-3(b)(3).

\(^\text{190}\) IRC Section 170.

\(^\text{191}\) IRC Section 2037.

\(^\text{192}\) IRC Section 2038.
tains a life interest\textsuperscript{193} or a reversionary interest in the trust of more than 5 percent of the value of the property\textsuperscript{194} or if, as trustee, the insured may exercise incidents of ownership\textsuperscript{195}

However, the estate normally would be allowed a charitable deduction\textsuperscript{196}, which would serve to offset the amount includible in the insured decedent’s estate. Of course, the insured can avoid inclusion altogether by transferring the policy and all incidents of ownership in the policy more than three years before death.

\textbf{.03 Insurable Interest}

The requirement of an insurable interest is a familiar concept in all insurance law. The idea is that the applicant for an insurance policy on another person’s life should have an interest based on marriage, blood, or financial considerations that takes the policy out of the category of a wagering contract. If a charity were to take out a policy on an individual whose only connection with it was that he or she wanted to make a contribution, a question could arise about whether the charity had an insurable interest. For this reason, prudence suggests that the charity should never be the applicant for the policy, nor should the donor apply for the policy in the charity’s name.

A possible danger occurs if a policy taken out by the insured is transferred too soon thereafter to the charity. The transaction might be viewed as prearranged, with the charity really procuring the policy. The preferred approach would be to assign a policy that has been in existence for some time. If necessary, the donor should obtain a new policy to protect the donor’s family.

\textbf{¶530 Gifts of Income to Charity—Charitable Lead Trust}

An individual may use a charitable remainder trust to give income-producing property to a favorite charity while retaining a stream of income and obtain an income tax deduction for the value of the gift of the remainder interest. What about the individual who would like to reverse the process, and give the income to charity and keep the property?

A wealthy person who wishes to give to charity but who is also concerned with increasing the long-term level of affluence of family members, may use the \textit{charitable lead trust}. Sometimes referred to as a \textit{front trust}, it is designed to provide the charity with a determinable amount of income for a determinable period. At the end of the period, individual beneficiaries receive a remainder interest. Conceptually, it is basically the reverse of the charitable remainder trust in which individuals start out as the income beneficiaries, and the charity holds a remainder interest.

The charitable lead trust may exist either in the form of a living trust or a testamentary trust. It may be an annuity trust (CLAT) or a unitrust (CLUT). It is most appropriate for use in situations in which the

\textsuperscript{193} IRC Section 2036.

\textsuperscript{194} IRC Section 2037.

\textsuperscript{195} IRC Section 2042.

\textsuperscript{196} IRC Section 2055(a).
settlor and his or her family have no immediate need for more income than they currently enjoy. They should be able and willing to forego current income for the prospect of long-term capital appreciation. In such situations, the lead trust can accomplish the following:

- Enable the donor to carry out charitable purposes and commitments over a period of years with monies that might otherwise be expended largely in income taxes.

- Enable the donor funding the trust with property with strong appreciation potential to pass the appreciation to chosen beneficiaries without transfer tax cost on the appreciation.

- Enable the donor to exclude the future appreciation and transfer taxes from the gross estate. This reduction in the gross estate might, in turn, reduce estate liquidity needs. Thus, the donor could retain illiquid assets with high yield or growth potential, or both, to the ultimate benefit of the individual beneficiaries.

- Enable the donor to keep control of the trust assets within the family. If the donor uses a closely held business interest to fund the trust, keeping control of the business will be a matter of crucial importance. Funding the trust with other types of investment property will permit the development of investment strategies that will serve family interests.

An income tax deduction based on the value of the charity’s income interest under a charitable lead trust is seldom a factor in setting up such a trust. Special rules deny the donor an income tax deduction unless the donor-grantor is taxable on the ongoing trust income under the grantor trust rules of IRC Sections 671–677, and then, only if the charity’s income interest qualifies as a guaranteed annuity interest or unitrust interest.\(^{197}\) The law does not require that the annual payments to charity be at least equal to 5 percent of the initial or annual value of the trust as it does for the charitable remainder annuity trust or unitrust.\(^{198}\)

In a grantor CLAT, the grantor receives an income tax deduction upon creating the trust, is taxed on all the trust income while the trust remains in operation, and the trust property is included in the grantor’s estate at death. The grantor CLAT is not usually utilized unless the taxpayer is looking for a very significant income tax deduction in the year the trust is created (possibly to offset a large bonus, the exercise of stock options, or other windfall payment) and is willing to endure the ongoing income and potential ultimate death tax results. If the lead trust requires qualifying payments to one or more qualified charities, the donor or his or her estate will be entitled to a gift\(^{199}\) or estate tax deduction\(^{200}\) at the time of the creation and funding of the trust based on the present value of the charitable interest. This value is determined on the basis of the actuarially determined present value of the payments to charity provided for in the trust instrument.

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\(^{197}\) Regulations Section 1.170A-6(c)(1).

\(^{198}\) IRC Section 664(d).

\(^{199}\) IRC Section 2522.

\(^{200}\) IRC Section 2055.
The remainder interest created for the noncharitable beneficiaries when a charitable lead trust is established during the life of the grantor is subject to gift tax. The value of the gift is the value of the property transferred to the trust at the time of transfer, less the present value of the charity’s income interest computed on the basis of IRC Section 7520 tables. The interest factor under these tables is based on 120 percent of the federal midterm rate, and it changes monthly. For charitable transfers, the interest factor for the month of the transfer or either of the two prior months may be used.\textsuperscript{201} Thus, if interest rates change within this three-month time period, a taxpayer will be in a position to choose the rate that produces the maximum deduction. Periods of low interest rates favor the charitable lead trust because they result in an enhanced value for the charitable lead interest and a reduced value of the remainder gift to family members.

The standard actuarial factors embodied in the IRC Section 7520 tables may not be used if the grantor is terminally ill at the time of the transfer. The grantor is deemed to be terminally ill if he or she is known to have an incurable illness or deteriorating physical condition such that there is at least a 50-percent chance that he or she will die within one year. If the individual survives for at least 18 months after the date the gift is completed, however, the presumption is made that the grantor was not terminally ill at the time of the gift.\textsuperscript{202}

Sample provisions for charitable lead trusts are set forth in Revenue Procedure 2007-45 (sample inter vivos trust) and Revenue Procedure 2007-46 (sample testamentary trust).\textsuperscript{203}

\textbf{¶535 Contribution of Partial Interests in Property}

A deduction is allowed for gifts to charity of partial interests in property when the gift is made in trust, and the trust conforms to the IRC requirements governing charitable remainder trusts, more specifically, annuity trusts and unitrusts, as discussed earlier.\textsuperscript{204} A deduction is also allowable for gifts of partial interests not in trust made to a pooled income fund, as discussed in ¶515.02,\textsuperscript{205} and for gifts of remainder interests in a personal residence or farm.\textsuperscript{206} See ¶515.03.

With these exceptions aside, a charitable contribution of any interest in property that consists of less than the donor’s entire interest in the property does not qualify for a deduction\textsuperscript{207} unless it is one of the following:

\begin{itemize}
  \item A gift of an undivided portion of the donor’s entire interest.\textsuperscript{208}
\end{itemize}

\textsuperscript{201} IRC Section 7520(a)(2).

\textsuperscript{202} Regulations Sections 20.7520-3(b)(3) and 25.7520-3(b)(3).


\textsuperscript{204} IRC Section 170(f)(2)(A).

\textsuperscript{205} IRC Section 170(f)(2)(A).

\textsuperscript{206} IRC Section 170(f)(3)(B).

\textsuperscript{207} IRC Section 170(f)(3)(A).
A gift of a partial interest in property that would have been deductible if it had been made in trust.209

A transfer of a work of art to which the copyright is retained. Under IRC Section 2055(e)(4), the work of art and the copyright are treated as separate properties for purposes of the estate and gift tax charitable deductions.

A gift of a partial interest in property will qualify for a charitable deduction if it is the donor’s entire interest in the property. An individual could hold only an income interest in property or only a remainder interest. If the individual holds only such an interest and donates it to a charity, he or she will be entitled to a charitable contribution deduction measured by the value of the interest at the time of the contribution.

Under a long-standing rule, a deduction is allowed for the value of a charitable contribution of an undivided portion of the donor’s entire interest in property. However, there are significant restrictions on such donations.210

No deduction is allowed for a contribution of a fractional interest in an item of tangible personal property, unless immediately before the contribution all interests in the property are owned (1) by the donor or (2) by the donor and the donee organization. The IRS is authorized to make exceptions in cases in which all persons who hold an interest in the property make proportional contributions of undivided interests in their respective shares of the property to the charity.

In addition, these rules require the donor to eventually transfer the entire property to the charity. If a donor makes an initial fractional contribution, then fails to contribute all of his or her remaining interest in the property before the earlier of 10 years from the initial fractional contribution or the donor’s death, then all deductions from prior contributions of interests in the property are recaptured (plus interest).

During the time between the initial fractional contribution and the final contribution, the charity must take substantial physical possession of the property (possession requirement) and use the property in a manner related to its exempt purpose (related use). If the possession and related use tests are not met, the donor’s deductions for all previous contributions of interests in the property are recaptured (plus interest).

Finally, a donor of a fractional interest may not benefit from appreciation in the value of the property after the initial contribution. The fair market value of any subsequent contributed interest is determined by using the lesser of (1) the property’s fair market value at the time of the initial fractional contribution or (2) the property’s fair market value at the time of the subsequent contribution.

Regulations Section 1.170A-7(b)(2) provides that a deduction is allowed for the value of a charitable contribution not in trust of a partial interest in property that is less than the donor’s entire interest in the


property and that would be deductible if it had been transferred in trust. The rules regarding fractional interest contributions generally do not change that rule.

This limitation includes gifts of remainder interests by an individual who retains a life or term interest in the property. The only gifts of a remainder interest in trust that permit a charitable contribution deduction are those in which the annual dollar amount of income interest is payable in the form of a fixed annuity based on the value of the property at the time of the gift (the annuity trust—or CRAT) or in which the annual income payments are based on a fixed percentage of the net fair market value of the trust’s assets determined annually (the unitrust—or CRUT).

**01 Income and Estate Tax Deductions for Conservation Purposes**

As a general rule, gifts of partial interests in real estate do not qualify for a charitable contribution deduction. One exception under IRC Section 170(f)(3)(B)(iii) is a qualified conservation contribution. IRC Section 170(h) defines a *qualified conservation contribution* as a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. It then defines a *qualified real property interest* as either (1) the entire interest of the donor other than a qualified mineral interest, (2) a remainder interest, or (3) a restriction (granted in perpetuity) on the use which may be made of real property.

The same contribution, if made during the donor’s lifetime, can generate both an income tax deduction and an estate tax deduction. This situation can occur if the property is includible in the donor’s gross estate by reason of the donor’s retention of a lifetime interest or powers over it. If the contribution is made by will, only an estate tax deduction may be taken.

A contribution will not qualify under this provision if the donor has reduced his or her entire interest in real property before the contribution is made. For example, the contribution would not qualify if the donor transferred part of his or her interest in the property.

Qualified conservation contributions of capital gain property are generally subject to the 30-percent limit that applies to other charitable contributions of capital gain property. Individuals can deduct the fair market value of any qualified conservation contribution to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account when determining the amount of other allowable charita-

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211 IRC Section 170.
212 IRC Section 2055.
213 IRC Section 2036(a).
214 IRC Section 2041.
215 IRC Section 2055.
216 Regulations Section 1.170A-14(b)(1).
217 IRC Section 170(b)(1)(E)(i).
ble contributions. Individuals can carry over any qualified conservation contributions that exceed the 50 percent limitation for up to 15 years. This enhanced deduction for charitable contributions of real property for conservation purposes was made permanent by the PATH Act of 2015.

In addition, a higher deduction limit applies to qualified conservation contributions by qualified farmers and ranchers. In the case of an individual who is a qualified farmer or rancher for the contribution year, a qualified conservation contribution is allowable up to 100 percent of the excess of the contribution base over the amount of all other allowable charitable contributions.\(^\text{218}\) This provision was also made permanent by the PATH Act of 2015. However, the 100-percent limitation was not available (and, thus, the 50-percent limitation applied) to any contribution of property used in agriculture or livestock production (or available for that production) unless the contribution was subject to a restriction that the property remain available for agriculture or livestock production.

A qualified farmer or rancher is a taxpayer whose gross income from the trade or business of farming or ranching is more than 50 percent of total gross income for the tax year.

.02 Conservation Purposes

The term *conservation purposes* is defined to include any one (or more) of four objectives:\(^\text{219}\)

1. The preservation of land areas for outdoor recreation by the general public or for the education of the general public.

2. The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.

3. The preservation of open space, including farmland and forest land, when such preservation
   a. is for the scenic enjoyment of the general public and will yield a significant public benefit or
   b. is pursuant to a clearly delineated federal, state, or local conservation policy and will yield a significant public benefit.

4. The preservation of a historically important land area or certified historic structure.

In the past, the term *certified historic structure* included any building, structure, or land area that was (1) listed in the National Historic Register or (2) located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district. However, a charitable deduction is now limited for a qualified conservation contribution relating to a structure or land area by reason of the property’s location in a registered historic district.\(^\text{220}\)

\(^\text{218}\) IRC Section 170(b)(1)(E)(iv).

\(^\text{219}\) IRC Section 170(h)(4).

\(^\text{220}\) IRC Section 170(h)(4)(C).
A charitable deduction continues to be allowable for buildings located in a registered historic district but with some strings attached. An easement or restriction that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, plus the sides, rear, and front of the building. In addition, the easement or restriction must provide that no portion of the exterior of the building may be changed in a manner inconsistent with its historical character.

For any conservation contribution relating to a registered historic district, taxpayers must include with the return for the tax year of the contribution a qualified appraisal of the contributed interest (irrespective of the claimed value), along with photographs of the entire exterior of the building and descriptions of all current restrictions on development of the building.

Taxpayers claiming a deduction for a qualified conservation contribution in connection with the exterior of a building located in a registered historic district in excess of $10,000 must pay a $500 fee to the IRS, or the deduction will be disallowed.221

The conservation purpose must be protected in perpetuity to satisfy the requirement that no surface mining rights may be retained.222 No deduction is allowed for an interest in property subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce in perpetuity the conservation purposes of the gift.223

Qualified organizations are limited to government and publicly supported charities or those which, if not publicly supported, are controlled by a government or publicly supported organization.224

The value of the conservation easement is based on sales of similar easements (for example, to governmental bodies) if a substantial record of such sales exists. Otherwise, the conservation easement is valued indirectly as the difference between the fair market value of the property before and after the easement.225 The before-and-after value must take into account a number of factors, such as any effect of the easement on other property owned by the donor and the likelihood that development barred by the easement would, in fact, have taken place (and when).

After the conservation easement is made, the donor must reduce the basis of his or her retained property by that part of the total basis allocable to the easement.226 Basis allocable to the easement is equal to the basis of the property multiplied by the fair market value of the easement divided by the fair market value of the property before the donation of the easement.


\[221\] IRC Section 170(f)(13).

\[222\] IRC Section 170(h)(5)(B).

\[223\] Regulations Section 1.170A-14(g)(2).

\[224\] IRC Section 170(h)(3).

\[225\] Regulations Section 1.170A-14(h)(3).

\[226\] Regulations Section 1.170A-14(h)(3)(iii).
In recent years, the IRS has initiated a crackdown on taxpayers who claim what it considers inappropriate charitable contribution deductions for cash payments or easement transfers to charitable organizations in connection with the taxpayers’ purchases of real property. In some cases, a charitable organization purchases property and places a conservation easement on the property. The charity then sells the property subject to the easement to the taxpayer for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the taxpayer makes a second payment, designated as a charitable contribution, to the charity. The total payments from the taxpayer to the charity fully reimburse the charity for the cost of the property. The IRS says that, in appropriate cases, it will treat these transactions in accordance with their substance, rather than their form. Thus, the IRS may treat the total of the buyer’s payments to the charity as the purchase price paid by the taxpayer for the property, with no amount deductible as a charitable contribution.227

.03 Partial Exclusion From Gross Estate for a Conservation Easement

If an executor so elects, IRC Section 2031(c) allows an exclusion from a decedent’s gross estate of up to 40 percent (the applicable percentage) of the value of the land subject to a qualified conservation easement, subject to a maximum exclusion limitation described in the following paragraph. When an estate also claims an IRC Section 2055(f) charitable deduction with respect to the land, the qualified conservation easement exclusion is reduced by the amount of this deduction.

Limitation of benefits. Under IRC Section 2031(c)(3), the maximum amount that an estate may exclude as a qualified conservation easement is the lesser of the amount calculated by applying the applicable percentage or the exclusion limitation. The exclusion limitation is $500,000.

Location and use requirements. To qualify for the conservation easement exclusion, requirements relating to the location and use of the land must be met.

The estate tax exclusion for a qualified conservation easement is available for any otherwise qualifying real property that is located in the United States or any possession of the United States.

In addition, the following requirements related to family use and control must also be met:

- The land must have been owned by the decedent or a member of the decedent’s family (generally defined as the decedent’s spouse, parents, brothers, sisters, children, stepchildren, and lineal descendants of these individuals) during the three-year period ending on the date of the decedent’s death.228

- The land must be subject to a qualified conservation easement (discussed in more detail under the heading "Qualified conservation easement") granted by the decedent or a member of the de-

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228 IRC Section 2031(c)(8)(A)(ii).
An after-death easement can be placed on the property, but if this is done, the easement must be in place by the date of the election to claim the exclusion.\textsuperscript{230}

**Planning Pointer.**

The current tax law rules extend the exclusion to easements on land located anywhere within the United States or its possessions. Bear in mind, too, that this is one situation in which a taxpayer’s heirs can engage in some after-the-fact tax planning, since qualified conservation easements can be placed on property after death.

An election to treat an easement as a qualified conservation easement for purposes of the IRC Section 2031(c) provision is made on Schedule U of the decedent’s federal estate tax return (Form 706), and once made, is irrevocable.\textsuperscript{231}

**Qualified conservation easement.** Under IRC Section 2031(c)(8)(B), for an estate tax deduction to be allowed, a qualified conservation easement must be a *qualified conservation contribution*, as defined in IRC Section 170(h)(1). To meet this definition, the donated property interest must either be the donor’s entire interest in the real property (other than a qualified mineral interest) or a remainder interest. The donation must also be considered to be for *conservation purposes* as defined in IRC Section 170(h)(4)(A) (as described under the heading "Conservation purposes," in paragraph 535.02). However, the fourth listed objective, that of preservation of a historically important land area or certified historic structure, will not alone support an exclusion claimed as a qualified conservation easement. Further, certain *de minimis* commercial recreational activity that is consistent with the conservation purpose will not cause the property to fail to qualify for the exclusion.

**Exclusion amount.** The exclusion amount is calculated based on the value of the property after the conservation easement has been placed on the property. In addition, the exclusion amount does not include the value of any development rights retained by the decedent’s estate or heirs. *Development rights* are defined as rights retained to use the land for any commercial purpose. However, development rights do not include rights that are subordinate to, and directly supportive of, use of the land for *farming purposes*, as defined in IRC Section 2032A(e)(5).

**Applicable percentage.** Computation of the exclusion depends, in part, on determining an applicable percentage with respect to the property. To determine this applicable percentage, the estate initially starts out with 40 percent, then reduces this number by two percentage points for every percentage point (or fraction thereof) by which the value of the conservation easement is less than 30 percent of the value of the land.\textsuperscript{232} For this purpose, the value of the land is determined without regard to the easement and is reduced by the value of any retained development rights.

\textsuperscript{229} IRC Section 2031(c)(8)(A)(iii).
\textsuperscript{230} IRC Section 2031(c)(9).
\textsuperscript{231} IRC Section 2031(c)(6).
\textsuperscript{232} IRC Section 2031(c)(2).
No qualified conservation easement exclusion will be available if the value of the easement is 10 percent or less of the value of the land before the easement. Computation of the applicable percentage of an easement that would lead to an exclusion appears in the following example.

Example 5.3. John Thomas died owning land subject to a qualified conservation easement. He retained no development rights in the property, and the property was not mortgaged. The fair market value of the property on John’s date of death was $8 million without the conservation easement and $6 million with the easement. Thus, the value of the easement is $2 million, or 25 percent of the value of the property without the easement. The applicable percentage is 30 percent (40 percent reduced by twice the difference between 30 percent and 25 percent). Although this result would yield an exclusion amount of $600,000 (30 percent of $2 million), the exclusion is limited to $500,000 because of the statutory exclusion limitation.

To the extent that the value of the land is excluded from the decedent’s gross estate, the transfer of the land to the decedent’s heirs subject to the conservation easement receives a carryover basis, rather than a stepped-up basis. 233

Debt-financed property. Land for which there is acquisition indebtedness outstanding on the date of the decedent’s death can qualify for the conservation easement deduction to the extent of the net equity in the property. 234

Retained mineral rights. A contribution of a conservation easement on property qualifies for a charitable deduction for estate and income tax purposes when a mineral interest has been retained, and surface mining is possible, but only if the possibility is so remote as to be negligible.

Special use valuation. The granting of a conservation easement does not affect specially-valued farm or business property under IRC Section 2032A. Thus, the grant of such an easement is not treated as a disposition for purposes of IRC Section 2032A(c) and does not trigger liability for the additional estate tax. Further, the existence of a qualified conservation easement does not prevent the property from subsequently qualifying for special use valuation.

Planning Pointer.

In order to receive the conservation easement exclusion, the decedent (or his or her estate) will have to grant the easement permanently to a qualified charity. By its nature, such a transfer will lessen the value and limit the marketability of the land subject to the easement. Accordingly, like any other significant property transfer, the client should carefully consider the consequences of a conservation easement within the parameters of the client’s total estate plan. If the grant of such an easement is consistent with this plan, it can offer a meaningful reduction of the decedent’s gross estate.

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233 IRC Section 1014(a)(4).

234 IRC Section 2031(c)(4).
In addition to the direct savings that a qualified conservation easement can offer by reason of reducing the gross estate, it can also help the estate qualify to satisfy the various percentage requirements for the special use valuation election. In addition, a qualified conservation easement can help the estate satisfy the percentage ownership tests and qualify for the deferred installment payment of estate taxes with respect to family-owned farms and other closely held businesses. However, if the land qualifying for the easement exclusion is special use valuation property or closely held business property, the reduction in value of the property would make qualifying under IRC Sections 2032A or 6166 more difficult. If, however, meeting the percentage qualifications for special use valuation and deferred payment of estate taxes is not a problem, granting a conservation easement will help the estate qualify for special use valuation without disrupting the operation of the family-owned business itself.

¶540 Caution: Charitable Deduction Reduction Rules, IRC Section 170(e)

The financial planner must be aware of several important rules that may serve to limit the value of a client’s income tax charitable deductions.

A general rule states that a taxpayer receives an income tax charitable deduction equal to the fair market value of the gifted property. However, the amount of the charitable deduction from a contribution of property must be reduced by the amount of gain, which would not have been long-term capital gain if the contributed property had been sold by the taxpayer at its fair market value—regardless of the type of charitable donee. This means that contributions of ordinary income property (inventory, recapture property, accounts receivable, short term capital gains, self-created property donated by the creator, such as musical or artistic creations) are limited to the cost basis of the property donated.

Another general rule provides that contributions of long-term capital gain property given to a private non-operating foundation must be reduced by the amount of any gain that would have been long-term capital gain had the property been sold at its fair market value. Again, this means that the contribution deduction is limited to the cost basis of the property. However, if the contribution to the private foundation is “qualified appreciated stock”—that is, stock traded on an established security market representing not more than 10 percent of the value of the company stock, the sale of which would have resulted in long-term capital gain—the deduction is equal to the fair market value of the stock, subject to the general percentage of AGI requirements that gifts to charities must respect.

Another general rule provides that a charitable deduction equal to the fair market value of the property is available for a gift of tangible personal property to a donee charity so long as the donee charity puts the

235 IRC Section 2032A.
236 IRC Section 6166.
237 Regulations Section 1.170A-1(e)(1).
238 IRC Section 170(e)(1)(A).
239 IRC Section 170(e)(1)(B).
property to a use “related” to its charitable purpose. If the donated property is not put to such a related
use, the deduction to the donor is limited to the basis of the donated property. The responsibility to es-

tablish that the tangible personal property is being put to a related use falls on the donor of the property.
The law provides a safe harbor presumption of related use for contributions of tangible property to a
museum, and assumes that contributions of items of tangible property to events such as rummage sales
and auctions requires the value of the contribution to be limited to the cost basis of the property.

545 Recent Developments

.01 Historic Easement Contribution Not Deductible as Entire Façade “Not Protected” From Development

In Partita Partners, LLC, the U.S. District Court denied more than $4 million in income tax deductions to a
partnership that contributed a façade easement over an historic building as the partnership reserved the right
to make further modifications to the building that would change the façade. Specifically, the partnership
reserved 2,700 square feet of development rights for “future expansion of the Property in accordance with
the terms of this Easement.” On balance, the court held that this violated the requirement that the easement
“preserve … the entire exterior of the building (including the front, sides, rear, and height of the building,
and … prohibit … any change in the exterior of the building which is inconsistent with the historical charac-
ter of such exterior.”

Charitable Contributions: Imperfect Appraisal Still Qualifies as a “Qualified Appraisal.” For any
noncash charitable contribution exceeding $5,000, the donor must obtain a “qualified appraisal” for the
contributed property—one that contains information such as a description of the property, the appraiser's
qualification, the appraisal dates, the valuation method used, and the specific basis for the valuation.
Nevertheless, the Tax Court held that, although several elements of an appraisal of real property con-
tributed to a state agency were not in strict conformity with the relevant regulations, the appraisal met
the requirements of a qualified appraisal.241 In upholding the validity of the appraisal, the court noted
that strict compliance with the qualified appraisal requirements is sufficient to win a deduction, but it is
not necessary, as the regulations are to be viewed as directory in this context rather than mandatory.

Charitable Contribution Deduction Reduced for Lack of Proper Documentation. In Barnes, the
Tax Court held that a taxpayer could not deduct part of the cost of a trip to Africa with a church group or
part of the unreimbursed expenses for working for the church, as the taxpayer lacked proper contempo-
ranous written acknowledgements from the church for the two sets of deductions. This case illus-
trates the importance of maintaining proper records and substantiation to support deductions. Without
such backup, it becomes highly difficult, if not impossible, to defend an IRS audit.

242 See Barnes v. Commissioner, T.C. Memo. 2016-212.
Chapter 6

The Use of Trusts

¶601 Overview

The trust is an essential tool of the financial planner and is widely used in financial and estate planning. It is simply an arrangement by which one person holds legal title to an asset and manages it for the benefit of someone else. It has, of course, many uses outside the field of financial and estate planning. One can use a trust in a business setting. For example, consider the employee benefit trust, the debtor-creditor trust, the voting trust, and the trust used in connection with sales and financing. A trust is an excellent asset protection vehicle. Given the wide array of potential uses, certain trusts have also become the subject of abuse by unscrupulous promoters and have been included in the IRS "Dirty Dozen Tax Scams." As a result, the financial planner should be cognizant of this fact and ensure a legitimate and valid purpose of any trust vehicle.
Given sufficient input, a trust can do almost anything that the settlor might do and some things that the settlor might not be able to do because of lack of a required skill, or as the result of sickness, disability, distance from the scene, or death.

The ability of the trust to bridge the gap between life and death is surely one of its most remarkable characteristics. Through a trust, the settlor can rule from the grave, for as long as the law allows, which in some jurisdictions is for perpetuity. Generally, the trust may last as long as any living individuals the settlor names remain alive, and for 21 years after the last of those designated individuals dies. This rule is the rule against perpetuities in its common law form. Many states have enacted the uniform rule against perpetuities, which permits trusts to last for either the common law period or 90 years. The rule against perpetuities is a matter of state substantive law, not of tax law. In recent years, a growing number of states have either completely repealed the rule against perpetuities or extended it for many years, allowing trusts to potentially last a very long time, if not indefinitely.

Often, a settlor will set up a trust for his or her own benefit, not necessarily for tax planning, but for various other important reasons. The settlor might want investment management assistance or might want to take a chance on some new business venture and use the trust as a vehicle to provide income in the event the venture struggles or fails. Probate issues may be cumbersome in the settlor’s state of domicile. A settlor might feel that, while currently able to manage one’s own finances, the future is uncertain. The settlor might go off on a long trip abroad or might have an accident, in which case a standby trust would be beneficial to manage financial affairs pending recovery. Privacy concerns may arise in connection with a will, and can be protected by using a trust.

A settlor may form a trust for the benefit of others, such as a spouse, children, parents, or grandchildren. The settlor might want to provide the beneficiaries with what he or she might regard as missing elements in their abilities, experiences, or training. This is clearly the case when minors or others who have been deemed legally incompetent are the intended beneficiaries. However, trusts may be created for the benefit of responsible, competent adults for the same reasons. The settlor might also want to set up a trust for the settlor’s own benefit or for the benefit of loved ones for reasons such as asset protection from all varieties of creditors, caution regarding matrimonial involvements, and other practical reasons, the most practical being cash savings.

For some clients, the cash savings for the family and other benefits that can be achieved through the use of trusts to avoid probate might be important. Possible estate and gift tax savings can be even more important. However, these potential savings must be balanced against income tax costs. Trust income tax brackets are extremely compressed so that accumulated trust income is likely to be taxed at much higher rates than if it were distributed to the trust settlor or to the trust beneficiaries. The 3.8 percent net investment income tax also affects trusts at low levels of undistributed income, that is, $12,500 for 2017. This number is indexed annually for inflation. This same threshold of $12,500 is also the point where the 39.6 percent tax rate begins to apply to the undistributed income of a trust, and also where the 20 percent tax rate on undistributed qualified dividends and long-term capital gains begins to apply. The tightly compressed tax brackets for trusts and estates make distributions of ordinary income and capital gains increasingly valuable.

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1 IRC Sections 1(e) and 661(a). See also, Oshins, Richard and Siegel, Steven, “The Anatomy of the Perfect Modern Trust,” Estate Planning, January 2016 – Part I, February 2016 – Part II.
These potential transfer tax savings, and how, when, and for whom they might be achieved, along with the nontax benefits of trusts, constitute the main concern of this chapter. This chapter examines the following types of trusts:

- Living trusts (trusts that come into being while the settlor is still alive), which may be either revocable or irrevocable
- Testamentary trusts (created by a person’s will), which become irrevocable on the death of the maker of the will
- Pourover trusts, which are a special kind of trust used to transfer estate assets
- Sprinkling or discretionary trusts
- Foreign trusts
- Multiple trusts
- Annuity or unitrusts (trusts in which the grantor retains an interest but also creates an interest for another)

Before addressing the specifics of each type of trust, this chapter will discuss the various rules that need to be taken into account when dealing with trusts. These rules include how and when trust income is taxable to the trust, the beneficiary, and the settlor, and how the settlor can keep trust property out of his or her gross estate. The gift tax aspects involved in the creation of trusts and the transfer of trust interests will also be examined.

This very brief summary provides an overview of the tax rules:

- Trusts, aside from grantor trusts, are generally treated as separate taxable entities,2 and they have their own limited exemptions from income tax3 and their own tax brackets, which are extremely compressed when compared with the tax brackets that apply to individuals.4
- If the trust is one that requires all of its income to be distributed currently to the beneficiaries, the trust beneficiaries are generally taxable on the income.5
- If the beneficiary is under the age of 19, and either parent is alive at the end of the tax year, unearned income of the child in excess of $2,100 (for 2017) is taxed at the higher of the child’s in-

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2 IRC Section 641.
3 IRC Section 642(b).
4 IRC Section 1(e).
5 IRC Section 652(a).
come tax rate or the parent’s income tax rate.6 This rule also applies to the unearned income of a child over 19 but under age 24, who is a full-time student and who does not provide more than one-half of his or her own support. A parent may elect to include the child’s income on the parent’s own income tax return in some limited cases.7

- If trust income is accumulated, the trust is taxed on the income retained.8
- The settlor (grantor) of a living trust may be taxable on the income of the trust if it can be used for his or her personal or economic benefit, now, or in the future.9
- Trust property is not includible in the settlor’s gross estate if the trust is irrevocable, and the settlor does not retain or possess any substantial rights, interests, and powers over it.10
- Transfers to trusts are treated as gifts to the trust beneficiaries and may be taxable or not taxable in accordance with the general gift tax rules.

A financial planner should also have a general idea of what a trust looks like. The following is a description of the provisions ordinarily found in a trust:

- **Settlor.** The person who creates the trust. The settlor may also be referred to as the grantor or the trustor.

- **Property transferred.** The property transferred is described in the trust document or in an associated schedule. It may be called the corpus or the principal.

- **Trustee.** The trustee is named, and if it is a living (inter vivos) trust, the trustee also signs the trust agreement. The trustee may be an individual or a corporate (bank or trust company) trustee. Multiple trustees are allowed.

- **Beneficiaries.** Both primary and contingent beneficiaries are named, and the conditions under which they are to receive income or principal (corpus) are spelled out. The settlor may or may not be one of the beneficiaries.

- **Powers.** The administrative powers of the trustee are spelled out.

- **Spendthrift provision.** This provision bars transfer of a beneficiary’s interest and stipulates that it is not subject to the claims of the beneficiary’s creditors.

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6 IRC Section 1(g).
7 IRC Section 1(g)(7).
8 IRC Section 641(a).
9 IRC Section 671.
10 IRC Section 2038.
• **Savings clause—perpetuities.** This clause provides that, anything else in the trust to the contrary notwithstanding, the trust is to terminate no later than the period allowed by the state rule against perpetuities, if any.

• **Bond.** Normally, the appointed trustee will be exempted from having to post bond or other security. Special provision will be made about whether the exemption extends to a successor or substitute trustee.

• **Successor.** Provisions are made for the appointment of a successor trustee in the event of the named trustee’s declining the appointment (in a testamentary trust), dying, resigning, being removed, or being incapable of serving. A corporate trustee, for example, named in a will, might decline to serve because the amount of its fee might be insufficient.

• **Trustee’s fee.** Provisions are made for the payment of a reasonable fee that is acceptable to the trustee. In some cases the provision appointing the trustee may say that the trustee is to serve without fee, especially in situations in which family members are appointed trustees.

A financial planner should also understand that trust law is complex and is based on the statutes and court decisions of both federal law and the applicable state. Moreover, the various states do not have a uniform law of trusts. Consequently, a trust instrument should be drafted by a lawyer who knows all the applicable federal and local rules.

.01 Marital Deduction Trusts and Nonmarital Trusts

Marital deduction trusts, along with nonmarital trusts, are discussed in chapter 12, "The Marital Deduction."

.02 Generation-Skipping Trusts

Wealthy clients might wish to create trusts lasting for several generations for the purpose of reducing transfer taxes. Alternatively, they might wish to make gifts directly to members of a generation younger than that of their children (that is, to grandchildren or great-grandchildren). Generation-skipping transfers are discussed in chapter 27, "Planning for Generation-Skipping Transfers."

¶605 Trusts and Income Taxes

Numerous tax law changes over the past years have had a major impact on the income taxation of trusts (and estates). As a result of these changes, achieving income tax savings through the use of trusts is very difficult. In many cases, the family tax bill could be increased if income is allowed to accumulate in a trust. This problem became even more serious in 2013 when the 3.8 percent tax on the net investment income of certain "wealthy" taxpayers became effective. For a trust and an estate, a *wealthy* taxpayer is considered an entity with undistributed net income in excess of $12,500 for 2017 (indexed annually). Compare this threshold with the threshold at which individuals become subject to the net investment income tax: $200,000 of adjusted gross income (AGI) for single filers; $250,000 of AGI for married persons filing jointly; and $125,000 of AGI for married persons filing separately. The individual thresholds are not indexed for inflation. Also, above the $12,500 threshold is the point where trusts and estates begin to pay the 39.6 percent tax rate on undistributed ordinary income and short-term capital gains, and the 20 percent rate on undistributed qualified dividends and long-term capital gains for 2017. These compressed tax rates imposed on trusts and estates put a premium on efforts to distribute more income to individual taxpayers who have much higher thresholds before being impacted by these same taxes.
.01 Tax Considerations

The following are some of the tax considerations involved in using a trust.

**Tax rates.** The income tax brackets of trusts are greatly compressed.\(^{11}\) For example, for tax year 2017, the 39.6 percent rate applies to taxable income over $12,500. A single individual, on the other hand, is taxed at a rate of 10 percent up to $9,325, at a rate of 15 percent on taxable income between $9,325 and $37,950; at 25 percent between $37,950 and $91,900; and at higher rates on taxable income above that amount. A 39.6 percent tax rate does not apply until a single person’s income exceeds $418,400 for 2017. These compressed rates create difficulty when using trusts as vehicles for saving family income taxes if trust income is to be accumulated rather than distributed. However, a trust can offer family tax savings if the income will be paid out to beneficiaries who are in lower tax brackets than the grantor. Purposely setting up a trust to be a grantor trust whose income is taxed to the grantor also can yield savings in some cases, as discussed subsequently in section .02 of this chapter in connection with the grantor trust rules.

**Estimated tax payments.** Trusts, as a general rule, must make annual estimated payments of income tax.\(^{12}\) A grantor trust to which the residue of the decedent’s estate will pass under his or her will (or, if the decedent had no will, under the terms of the trust primarily responsible for paying debts, taxes, and administration expenses) is not required to pay estimated taxes for taxable years ending within two years of the decedent’s death, so long as the trustee of the trust and the personal representative of the decedent’s estate elect to treat the trust as a qualified revocable trust under IRC Section 645.\(^{13}\) In the case of trusts making estimated payments, IRC Section 643(g)(1) provides that if the trust’s estimated tax payments for a taxable year exceed its income tax liability shown on its return for that year, the trustee may elect to assign any amount of the quarterly estimated payments to the extent the payments exceed the trust’s tax liability, to a beneficiary or beneficiaries. Such election must be made on an income tax return of the trust, which is filed within 65 days after the end of the trust’s taxable year.\(^{14}\) If the trustee makes such an election, the amount assigned to beneficiaries is considered a distribution under the 65-day rule of IRC Section 663(b)(1). The beneficiary to whom the credit is assigned is deemed to have received a distribution on the last day of the trust year for federal income tax purposes (although the credit will be treated as received on the date the election is made for purposes of the beneficiary’s estimated tax payments).

**Calendar year.** Trusts, other than certain charitable trusts and those qualified revocable trusts eligible to make an IRC Section 645 election, must use a calendar year as their tax reporting year.\(^{15}\) Thus, deferral of income by a trust through use of a fiscal year (absent the IRC Section 645 election) is not possible.

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\(^{11}\) IRC Section 1(e).

\(^{12}\) IRC Section 6654(l).

\(^{13}\) IRC Section 6654(l)(2).

\(^{14}\) IRC Section 643(g)(2). File Form 1041-T to make this election.

\(^{15}\) IRC Section 644.
Miscellaneous deductions. The 2 percent of AGI floor beneath miscellaneous itemized deductions\(^{16}\) applies to trusts. However, the costs paid or incurred in connection with trust administration that would not have been incurred if the property were not held in trust are not subject to the 2 percent of AGI floor. In a case decided by the Supreme Court, *Knight v. Commissioner*, 552 U.S. 181; 128 S. Ct. 782 (2008), aff’g 467 F.3d 149 (2d Cir. 2006), this exception was held not to apply to investment advisory fees paid by a trust.\(^{17}\) The court reasoned that the exception to the application of the 2 percent rule applies only to costs that would be uncommon for an individual to incur outside of a trust. The court acknowledged that a special, additional investment advisory charge that applies only to trust accounts may be eligible for the exception from the 2-percent rule. However, in the case before the court, there was no indication that the trust was treated any differently than an individual with similar investment objectives. The Supreme Court decision resolved a split among the circuit courts on this issue.

The IRS issued final regulations in 2014 on deductible expenses for trusts and estates. After several years of proposals and withdrawals, the IRS has issued final regulations under IRC Section 67(e) addressing deductible expenses for trusts and estates following the Supreme Court decision in *Knight v. Commissioner*, 552 U.S. 181 (2008). These final regulations are effective for tax years beginning after December 31, 2014.

The regulations address the court’s “commonly” or “customarily” incurred standard. In analyzing whether a given trust or estate expense is subject to the 2-percent floor because a hypothetical individual owning the same property would “commonly” or “customarily” incur that same expense, what matters, according to the IRS, is the type of product or service to which the expense relates, rather than a description of it.

- **Ownership costs.** Ownership costs are chargeable to a property owner by virtue of being the property owner. Thus, because a hypothetical individual could be charged with costs such as condominium fees, insurance premiums, maintenance, and lawn services, these expenses are subject to the 2-percent floor. Expenses for real estate taxes or “ordinary and necessary” trade or business expenses are not subject to the 2-percent floor, however, and are generally fully deductible.

- **Tax preparation fees.** The only tax preparation fees that will be fully deductible are those relating to all estate and generation-skipping transfer tax returns, income tax returns for the estate or trust (known as “fiduciary” income tax returns), and the decedent’s final income tax return. Any other tax return preparation fees (such as for gift tax returns) are subject to the 2-percent floor.

- **Investment advisory fees.** Investment advisory fees are subject to the 2-percent floor, although certain “incremental” costs would not be. An incremental cost is a special charge added solely because the advice pertains to a trust (or an estate), the trust or estate has unusual investment objectives, or more is required than the usual balancing of interests between current and future beneficiaries.

\(^{16}\) IRC Section 67.

• **Appraisal fees.** Appraisal fees are fully deductible if they are incurred to determine the fair market value of a decedent’s assets, to determine value for purposes of making distributions, or “as otherwise required” to properly prepare the estate’s or trust’s tax returns or a generation-skipping transfer tax return. Appraisal fees for other purposes, such as insurance, are subject to the 2-percent floor.

• **Certain fiduciary expenses.** Fiduciary expenses that are not commonly or customarily incurred by individuals are fully deductible. Such expenses include probate court fees and costs, fiduciary bond premiums, legal publication costs notices to heirs, trust or will contests or document construction issues, the cost of death certificates, and costs related to fiduciary accountings.

• **“Bundled” fees.** If a trust or an estate pays a single fee (such as a fiduciary’s commission, attorney’s fee, or accountant’s fee), and that fee covers costs that are subject to both the 2-percent floor and those that are not, the fee must be allocated between these two types of costs. If, however, the bundled fee is not computed on an hourly basis, it is fully deductible, except for the investment advisory portion of the fee, which must be broken out, and is subject to the 2-percent floor. Out-of-pocket expenses are treated as separate from the bundled fee. Payments made to third parties from the bundled fee will be subject to the 2-percent floor if those payments would have been subject to the floor if the trust or estate had paid the provider directly. In addition, separately charged expenses that individuals commonly or customarily incur will also be subject to the 2-percent floor.

• **“Reasonable method.”** The fiduciary may use any “reasonable method” to unbundle the bundled fee between costs that are subject to the 2-percent floor and those that are not. The same “reasonable method” may be used to determine the investment advisory portion of the non-hourly bundled fee. Facts that may be considered in determining whether an allocation is reasonable include the percentage of the principal subject to investment advice, whether a third party would have charged a comparable fee for similar advisory services, and “the amount of the fiduciary’s attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.”

**Commentary:** The IRS’s position regarding the deductibility of fees for investment advisory services reflects its view that “similarly situated” taxpayers should receive similar treatment. If an individual cannot fully deduct these expenses, why should a trust or an estate be any different? However, although the tax computations for trusts and estates and individuals may be similar, the standard of behavior that applies to individuals and fiduciaries is very different. Fiduciaries are bound by a high level of responsibility and potential liability attached to all of their actions. Accordingly, the “similarly situated” references may prove to be troublesome.

The most troublesome aspect of these regulations involves the “unbundling” of the trustee fees requirement. Many trust companies are taking the position that they are not providing "investment advice" or "investment advisory services" to the trust and therefore, have nothing to unbundle. It is submitted that this is exactly right. The regulations require unbundling only to the extent that part of the fee is for investment “advice” or “advisory” services. Certain trustees are not advising anyone. They control the corpus and make investment decisions themselves. They do not advise someone who then takes action on their advice.

**Example:** Assume that a large bank is a trustee for client A, and an investment adviser for client B. It would seem to be a reasonable position that the entire fee charged to client A is deductible
without regard to the 2-percent floor because the bank is the decision-maker, not the client, and is “doing,” not advising. Conversely, the fees charged for the advice provided to client B would be subject to the 2-percent floor, because the bank is the adviser and the client is making the final decision.

Finally, withdrawn proposed regulations had provided a list of unique products and services, the cost of which the IRS considers exempt from the two-percent floor, as well as a list of products and services the cost of which it considers subject to the two-percent floor. These lists are likely to prove instructive about the position of the IRS when the final regulations are interpreted.

Under the withdrawn regulations, unique exempt products and services included

- fiduciary accountings;
- judicial or quasi-judicial filings required as part of the administration of an estate or trust;
- fiduciary income tax and estate tax returns;
- the division or distribution of income or corpus to or among beneficiaries;
- trust or will contests or constructions;
- fiduciary bond premiums; and
- communications with beneficiaries regarding estate or trust matters.

Non-unique products and services said to be subject to the two-percent floor include

- custody or management of property;
- advice on investing for total return;
- gift tax returns;
- defense of claims by creditors of the decedent or grantor; and
- purchase, sale, maintenance, repair, insurance, or management of nontrade or business property.

**Consistency requirements for beneficiaries.** Beneficiaries must file their income tax returns in a manner consistent with how the trust reported their respective shares of the trust’s income (Form 1041, Schedule K-1). If the beneficiaries disagree with the trust’s treatment of an item or items, they must file a notice of inconsistent treatment with the IRS on Form 8082.

A trust can be a separate taxable entity or a conduit through which income is passed to the beneficiaries. Income will be taxable to the beneficiaries to the extent that the trust actually distributes the income to them or makes it available to them.\(^{18}\) Income is taxable to the trust if it is accumulated by the trust;\(^{19}\)

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\(^{18}\) IRC Sections 652(a) and 662(a).
however, the trust can be set up so that part of the income is taxable to the trust and part to the beneficiaries. In this way, the income may be split in at least one more portion than the number of beneficiaries.

.02 Grantor Trust Rules

The grantor may be taxed on trust income in accordance with the grantor trust rules set out in IRC Sections 671–679. When originally enacted, trust income tax brackets were much lower than they are today, and the enactment of these rules was viewed as a deterrent to allowing individuals to save income taxes, forcing the grantor wanting to control trust income or distributions to bear more income tax liability. However, with trust tax brackets now being highly compressed, in some cases family savings can be realized by intentionally causing the grantor trust rules to apply. The income tax cost to an individual grantor may be significantly lower than if the same income were taxed at the trust’s compressed rates. Additionally, payment of the income tax by the grantor will not be regarded as a taxable gift by the grantor to the trust beneficiary who is directly benefited by the payment. A discussion of these rules follows.

IRC Section 673 taxes trust income to the grantor if he or she has a reversionary interest in the corpus or income of the trust that is worth more than 5 percent of the value of the trust at the time of the trust’s inception. In addition, IRC Section 673(c) provides that when testing for the five-percent reversionary interest, any discretionary powers are assumed to be exercised in such a way as to maximize the reversionary interest of the grantor. The only exception to this rule is if the reversion to the grantor is to take place on the death of the beneficiary, who is an under-age-21 lineal descendant of the grantor.20 Also, the grantor is generally treated as holding any power or interest in the trust held by his or her spouse.21

The grantor is taxable on the trust income if the income is, or may be, paid to the grantor or his or her spouse, accumulated for future distribution to either of them or applied to pay premiums for life insurance policies on either of their lives.22 The regulations under IRC Section 677 make the grantor liable for the trust’s income tax if trust income is, or may be, used to discharge a legal obligation of the grantor or his or her spouse.23 The only exception to this approach is in connection with the support of dependents. Here, IRC Section 677(b) taxes the grantor only if trust income is actually used for the support of someone the grantor is legally obligated to support. The fact that the trust income may be used for support is not sufficient to cause the income to be taxed to the grantor.

If the grantor can escape being taxed under IRC Section 673 and 677, the grantor might be taxed under IRC Section 676 by retaining the power to revoke the trust, except under the very remote contingency involving a distant power of revocation specified in IRC Section 676(b). In addition, income may be taxed to the grantor under IRC Section 674 if the grantor retains the power to control the beneficial en-

19 IRC Sections 641(a) and 661(a).


21 IRC Section 672(e).

22 IRC Section 677.

23 Regulations Section 1.677(a)-1(d).
joyment of the trust property or its income, except that paragraph (b) of Section 674 allows the grantor to retain certain specific powers without being subjected to income taxation. The following is a brief explanation of the IRC Section 674 (b) exceptions to taxing the grantor on the trust’s income, which can be thought of as safe harbors:

- An unexercised power to apply income to the support of a dependent; but, if the income is actually applied to the support of the dependent, it would be taxable to the grantor under IRC Section 677(b), previously mentioned.

- Power to affect enjoyment after the death of an income beneficiary, who is a lineal descendant dying before age 21, will not affect taxability of the grantor during the lifetime of the income beneficiary, but will thereafter, unless relinquished.

- A power exercisable only by will. (This exception does not apply to a power to appoint income accumulated without the consent of an adverse party.)

- Power to allocate income or corpus among charitable beneficiaries.

- Power to distribute corpus
  - to or for any beneficiary limited by a reasonably definite (ascertainable) standard or
  - to or for current income beneficiaries, if chargeable to their proportionate share of corpus held in trust to pay them income.

- Power to withhold income temporarily on certain specified conditions.

- Power to withhold income during a period of legal disability or minority of a beneficiary.

- Power to allocate receipts and disbursements between income and corpus.

- Powers of independent trustees will not cause trust income to be taxed to the grantor. This very important exception, provided by IRC Section 674(c), permits trustees other than the grantor to pay or accumulate income and principal to or for the benefit of trust beneficiaries under certain circumstances.

Insofar as the rules described for IRC Sections 674, 676, and 677 are concerned, if the power is exercisable by someone who is described as a nonadverse party, the rules are the same as if the power were exercisable by the grantor. A nonadverse party is simply any person who does not have a substantial beneficial interest that would be adversely affected by the exercise or nonexercise of the power that he or she possesses. A trustee is generally considered a nonadverse party unless the trustee is an independent trustee within the meaning of IRC Section 674(c).

IRC Section 675 provides that the grantor will be taxable as the owner of any portion of the trust over which he or she has certain administrative powers. The first and second powers set out in IRC Section 24 IRC Section 672(a) and (b).
675 both deal with actions taken by the grantor or a nonadverse party without the approval of an adverse party. These powers enable anyone to dispose of trust income or corpus for less than full value or enable the grantor to borrow the trust income or corpus without providing adequate interest or adequate security. The third power treats the grantor as owner of a trust from which he or she has directly or indirectly borrowed the corpus or income and has not completely repaid the loan before the beginning of the next tax year. This latter rule does not apply, however, if the loan provides for an adequate interest rate and adequate security and is made by a trustee unrelated and not subservient to the grantor.

There is a fourth part of IRC Section 675. It provides that the grantor will be taxed on the trust income if the grantor retains certain powers exercisable by the grantor in a nonfiduciary capacity (without being a fiduciary or without the consent of a fiduciary) in three specific areas: (1) voting stock held by the trust in a corporation in which the grantor and the trust have significant voting control, (2) controlling investments by the trust to the extent that the trust owns securities in which the grantor and the trust have significant voting control, and (3) repurchasing or substituting trust assets for other assets of equivalent value, with the approval of an independent trustee.

Planning Pointer.

Sometimes setting up a trust whose income will be taxed to the grantor under the grantor trust rules will be beneficial for income tax purposes. However, such a trust poses the danger that the trust property will be included in the grantor’s gross estate. Nonetheless, discrepancies between the grantor trust rules and the estate tax inclusion rules allow for the creation of what are referred to as "defective grantor trusts." The income of a defective grantor trust is taxable to the grantor, but the trust property is not includible in the grantor’s gross estate for estate tax purposes (¶610). Carefully limiting a grantor’s administrative control over a trust or giving the grantor the power to substitute property of an equivalent value are techniques for making a grantor trust "defective" without causing an estate inclusion.

Example 6.1. Jim Green establishes a non-grantor trust for his one-year-old son, Frank, on January 1, 2017, funding the trust with $200,000 in assets yielding 6 percent interest. None of the income is distributed to Frank, so that it is taxable to the trust. The trust is allowed an exemption of $100 as a "complex" trust. The trust’s tax on $11,900 is $3,034.50

Now, assume that the trust is a grantor trust, and Green is taxed on the $12,000 of trust income at a rate of 33 percent (for simplicity, ignoring the possible effect of the additional income on Green’s itemized deductions and other tax benefits). The tax to Green would be $3,960, an extra tax cost of $925.50. However, a financial planner cannot just look at the comparative income tax costs. A financial planner also has to consider that Green, by paying the tax, in effect, will be making a tax-free gift to Frank and reducing his estate without using any portion of his annual gift tax exclusion25 ($14,000 for 2017 and indexed annually for inflation) or any of his unified credit.26 Under this approach, at the end of the trust, more money will go to Frank than if the trust paid the income taxes (as would be the case if the trust were a non-grantor trust) without any additional transfer tax cost.

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25 IRC Section 2503(b).

26 IRC Sections 2505 and 2010.
A word of caution is in order here, however. The result could be different if the trust reimburses the grantor for the income tax paid. An IRS revenue ruling makes it clear that when the grantor of a trust pays income tax on the trust’s income under the grantor trust rules, the grantor is not treated as having made a gift of the amount of the tax to the trust beneficiary. However, if under the terms of the trust instrument or under applicable local law the grantor must be reimbursed by the trust for the income tax paid by the grantor on the trust’s income, the full value of the trust’s assets will be includable in the grantor’s gross estate under IRC Section 2036(a)(1). On the other hand, if the trust prohibits reimbursement of the grantor or if the trust or local law merely gives an independent trustee discretion to reimburse the grantor—but does not require reimbursement—the existence of that discretion (whether or not it is exercised) will not cause the value of the trust’s assets to be included in the grantor’s gross estate. The IRS revenue ruling applies prospectively only; the IRS will not apply the holding adversely to grantees’ estates with respect to any trust created before October 4, 2004.27

.03 How Trust and Beneficiary Are Taxed

Generally, a trust is taxed like an individual, with certain exceptions.28 A trust required to distribute all of its income currently is referred to as a simple trust and receives the equivalent of a personal exemption of $300. A trust allowing the trustee the discretion to distribute or accumulate its income or distribute principal or have a charity as a beneficiary is referred to as a complex trust and is allowed only a $100 exemption.29 There is no exemption for a grantor trust.

For tax years beginning in 2017, a trust is taxed at the rate of 15 percent on the first $2,550 of trust income. The 25-percent rate applies to income over $2,550 up to $6,000. Trust income between $6,000 and $9,150 is taxed at the rate of 28 percent. The 33-percent rate applies to taxable income between $9,150 and $12,500, and the 39.6 percent rate applies to taxable income over $12,500. There is no 35-percent bracket for trusts and estates.

The deductions and credits the trust may take are normally the same as those for individuals, with some differences. Most of these are spelled out in IRC Section 642 and flow principally from the conduit principle that applies to the taxation of trusts.

The conduit principle applies to current distributions of income. The trust reports its income, is allowed a deduction for the income distributed or required to be distributed to the beneficiary, and this income is then taxable to the beneficiary. The beneficiary is taxable on income required to be distributed to him or her regardless of whether he or she actually receives the income.30 The fact that the income could be distributed to the beneficiary is not sufficient. If the beneficiary is to be taxed, the beneficiary must have an enforceable right or entitlement of some kind to the income. If the beneficiary has that right and chooses to leave the income in the trust, or the trustee does not actually distribute it, the beneficiary is still taxable on it.

28 IRC Section 641(b).
29 IRC Section 642(b).
30 IRC Section 652(a).
In effect, the trust operates as a conduit through which income, actual or phantom, may be passed through to the beneficiaries. The most important concept involved in the conduit treatment of income is that of distributable net income (DNI), defined in IRC Section 643(a). The DNI concept limits the distribution deduction allowed to the trust\textsuperscript{31} and also limits the amount includible in the beneficiary’s gross income.\textsuperscript{32}

Basically, DNI is trust accounting income less certain expenses. The practical effect is to give the beneficiary of trust income the benefit of all trust deductions entering into the computation of taxable income. The beneficiary receives the benefit of these deductions, even though the trust allows some of these deductions to be chargeable to principal or trust corpus, not to trust income.

For example, assume that a simple trust requires the current distribution of all income to the life beneficiary. The trust has ordinary income of $12,000, expenses of $2,000 chargeable to income, and long-term capital gains of $4,000 allocable to principal.

The beneficiary would receive $10,000. The trust’s DNI is $12,000 (capital gains are generally excluded from DNI under IRC Section 643(a)(3)), less $2,000 in expenses, or $10,000. This amount is the ceiling on the amount taxable to the beneficiary. The trust’s taxable income would be computed this way: $12,000 ordinary income, plus the long-term capital gain of $4,000, for a total of $16,000, less the trust’s exemption of $300, less $2,000 in deductible expenses, less the $10,000 deductible as a distribution to the beneficiary, leaving the trust with taxable income of $3,700. The character of the taxable income in this example would be long-term capital gain.

The preceding example is that of a simple trust. The taxation of complex trusts—which, in the discretion of the trustee, may accumulate income or may distribute principal—is much more intricate. Two different categories of distributions are recognized: current income of the trust, which is that income required to be distributed currently, if any, and any other amounts properly paid or credited or required to be distributed by the trust for the taxable year.\textsuperscript{33}

Those beneficiaries receiving, or entitled to receive, the first type of distribution (required) include that amount in their own gross incomes.\textsuperscript{34} Insofar as the second type of distribution (discretionary) is concerned, those receiving it are taxed only if the first type of distribution fails to exhaust the DNI of the trust.\textsuperscript{35} Even if they are taxed, the amount taxed may be only a comparatively small portion of the entire DNI. Hence, when structuring a trust that has both high and low bracket beneficiaries and is consistent with the settlor’s intent and desires, one would want the high bracket beneficiaries to receive distributions of the second type.

\textsuperscript{31} IRC Section 651(b).
\textsuperscript{32} IRC Section 652(a).
\textsuperscript{33} IRC Section 661(a).
\textsuperscript{34} IRC Section 662(a)(1).
\textsuperscript{35} IRC Section 662(a)(2).
As a general rule, a beneficiary receiving property in kind from a trust takes the trust’s basis, and the trust’s distribution deduction is limited to the lesser of the property’s basis or fair market value at the time of distribution. However, when the property has appreciated, the trustee may elect to have the gain recognized to the trust with the result of a stepped-up basis for the beneficiary and a full distribution deduction for the trust.

Trustees will have to take a close look at the trust’s and the beneficiaries’ comparative income tax pictures before making distributions in kind. The gain election should be considered when the trust has losses.

The income tax basis of lifetime gifts to a trust is the donor’s basis increased by the gift tax paid, if any, attributable to unrealized appreciation. This rule is explained in ¶410.

Assets passing from a decedent, when includible in the gross estate of the decedent, receive a basis equal to their value for estate tax purposes. Often, but not necessarily, this value is a stepped-up basis. This rule is an important income tax planning factor when dealing with testamentary trusts. There are new requirements for basis reporting in connection with a person’s death: the “consistent basis reporting requirements.”

.04 The Consistent Basis Rules

In general, a recipient of property from a decedent takes a basis equal to the fair market value of the property at the time of the decedent's death (that is, stepped-up basis/stepped-down basis). IRC Section 1014(f) now requires that a recipient's basis in certain property acquired from a decedent shall not exceed the value of the property as finally determined for federal estate tax purposes or, if the final value has not been determined, the value reported on the furnished statement required under IRC Section 6035. To implement the consistent basis requirement, a new reporting regime was created under IRC Section 6035. The executor, if required to file a federal estate tax return (IRS Form 706 or 706-NA), is now further required to furnish to the IRS and to the person acquiring the property a statement identifying the value of the property received and other information as the Secretary may prescribe. Federal estate tax returns are required to be filed by: (1) the estates of U.S. citizens and those domiciled in the U.S. with gross estates exceeding the $5.49 million (for 2017) federal estate tax exemption, and (2) the estates of noncitizen nonresidents with U.S. situs property exceeding the $60,000 federal estate tax exemption. The IRS has released Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent) to serve as the required form to comply with the new consistent basis reporting rules under IRC Section 6035.

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36 IRC Section 643(e)(1).
37 IRC Section 643(e)(2). Consider recognizing gain when an entity has current losses or a loss carryover.
38 IRC Section 643(e)(3).
39 IRC Section 2015.
40 IRC Section 1014(a).
The law further instituted new accuracy-related penalty provisions under IRC Section 6662(b)(8) for recipients who reported basis on a tax return that exceeds the basis determined under IRC Section 1014(f) and such underpayment of tax is attributable to the reporting of an inconsistent estate basis. In addition, the failure to file IRS Form 8971 and furnish the required statement to the beneficiary will be subject to the penalties under IRC Sections 6721 and 6722, respectively, which are generally $250 per form or statement (but can accrue up to a maximum of $3 million for an executor’s intentional disregard of the reporting rules). The consistent basis reporting rules are effective and apply to property upon which a U.S. federal estate tax return is filed after July 31, 2015, resulting in the basis reporting statement to apply even if the decedent died before July 31, 2015. IRS Notices delayed the Form 8971 filing requirements until June 30, 2016.

Note: Form 8971 is not required to be filed when Form 706 is filed only to elect portability.

Planning Pointer.
Visit the Estate Basis Consistency Reporting Resource Center (aicpa.org/interestareas/personalfinancialplanning/cpeandevents/pages/estate-basis-consistency.aspx) and use this information from the AICPA PFP Divisions to learn about the regulations, requirements for filing the forms, and other accounting and legal issues you need to know to comply with the Code.

.05 How Accumulated Income Is Taxed

The tax brackets for estates and trusts are extremely narrow. For example, for tax years beginning in 2017, trust income above $12,500 is taxed at the highest 39.6 percent rate. Therefore, the desirability to use accumulation trusts to save income tax for well-off individual income beneficiaries is greatly reduced. However, sometimes one might want to accumulate trust income without any particular thought of tax consequences. A grantor might feel, for example, that the beneficiary does not need or should not receive all the income that the trust investments will generate or the beneficiary will not be able to handle it wisely if it is distributed currently, or both. Additional nontax benefits of accumulation trusts are discussed in ¶660.

.06 Multiple Trust Benefits

IRC Section 643(f) provides that two or more trusts will be treated as one trust if they have the same grantor(s) and substantially the same primary beneficiary (or beneficiaries), and a principal purpose of the trusts is the avoidance of tax.

The following example of trusts that would not be aggregated might be helpful in avoiding the reach of IRC Section 643(f).

Example 6.2. Frank McGill establishes two irrevocable trusts for the benefit of his son and daughter. The son is the income beneficiary of the first trust, and the trustee (Bank of P) is required to pay all income currently to the son for life. The daughter is the remainder beneficiary of the first trust and is an income beneficiary of the second trust. The trust instrument for the second trust permits the trustee (Bank of D) to accumulate or to pay income, in its discretion, to the daughter for her health, education, support, and maintenance. The trustee may also pay income or corpus of the second trust to the son for his medical expenses. The daughter is the remainder beneficiary of the second trust and will receive the trust corpus upon the son’s death.
Absent rules or regulations to the contrary, financial planners might also find the following strategies to be useful:

- Two or more trusts may be created by the same grantor for different beneficiaries, and the trusts will be entitled to independent recognition for tax purposes.

- The U.S. Tax Court’s holding in *E. Morris Trusts*,\(^\text{41}\) approving a situation in which the same grantor uses one instrument to create two or more trusts for different beneficiaries with independent interests in the trust property, might be useful in creating separate taxpaying entities.

- IRC Section 643(f) recognizes the independence of separate trusts created by the same grantor if the trusts have different dispositive provisions, do not have substantially the same beneficiaries, and do not have tax avoidance as a principal purpose.

- Any multiple trusts used should be structured so that the trusts are as different as possible while remaining consistent with the grantor’s underlying intent. The grantor should make clear the purposes for which each trust is to be established, especially when substantive, dispositive provisions are involved. If possible, the beneficiaries should be different.

Nontax reasons for creating and maintaining the trusts should be stressed. If adult children, for example, are the beneficiaries, each one might have different needs, different attitudes toward investment risk, and varying degrees of sophistication and maturity. All of these differences can be used to negate tax considerations as a principal purpose for creating the multiple trusts. The intent to avoid jealousies and antagonism, if a real factor, might also support the claim of nontax multiple trust factors.

- The statute refers to two or more trusts. Unless the regulations take a broad view of what a trust is, a grantor might be able to make gifts, for example, to a uniform gift to a minor’s custodianship account and to a trust for the child and not run afoul of the rules of IRC Section 643(f). This strategy could give the grantor all the benefits of two trusts for the same child, with attendant income-splitting possibilities. Yet, this arrangement would technically be outside the scope of the statute’s definition.

.07 Trusts and S Corporations

Subject to certain broad exceptions, trusts may not be shareholders of an S corporation. The chief exceptions are a voting trust, a grantor trust (that is, income from the trust is taxable to the grantor under IRC Sections 671-679), a trust in which a person other than the grantor is treated as the owner under IRC Section 678, and a qualified subchapter S trust. In addition, an electing small business trust may be an S corporation shareholder.\(^\text{42}\)

The electing small business trust provisions permit broader estate planning opportunities for S corporation shareholders by allowing trusts to be funded with S corporation stock and allowing the income to be

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\(^{41}\) 51 TC 20, AICPA Dec. 29,181 (1968).

\(^{42}\) IRC Section 1361(c)(2)(A).
paid to, or accumulated for, the trust beneficiaries at the trustee’s discretion. To qualify, all beneficiaries of the electing small business trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. For an electing small business trust to be an eligible S corporation shareholder, interests in the trust must be acquired by reason of gift, bequest, or other non-purchase acquisition method.\(^{43}\)

Although electing small business trusts may allow broader transfer tax planning opportunities, they come with a distinctly negative income tax consequence. The portion of the trust that consists of S corporation stock is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. This portion of the trust’s income, except for net capital gains, is taxed at the highest rate imposed on estates and trusts (39.6 percent for 2017 under IRC Section 1(e)). Net capital gains are taxed at the usual rates specified in IRC Section 1(h).\(^{44}\) The income is also subject to the net investment income tax. The taxable income attributable to this S corporation portion of the trust includes the following:

- The items of income, loss, or deduction allocated to the trust as an S corporation shareholder under the rules of subchapter S.
- Gain or loss from the sale of the S corporation stock.
- Any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise, allowable capital losses are allowed only to the extent of capital gains.\(^{45}\)
- An electing small business trust is not allowed a distribution deduction for distribution of S corporation income to its shareholders.

As a general rule, if any trust, other than those types listed previously, holds stock in a corporation that has made an S election, the election is automatically nullified.\(^{46}\) In such cases, the corporation will be taxed as a regular C corporation. Hence, it will not be able to pass through its income and losses to its shareholders. Note, however, that there are two limited exceptions to this rule. A trust in which the grantor or another person is treated as the owner may continue as an eligible shareholder following the death of the owner, but only for two years beginning on the date of the owner’s death.\(^{47}\) In addition, a testamentary trust that receives S corporation stock on the death of an S corporation owner qualifies as an eligible shareholder for a two-year period beginning on the date the stock is transferred to the trust.\(^{48}\)

\(^{43}\) IRC Section 1361(e).
\(^{44}\) Regulations Section 1.641(c)-1(e)(1).
\(^{45}\) IRC Section 641(c).
\(^{46}\) IRC Section 1362(d)(2).
\(^{47}\) IRC Section 1361(c)(2)(A)(ii).
\(^{48}\)
In IRS Letter Ruling 201709020, the IRS determined that a trust was an eligible S corporation shareholder during the grantor’s lifetime because the grantor would be treated as the owner of the trust under IRC Section 674(a). The IRS also ruled that the trust would be an eligible S corporation shareholder for the two-year period beginning on the day of the grantor’s death. The IRS further concluded that separate trusts met the requirements of Section 1361(d)(3), provided that each beneficiary of each trust was a U.S. citizen or resident, or both. Accordingly, each of the trusts qualified as a qualified subchapter S trust (QSST), provided that each beneficiary made a proper election under Section 1361(d)(2) for his or her trust and all of the income was distributed currently to the beneficiary while the trust held S corporation stock.

.08 Short-Term Trusts

Both the once-popular Clifford trusts (in which the grantor created a trust for a limited duration of time, typically at least 10 years, and then had a reversionary interest) and spousal remainder trusts (in which the grantor created a trust with a retained interest for a limited duration of time and allowed his or her spouse to be the remainder trust beneficiary) are no longer recommended or used in planning (after March 1, 1986) due to changes in the law. IRC Section 673 now provides that grantors are taxable on trust income if either they or their spouses retained a reversionary or remainder interest in the trust property of a present value of more than 5 percent. An exception is provided for an interest to take effect on the death of a minor income beneficiary before age 21. It is extremely unlikely that a grantor trust with a reversionary or remainder interest for the grantor or the grantor’s spouse in the current low interest rate environment of 2017 can be designed successfully to get around the rules of IRC Section 673.

The demise of Clifford trusts eliminated an opportunity to save family income taxes. However, as a result of the extremely compressed trust income tax brackets, an individual grantor might want to set up a short-term trust for a junior family member, even though the individual grantor will be taxed on the trust’s income under the grantor trust rules. Depending on the comparative tax brackets of the grantor and the trust, this result might produce a lower tax bill than if the trust accumulated income and was taxed at the trust income tax brackets. Also, the grantor’s payment of the income tax on the trust’s income, absent requiring reimbursement to the grantor of that tax liability, will not be regarded as a gift to the child, thereby reducing the grantor’s estate and possibly saving future transfer tax. See the preceding discussion of the grantor trust rules (see ¶605.02).

.09 Alternative Minimum Tax

The alternative minimum tax (AMT) is applied to estates and trusts by determining distributable net income on a minimum tax basis. The estate or trust then allocates to each beneficiary his or her proportionate share of distributable net alternative minimum taxable income (DNAMTI) when such income is distributed. Form 1041 Schedule I is used by a fiduciary to compute DNAMTI, the beneficiary’s share of DNAMTI, and the fiduciary’s share of alternative minimum income and the corresponding tax, if any. Trusts and estates have an available AMT exclusion. For 2017, the amount of the exclusion is $24,100, to be indexed annually for inflation.

49 IRC Section 673(b).

50 IRC Section 55.
A financial planner should answer several preliminary questions regarding the effect of estate taxes on trust assets. The first question is, Will the trust property be included in the gross estate of the settlor (grantor) or in the gross estate of one or more of the trust beneficiaries? The second question is, Will exclusion from the settlor’s gross estate really make a difference in the taxable estate?

A financial planner should not exert much effort to keep trust property out of the settlor’s gross estate or out of another individual’s gross estate if its inclusion in the gross estate will not cause any estate tax. If its inclusion in the gross estate will cause no tax, the financial planner must determine whether keeping the trust property out of the estate to avoid probate and its attendant expenses is worthwhile. Costs of probate vary from state to state, depending principally on the complexity of the state’s probate rules and the corresponding fees to be paid to the executor of the estate and the executor’s legal counsel. For many clients, increased basis for income tax purposes is far more important than avoiding estate inclusion, especially when no transfer tax will be due.

A living (inter vivos) trust is one that takes effect during the settlor’s lifetime. Whether property held in such a trust will be includible in the settlor’s gross estate depends on whether the settlor is willing to give up all of his or her interests in the trust property and personal control over it.51

If the settlor is willing to part with the trust property forever and have nothing further to do with it and its administration, and does in fact part with the property, the property will not be included in the settlor’s gross estate. An exception applies if the trust property includes life insurance on the life of the settlor and the settlor dies within three years of transferring the life insurance policy to an irrevocable trust.52 In such a case, the insurance proceeds will be includible in the settlor’s gross estate.

Most settlors, however, are reluctant to sever themselves from any substantial part of their property, permanently and absolutely, to save estate taxes. They want a regular check coming from the trust or to be able to terminate the trust if it does not seem to be working out the way they intended. The settlors might want to retain some income interest in, or enjoyment of the property, or designate which beneficiaries receive distributions, when they receive them, or for what purpose they receive them, and be able to change their minds as circumstances dictate. In all of these circumstances, the property is includible in the settlor’s gross estate.53 Given the increased estate tax threshold of $5,490,000 for 2017, indexed annually for inflation, most taxpayers will not need to make lifetime gifts to reduce or eliminate their exposure to the federal estate tax.

Problems sometimes arise with living trusts in situations between the two extremes of retained control and complete transfer. In these cases, the settlor is not entirely separated from the trust property. Whether the settlor has retained enough control over the trust, or has benefited from it, to warrant its inclusion in the settlor’s gross estate is not always clear. Ultimately, the trust settlor must choose between enjoyment and control of the property or the opportunity to exclude the property from the gross estate.

51 IRC Section 2038.
52 IRC Sections 2035(a) and 2042.
53 IRC Section 2041.
The underlying tax policy is reflected in, and implemented by, an array of IRC sections. The essence of these provisions is that if the settlor wants to keep the trust property out of his or her gross estate, the settlor should observe the following rules:

- **Power to revoke or change.** The settlor should not, under any circumstances, retain a power to revoke, alter, amend, or terminate the trust. If the settlor does have such power, it should be relinquished more than three years before death.\(^{54}\)

- **Retained life interest.** The settlor should not retain a life interest in the possession or enjoyment of, or the right to, the income from the property or the right, either alone or with anyone else, to dictate who is going to enjoy or possess the property or its income.\(^{55}\) The settlor also should not retain 20 percent or more of the voting rights in stock in a controlled corporation transferred to a trust.\(^{56}\)

- **Reversionary interest.** A settlor should not form a trust so that someone else can get the property only by surviving the settlor, while the settlor keeps a reversionary interest proving to be worth more than 5 percent of the value of the property when the settlor dies. This value is determined by mortality tables and actuarial principles. A *reversionary interest* is broadly defined to include a possibility that the property might return to the settlor or his or her estate or that the settlor might control its disposition.\(^{57}\) If the settlor has such an interest, the interest should be relinquished more than three years before death.\(^{58}\)

- **Power to direct disposition.** The settlor should not retain a general power of appointment over the trust property, as defined in IRC Section 2041. Briefly, a general power of appointment permits its holder to control the disposition of the property in the holder’s own favor or that of the holder’s estate or creditors or the creditors of the power holder’s estate. However, IRC Section 2041 has exceptions that allow the holder to use trust property for his or her own benefit if the power is limited by an ascertainable standard relating to the power holder’s health, education, support, or maintenance. IRC Section 2041 deals not only with the situation in which the settlor is the holder of a general power of appointment, but also with those cases in which that power is held by anyone else. The trust property is includible in the power holder’s gross estate, no matter who the settlor is, if he or she still holds that power at death, or if it was released sometime before the power holder’s death so that it would be includible in the holder’s gross estate under any one of the IRC sections mentioned in the three preceding paragraphs.

- **Power over life insurance policy.** If a life insurance policy is to be part of the trust property, the insured should not designate his or her estate as the beneficiary. If someone else is named as

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\(^{54}\) IRC Sections 2035 and 2038.

\(^{55}\) IRC Section 2036(a).

\(^{56}\) IRC Section 2036(b).

\(^{57}\) IRC Section 2037.

\(^{58}\) IRC Sections 2035 and 2037.
beneficiary, the insured should not retain any incidents of ownership in the policy; otherwise, the proceeds will be includible in the insured’s gross estate under IRC Section 2042. A transfer of the policy, or of the incidents of ownership in the policy, within three years of death will result in inclusion of the policy proceeds in the decedent’s gross estate. However, if the trustee of a trust applies for a new policy of life insurance on the settlor’s life and the policy is issued to the trust from its outset, the proceeds may be excludable even if the settlor dies within three years. This topic is discussed further in ¶735, where life insurance trusts are also discussed.

- **Retention of any interest—the catchall.** The settlor should not retain any interest in the property at the time of death. Generally, one must check local laws to determine whether they treat the settlor as holding any interest in the property.

- **Transfers within three years of death.** As a general rule, transfers within three years of death are not includible in the transferor’s gross estate. However, interests in property otherwise includible in the gross estate under any one or more of IRC Sections 2036-2038 or 2042 (or those that would have been included if the interest had been retained by the decedent) will be included in the transferor’s gross estate if the transferor dies within three years of the transfer.

Despite this rather formidable lineup of barriers to prevent the trust property from being kept out of the settlor’s gross estate, the settlor can still exclude it through careful planning. All the interests and powers mentioned in the preceding seven paragraphs refer to interests or powers possessed at death. Hence, the mere fact that the settlor possesses any of these interests or powers at the time the trust is formed does not automatically cause the trust property to be included in the settlor’s gross estate. The settlor must relinquish such powers or interests before death. However, if the settlor waits too long, that is, until within three years of death, then the property may be includible in the settlor’s gross estate under IRC Section 2035, as discussed previously.

The settlor should also consider the gift considerations discussed in chapter 4, "Lifetime Gifts to Individuals," and the gift tax factors in ¶405. Deductions that operate in favor of the settlor and the settlor’s estate are also allowed. If the settlor is married, the unlimited marital deduction is available. The unlimited charitable deduction is also available. If the settlor wants to give a spouse the entire estate or something less than the entire estate and the rest of the estate to a qualified charity, the estate will be free of federal estate taxes. Also, life insurance proceeds may be excluded under IRC Section 2042 if properly handled. Further, any tentative estate tax liability may be offset by the unified credit, so that no estate tax actually will need to be paid.

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59 IRC Section 2035(a).
60 IRC Section 2033.
61 IRC Section 2035(a) and (d).
62 IRC Section 2056(a).
63 IRC Section 2055(a).
64 IRC Section 2010.
If the estate will have no tax liability after the unified credit despite the inclusion of the trust property in
the gross estate, the more immediate concern may be to make sure that the settlor retains control over
the trust property. If the settlor is making a lifetime transfer to a trust, consider the effect of inclusion of
the property in the estate not merely on the basis of its current value but also in terms of its appreciation
potential. If the appreciation potential is such as to provide estate tax exposure when death is likely to
occur (based on reasonable assumptions as to the life expectancy of the settlor), the settlor might prefer
to surrender control over the property. With the federal estate tax exemption at $5,490,000 in 2017, tax
planning for most clients will focus less on estate tax liability issues and more on income tax basis is-
suess. Retaining appreciating property to enable heirs to gain a stepped-up basis may be a more valuable
planning direction. However, this advice becomes more complicated when a client lives in a state with
its own state estate or inheritance tax, in which case it may be advisable to consider making some trans-
sfers to minimize the impact of the state death tax.

.01 Retention of Beneficial Enjoyment or Management or Administrative Powers

The basic test of whether a retained power will result in the inclusion of the property subject to the pow-
er in the holder’s gross estate is whether it affects the beneficial enjoyment of the property. As a general
rule, mere administrative or management powers do not affect beneficial enjoyment. Whether a given
power is merely administrative or affects beneficial enjoyment is not always clear.

State law is the first thing to consult. Because federal tax law is also involved, controversial issues may
arise in the federal courts. The U.S. Supreme Court has ruled that federal courts are bound only by deci-
sions of the highest state court on the interpretation of state law.65 The result is that federal decisions, ei-
ther applying state law as laid down by the state’s highest court or supplying their own interpretations of
state law, become the principal benchmarks for determining whether powers are administrative or man-
gerial.

However, Congress can, and has, overturned such court decisions. For example, an amendment to IRC
Section 2036 effectively reversed a decision of the U.S. Supreme Court construing the cited section be-
fore it was amended. The decision was made in M. Byrum,66 which held that Byrum’s retention of the
voting rights to the stock transferred to a trust did not constitute retained enjoyment of the stock within
the meaning of IRC Section 2036(a)(1). Congress reversed the Court’s result, and provided that retained
voting rights in a controlled corporation (that is, one in which the decedent or his or her relatives owned
or had the power to vote at least 20 percent of the total combined voting power of all classes of stock)
did constitute retained enjoyment of the transferred stock.67

According to IRS regulations and the U.S. Tax Court, if the grantor reserves the power to discharge a
trustee and appoint himself or herself as trustee, the grantor is considered as having the power held by
the trustee.68 At one time, the IRS took the position69 that a reservation by a grantor of a power to re-
move a trustee at will and appoint another trustee is equivalent to reservation of the trustee’s powers. After defeat on this issue in the U.S. Tax Court\textsuperscript{70} and in the Eighth Circuit,\textsuperscript{71} the IRS reconsidered its stance. The IRS revoked Revenue Ruling 79-353. The IRS later ruled in Revenue Ruling 95-58\textsuperscript{72} that a grantor’s reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the grantor within the meaning of IRC Section 672(c) is not considered a reservation to the grantor of the trustee’s discretionary powers of distribution over the trust property.

Planning Pointer.

Allowing a grantor to replace a trustee is useful for dealing with such situations as a move by the beneficiary to a distant location that would make the beneficiary’s contact with the trustee impractical; a takeover of a corporate trust company by an out-of-state entity; or the grantor’s dissatisfaction with the trustee’s performance.

.02 Safeguards

When the settlor, as an individual and not as a trustee, reserves administrative powers, the trust should be precise about the fact that these powers are to be exercised in a fiduciary capacity. At the same time, however, one would not want to have the settlor placed in the position of being treated as a fiduciary \textit{for all purposes} or to have attributed to him or her substantive or dispositive powers. That fact, too, should be made clear in the trust instrument or related documents. The settlor may retain limited administrative powers over the trust property in a nonfiduciary capacity within IRC Section 675 without having the trust property included in the settlor’s estate.

The trust instrument could include a clause declaring void any powers given a trustee or retained by the settlor if they could result in adverse estate tax consequences. Although the IRS has ruled that such a provision does not help,\textsuperscript{73} the courts might uphold it if valid under state law.\textsuperscript{74}

\section{615 Trusts and Gift Taxes}

A transfer to a trust may involve a gift. The subject of gifts and gift taxes is generally covered in chapter 4, "Lifetime Gifts to Individuals." This chapter simply calls attention to the fact that, in the case of a transfer to a trust, the trust beneficiaries, rather than the trust or trustee, are the donees. This factor takes on special importance when applying the annual gift tax exclusion ($14,000 for 2017, indexed annually

\textsuperscript{69} Revenue Ruling 79-353, 1979-2 CB 325.

\textsuperscript{70} H. Wall Est., 101 T.C. 300 (1993).

\textsuperscript{71} J. Vak Est., 973 F.2d 1409 (8th Cir. 1992) rev’g and rem’g 62 T.C.M. 942 (1991).

\textsuperscript{72} 1995-2 CB 191.

\textsuperscript{73} Revenue Ruling 65-144, 1965-1 CB 442.

\textsuperscript{74} Miami Beach First National Bank (DC Fla.), 1970-1 USTC ¶12,681, rev’d on other grounds 443 F.2d 116 (5th Cir. 1971).
for inflation). It means that instead of only one available annual exclusion or twice the amount of the annual exclusion if the donor’s spouse consents to gift splitting under IRC Section 2513, the number of annual exclusions available may equal the number of trust beneficiaries.

The annual gift tax exclusion is available only for gifts of present interests. If the trust beneficiary is given a Crummey power (¶660.04), the present interest requirement may be satisfied. Such powers allow the beneficiary the right to make a withdrawal from the trust in amounts up to the amount of the annual gift tax exclusion during a limited period. The right need not be exercised. The annual exclusion may also be used for a gift of an income interest in a trust if the trust requires the income of the trust to be distributed at least annually. Such a gift of an income interest is valued using the tables in Regulations Section 25.2512-5. If, in the trustee’s discretion, the income may either be distributed currently or accumulated, the annual exclusion may not be used except for a trust for a minor that meets all the IRC Section 2503(c) requirements. Trusts for minors are discussed separately in ¶425.

Transfers of non-income-producing property to a trust pose special problems in connection with the availability of the annual gift tax exclusion for gifts of income interests. This problem may be particularly acute when stock is transferred to the trust in a situation in which the company has a history of non-payment of dividends. The problem, however, is not limited to transfers of such property.

Two questions are relevant: Has there been a transfer of a present income interest in the non-income-producing property and if that question can be answered affirmatively, is the value of that interest ascertainable? The IRS has occasionally conceded that the present interest requirement may be satisfied in these situations, but, it has also ruled that the annual gift tax exclusion is not allowed because the value of the interest is unascertainable. The U.S. Tax Court has sided with the IRS in the cases of Berzon and Rosen. However, Rosen was reversed by the U.S. Court of Appeals for the Fourth Circuit, which held that the taxpayer could use actuarial tables to value the income interest in a stock that had not paid dividends for a considerable period of time. To cloud the issue further, the Eighth Circuit later followed the IRS view and the U.S. Tax Court decisions.

In this uncertain state of affairs, with the authority favoring the IRS and the U.S. Tax Court positions, if a donor wants to be certain of obtaining the annual gift tax exclusion, the donor should avoid transferring non-income-producing property. If the donor has no choice of the property to be transferred, perhaps the exclusion can be salvaged in one of the following ways:

- The transferor could give the income beneficiary a Crummey power to withdraw income or principal in a specific amount up to the amount of the annual gift tax exclusion with a limited time for exercise of the power. The transferor should consider limiting the right to withdraw principal

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75 IRC Section 2503(b).

76 IRC Section 2503(b).

77 F. Berzon, 63 T.C. 601 (1975), acq. 1975-2 CB 1, aff’d 534 F.2d 528 (2d Cir. 1976); and L. Rosen, 48 T.C. 834 (1967).

78 397 F.2d 245 (4th Cir. 1968).

annually to the greater of $5,000 or 5 percent of principal to keep the principal from being in-
cludible in the beneficiary’s gross estate.80

- The transferor could give the beneficiary a right to require that non-income-producing property 
be converted into income-producing property.

- The beneficiary could be given a right to sell the transferred property, perhaps with a right of 
first refusal to be held by the transferor of the property.

In the case of stock, persuading the corporation to pay nominal dividends before and after transfer to the 
trust has not worked.81

¶620 Types of Trusts and Special Trust Provisions

Trusts have many varied uses and purposes in estate planning. Regardless of the other purposes they 
may serve, trusts can provide one or more qualifications for managing assets that the trust beneficiaries 
lack or that the trust settlor perceives they lack. The beneficiaries could lack prudence, maturity, man-
agement or investment skill and experience, financial acumen, physical capacity, mental competence, 
sufficient interest, or adequate time.

Other uses and purposes for trusts include asset protection, (that is, insulating trust assets from the 
claims of financial and judgment creditors of an individual or a business and from matrimonial credi-
tors), accumulating funds for special purposes, or serving as a parental substitute in financial matters.

In addition to these purposes, settlors might also form trusts to save income taxes or estate taxes, or 
both. Many settlors also want to avoid probate and preserve the privacy of their affairs.

To carry out the purposes of the individual creating the trust, special trust provisions are often required. 
Some provisions can be useful with all types of trusts; some provisions are useful for a particular type of 
trust only. A revocable trust, in which the settlor retains the right to amend the trust, may be adapted to 
changing circumstances as they unfold. Changing an irrevocable trust is generally not permitted, alt-
though some states allow properly authorized trustees to make changes in irrevocable trusts under so-
called "decanting" powers or trust protector provisions. Judicial reformation of a trust may be permitted. 
Ideally, the settlor should build sufficient flexibility into the trust to permit reasonable adaptation to al-
tered circumstances. Special provisions that might be useful in various types of trusts are discussed in 
¶660. Trusts for minors are discussed in connection with the discussion of gifts to minors in ¶425. Life 
insurance trusts are discussed in connection with the broad topic of life insurance in estate planning in 
chapter 7, "Life Insurance," and the marital deduction trust and the nonmarital trust for the surviving 
spouse are discussed in chapter 12, "The Marital Deduction." Trusts that qualify to hold S corporation 
stock are discussed in ¶1945. Generation-skipping trusts are discussed in chapter 27, "Planning for Gen-
eration-Skipping Transfers."

80 IRC Section 2041(b)(2).

81 E.M. Morgan, 42 T.C. 1080 (1964), aff’d per curiam 353 F.2d 209 (4th Cir. 1966).
Exhibit 6-1 in ¶625 compares eight basic types of trusts in terms of essential characteristics, nontax benefits, and tax treatment (income, estate, and gift taxes).

¶625 The Irrevocable Living Trust

The irrevocable living trust has many features that promote its use as an estate-planning tool. It can save income taxes for the family, help build an estate, protect the family’s assets and beneficiaries, save estate taxes in both the estate of the settlor and the estate or estates of the life beneficiaries, and avoid probate.

The price for saving income and estate taxes and avoiding probate is making an irrevocable transfer of property to the trust. Generally, the settlor must maintain a hands-off position forevermore. The client must decide if this sacrifice is acceptable or too much for the benefits. The client should especially consider the potential estate tax savings and weigh that against the carryover income tax basis to the donee.

The client should also consider the benefits of avoiding probate. Although an irrevocable trust can be used to avoid probate, it is not the only trust with that benefit. The revocable trust also has that feature (¶630), but it does not carry the income and estate tax benefits of the irrevocable trust.

Is probate really worth avoiding? The burdens and complexities of probate administration vary widely from state to state. The Uniform Probate Code, adopted in a number of states, as well as other reform measures, have significantly improved the probate process. Still, probate generally has these disadvantages:

- **Publicity.** Dispositions made by will are public documents. Details about the deceased’s financial affairs are in the probate records, as well as the size of the estate, the names of the recipients, what they receive, and on what terms. A living trust generally keeps these matters secret. Questions can also arise concerning the interpretation of trust provisions, which could bring the trust into the public courts where it might become a matter of public record. Clearing title to property might demand disclosure. In general, however, one can expect far less publicity by avoiding probate.

- **Delay.** Probate is bound to involve a certain amount of delay. Therefore, if the beneficiaries need to receive cash and other assets quickly, special steps to prevent delay must be taken.

- **Costs.** The greater the value of the property includible in the probate estate, the bigger the fees of the executor and his or her legal counsel. Setting up an irrevocable trust usually involves legal expenses and trustees’ fees, but they are not likely to be as high as those involved in probate. States may impose fees on the assets passing through probate. Creditors may assert their claims against a decedent’s probate estate.

In addition, the probate court might be required to appoint appraisers and guardians if the interests of minor children are involved, each of which can be a further expense to the estate.

The irrevocable trust offers the possibility of saving income tax when the trust income is to be paid to beneficiaries who are in lower tax brackets than the grantor. If trust income is to be accumulated within
the trust, income tax savings generally will not be realized if the income is taxed to the trust under the highly compressed trust tax brackets. However, in some cases, savings can be realized if the trust is purposely set up to fail the grantor trust rules, and the income is taxed to the grantor. Such a move also results in gift tax savings in that the benefit of income taxes paid by the grantor is not treated as a gift to the beneficiaries. These points are discussed in ¶605.

To achieve the estate tax savings, the settlor must keep the trust property out of his or her gross estate by complying with all the applicable rules discussed in ¶610. The settlor must not retain a life interest in the property or control its enjoyment; possess a reversionary interest worth more than 5 percent of the value of the property at the time of his or her death; possess the power to alter, amend, terminate, or revoke the trust; possess a general power of appointment over the trust property; possess an incident of ownership in any insurance policy on his or her life naming the trust as beneficiary; or transfer life insurance on his or her own life to the trust within three years of death.

When a settlor forms an irrevocable trust, the settlor could be liable for gift tax. The settlor makes a gift of a present interest in the income of the trust and a gift of a future interest in the principal or corpus. A Crummey power to withdraw income or principal (¶660.04) given to trust beneficiaries may operate to convert a future interest into a present interest. The annual gift tax exclusion ($14,000 for 2017 and indexed annually for inflation) is available for gifts of present interests. The trust beneficiaries are the donees, and the donor may claim the annual gift tax exclusion for each gift made to each donee that constitutes a present interest. The exclusion amount may be doubled if the donor is married, and his or her spouse consents to gift splitting. In addition, the donor and his or her spouse may use the unified credit to reduce or eliminate any gift tax for gifts of present interests beyond the annual exclusion and gifts of future interests. The lifetime exclusion has been made permanent and is adjusted annually for inflation. It is $5,490,000 in 2017. If coupled with a timely and correct portability election, it may be possible for a surviving spouse to have an available gift tax exclusion of as much as $10,980,000 in 2017.

82 IRC Section 1(e).
83 IRC Section 2036.
84 IRC Section 2037.
85 IRC Section 2038.
86 IRC Section 2041.
87 IRC Section 2042.
88 IRC Section 2035.
89 IRC Section 2503(b).
90 IRC Section 2513.
91 IRC Sections 2010 and 2505.
Exhibit 6-1: Basic Types of Trusts, Their Benefits, and Tax Treatment

<table>
<thead>
<tr>
<th>Trust Type</th>
<th>Characteristics</th>
<th>Nontax Benefits</th>
<th>Income</th>
<th>Estate</th>
<th>Gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Irrevocable living</td>
<td>Settlor gives up property forever.</td>
<td>Supervised control and investment; avoids probate.</td>
<td>Currently distributed. Is taxed to beneficiary. Accumulated, first to trust, then to beneficiary on distribution subject to special rule.</td>
<td>Not taxable in settlor’s estate unless life insurance on his or her life transferred within 3 years of death. Can avoid tax on life beneficiary’s death.</td>
<td>Taxable to settlor. Annual exclusion available for present gift of income interest, not remainder.</td>
</tr>
<tr>
<td>2) Revocable living</td>
<td>Settler can revoke. May be funded or unfunded.</td>
<td>Same as trust type 1.</td>
<td>Taxable to settlor.</td>
<td>Includible in settlor’s estate.</td>
<td>No liability. No completed gift.</td>
</tr>
<tr>
<td>3) Testamentary</td>
<td>Created by will.</td>
<td>Supervised control and investment.</td>
<td>Same as trust type 1.</td>
<td>Includible in estate of creator. Can avoid tax on death of life beneficiary.</td>
<td>No liability.</td>
</tr>
<tr>
<td>4) Grantor retained interest trust (GRIT, GRAT(1), and GRUT(2))</td>
<td>Grantor reserves a qualified term interest in the form of an annuity or unitrust under Internal Revenue Code (IRC) Section 2702, after which principal passes to remaindermen.</td>
<td>Often negligible.</td>
<td>Taxable to settlor (grantor).</td>
<td>Not taxable in grantor’s estate unless grantor dies within reserved income term, subject to special rules under IRC Section 2702 (see chapter 23, &quot;Impact of Estate Freeze Rules on Intra-Family Transfers&quot;).</td>
<td>Tax based on value of remainder at time of creation of trust. Special rules apply (see chapter 23, &quot;Impact of Estate Freeze Rules on Intra-Family Transfers&quot;).</td>
</tr>
<tr>
<td>5) Standby</td>
<td>Generally revocable, but may be irrevocable on settlor’s permanent disability.</td>
<td>Supervised control and investment on settlor’s disability or absence.</td>
<td>Taxable to settlor.</td>
<td>Includible in settlor’s estate.</td>
<td>No liability.</td>
</tr>
<tr>
<td>6) Pourover</td>
<td>Living trust, revocable or irrevocable, funded or unfunded.</td>
<td>Receptacle for employee benefits, life insurance proceeds, estate assets.</td>
<td>Taxable to settlor.</td>
<td>Same as trust type 1 or 2 depending on revocability.</td>
<td>Same as trust type 1 or 2 depending on revocability.</td>
</tr>
</tbody>
</table>

1 Grantor retained annuity trust
2 Grantor retained unitrust

¶630 The Revocable Living Trust

The revocable living trust is a useful estate planning tool offering these advantages:

- Avoids the publicity, expenses, and delays of probate
- Avoids the interruption of income for family members on the death of the settlor or upon the settlor becoming disabled or incompetent
- Permits the settlor to see the trust in operation and make changes as experience and changed circumstances suggest
- Serves as a receptacle for estate assets and death benefits from qualified employee benefit plans and insurance on the life of the settlor

- Can bring together scattered assets in two or more states or jurisdictions by placing title in the trustee and avoiding administration of the individual’s estate (particularly real estate) in different places

- Makes selecting the law that is to govern the trust easier than if the settlor attempted to do so through a will

- Enables a going business to continue without interruption

- Facilitates gifts to charities in states where restrictions apply to charitable bequests

- Relieves the settlor of burdens of investment management

- May authorize the trustee to advance funds to the settlor’s executor for certain purposes or to buy assets from the executor at a fixed price, and so help avoid the forced sale of estate assets at depressed prices

- Can be less vulnerable to attack on the grounds of the settlor’s capacity, fraud, and duress than a will or will-created trust would be

- Requires less accounting, administration, and judicial supervision than a trust created by will

- Bars a surviving spouse’s statutory right in some states to share in the deceased spouse’s property

- Places the property beyond the reach of the settlor’s creditors, at least in some states

A revocable living trust provides no income tax savings for the settlor. IRC Section 676 makes the settlor taxable on the income of a revocable living trust. However, on the settlor’s death, without the trust having been revoked, the trust becomes irrevocable. The beneficiaries are then entitled to whatever income tax savings may be available to the beneficiaries of an irrevocable trust. If the settlor has formed several trusts, the beneficiaries will have all the advantages of multiple trusts, provided care has been taken to avoid having the multiple trusts treated as one for tax purposes.

The settlor’s estate will not derive any estate tax benefits. IRC Section 2038 makes the property of a revocable trust includible in the settlor’s gross estate. However, the settlor can establish the trust to avoid a second estate tax on the deaths of its primary beneficiaries. If they are merely given a life interest with a limited right to principal subject to an ascertainable standard, upon their deaths, the remaining principal may pass to other beneficiaries tax free. However, this approach is subject to considerable restrictions under the generation-skipping transfer tax rules, as discussed in chapter 27, "Planning for Generation-Skipping Transfers."

In general, a revocable living trust provides no immediate income tax or first-generation estate tax advantages. However, because the transfers to the trust are revocable, the settlor avoids any liability for gift tax as the trust is funded during the settlor’s lifetime.
Having listed the advantages of the revocable living trust in general terms, this chapter will now take a closer look at some of these items and also examine some problem areas.

The revocable trust saves future probate costs but at the expense of present costs of setting up and funding the trust. To make the trust effective, all of the settlor’s assets must be titled in the name of the trust. This can prove to be a cumbersome process. Another expense is the current trustee’s fee. A revocable trust does not have the same income and estate tax pressures as does an irrevocable trust to have an independent (often paid) trustee. The settlor may be the trustee of the settlor’s own revocable trust. However, one can assume that at some point in time a successor trustee may have to be paid, just as an executor may take commissions.

In some localities, a trust company, acting as the trustee of a revocable trust, will want extra compensation of as much as one full executor’s commission on the death of the settlor for the extra work required. This compensation includes the handling of postmortem income of the trust and estate tax planning. There may be an accounting for the trust on the death of the settlor. This accounting will involve legal and accounting fees. The revocable trust could save some filing fees. If minors are involved, the revocable trust might reduce guardian’s fees because those fees are usually measured by the size of the probate estate.

One of the advantages of a revocable trust is that the settlor can locate it in a state whose laws are favorable. If that state happens to be a state in which probate is required, the probate proceedings could become complicated, causing delay and added expense if the trust assets are not allowed to avoid the probate process. The settlor should pay particular attention to any legal formalities of execution under the laws of the state chosen to establish the trust.

When making a choice of jurisdictions, the settlor should consider creditors’ rights, any right of election against the settlor’s plan a surviving spouse may have, the duration of the state rule against perpetuities, powers of appointment and their exercise, the capacity of beneficiaries to take, the imposition of income and estate taxes, and, if the state is a community property state, the impact of community property laws.

Also, the estate could have practical problems in which a revocable trust is located in one state and there is a probate estate in another state. These problems are compounded if the trust and estate have different fiduciaries.

If the trust authorizes the trustee to advance funds to the executor for specific purposes, problems could occur if the funds are not used for the stated purposes. The trust should provide safeguards for such an event.

As a general rule, if a trust, other than a voting trust, grantor trust, IRC Section 678 trust (that is, one in which a person other than the grantor is taxable as the owner), qualified subchapter S trust, or an electing small business trust, holds stock of an S corporation, the S election will be nullified. A trust in which the grantor or another person is treated as the owner may continue as an eligible S corporation shareholder following the death of the owner, but only for two years, beginning on the date of the own-

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92 IRC Section 1362(d).
er’s death. An estate, on the other hand, may hold such stock for its "reasonable" period of administration without destroying the election.

The settlor should also consider the possibility that he or she might become incapable of effective revocation. In that case, the settlor might want to provide that the trust is to become irrevocable or name a trust protector authorized to revoke the trust.

In sum, the revocable living trust offers numerous advantages, but it is not without its problems and pitfalls. The financial planner and attorney can avoid many of these problems by careful draftsmanship and special handling. The will should be coordinated with the trust instrument. Generally, the trust and estate should have common fiduciaries. If the settlor has assets scattered in different jurisdictions, the financial planner should pay particular attention to the problems likely to arise. The financial planner will need to check out the law in the various jurisdictions involved. Also, the settlor might want to give the trustee authority to shift the trust’s situs, transfer assets, and give the trustee power to administer assets outside the primary jurisdiction.

¶635 The Standby Trust

A special kind of trust known as the standby trust merits the financial planner’s consideration. This type of trust stands in readiness to take over and manage trust assets when the settlor is no longer able to manage for himself or herself. It may provide for a takeover upon the settlor’s physical or mental disability or when the settlor is away on a trip or otherwise unable to manage his or her affairs. It is not specially designed to save taxes, although it can be structured to do so. Instead, its best use is to help the ailing client avoid cumbersome and expensive incompetency proceedings under state law. The standby trust can preserve the client’s assets while providing the financial structure to help meet personal needs.

A standby trust is usually revocable at the beginning, but it may be made to become irrevocable upon the settlor’s suffering permanent mental disability. Absent such provision, on the settlor’s suffering such disability, a court might appoint a guardian who could exercise the power to revoke for the settlor with attending tax and dispositive consequences.

A financial planner should always check local law to find out if, when, and how standby trusts are permitted.

¶640 Trusts Created by Will

A trust may be created in accordance with instructions contained in a person’s will. Such trusts are known as testamentary trusts. Testamentary trusts are for the individual who is unable or unwilling to part with certain property while alive, not even in a revocable trust. Such a person wants the control that a trust can provide for what is perceived to be the best interests of the beneficiaries after the decedent’s passing.

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93 IRC Section 1361(c)(2)(A)(ii).

94 IRC Section 1361(b)(1).
Although the testamentary trust does not result in any immediate estate or income tax savings when the will is executed or takes effect, it ultimately can result in tax savings. The trust can protect the trust property from successive estate tax levies as it passes from one beneficiary to another, from the surviving spouse to the children, and even to the grandchildren. However, the generation-skipping transfer tax may limit one’s ability to pass assets to successive generations without incurring additional transfer tax (see chapter 27, "Planning for Generation-Skipping Transfers").

The most common example of the estate tax-saving trust is the bypass trust, also called the credit shelter trust. Part of the estate owner’s property is typically bequeathed to the surviving spouse either outright or in a trust that qualifies for the unlimited marital deduction. The rest (often an amount equal to the applicable exclusion amount under IRC Section 2010 [exemption equivalent] available to the estate owner) is put into a bypass trust that pays the surviving spouse or children (or both) income for life or for a term of years. The bypass trust might also permit use of the principal (corpus) for the survivor’s defined and ascertainable needs, but it carefully avoids giving the surviving spouse too much control or rights in the trust property. In this way, the property will not be includible in the surviving spouse’s gross estate and can pass estate-tax free to the beneficiary or beneficiaries next in line. If there are multiple beneficiaries, the financial planner might want to set up separate shares for them. The client should have enough money or property involved to warrant the added expense of trust administration, and the financial planner should be able to project worthwhile income tax savings for those concerned (¶605).

The advantages of the use of the bypass trust should be weighed against the advantages of portability, including stepped-up basis opportunities in which the decedent would leave more to a surviving spouse and less to the bypass trust. There are strong arguments to be made on both sides of this issue. Portability and its advantages and disadvantages are discussed in detail in chapter 37.

The settlor might also want to allow the trustee to accumulate income and use it for specific purposes spelled out in the trust. Flexibility can be most important in a testamentary trust, and the financial planner will want to consider the use of a number of special provisions discussed in ¶660 designed to impart flexibility to meet changes in the circumstances of the beneficiaries, as well as the uncertainty of future tax laws.

A financial planner should remember something very important in connection with testamentary trusts. A testamentary trust can make provisions for a trust beneficiary that the beneficiary could not make for himself or herself if the beneficiary were to set up a trust, without addressing income and estate tax complications. For example, if a beneficiary created a trust and retained the income rights, the trust property would be includible in the beneficiary’s gross estate under IRC Section 2036. If, under the terms of this trust, income may be used to pay insurance premiums on the settlor’s life or that of the spouse, the income would be taxable to the settlor under IRC Section 677. The settlor would also be treated as the owner of the policy, and the proceeds would be includible in the settlor’s gross estate. However, none of these consequences would result if the settlor occupied the position of beneficiary of a testamentary trust.

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95 IRC Section 2056.

96 IRC Section 2041(b)(1).
The pourover trust, as its name suggests, is a trust into which assets are poured from another source. The pourover may be from the settlor’s will or a source completely outside the testamentary estate. It is most useful as a receptacle for benefits from qualified employee benefit plans, Keogh plans, IRAs, or life insurance proceeds. Also, it may receive assets from other trusts or estates.

The trust may be either revocable or irrevocable, with all the attendant advantages and disadvantages of either. If the trust is revocable, the settlor, after seeing it in operation and noting changes in circumstances, may make appropriate changes and adjustments. If it is irrevocable, then change is barred (absent decanting authority under state law), and the settlor will want to build into the trust enough flexibility to permit the trustee to adjust to changed conditions.

In both revocable and irrevocable trusts the settlor avoids probate of the trust property and reduces publicity.

The pourover trust is likely to be especially useful when it is made to receive life insurance proceeds exempt from estate taxes under IRC Section 2042, employee benefits, or IRA benefits. IRC Section 2042 exempts the proceeds of a life insurance policy payable to a beneficiary other than the insured’s estate, provided the insured retained no incidents of ownership in the policy at the time of his or her death and did not transfer the policy or policy rights within three years of death.97

The pourover trust can be used to take advantage of this exemption. It can also save a second tax on these assets. If they were made payable directly to an individual, what remained of the assets would be potentially taxable eventually as part of that individual’s estate. With the pourover trust, this tax may be avoided by giving the primary beneficiary only a life interest and directing payment of what is left of the policy proceeds to others on the primary beneficiary’s death.

When the client wants benefits payable to several beneficiaries, the trust form will normally be the most effective way of making distributions in accordance with the wishes of the settlor and the needs of the beneficiaries. In this respect, the financial planner will want to build into the trust various provisions, such as those discussed in ¶660, which will permit the desired flexibility.

The pourover trust is helpful not only when there are multiple beneficiaries but also when there are multiple assets. It permits ease of administration by bringing together these assets in one place and development of a plan that coordinates and makes use of them in a way that is most likely to further the objectives of the settlor and the interests of the family. It also has the advantage of the revocable trust in bringing together trust assets in different jurisdictions, as noted in ¶630. However, a financial planner needs to note possible problems as well.

When pourover trusts first appeared on the scene, the courts were troubled by them. The main problem concerned pourovers from wills. Nearly all states now have statutes that, in one form or another, uphold the validity of pourovers. Nevertheless, a financial planner should be familiar with some of the problems, especially because state statutes may leave some of them unresolved.

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97 IRC Section 2035(a).
When used with a will, one might view the pourover trust as involving a testamentary disposition of property. One then has the problem of observance of the formalities required to make testamentary dispositions. Courts have long recognized that a will may incorporate another document by reference. The other document would then become a part of the will. The testator does not want the pourover trust to be incorporated into the will. Rather, the testator prefers that the two documents be kept separate. Notwithstanding this difficulty, the courts have been able to sustain pourovers on the basis of incorporation-by-reference. Implicit in the incorporation-by-reference theory is a requirement that the trust be in existence when the testator executes the will. Also, problems will arise under this doctrine if the trust is revocable or subject to amendment after the date the testator executes his or her will.

Against this background, one can better understand the purpose of the Uniform Testamentary Additions to Trusts Act, which is in force in a number of states. Its main section provides (emphasis supplied) as follows:

Section 1. Testamentary Additions to Trusts.—A devise or bequest, the validity of which is determinable by the law of this state, may be made by a will to the trustee or trustees of a trust established or to be established by the testator or by the testator and some other person or persons or by some other person or persons (including a funded or unfunded life insurance trust, although the trustor has reserved any or all rights of ownership of the insurance contracts) if the trust is identified in the testator’s will and its terms are set forth in a written instrument (other than a will) executed before or concurrently with the execution of the testator’s will or in the valid last will of a person who has predeceased the testator (regardless of the existence, size, or character of the corpus of the trust). The devise or bequest shall not be invalid because the trust is amendable or revocable, or both, or because the trust was amended after the execution of the will or after the death of the testator. Unless the testator’s will provides otherwise, the property devised or bequeathed (a) shall not be deemed to be held under a testamentary trust of the testator but shall become a part of the trust to which it is given and (b) shall be administered and disposed of in accordance with the provisions of the instrument or will setting forth the terms of the trust, including any amendments thereto made before the death of the testator (regardless of whether made before or after the execution of the testator’s will), and, if the testator’s will so provides, including any amendments to the trust made after the death of the testator. A revocation or termination of the trust before the death of the testator shall cause the devise or bequest to lapse.

This act provides that the validity of the plan is not affected by the fact that the trust is amended after the execution of the will. Other statutes of this type might not be so explicit. If any doubt exists about this matter and the trust is amended after the execution of the will, conservative practice calls for a new will or codicil to be executed. The new will or codicil should note the trust amendment and provide for a pourover to the amended trust.

Note also that the Uniform Act permits a bequest to a trust to be established, provided a written instrument exists that sets out its terms, before or concurrently with the execution of the will. Still, having the trust in existence before the will is executed is better practice. A codicil to the will referencing a trust set up after the will’s execution might be sufficient.

All the care that goes into putting together a testamentary trust should go into the preparation of a pourover trust, including the consideration of those provisions discussed in §660 designed to give flexibility. In addition, the pourover trust should be clear about whether it is to be revocable or irrevocable and whether it may be amended by the trustee, and, if so, how and when. Also, the settlor should give consideration to the estate’s tax liabilities and how they are to be handled. If the bulk of the taxable estate goes into the pourover trust, leaving the estate with insufficient assets to pay estate taxes, the trust
should contain a provision for the payment of estate taxes. Consider provisions allowing the trustee of the trust to purchase assets from the estate in order to allow cash to flow into the estate. The trust could also provide for payment of debts and expenses of administration of the estate.

The will used in conjunction with a pourover trust merits special attention. The will should mention that heirs not mentioned in the will are provided for in the trust, if that is the case, or that the omission of certain heirs in both the will and the trust is intentional. A will might contain various specific legacies that may lapse and fall into the residue to be turned over to the trust. In such a case, the testator should consider having the executor turn these into cash rather than turn them over in kind to the trust, if retention, allocation, sale, or exchange might create problems for the trustee. Consideration also needs to be given to the potential problems caused by assets scattered in different jurisdictions in line with the discussion of revocable trusts (¶630).

The surviving spouse’s statutory right of election against the decedent’s will may also apply to the pourover trust. The spouse should be given the economic equivalent of the statutory share of the estate. This provision reduces the possibility of the surviving spouse renouncing the will. In addition, an alternate plan of disposition is recommended if the surviving spouse renounces the will. Also, a failsafe provision in the will, providing alternate dispositions of the estate if the pourover trust is invalidated, is always advisable.

**¶650 Grantor Retained Interest Trust: GRIT, GRAT, and GRUT**

When a grantor retains an income interest in a trust for life or for a term of years and designates certain specified family members (for example, a spouse or child) to receive the remainder, the grantor is treated as having made a gift of 100 percent of the value of the property unless the retained interest is a qualified interest.98 Two types of trusts are treated as qualified interests: a grantor retained annuity trust (GRAT), in which the grantor retains the right to receive a fixed payment each year based on the initial value of the property contributed to the trust, and a grantor retained unitrust trust (GRUT), in which the grantor retains the right to receive a fixed percentage of the annually revalued trust assets each year.

A GRAT or GRUT can save gift taxes because the value of the gift the remainder interest is determined by subtracting the present value of the grantor’s retained interest from the fair market value of the transferred property using special valuation tables (discussed in ¶2315). By contrast, a trust in which the grantor retains all the income from the trust property (GRIT) will in most cases be subject to gift tax on 100 percent of the value of the trust property. (See, however, ¶2315.02 for a discussion of the use of a GRAT when the person designated to receive the remainder interest is not a designated family member).

A GRAT, GRUT, or GRIT can be an estate tax-saver as well. Post transfer appreciation in the value of the trust assets will not be included in the grantor’s estate, provided the grantor survives the trust term. However, if the grantor dies during the term of the trust, the portion of the trust property required to produce the remaining annuity payments will be included in the grantor’s estate in the case of the GRAT and GRUT, and the entire value of the trust property in the case of the GRIT.99

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98 IRC Section 2702.

99 IRC Section 2036.
The IRS has issued regulations for determining the portion of the trust that is includible in the grantor’s estate where the grantor retained the right to an income payment from a trust or the use of a trust asset for life, for a period that does not, in fact, end before death or for a period not ascertainable without reference to death. Under the regulations, the portion of the trust includible in the grantor’s gross estate would be that portion, valued as of the decedent’s death (or the alternate valuation date, if applicable) necessary to yield the annual income payment or use.\footnote{Regulations Section 20.2036-1.}

In IRS Letter Ruling 201652002, an attorney drafted several grantor retained annuity trusts (GRATs). However, the attorney failed to include language prohibiting the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity obligation as required by Code of Federal Regulations (CFR), \textit{Qualified interests}, Title 26, Section 25.2702-3(d)(6). A court issued an order reforming the trusts to include the required language, retroactive to the date that each trust was established. The IRS ruled that, as a result of the judicial reformation of the trusts, the grantor’s interest in each trust was a qualified interest under 26 CFR 25.2702-2 and 25.2702-3, effective as of the date each trust was created.

\section*{655 The Foreign Trust}

Foreign trusts may be unfamiliar to many financial planners. Foreign trusts have never been for every person or for every financial planner because they have required specialized expertise in their creation and use. Foreign trusts are subject to generally unfavorable income tax rules, generally taxing the United States beneficiaries on the trust income, even when the trust settlor is a foreign national (see IRC Section 679).

Discussion of foreign trusts, in any depth, is beyond the scope of this publication. However, a financial planner should generally beware of foreign trusts for U.S. persons. The IRS will often view them as tax dodges worthy of special scrutiny. Unless very large sums of money are involved, the complications and uncertainties associated with these trusts will likely outweigh the expected benefit. Most of the rules involving foreign trusts look for ways to tax the U.S. person on the income of the trust—either as the grantor or as a beneficiary. There are extensive and complex annual reporting requirements when foreign trusts /or foreign bank accounts (or both) are involved.

\section*{660 Special Trust Provisions to Provide Flexibility and Safety}

Trusts are usually built to last for a long duration. Many things can change in the course of time that require different approaches and responses from those contemplated when the trust was created. If the trust is revocable, the settlor, if alive and well, can make appropriate changes in the trust. If the trust is an irrevocable living trust or a testamentary trust, the trustee could have difficulty dealing with changing circumstances and needs of the beneficiaries. To avoid this problem, the trust should include the flexibility required to enable the trustee to develop sensible responses to new situations.

Everyone will agree to the need for flexibility in the abstract. However, in practice, the financial planner may find that many clients are afraid of it. The settlor is being asked to confer a degree of discretion on a fiduciary. The settlor may or may not have complete confidence in the fiduciary. If the settlor has that
confident, he or she may lack confidence in the fiduciary’s durability or longevity, and the settlor might be fearful of entrusting an unknown successor or substitute. The settlor might be more fearful of entrusting someone with the tools for doing what might be required than of the consequences that could result if required changes cannot be made. This problem has psychological and emotional roots. It illustrates the point that estate planning is not a pure science, providing neat and sensible property arrangements, but an art that fundamentally involves dealing with human beings in a creative way.

The following are some of the key provisions that can, if accepted by the settlor, impart flexibility and safety.

.01 Income Sprinkling Clause

Few people make up a family budget and division of income among family members to run for a year, let alone 10 or 20 years. Family income is generally used to meet actual family needs, (that is, the needs of each family member as they develop). Income is sprinkled where the parents think it is most needed. That is the idea of the sprinkling trust. The trustee functions as a parental substitute, assuming that the beneficiaries are the children of the settlor, distributing income or accumulating it as the fiduciary thinks best.

Usually, an experienced trustee given sprinkling powers will closely follow the suggestions of the surviving parent about how the sprinkling should go. When there is no surviving parent, the trustee will be very careful about any sort of uneven sprinkling, unless a clear family consensus develops, indisputable special circumstances justify it, or the trust itself or the will creating it explicitly authorizes it.

Generally, the "spray" of distributions from the trust will be what is called a horizontal one, taking into account the entire family, including a surviving spouse, children, and grandchildren. One may also have a sprinkling trust set up for an individual, usually a child of the settlor, and his or her descendants. This arrangement is considered a vertical spray.

A well designed and administered trust with a sprinkling feature can produce family income tax savings insofar as low bracket beneficiaries are favored. When the surviving spouse is included as a beneficiary, the trust can also produce estate tax savings to the extent that the spouse is given no more income than needed. Thus, the surviving spouse’s gross estate will not be increased unnecessarily.

Because the beneficiaries have no right to income until it is allocated to them, the sprinkling feature operates as an asset protection vehicle for the beneficiaries against creditors.

Some of the key considerations in setting up a sprinkling arrangement are as follows:

- The trustee should be given guidelines for sprinkling, indicating, for example, the settlor’s preferences and priorities both about beneficiaries and the needs and purposes to be served. If appropriate, the settlor can consider doing this by a separate memo outside the trust instrument.

- To avoid antagonisms between siblings, consideration should be given to the adoption of separate trusts or separate shares within a trust with a vertical spray only. Some inequality in the amount funding each trust may be more readily tolerated when made by the settlor than it would be within a single trust by the discretionary actions of a trustee.
• If the surviving spouse is to be included as a beneficiary and is the settlor’s prime concern, the settlor should consider giving the surviving spouse a set minimum amount of income and limiting the discretionary sprinkling to the excess.

• If the sprinkling is part of a living trust, one must be concerned with the grantor trust income tax rules of IRC Sections 671-677. Income will be taxable to the grantor if the grantor is in a position to direct the spray or if the grantor or the grantor’s spouse may benefit. A financial planner must also be concerned with the estate tax consequences of powers retained by the settlor, which would throw trust assets into the settlor’s gross estate under IRC Section 2036 (retained life interest) and 2038 (power to revoke, alter, amend, or terminate).

• The selection of an able trustee is most critical. How long will a trustee be needed? Holding property in trust for a long duration should influence the choice of trustee. Successors should be considered. The settlor should also be sensitive to the tax ramifications and generally avoid naming someone who has an interest in the trust. A corporate trustee plus a co-trustee who knows the family and family needs might be best, if the costs (fees) are acceptable.

• The settlor should consider what is to be done with excess income not needed for the educational, medical, or other needs of individual participants. Is it to be accumulated or distributed? If distributed, on what basis? It can be done on a per capita or per stirpes basis. With the former, it would be distributed evenly per capita to all in the group. On a per stirpes basis, the distribution would be by representation to members of a subgroup. For example, assume that A and B are children of the settlor, with A having four children and B one. Per stirpes would call for a distribution of the excess income by halves, half to A’s family and half to B’s. Per capita would result in a share being distributed to each designated beneficiary.

• The settlor should consider the distribution of principal to children as they come of age. Is the trust to be divided into separate shares when it makes the first distribution of principal? Is the trust to distribute the entire principal when the oldest or youngest attains a given age? Is payment to each child to be made as he or she attains a specified age? The settlor should consider the effect of the distribution scheme on the beneficiaries. When the older beneficiaries take principal out of the trust, the younger ones are left with less in the common fund to satisfy their needs. Because the expenses of administering the trust are not likely to diminish proportionately as trust assets are reduced, the younger beneficiaries in this situation may have to bear relatively larger administration fees. Consider separate shares as an alternative to a common “pooled” trust fund in these situations.

These factors are only some of the key considerations. The most important consideration is to develop a mode of operation and distribution that reflects the objectives and desires of the settlor.

.02 Use of Trust Principal

Almost all trusts give the trustee discretion to use the principal or corpus of the trust for the benefit of income beneficiaries on certain terms and conditions. This discretion is known as a power to invade corpus.

Ascertainable standard. A trust beneficiary will rarely be the sole trustee. However, even if a person is only a co-trustee, possession of a power to invade corpus could cause the trust corpus to be includible in his or her gross estate under the terms of IRC Section 2041. To avoid inclusion, the power must be limited by a definite external or ascertainable standard. That rule has generated a lot of litigation. The safest
course is to follow the Treasury regulations on the subject. As examples of powers properly limited by an ascertainable standard, the regulations cite powers for the holder’s "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," and similar formulations dealing with health, medical care, and dental care. Conversely, the regulations state that a power to use property for the comfort, welfare, or happiness of the holder is not limited by the requisite standard, and would be considered a general power of appointment.\footnote{Regulations Section 20.2041-1(c)(2).}

Similar considerations affect the power of invasion as it may relate to a trust’s income being taxable to the grantor. IRC Section 674 makes the income taxable to the grantor if the grantor has power to control beneficial enjoyment of the income or corpus, but it excepts a power to distribute corpus if limited to a reasonably definite standard. Regulations Section 1.674(b)-1(b)(5)(i) cites standards similar to those contained in the IRC Section 2041 estate tax regulations (discussed previously) as acceptable.

A similar rule will apply under IRC Section 678 to persons other than the grantor who possess a grantor-like power over the trust.

\textbf{No ascertainable standard.} What provision should a trust include if a beneficiary serves as co-trustee and the trust permits distributions of corpus not limited by an ascertainable standard, or if there is doubt about whether distributions are so limited? The trust should prohibit the beneficiary-trustee from participating in the exercise of any discretion that might benefit him or her or anyone to whom he or she owes a legal obligation, such as an obligation of support.

When there is a primary beneficiary (that is, a surviving spouse), and secondary beneficiaries, (that is, children), one may want to permit invasion on behalf of the latter only if the security of the former is not jeopardized.

The trust could also provide that invasions of principal on behalf of a beneficiary, who will ultimately receive a distribution of principal, are to be regarded as an advance principal distribution. Alternatively, the trust could provide that such invasions do not constitute advancements of principal.

\textbf{.03 Power of Beneficiary to Withdraw Principal}

A settlor might not want a beneficiary to have full control of the trust assets. At the same time, the settlor might not want to leave the beneficiary completely at the mercy of the trustee to make payments to the beneficiary out of corpus if the need arises. The settlor can resolve this dilemma by giving the beneficiary a right to withdraw corpus, subject to limitations. If the trust instrument has no provision that would otherwise make the trust property includible in the gross estate of the beneficiary, one will most likely want to limit the power of withdrawal to preserve the beneficiary’s estate tax exclusion benefit.

To do so, the trust should limit the power of withdrawal in any one year to what is referred to as a \textit{five and five power}, the power to withdraw the greater of $5,000 or 5 percent of the value of the trust property at the time the power is exercisable.\footnote{IRC Section 2041(b)(2).} The power should be noncumulative. In this way, no gift will
result on the non-exercise or lapse of the power. The only amount includible in the power holder’s gross estate is the amount he or she was entitled to withdraw for the year in which death occurs, less any amount which was withdrawn that year.\textsuperscript{103}

When advising a client, a financial planner should also consider that under IRC Section 678(a) the beneficiary may be deemed to be the owner for income tax purposes of so much of the corpus as is subject to the beneficiary’s right of withdrawal. Hence, the beneficiary would be taxable on the income attributable to that part.

\textbf{.04 Power of Withdrawal to Assure Availability of the Annual Exclusion—The Crummey Power}

\textit{Crummey powers} are frequently used in trusts that permit the accumulation of income in order to allow contributions to the trust to satisfy the present interest requirement for the annual gift tax exclusion ($14,000 for 2017, indexed annually for inflation) under IRC Section 2503(b).\textsuperscript{104}

A Crummey power gives the beneficiary a limited power to withdraw trust property. The beneficiary must receive proper notice of his or her right to demand a portion of the trust corpus. Generally, the power is exercisable only during a limited period following notice (30 days or 60 days, typically) each year. The power is noncumulative. Thus, if the beneficiary does not exercise the power in one year, the beneficiary loses the power of withdrawal for that year. The U.S. Tax Court has allowed annual gift tax exclusions for Crummey powers given to trust beneficiaries who held contingent remainder interests.\textsuperscript{105}

Much to the undoubted consternation of the IRS, the U.S. Tax Court, citing the \textit{Cristofani} decision, allowed annual exclusions with respect to the unrestricted rights of each of 16 contingent beneficiaries to demand up to the then $10,000 annual exclusion amount annually from an irrevocable trust created by a grantor just 3 months before his death. None of the beneficiaries exercised the rights after being timely notified of their existence. None requested notification of future transfers of property to the trust. Nevertheless, the court refused to conclude that the beneficiaries and the grantor had agreed the rights would not be exercised.\textsuperscript{106}

The power of withdrawal is generally limited to the amount excludable from gift tax under the annual exclusion ($14,000 for 2017, and indexed annually for inflation under IRC Section 2503(b)). However, tying the Crummey power to the amount of the annual gift tax exclusion in order to assure full availability of the annual exclusion for transfers to the trust may possibly involve adverse gift and estate tax considerations to the beneficiary. In the prior discussion under the heading "Power of Beneficiary to Withdraw Principal" (¶660.03), reference was made to the need to limit the annual Crummey withdrawal power to the greater of $5,000 or 5 percent of the trust corpus in order for the beneficiary to avoid gift tax\textsuperscript{107} on the lapse of the power and to avoid having the trust includible in the gross estate of the benefi-

\textsuperscript{103} Regulations Section 20.2041-3(d)(3).

\textsuperscript{104} \textit{D. Clifford Crummey}, CA-9, 68-2 USTC ¶ 12,541, 397 F.2d 82, aff'g 25 TCM 772, AICPA Dec. 28,012(M), TC Memo. 1966-144.

\textsuperscript{105} \textit{M. Cristofani}, 97 TC 74, AICPA Dec. 47,491, acq. in result only.

\textsuperscript{106} \textit{L. Kohlsaat Est.}, 73 TCM 2732, AICPA Dec. 52,031; \textit{Mikel v. Commissioner}, TC Memo 2015-64.

\textsuperscript{107} IRC Section 2514(e).
If one is concerned at all about possible gift tax or inclusion of the trust in the beneficiary’s gross estate, one would not want to run the risk of inclusion under the five-percent test. In such cases, it is preferable to limit the annual Crummey right of withdrawal to $5,000.

The $5,000 or five-percent limitation has gift tax implications that may be more important than the estate tax implications for the trust beneficiary. It also may operate to limit full funding of the trust and thinning of the estate of the grantor. For example, suppose a grantor establishes a trust in 2017 and initially funds it with an amount equal to the $14,000 annual gift tax exclusion, giving the trust beneficiary a Crummey power to withdraw the full amount of the trust contribution. Because the amount the beneficiary can withdraw may exceed the greater of $5,000 or 5 percent of the trust corpus (depending on the amount of property in the trust), the beneficiary may be treated as having made a taxable gift to the other trust beneficiaries, if any, of the excess $9,000 when the Crummey power lapses. One way to avoid this problem is to limit the grantor’s contributions to the trust until the trust grows large enough to support a Crummey power equal to the annual exclusion. Another option (though possibly impractical in certain situations) may be to have separate trusts for each beneficiary.

However, these limitations can be overcome by the use of a so-called "hanging" or "pendent" power. The grantor may make annual gifts to the trust to the maximum allowed by the annual gift tax exclusion ($14,000 per donee for 2017 and indexed annually for inflation under IRC Section 2503(b); double to $28,000 with gift splitting under IRC Section 2513) while providing that the noncumulative power is to lapse only to the extent of the greater of $5,000 or 5 percent of the trust property. This plan would assure full use of the annual exclusion. The unused power would be "hanging" (that is carried over for use at some future time unless limited). It would not lapse. The grantor will usually want to limit the future use of the carried over power in order to assure that the trust funds are primarily distributed in accordance with the terms of the trust. Ideally, the limitation should be done in such a way that it would not result in gift tax exposure to the holder of the Crummey power.

In Letter Ruling 8901004 (September 16, 1988), the IRS ruled that pendent or hanging powers are invalid when they are drafted so that the withdrawal power will continue if lapse of the power would be deemed a taxable gift by the beneficiary. According to the IRS, any attempt to make the lapse of the power subject to a condition subsequent tends to discourage enforcement of the gift tax law, and, therefore, offends public policy.

However, hanging powers that are drafted to avoid imposing what the IRS considers a condition subsequent appear to withstand IRS scrutiny. This result can be accomplished by drafting the power so that it does not refer to a "lapse" or "release." Instead, the trust can contain a provision that causes powers to lapse only in the amount permitted under IRC Section 2514(e), that is, the greater of $5,000 or 5 percent of trust principal.

Using hanging powers might be especially appropriate when the trust owns a large policy of life insurance, demanding a large annual premium payment, and the client will need maximum use of annual exclusion gifts. The financial planner should make the client aware that the IRS has not ruled definitively

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108 IRC Section 2041(b)(2).

109 IRC Section 2514(e).
on the use of hanging powers, and there is some risk of an IRS challenge (which may not arise for many years after the creation of the trust), and keep a record of the client’s informed decision. Also, with the lifetime gift exclusion at $5,490,000 for 2017, indexed for inflation, consider making a large gift to a trust within the available lifetime exclusion amount sufficient to fund many years of life insurance premium payments to avoid the Crummey and hanging power issues altogether, especially for a client unlikely to ever be a federal taxpayer.

.05 Provisions for Beneficiaries With Disabilities

A settlor should consider the effect of disability of a beneficiary. The trust should define disability. The trust might provide that a determination of disability made by two medical doctors and submitted in writing would be sufficient. The trust should make provision for payment to a guardian of a beneficiary, if one is appointed, so the guardian can apply payments for the beneficiary, deposit them in a bank account, or retain them in the trust in a separate account.

The Achieving a Better Life Experience (ABLE) Act, enacted in 2014, allows people with disabilities to open special accounts where they can save up to $100,000 without risking their eligibility for Social Security and other government programs. Individuals can keep their Medicaid coverage no matter how much money is accrued in an ABLE account. Modeled after Section 529 college savings plans, interest earned on ABLE savings will be tax-free. Funds accrued in the accounts can be used to pay for education, health care, transportation, housing, and other expenses.

To be eligible, individuals must have a condition that occurred before age 26, and each person may open only one ABLE account. Under current gift-tax limitations, as much as $14,000 may be deposited annually. Although the law alters federal rules to allow for ABLE accounts, each state must now put regulations in place—much as they have done for other types of 529 plans—so that financial institutions can make the new offering available. (See the discussion of the ABLE Act in chapter 44.)

PFP/PFS members can send a customizable Broadridge Forefield client alert that provides an overview of ABLE account features to their clients. Additionally, a white paper outlining what the ABLE Act accomplishes, its significance, eligibility requirements, when the accounts will be available, what this means from a planning perspective, and more is available to PFP/PFS members from WealthCounsel, ElderCounsel, and its authors, Jeremiah Barlow, JD, and Stephen Dale, JD, LLM.

.06 Spendthrift Provision

The whole purpose of a trust might be defeated if a beneficiary could anticipate payment of trust income and principal and assign his or her rights to it to creditors or others before the trust distributes the income and principal. This consideration is applicable to trusts for minors, but it is not limited to minors. Therefore, any trust for any beneficiary should expressly prohibit the beneficiary’s anticipation and assignment of income or principal.

.07 Provisions Aimed at Cutting Costs

When structuring a trust, one should weigh the benefits against the costs involved and not extend the life of the trust to the point where the costs outweigh the benefits. This consideration is especially important when trust assets are not substantial or might be rapidly consumed. The trust should provide for termination by the trustee or third party when administration becomes uneconomical, such as when the trust assets fall to a minimum level.
The settlor should also give thought to the use of co-trustees and the added costs involved. This cost, and other cost factors concerning fiduciaries, are discussed in ¶665.

Finally, the settlor should consider express provisions to limit the compensation of trustees to reduce administrative costs. Of course, one should not specify commissions that are so low that the trustees will be unwilling to act or will soon lose interest (except perhaps in the case of close family members whose continued interest should be assured).

The elimination of a required formal accounting is another way to reduce costs. However, some informal accounting may be required to protect beneficiaries and satisfy local law requirements. Giving beneficiaries the right to request an accounting may be a good provision to include in a trust.

.08 Inflation- and Recession-Proofing the Trust

Inflation- and recession-proofing a trust is not easy. When trust income declines or the income distributed loses purchasing power, provisions permitting discretionary distribution of trust principal for the benefit of income beneficiaries will obviously help. Sprinkling provisions that allow beneficiaries’ needs to be taken into account will also help.

.09 Influencing Conduct Through Trusts

Individuals traditionally have used trusts to hold and manage assets for persons who are inexperienced or otherwise incapable of handling large sums of money or other assets. Individuals can also use trusts to influence beneficiary behavior through positive and negative means that affect payments of principal and income, so-called "incentive trusts" and "disincentive trusts."

The following hold-back provisions offer positive encouragement.

.10 Hold-Back Provisions

A trust often provides for the distribution of all principal and income on the occurrence of a specified event, such as the principal life beneficiary’s death or the beneficiary’s attainment of a certain age. However, circumstances might arise in which a mandated distribution will not be in the best interest of the beneficiary. Examples of such circumstances are involvement in divorce proceedings or other litigation, terminal illness, or severe problems with gambling, alcohol, or other drugs.

Because of such possibilities, the settlor should consider the use of a trust hold-back provision that will enable the trustee to withhold distributions in specified circumstances, while continuing the trust and otherwise administering it in accordance with its terms.

Some clients might wish to disinherit beneficiaries and go much further than the hold-back provisions. These clients would direct that the beneficiary be divested of any interest he or she might have in the trust in the event that the beneficiary fails to live up to certain societal norms. For example, the trust might provide that a beneficiary loses an interest in the trust if the beneficiary is convicted of a drug offense or becomes a cult member, or if the beneficiary in some other sense fails to measure up to other specified standards of the grantor. In this case, the trust assets could be distributed to other beneficiaries, including charities.
.11 Delayed Distribution

Going beyond positive encouragement and negative sanctions, the grantor of the trust might wish to delay the age at which the beneficiary becomes entitled to any distribution of income. Trusts often provide that the beneficiary of a trust of long duration will receive all the income of the trust once he or she attains a specified age, for example, 25 or 30. However, trust income itself might be enough to make a young beneficiary relatively wealthy. In fact, the income could be a burden to the beneficiary by taking away any incentive to become a productive member of society. Therefore, the financial planner and client might wish to consider delaying the receipt of income by requiring the accumulation of all trust income until the beneficiary becomes much older. Forced accumulation of income can result in higher income taxes and the 3.8 percent net investment income tax at the trust level given the highly compressed trust tax brackets, as discussed in ¶605. However, as long as the financial planner explains the potential tax cost, the client may properly create an income-accumulating trust that has as its primary goal ensuring that the beneficiaries receive their inheritances at appropriate times.

.12 Special Powers of Appointment

A person creating a living or testamentary trust may give a trust beneficiary a power to direct who will enjoy the right to the trust property. This trust is known as a power of appointment trust, and the power may be either general or special.

A general power of appointment under IRC Section 2041 gives the holder the right to direct that property subject to the power be paid to anyone, including the holder, his or her estate, his or her creditors, or the creditors of his or her estate. Under a special or limited power, however, the holder may not appoint the trust property to himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. The advantage offered by the special power is that the power-holder can alter trust ownership, as he or she deems fit, by appointing property to any recipient outside of the prohibited categories without adverse estate tax consequences to himself or herself.

Provided a power qualifies as a special one, its scope may be as narrow or as broad as the person creating the trust might wish. An example of a narrow restriction would be when the holder is given the power by will to appoint the principal of the trust, created by the grantor, among such of the power-holder’s descendants as shall survive, in such amounts or proportions, and outright, or in further trust as the power-holder shall appoint. A broader special power of appointment would permit the holder to appoint the principal of the trust to any individual or corporation whatsoever (other than the power-holder, his or her estate, his or her creditors, or the creditors of his or her estate). Whether the power is broad or narrow, its careful exercise can provide the holder with a valuable estate planning tool permitting appropriate dispositions for chosen beneficiaries. For example, instead of requiring that the trust principal pass per stirpes to the descendants of the power-holder on his or her death, exercise of a special power of appointment could permit the holder not to allow payments to be made to any particular child. Alternatively, the special power could allow the holder to appoint the property in further trust for a child for his or her lifetime. Especially in situations where one spouse dies and the survivor lives for many years, giving the survivor the opportunity to see the future of the family and have some control over the disposition of family assets may be an attractive planning alternative.

¶665 Trustees—Their Selection, Responsibilities, and Powers

A critical choice for the trust settlor is the selection of the trustee or trustees. The first qualification to consider is that the person selected must measure up to the job in a practical way. If a large part of the trust property consists of an ongoing business, for example, an individual with business experience...
might be preferred. If the trust property is a large portfolio of listed securities, an investment adviser, if available, might be a suitable appointee. Consider appointing a professional trustee to address investments and a family trustee to address distributions to beneficiaries. Trustees must also meet legal qualifications. Local law requirements are usually more restrictive about executors than they are about trustees. Nevertheless, the financial planner should check local law, especially if the situs of the trust is to be in one state and a potential trustee is from another state.

Ability, durability, integrity, experience, judgment, understanding, and solvency are all qualities to look for in the trustee, whether the trust is big or small. Indeed, with a small trust, the need for care in trustee selection will be even greater because the beneficiaries may have greater needs with less to go around.

Tax considerations also affect the selection of a trustee. If the settlor names himself or herself as trustee, the retained powers over principal and income may make the settlor taxable on trust income under IRC Sections 671–677. If a person other than the settlor is named as trustee, the financial planner should consider whether such person will be taxable on trust income under IRC Section 678. Under IRC Section 678, a person other than the settlor is taxable on the trust income if given the power solely by himself or herself to vest income or principal in himself or herself or has partially released such power but retains such control as would make him or her taxable if he or she were the settlor.

The financial planner should also consider estate tax issues flowing from the IRC provisions designed to include in an individual’s gross estate property that he or she is able to control or enjoy beneficially. The financial planner needs to look at whether the possession of powers within the reach of one or more of those sections will bring the property into the trustee’s gross estate.

Trustee’s fees are also a matter of practical concern. This issue might involve the question of whether to select a corporate or individual trustee, as well as whether to use co-trustees. Both topics are separately discussed in the text that follows. Cost considerations might lead the settlor to use an individual as trustee while the trust is largely unfunded and add a corporate trustee and possibly an individual co-trustee when full funding takes place. Similar considerations are applicable to a living trust as long as it is revocable or while it merely serves as a standby trust, with the settlor serving as trustee. When some event occurs that makes the trust irrevocable or the standby becomes effective, the settlor might wish to switch to a paid trustee. The client might be able to bargain with the trustee on commission rates that are lower than those provided under state law or published by a corporate trustee. Agreements to limit the compensation of trustees of testamentary trusts should be secured during the client’s lifetime.

.01 Corporate or Individual Trustee?

The financial planner does not generally need to discuss with the client whether to use a corporation as a trustee until the trust assets are sufficient to warrant consideration of a corporate trustee. A corporate trustee, depending on locality, might not be willing to serve as a trustee unless the trust assets are substantial. For example, a corporate trustee might not be willing to serve as trustee unless the trust assets are worth at least $500,000.

Although a corporate trustee may be more costly than an individual trustee and less likely to provide the same personal touch, in certain situations the corporate trustee may be more effective than an individual. The corporate trustee is a specialist. It has experience. It is a combination of individuals. It never gets sick, and it is immortal. When dealing with the trust and beneficiaries, a corporate trustee is not distracted by emotional ties and commitments and should act impartially.
Fees for a corporate trustee, however, can be expensive. A settlor might be able to get a family member to take the job without any compensation. However, corporate trustees are in business to make money. They may have minimum fees. They may have an acceptance fee or a termination fee and sometimes both. The trustee could charge additional fees for the preparation of tax returns or beneficiary tax reports. Corporate trustees might demand extra fees if the trust has a co-trustee, on the theory that a co-trustee makes their job more difficult. These fees are all proper subjects of inquiry before making a commitment to a corporate trustee.

Some corporate trustees will discount their regular fees if they are permitted to invest trust funds in their common funds. In such cases, the financial planner will want to know the performance history of the common fund, as well as the amount of common fund management fees and expenses. It is advisable for the settlor or a beneficiary to have the power to remove funds from the common fund of the trustee. The client with substantial liquid assets might be able to persuade a corporate trustee to serve for lower than customary rates.

The corporate trustee may lack a personal touch and knowledge that an individual close to the settlor and his or her family might have. Such a personal connection might be helpful in exercising discretion about distributions to trust beneficiaries.

The combination of cost and lack of personal touch and knowledge are factors that argue against the corporate trustee and favor the qualified individual to serve as trustee. The settlor might especially prefer an individual trustee willing to serve without a fee if few complications are anticipated in the administration of the trust and the trust assets are not very substantial.

Conversely, if the trust is likely to have a long duration, the “longevity” of the corporate trustee is attractive. In any event, to assure performance will be satisfactory, the settlor should include in the trust a mechanism for the removal of a corporate trustee by the settlor or the beneficiaries, even if the required replacement is a different corporate trustee.

.02 Co-trustees

The ideal arrangement might seem to be to have a corporation and an individual serve as co-trustees. The individual would supply the personal touch and knowledge that the corporate trustee lacks. However, co-trusteeships can be very expensive if both are to receive full fees, especially if the corporate trustee wants additional fees because of the additional work (conferences, meetings, and delays) involved.

An arrangement might be possible in which the trust would allocate special duties and responsibilities to each co-trustee and fix reasonable compensation on that basis. Another way of approaching it might be to have the individual delegate rights and powers to the corporate trustee, subject to recall at will. Alternatively, instead of having the individual appointed as trustee, he or she might simply be authorized to carry out special functions, such as advising the corporate trustee of individual needs of beneficiaries. The trust would then provide compensation for such limited functions.

.03 Naming Alternate or Successor Trustees

The financial planner should advise the settlor to consider appointing alternate or successor trustees. This consideration applies even when the settlor initially names a corporate trustee, especially if the trust is a testamentary trust. Although a corporate trustee might have given a preliminary commitment of acceptance, by the time the trust becomes operative, it might have merged or not have substantial assets. Therefore, the corporate trustee might renounce the appointment.
If the trustee accepts the appointment, the trustee might later resign. If a vacancy occurs, and the trust itself makes no provision for an alternate or successor, courts of equity will find the vacuum unacceptable and will undertake to fill it on an application duly made. However, the trust will incur a legal fee for the proceeding. In addition, a surety bond may be required. The trust would have to pay a premium for the bond. The choice of a successor trustee by a court may not be in accordance with the settlor’s desires for the trust administration.

Therefore, selecting an alternate or successor trustee is very important. The settlor should exercise the same care when selecting a successor or alternate trustee as was exercised when making the initial choice. The settlor, in creating the trust agreement, may provide for or dispense with the requirement of a bond for an alternate or successor trustee as seems prudent.

The settlor’s reservation of the right to fill a vacancy or name a successor trustee that does not bar the settlor’s own appointment as trustee will result in the inclusion of the trust property in the settlor’s gross estate under IRC Section 2036(a)(2). However, a settlor’s reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not the settlor or a person related or subordinate to the settlor within the meaning of IRC Section 672(c) is not considered a reservation of the trustee’s discretionary powers of distribution over the trust property.

.04 Powers of Trustees

The trustee needs to be given sufficient power to enable him or her to carry out the purposes and objectives of the settlor. State law will spell out, in considerable detail, the powers with which the trustee is vested, absent anything in the trust to the contrary. The financial planner should check local law, but usually a trustee will have power to do the following:

- Retain trust property
- Sell trust property and reinvest the proceeds
- Consent to corporate adjustments
- Manage real estate
- Allocate receipts and disbursements to income or principal (corpus)
- Lend and borrow
- Settle claims
- Exercise stock options
- Distribute property in kind


• File tax returns

• Exercise all powers appropriate to a trustee

The settlor will want to go beyond these statutory powers, if need be, to permit the trustee to carry out the trust’s objectives. The special provisions addressed in ¶660 suggest some of the additional powers that the settlor might want to confer. The settlor might provide the trustee with more specific powers for investment management, such as trading options and other more “exotic” financial instruments. The settlor might do so to liberalize or limit the usual prudent-investor rule under the Uniform Prudent Investor Act. The settlor might want to confer specific authority to invest in common bank funds, mutual funds, variable annuities, or the like, in which investment decisions are, in effect, delegated to others. Special provisions might be necessary in relation to permitting the holding of non-income-producing property. In short, the purpose is to authorize powers that are sufficiently broad (or narrow, as the case may be) to permit the trustee to carry out the goals and objectives of the settlor.
Life insurance has two major functions: (1) to replace the earning power of the family breadwinner, and (2) to provide liquidity for an estate. Estate liquidity is necessary to guard against its loss in value by the forced sale of estate assets to meet the family’s current cash needs, the costs of estate administration, and the possible liability for federal estate tax and state estate and inheritance taxes. For most families some amount of life insurance is an essential safety net.

The first function is a fairly compelling reason for heads of young families who have few assets and many long-term family responsibilities. Life insurance is the only sure way to provide a family with an instant estate upon the death of a breadwinner.

The need for liquidity may not be quite as compelling. However, an understanding of the family’s assets is essential in order to determine whether life insurance is the best solution. A client can provide for estate liquidity in other ways, such as cash and cash equivalents. Although an estate can easily liquidate publicly traded equity securities and bonds, their values can fluctuate greatly. Neither the executor nor
the beneficiaries of an estate will be happy if the estate is forced to sell securities at low prices in a down market or just before a stock market upturn. In any event, life insurance can eliminate the need for holding low-yield liquid investments when high-yield illiquid investments are available.

Life insurance that offers a cash value or cash accumulation feature can also serve as an investment, which is safer than other investments. State supervision, diversification, and professional investment management are key safety factors. A life insurance policy might guarantee a minimum return. Some newer forms of variable life insurance might provide higher investment returns than those traditionally associated with whole life insurance, but with accompanying risk. Life insurance can also be a tax shelter, as discussed in ¶710, and the policy proceeds are usually sheltered against the claims of creditors. The internal buildup of value in a whole life insurance policy is not subject to the 3.8 percent tax on net investment income.

Life insurance, with proper planning, can be favorably treated under federal and state estate tax laws. Many states exempt life insurance proceeds payable to named beneficiaries from their inheritance tax laws. The federal estate tax, as a general rule, exempts life insurance proceeds payable to beneficiaries other than the executor or administrator of the insured’s estate if the insured, at the time of death, retains no incidents of ownership in the policy.¹ This benefit is further discussed in ¶715.

Insurance also is favorably treated under both federal and state income tax laws. Many states follow the federal rule generally exempting life insurance proceeds from income tax.²

The various settlement options available under insurance policies constitute another benefit, permitting flexibility and security for policy owners and their beneficiaries (¶750).

In addition, relatively low interest loans against cash values generally offer a valuable benefit in times when money is tight. However, loans from modified endowment policies may be subject to income tax, as discussed in ¶705.

Life insurance, as an estate planning tool, takes on added importance when business interests are involved. The role of life insurance in planning for succession planning for the owner of an interest in a close corporation is discussed in ¶1935, in partnerships in ¶2015, and in sole proprietorships in chapter 21, "Planning for the Sole Proprietor."

As discussed in ¶945, group life insurance as an employee benefit receives special income tax treatment. Life insurance for the executive is discussed in ¶1605.

This chapter has a broader focus. It examines life insurance in general and its various aspects and applications.

¹ IRC Section 2042(2).
² IRC Section 101(a).
Planning Pointer.

- The federal estate tax exclusion is $5,490,000 in 2017, to be indexed annually for inflation. This increase will remove many estates from federal taxable status. Should financial planners recommend new planning with life insurance?

- Is the client overinsured?

- Should existing policies be dropped as no longer needed to cover federal estate tax liabilities?

- Should policies be exchanged for smaller, lower cost policies to generate a premium savings?

It is suggested that clients examine why they initially acquired their policies. Was the reason solely for federal estate tax liquidity planning? Were there other reasons, such as support of surviving beneficiaries, education of children, covering a possible state death tax liability, protecting a family from inflation, addressing the lack of liquidity if a death occurs because the decedent’s assets (for example, businesses or land) might be illiquid?

Despite the permanent increase of the federal estate tax exclusion, there are certainly no guarantees that the federal estate tax exclusion will remain at a level high enough to keep most taxpayers’ estates below its reach. Some clients will favor eliminating life insurance coverage to save the premium cost. That is completely understandable. However, the financial planner should make certain that this decision is made after taking into account all of the factors that recommend life insurance, not just the death tax protection aspect. Once a policy is cancelled, there is no guarantee the client will be able to replace it in the future, with age, health, underwriting, and cost factors to be considered.

Dan Moisand (Financial Advisor, January 30, 2017) suggests eight options for addressing one’s life insurance policies:

1. **Keep it**—Everyone dies eventually. If the policy is in no danger of lapsing, heirs should get the death benefit.

2. **Surrender it**—With the premiums stopped, cash received in excess of basis is taxed at ordinary income rates, not the lower capital gains rates. No death benefit is left for heirs.

3. **Let it ride**—Stop premium payments and let the remaining cash value fund the policy for as long as it can last on its own.

4. **Sell it**—Life insurance is an asset and can be sold. The older the insured or the worse the insured’s health, the more the policy will sell for.

5. **Donate it**—Like other assets, a life insurance policy can be donated to a charity for a charitable tax deduction.

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6. **Get some help**—In some cases, we have seen family members fund a policy because an unhealthy insured could not afford to do so.

7. **Modify it**—Many policies allow modifications that can make the structure of the policy more appealing.

8. **Exchange it**—Cash values in a life insurance policy can be exchanged, tax-free, to a new life insurance policy or an annuity contract.

.01 Understanding a Life Insurance Contract

Life insurance policies can be important assets in an individual’s potential gross estate. The financial planner should review all of the client’s policies and make appropriate summaries and recommendations. The following paragraphs review a few important provisions.

**Assignment.** The policy spells out the rules for making an assignment. Usually the life insurance company is not bound by any requests or instructions it receives until it receives a written notice of assignment. In addition, the assignment is subject to any policy loans. This clause is important to a potential creditor who wants to lend money on the policy’s security.

**Beneficiary.** The policy owner can designate one or more beneficiaries and can ensure that payment of the insurance proceeds shall be by means of a settlement option, which is not necessarily an outright payment of the proceeds. A financial planner should always check whether the policy owner made any beneficiary or settlement option irrevocable before planning or making changes. Also, the policy owner must comply with the procedural rules when changing beneficiaries.

**Cash value.** The policy specifies whether it has, or will have, any cash value. If the policy provides for a cash value, it will include a table that lists the amount of cash that the owner may obtain upon a surrender of the policy. This cash value is not the same as the gift tax value of the policy. Depending on the type of policy, the cash value may or may not be a reasonable estimate of the gift tax value (see ¶720).

**Dividends.** Participating policies stipulate the payment of dividends. These dividends are not like dividends on stock, but are merely the nontaxable return of some excess premiums by the insurance company. A participating policy will describe the various available dividend options that the policy owner may select. These options include the following:

- Cash payments (payment by the company)
- One-year term additions (automatic application of dividends to purchase additional one-year term coverage)
- Paid-up additions (applied to purchase additional paid-up insurance coverage)
• Dividends retained at interest (dividends held on deposit by the insurance company, which also credits interest on this amount)

• Reduced premium dividends (applied to pay for a portion of the premium that would otherwise be paid by the policy owner)

**Double indemnity.** This feature is a rider available for an additional premium under which the insurance company pays beneficiaries double the face amount of the policy if the insured dies as a result of an accident. The advisability of this rider is open to question. If the insured has adequate insurance, the rider is an unnecessary expense. If the insured needs greater coverage, he or she should buy additional life insurance.

**Extended insurance.** Unlike term insurance, a permanent insurance policy may provide that the coverage will not automatically expire if a premium is not paid on time. Instead, the insurance generally continues as term insurance for a limited period, which can sometimes run for a number of years. Generally, this option is not the preferred option when an individual decides to stop paying premiums.

**Guaranteed insurability.** This rider guarantees the insured the right to purchase specified amounts of additional insurance at specified times. It is normally less readily available with term policies. The rider usually specifies maximum and minimum amounts of insurance that the insured may purchase. The premium for the added coverage is based on the insured’s age at the time he or she acquires the added coverage and may be tied to certain life events, such as marriage or the birth of a child. The primary advantage of this rider is that it does not require underwriting of the insured.

**Living benefits.** If certain requirements are satisfied, accelerated death benefits received under a life insurance contract on a terminally or chronically ill insured may be excluded from gross income. Similarly, if an assignment or sale of a policy is made to a viatical settlement provider, amounts received from the provider are excludable from gross income. Thus, an individual diagnosed with a fatal illness (one reasonably expected to cause death within 24 months) may obtain a portion of the proceeds of a life insurance contract or assign the contract’s benefits to a viatical settlement provider without paying income tax on the payment received. This rule is an exception to the usual rule that life insurance proceeds must be paid by reason of death to be excluded from gross income. An individual who is chronically ill, but not expected to die within 24 months, may also exclude from income any advance payments of life insurance proceeds received. However, the amount must be received under a policy provision or rider treated as a long-term insurance contract under IRC Section 7702B (¶3420).

Payments made on a per diem or other periodic basis without regard to actual expenses are still excluded from gross income, but subject to the dollar cap applicable under a per diem type long-term care insurance contract (¶3420).

**Loan values.** Permanent insurance permits the policy owner to borrow up to a specified percent of the cash value (frequently 95 percent) at guaranteed interest rates. These interest rates are typically less than those charged by other commercial lenders. The insured may select an automatic premium loan provi-

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4 IRC Section 101.
sion, which provides that the insurance company will make loans automatically to pay any premiums that are not paid when due. This provision avoids a lapse of the policy for nonpayment of premiums.

**Nonparticipating policies.** Nonparticipating cash value policies provide fixed premium costs, but do not pay dividends. Usually, premium costs for these policies will be lower than those of participating policies. However, as dividends are produced, participating policies might prove less costly in the long run, particularly if the dividends are used to purchase additional insurance or keep the otherwise escalating cost of a term component of a blended policy at a level premium cost.

**Ownership clause.** The person owning the policy is usually named. The owner is usually the same as the named insured, but the insured may instead designate another individual, a trust, or another entity as the life insurance policy owner. If the insured does not hold the incidents of ownership in the policy, and the policy proceeds are not payable to the insured’s estate, the proceeds will not be included in the insured’s gross estate. It is important for the financial planner to be sure that an intended transfer of a policy is accompanied by the change of ownership paperwork. Merely signing a trust document does not place the policy in the trust without conveying ownership of the policy to the trust as well.

**Paid-up insurance.** If the owner decides to surrender the policy, permanent insurance with cash values also contains a table that shows the amount of paid-up insurance that the owner can obtain instead of receiving cash.

**Waiver of premiums.** A special rider supports that premiums will not have to be paid for the period in which the insured is disabled. With some policies, the rider is automatic and the cost is built into the annual premium. With others, it is an optional feature, the cost of which may vary depending on age, gender, the terms of the waiver, and the particular insurer. These provisions keep needed life insurance policies in force and ease the insured’s economic burden while disabled. The financial planner should understand the level of disability and documentation needed to obtain a waiver of premiums, as well as inquire about the adequacy of the insured’s basic disability coverage.

**Planning Pointer.**

Although a general comprehension of the various clauses in a life insurance policy is important, particular attention should be paid to the language contained within the provisions, as minor language variations can result in a profound impact on what the policy will provide to the insured or owner.

**.02 Definition of Life Insurance**

IRC Section 7702 provides a complex, multilevel general rule definition of life insurance for all tax purposes—estate, gift, and income. This provision prevents thinly disguised investment vehicles from qualifying as life insurance. In the event a contract fails to meet the applicable tests, the pure insurance portion of the contract (the difference between the cash surrender value and the death benefit) will be treated as term insurance for tax purposes. The cash surrender part of such a contract will be treated as a side fund, the income of which will be taxable to the policy owner in the year the contract fails to qualify as life insurance. Not only will the income of the current year be taxable to the policyholder, but all income

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5 IRC Section 2042(2).
earned in all prior years will be taxed as ordinary income. *Income*, in this connection, is the amount by
which the increase in net surrender value and the cost of the life insurance provided exceed the amount
of the premiums paid, less any dividends credited.

The cost of the insurance provided is the lower of (1) the cost of individual insurance on the insured’s
life (regulations provide uniform premium rates that must be used),\(^6\) or (2) the mortality charge, if any,
stated in the contract.

On the death of the insured, if the policy is disqualified as a life insurance policy, only the excess of the
death benefit over the net surrender value will qualify for the exclusion from gross income under IRC
Section 101(a).

.03 Tax Treatment of Lifetime Withdrawals

Withdrawals made by a policyholder from a life insurance policy are generally taxable only to the extent
that they exceed the premiums paid, minus dividends. However, withdrawals from modified endowment
policies are treated as income received first, then recovery of basis.

**Modified endowment policies.** Some of the tax advantages that generally apply to life insurance con-
tracts do not apply to policies known as modified endowment contracts (MECs) because these contracts
are considered to have too much of an investment orientation. A *MEC* is defined as a policy that satisfies
the definition of life insurance but fails to satisfy the seven-pay test.\(^7\) A policy fails this test if the cumu-
lative amount paid under the contract at any time during the first seven years exceeds the sum of the net
level premiums that would have been paid on or before such time had the contract provided for paid-up
future benefits after the payment of seven level premiums.\(^8\) The amount paid in this connection is the
amount of the premiums paid, reduced with some exceptions by amounts received under the contract.

Policies that fail the seven-pay test that were issued before June 21, 1988, and that were not later materi-
ally changed are “grandfathered” and are not considered MECs. Loans and distributions from these
grandfathered policies are subject to the same favorable tax rules that apply to regular life insurance pol-
icies.

MECs are subject to income tax rules and penalties, which are different from those that apply to other
life insurance contracts. Policy loans and partial withdrawals of funds are taxed to the extent of any in-
side income buildup within the policy.\(^9\) Thus, policy loans and withdrawals are taxable before any tax-
free return of investment is permitted from the policy. Also, a 10 percent additional tax applies to any
taxable withdrawals before age 59½, except for payments attributable to disability or for certain annu-
itized payments.\(^10\) The additional tax also applies to amounts withdrawn on termination of the policy.

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\(^{6}\) Regulation Section 1.79-3(d)(2).

\(^{7}\) IRC Section 7702A(a).

\(^{8}\) IRC Section 7702A(b).

\(^{9}\) IRC Sections 72(e)(10), 72(e)(2)(B), and 72(e)(4)(A).

\(^{10}\) IRC Section 72(v).
The tax rules for modified endowment policies principally affect those policyholders who take out policy loans or make withdrawals from the policy before age 59½. If the insured does not contemplate such loans or withdrawals, the holder of an affected policy should be in no hurry to terminate the policy, especially if the policy itself calls for surrender charges.

 ¶705 Types of Policies

An individual can choose from a wide variety of insurance policies to provide an instant estate, estate liquidity, or both. The fundamental choice is between term insurance and some form of cash value insurance, which is an investment combined with life insurance.

.01 Term Insurance

Term insurance is also known as pure insurance because it does not have any investment features. Term insurance provides insurance for a stated term, such as for one year or for five years. The premiums might be level for the term and then increase with the next term. An individual may use a declining term policy for such things as paying a mortgage in the event of his or her death. Declining term policies usually provide for level premiums, but the insurance coverage decreases annually. The term insurance might be guaranteed renewable as long as the policy owner pays the premiums. Some term policies are also convertible, which means that the insured may convert the term policy to a cash value policy, often without requiring a physical examination. The premiums for level term insurance are low when the insured is young, but usually increase as the insured grows older because the risk of death increases with age.

Some clients have a ready answer when confronted with the choice between term insurance and a cash value policy. They say, "Buy term (pure insurance) and invest the difference." However, the choice is not that simple. Term insurance buys the greatest amount of protection per premium dollar and will release dollars for other investments. However, term insurance also has uncertainties and risk. Premiums generally rise rapidly at higher age levels. The risk is that, as one ages, the policy may become too expensive, although the insured still needs insurance protection. In the end, term insurance, especially if not converted to an ordinary life policy, might show a higher true cost of insurance than some investment types of contracts. It is not at all unusual for a person to cancel a term life insurance policy when it becomes too expensive at an older age.

Many variations exist in term policies. Level premium term has set premiums for 10, 15, or even 20 years. Another type of term policy is renewable term to age 65. Convertible term allows the insured to change the policy to ordinary life without having to show evidence of insurability. These features, although available only on payment of an additional premium, reduce the risk of loss of insurability. Whether buying term and investing the difference will prove better over the long run depends on a number of variables:

- The soundness and the yield on the outside investment and whether it is taxable
- If it is taxable, the top tax bracket of the insured
• The premium cost and net cost, taking into account the buildup of cash value in the permanent insurance (whole life) policy (these figures may vary depending on the company and the type of policy, whether it guarantees a fixed rate of return or allows the insured to pick from a variety of investment choices within the policy, and whether it pays dividends or is nonparticipating)

• Whether the insured lives or dies while the policies are in force

The cash buildup outside the policy adds to the insured’s protection over and above the face amount of term insurance. Cash buildup within a policy of permanent insurance reduces the effective pure insurance coverage. This last statement is true because at the death of the insured, the typical cash value policy pays out only the policy’s face amount, not the face amount plus the accumulated cash value. However, some permanent insurance policies pay the cash value of the policy in addition to the face amount of the policy.

With permanent cash value insurance, the policyholder can borrow from the life insurance company against the policy at low interest rates for any purpose he or she sees fit. The term insurance buyer can use his or her savings, but at the cost of a lower yield on the amount borrowed. This cost might be higher than the cost of borrowing against a cash value policy.

Exhibit 7-1, "Comparison of Basic Insurance Policies," provides an overview of different types of basic policies, their characteristics, and uses.

.02 Types of Cash Value Policies

Many different types of cash value policies are available. The most common type of cash value policy is the whole life policy or straight life policy. With this type of policy, the insured continues to pay whatever premium is required at the issuance of the policy for his or her entire life up to age 95 or older. At that point, the cash value of the policy equals the face amount of the policy and the policy is said to endow.

The whole life policy has several variations. One variation affects the payment period. The policy may endow at age 95, but the policy is paid up at an earlier age, such as age 65, 75, or 85.

Some policies make automatic adjustments or make adjustments based on factors outside the insured’s control. Generally, a financial planner should base a recommendation for a client’s insurance coverage on a careful review of the client’s particular situation at periodic intervals. The financial planner might recommend whole life insurance, term insurance, or a combination of the two, sometimes referred to as a "blended policy."

Planning Pointer.

When evaluating existing life insurance plans, the financial planner should request an in-force life insurance illustration for the insured from time to time to ensure the policy will be adequate for the life circumstances of the insured. Extra caution should be paid to insurance policies with high loan balances as a policy lapse may trigger significant tax consequences.

The following paragraphs explore some of the most commonly known insurance policies. This information is not meant to be all-inclusive, but will serve as a general guideline of what is available.
Conventional whole life policies. With a conventional whole life policy, the death benefits are fixed, the policy has a fixed maturity date, the policy requires fixed level premiums, and the policy provides for a fixed progression of cash values. When available, a change in the plan of insurance requires a catch-up payment in the case of additional coverage, or a refund if the insured reduces coverage.

Single-premium life insurance. Single-premium life insurance once was heavily promoted as a tax-sheltered investment. Single-premium policies issued after June 20, 1988 (or issued earlier, but materially modified after June 20, 1988), are subject to the modified endowment rules discussed in ¶701 that affect the tax treatment of loans and withdrawals.

Single-premium policies still provide a number of advantages. They allow upfront funding of a vehicle providing tax-deferred growth. At death, the proceeds are income-tax free11 and, with proper planning discussed later in this chapter, can also be made free of federal estate tax and state death taxes.12 The insured can use the policy to avoid probate and to stem attacks on or elections against the insured’s will. The policy can bar creditors’ claims against the insured or his or her beneficiaries.

Universal life policies. This type of policy separates the cash value element and the term protection element inherent in a whole life policy. Part of the premiums paid is invested in a cash fund; the rest is used to finance renewable term insurance. The policy does not require payment of premiums beyond the initial premiums. This provision makes such a policy the ultimate in flexible premium policies. If the insured elects not to make a premium payment, the insurance company withdraws money from the cash fund to make the payment. If the cash fund is adequate to pay the premium, the death benefit will remain at the original level. However, if the cash fund does not increase at a pace sufficient to pay the missed premiums, the death benefit will decrease.

The real attraction of universal life was the higher yields produced in the high interest climate that once prevailed. The popularity of traditional universal life policies declined with the decline of interest rates. This scenario led to the development of a policy with a broad range of investment options that came to be known as variable universal life or Universal Life II in some quarters. This type of policy combines elements of traditional universal life with elements of variable life to permit maximum flexibility with high investment potential. Two elements of traditional universal life are present: (1) the ability to alter premium amounts, and (2) the ability to change the death benefit. At the same time, the policyholder may use the policy as an investment vehicle within the limits prescribed by law. Various investment options are available (for example, money market funds, bond funds, and stock funds). Further, investment vehicles may be split and investment choices shifted within certain parameters.

The insured bears the investment risk in these policies. Poor investment performance can result in a lower or eliminated death benefit. Universal life policies that fail to meet the seven-pay test will be treated as MECs and be subject to the tax rules that govern such contracts (discussed in ¶701).

11 IRC Section 101(a).
12 IRC Section 2042.
Planning Pointer.

The flexibility of a universal life policy allows an insured to scale back premium payments to an amount just sufficient to pay the term component of the policy. However, doing so is generally not a good idea, except to deal with an economic emergency. If, from the outset, the insured does not intend to pay premiums sufficient to build a meaningful cash fund, the universal policy is a bad choice as a vehicle to use to purchase only term insurance. With a universal life policy, the insured pays for policy features associated with the cash fund. If the insured does not plan to use these features, a portion of the premium payment is wasted and he or she could likely purchase term coverage at a cheaper price with a term policy itself.

Variable life policies. This type of policy is a variant of regular whole life cash value insurance, with premiums on a similar scale. Such policies do not ordinarily allow the insured the degree of flexibility of the flexible premium type policies previously discussed. When a variable life policy is purchased, net premiums, after expenses, are invested in a fund or funds selected by the policyholder. If the funds earn more than a specified return, the death benefit and the cash value increase. If the funds earn less than a specified return, the death benefit and the cash value decrease. However, the death benefit never decreases below the original face amount.

The choice of funds might include stock, bond, money market, real estate, and various other investment combinations. In addition, the policyholder may usually be permitted to switch from one fund to another at specified intervals.

Most policies allow a two-year period in which the policyholder may convert the variable life policy to ordinary life insurance.

The big advantage of a variable life policy is that it is a tax-deferred investment that permits the investor to take advantage of a bull market in equities. The disadvantage is that the unpredictability of the stock market places the burden of investment management and investment risk on the policyholder.

Although the policy usually guarantees that the death benefit will not fall below a specified minimum amount, the guarantee may depend on the insured paying a target premium. If the insured omits payment of a premium and the fund cannot support the minimum, the insurance company may reduce the death benefit. The prospective policyholder will want to check the terms of the policy to determine the scope and effect of the death benefit guarantee. If the death benefit guarantee is not strong, a declining stock market may force a higher premium payment to maintain the desired death benefit.

Adjustable life policies. This type of policy permits the insured to choose between term insurance, cash value insurance, or some combination of both, as well as the amount of coverage desired. The insured can control the premium to be paid by altering the ratio of cash value to term insurance within limits set by the insurer. With each change, the premiums are fixed until the next change. The insured may change the premiums and the face amount of the policy as his or her needs and income change. The flexibility afforded broadens the appeal of this type of policy.

Modified whole life. Another type of cash value policy is modified whole life. In this type of policy, the premium is not constant; it is lower in the early years and then increases. These policies might be suitable for young families who cannot afford sufficient insurance in the early years, but who might be able to pay higher premiums in later years. It also helps the insurer to sell insurance.
**Return of premium policy.** A relatively new policy that has made its way to market is the return of premium policy (ROP). Generally, in exchange for paying all of the premiums during the term of the policy, the policy allows a full refund of the policy premiums paid. The premiums on ROP policies are usually set between the cost of term insurance and whole life insurance premiums.

**Economatic policies.** Yet another cash value policy is known as an economatic policy. Insurance companies in the business of selling participating policies designed this type of policy. Their goal was to make their premiums more competitive with those offered by companies selling nonparticipating policies.

**Example 7.1.** Fred Pillow ultimately wants $100,000 of cash value insurance. He buys an economatic policy. It is a package consisting of a whole life policy in the face amount of $65,000 with a provision that each year the dividends on the policy are to be automatically applied to the purchase of a combination of one-year term insurance and whole life insurance in an additional amount to be added to the basic policy. As a result, the amount of whole life insurance increases and the amount of one-year term decreases. In time, Pillow has a whole life policy in the amount desired. At that time, Pillow is free to exercise any one of the dividend options usually provided in a whole life participating policy.

A possible disadvantage of an economatic policy is that, in the early years, the policy does not guarantee that the dividends will be sufficient to provide the full amount of coverage desired. Also, the policy requires the automatic application of the dividends in the manner indicated. This provision deprives the insured of other dividend options until the whole life portion has reached maturity. Exhibit 7-1, "Comparison of Basic Insurance Policies" provides an overview of different types of basic policies, their characteristics, and uses.

**Exhibit 7-1: Comparison of Basic Insurance Policies**

<table>
<thead>
<tr>
<th>Type</th>
<th>Characteristics</th>
<th>Uses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole life</td>
<td>Relatively low cost, cash value, premiums payable for lifetime (until age 95 or older).</td>
<td>For young single persons and young married persons for protection, with some savings, and as an emergency source of funds.</td>
</tr>
<tr>
<td>Modified whole life</td>
<td>Allows the insured to choose between term or cash value insurance or a combination of the two, and the amount of coverage.</td>
<td>For individuals who want a great deal of flexibility in changing their life insurance, and a reduced premium cost.</td>
</tr>
<tr>
<td>Economatic</td>
<td>Cash value insurance in which dividends are used to purchase term insurance and whole life insurance.</td>
<td>For individuals who want to increase their cash value insurance coverage over time.</td>
</tr>
<tr>
<td>Universal life</td>
<td>Higher investment component than traditional whole life.</td>
<td>For high-income individuals who find tax-free buildup attractive and are willing to incur some market risk.</td>
</tr>
<tr>
<td>Variable-universal life</td>
<td>Availability of mutual fund-like investments within the policy.</td>
<td>For individuals who accept more market risk and want to direct their investments within a tax-sheltered environment.</td>
</tr>
<tr>
<td>Limited payment life</td>
<td>Stays in force when paid up, Builds cash and paid-up values.</td>
<td>Good for persons with short-term high income, sports stars,</td>
</tr>
<tr>
<td>Type</td>
<td>Characteristics</td>
<td>Uses</td>
</tr>
<tr>
<td>--------------------</td>
<td>------------------------------------------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>Single-premium life</td>
<td>Less insurance payments, paid-up protection. Fixed insurance protection. Investment builds tax free.</td>
<td>entertainers, and high-income middle aged individuals. For high-income individuals who find tax-free buildup attractive and can use an estate tax-free transfer of assets.</td>
</tr>
<tr>
<td>First-to-die</td>
<td>Covers more than one individual but pays on the death of the first insured only.</td>
<td>Used to fund buyout plans of partnerships or small corporations.</td>
</tr>
<tr>
<td>Second-to-die</td>
<td>Pays only on the death of the second spouse.</td>
<td>Used to pay estate taxes due on the death of the second spouse. Good for couples who will take advantage of the marital deduction on the death of the first spouse who need cash to pay estate taxes on the death of the second spouse. It also provides liquidity protection.</td>
</tr>
<tr>
<td>Term</td>
<td>Insurance protection only. Low cost.</td>
<td>Good for persons who need a large amount of coverage for a short period (1-, 5-, 10-, 15-, 20-year term). Good for young married persons with growing children.</td>
</tr>
<tr>
<td>Decreasing term</td>
<td>Insurance protection reduced with time. Low cost.</td>
<td>Good for mortgage redemption, repayment of other loans, or installment payments.</td>
</tr>
<tr>
<td>Split-dollar</td>
<td>Employer and employee split cost and benefits of cash value insurance.</td>
<td>Used for providing insurance to executives.</td>
</tr>
</tbody>
</table>

**Split-dollar life insurance.** Split-dollar life insurance is a cash value life insurance policy that is often used to cover the lives of key executives of a company. The individual and the company may share the cost of the policy and the benefits and proceeds. The company might pay the premiums equal to the increase in the cash surrender value, or the individual might pay the cost of the equivalent term insurance. In some cases, the employer pays the entire insurance premium cost. Under a traditional split-dollar arrangement, the company is the beneficiary of the policy up to the amount of the cash surrender value (or the premiums paid by the company, if greater). The individual names a beneficiary for the remainder of the death benefit. However, under an equity split-dollar arrangement, the death benefit that goes to the individual’s beneficiary is not limited to what is left over after the company gets the cash value; the beneficiary gets a portion of the cash value as well. The company generally recovers only an amount equal to the cumulative premiums it paid. The remainder of the death benefit is paid to the beneficiary. During the life of the policy, the individual is considered to have an equity interest in the policy when the cash value buildup exceeds the cumulative premiums paid by the company. If the policy is surrendered, the individual will receive a portion of the cash value. Split-dollar life insurance plans are not subject to the antidiscrimination rules that apply to qualified retirement or certain other executive compensation plans.

The two basic types of split-dollar life insurance plans are the endorsement method and the collateral assignment method. Under the endorsement method, the employer owns the policy and endorses the death benefits to the employee. The employer pays most or all of the premiums. The employee pays the cost of the equivalent term insurance. Under the collateral assignment method, the employee owns the policy and the employer may pay all or most of the premiums. The employee assigns a security interest in the policy to the employer in an amount that equals the premiums paid by the employer.
On September 11, 2003, the IRS issued final regulations on the treatment of all split-dollar life insurance arrangements. These regulations apply to split-dollar arrangements executed or materially modified after September 17, 2003. For split-dollar arrangements entered into on or before September 17, 2003, taxpayers may continue to rely on revenue rulings as described in Cumulative Bulletin Notice 2002-8, Internal Revenue Bulletin 2002-4, 398 (January 3, 2002) as long as such arrangements are not materially modified.

Under the 2003 final regulations, the amount taxable to an individual under a traditional split-dollar arrangement with a company is generally determined as under prior law. This means the individual is taxed on the value of the death benefit coverage provided by the company, based on the cost of one year of term insurance. For split-dollar arrangements entered into before January 28, 2002, this cost may be determined using the PS 58 rates if a contractual arrangement between the company and the individual indicates that those rates will be used. For arrangements entered into on or after January 28, 2002, Table 2001 must be used to determine the cost of current life insurance protection.

Although the tax treatment of traditional split-dollar policies was left relatively intact, the final regulations substantially altered the tax treatment of equity split-dollar arrangements. The tax consequences of an equity split-dollar life insurance arrangement depend on its classification under one of two alternative regimes: (1) the economic benefit regime or (2) the loan regime.

The economic benefit regime applies when the employer is the owner of the policy. The employer is treated as providing an economic benefit to the individual employee. The economic benefit is taxable to the employee as compensation. Any right or benefit in the insurance policy, such as an interest in the cash surrender value, is treated as additional compensation.

Under the loan regime, the employee owns the policy and the employer pays the premiums. The employer is deemed to loan the premium payments to the employee. The loan regime applies where (1) the payment is made by the employer to the employee, (2) the payment is a loan under the tax law, or a reasonable person would expect the payments to be repaid, and (3) the payment is made from or secured by the death benefit or the cash surrender value of the policy. Each premium payment is treated as a separate loan. If the loan under the split-dollar arrangement is not a below-market loan, the general rules for loans and imputed interest apply. The borrower may not deduct any interest paid on the split-dollar loan because it is personal interest. If the loan under the split-dollar arrangement is a below-market loan, the imputed interest provisions of IRC Section 7872 apply. The de minimis exception of IRC Section 7872 does not apply to split-dollar loans. The imputed interest on a below-market loan to an employee under a split-dollar arrangement is usually taxable compensation to the employee.

The final regulations do not affect the calculation of the amount included in an employee’s gross income for group term life insurance that exceeds $50,000. The amount included in the employee’s gross income in such cases is still determined under Regulation Section 1.79-3(d)(2).

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13 Regulation Section 1.61-22 and Regulation Section 1.7872-15.


15 Notice 2002-8, 2002-4 IRB 398.
An IRS notice indicates that split-dollar life insurance arrangements that provide for deferred compensation may also be subject to the tax rules governing nonqualified deferred compensation.\(^{16}\) Under those rules, unless a nonqualified deferred compensation plan meets certain requirements, amounts deferred after 2004 and earnings on those deferred amounts are currently includable in the employee’s gross income to the extent they are not subject to a substantial risk of forfeiture.\(^{17}\) The IRS has issued regulations to tighten the substantial risk of forfeiture rules for deferring compensation.\(^{18}\) A split-dollar arrangement provides for deferred compensation if the employee has a legally binding right during a tax year to economic benefits that are payable in a later tax year. Conversely, a split-dollar life insurance arrangement that provides only death benefits to an employee is not covered by the nonqualified deferred compensation rules. Note, however, that even if a split-dollar arrangement is subject to the nonqualified deferred compensation rules, immediate taxation of deferred amounts can be avoided if the arrangement is structured to limit distributions and acceleration of benefits and meets certain election requirements.

**Vanishing premium policies.** This type of contract involves the reinvestment of policy dividends so that the owner eventually will not have to pay premiums. This type of policy is affected by the seven-pay, net level premium test, discussed in connection with MECs (¶701). For purposes of this test, the amount paid under the policy means the premiums paid are “reduced by amounts received under the contract that are not received as an annuity to the extent that such amounts are not includible in gross income and are not attributable to a reduction in the originally scheduled death benefit.”\(^{19}\) Thus, use of dividends to reduce premiums could cause the policy to fail the test. Failure to pass the test results in the contract being characterized as a MEC with LIFO-type tax treatment being applied to loans and other withdrawals. If the policyholder or would-be policyholder has no plans to borrow or withdraw before surrender or maturity, this potentially unfavorable tax treatment might not be a significant factor. The vanishing premium aspect and other life insurance features, including the benefits of IRC Section 101 (income tax-free proceeds at maturity) and planning exceptions to IRC Section 2042 (allowing an escape from estate tax), may make the contract attractive.

Vanishing premium policies might be well suited for gifts to life insurance trusts because the grantor may make gifts to each beneficiary of the full amount of the annual exclusion ($14,000 per donee per year for 2017\(^{20}\) and indexed annually for inflation\(^{21}\) ) or through pendent or hanging powers (¶660), or reduce or eliminate the beneficiaries’ exposure to gift tax liability (to the extent that the value of their unexercised withdrawal powers exceeds the greater of $5,000 or 5 percent of trust principal in any year under IRC Section 2041(b)(2)).

\(^{16}\) Notice 2007-34, 2007-17 IRB 996.


\(^{19}\) Conference Committee Report to the Technical and Miscellaneous Revenue Act of 1988 (Public Law No. 100-647).

\(^{20}\) IRC Section 2503(b)(1).

\(^{21}\) IRC Section 2503(b)(2).
Prospective buyers of vanishing premium life insurance should know how these policies work. Strictly speaking, the obligation to pay premiums never vanishes. However, at some point, the yearly earnings from the policy’s investment fund are expected to become sufficient to pay the premiums without future cash payments into the policy. The financial planner should inform the prospective buyer that the policy dividend rate assumed in the calculation might not be realized. A longer period than the period initially projected might be required for the owner’s premium payment to vanish. Even worse, a premium that vanished earlier can reappear at a later date if dividends fall short. If this event happens, the insured must again commence paying premiums or risk losing the policy.

**Joint lives.** Couples use spousal or second-to-die insurance to pay the estate tax liability of the surviving spouse. No estate tax is due on the death of the first spouse when the decedent transfers property and utilizes the unlimited marital deduction or the bypass trust and portability election (or both). First-to-die life insurance is used to fund buy-sell agreements.

**New Products.** The life insurance industry is constantly creating new products designed to address perceived needs of the populace. One such product combines the concepts of long-term care insurance and life insurance by requiring a substantial up front premium payment that will cover long-term care expenses, with any unspent coverage converted to a life insurance policy for a decedent’s heirs.

### ¶710 Life Insurance Investment Yields and the Income Tax

The rate of return on conventional, cash value life insurance traditionally has been low. However, the life insurance industry has developed new forms of life insurance designed to improve the rate of return. Their goal is to make life insurance more competitive with other investment vehicles. In the process, the life insurance industry has developed universal life and other flexible premium-type policies, variable life insurance, and single premium life insurance. In any case, a financial planner should measure life insurance returns in light of the potential tax shelter that life insurance provides.

The investment growth of a life insurance policy does not completely escape tax. Proceeds paid to the insured before death can be taxable if the policy is a MEC (¶701) or, if the policy is not a MEC, if the withdrawn cash value or proceeds exceed the insured’s cost of the policy. If the proceeds are received by the insured in a lump sum, the excess over cost is taxable as ordinary income. If the insured receives the proceeds in the form of annuity payments over a specified number of years, the cost or investment in the contract is prorated over the selected payment period. Only amounts received in excess of that amount are taxed in the year of receipt.

The insured uses the same approach, known as the exclusion ratio method, when the insured receives the policy proceeds as an annuity payable over the lifetime of the insured.

The exclusion ratio method, for individuals whose annuity start date is after 1986, compares the total amount that the individual may exclude from income to the total amount of his or her investment in the

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22 IRC Section 2056(a); IRC Section 2010(c)(4) and (5).
contract.\textsuperscript{23} If the insured dies before the insured has recovered all of his or her investment, the unrecovered cost is allowed as a deduction on the individual’s final income tax return.\textsuperscript{24}

Special adjustments are necessary if the annuity is payable over more than one life, or if the contract guarantees a minimum number of payments or a minimum total amount to be paid.\textsuperscript{25} Figuring the taxable amounts in these special cases is complex, and one may rely on the numbers furnished by the insurance company.

If a taxpayer transfers an insurance policy for consideration, the taxpayer usually must recognize gain to the extent that the consideration received exceeds the taxpayer’s basis in the policy. This is the so-called "transfer for value" rule. An exception to the transfer for value rule applies if the transfer is made by an insured who is terminally ill or chronically ill, as explained in the subsequent paragraphs. The purchaser of a life insurance policy for valuable consideration must recognize gross income on the insured’s death to the extent that the proceeds exceed the cost of the policy and the subsequent premiums paid by the purchaser.\textsuperscript{26} However, if the policy is transferred as a gift or for consideration to a partner, partnership, or corporation as a part of a partnership or corporate buy-sell agreement, another exception to the transfer for value rule applies. The exception from application of the transfer for value rule does not apply to a transfer to another shareholder of the corporation.\textsuperscript{27} If the transfer meets an exception from the transfer for value rule, then upon the death of the insured, all of the life insurance proceeds are excluded from the beneficiary’s gross income under the general rule.\textsuperscript{28} Revenue Ruling 2007-13 2007-11 Internal Revenue Bulletin (IRB) 684 holds that a transfer of a life insurance policy from one grantor trust to another grantor trust, where both trusts are wholly owned by the same grantor, is not a transfer for value within IRC Section 101(a)(2).

In certain circumstances, sometimes referred to as life settlements, an insured may receive the benefits of a life insurance policy while alive without having to recognize any gross income. If an individual is terminally ill or chronically ill and receives the proceeds of the policy while alive, he or she does not recognize any gross income.\textsuperscript{29} If a terminally ill or chronically ill insured sells or assigns a life insurance policy to a viatical settlement provider, the insured recognizes no gross income.\textsuperscript{30} A viatical settlement provider is a person engaged in the trade or business of purchasing life insurance policies on the lives of terminally ill or chronically ill individuals if the person is licensed to buy life insurance policies under such circumstances. If a state does not require licensing of viatical settlement providers, the provider

\begin{footnotes}
\footnotetext{23}{IRC Section 72(b)(1).}
\footnotetext{24}{IRC Section 72(b)(3).}
\footnotetext{25}{IRC Section 72(c)(2).}
\footnotetext{26}{IRC Section 101(a)(2).}
\footnotetext{27}{IRC Section 101(a)(2).}
\footnotetext{28}{IRC Section 101(a)(1).}
\footnotetext{29}{IRC Sections 101(g)(1) and 101(a)(1).}
\footnotetext{30}{IRC Sections 101(g)(2)(A) and 101(a).}
\end{footnotes}
must meet certain standards promulgated by the National Association of Insurance Commissioners.\textsuperscript{31} Payments received by a chronically ill individual who is not terminally ill are excluded from gross income only to the extent used to pay for qualified long-term care services that are not covered by Medicare.\textsuperscript{32} These rules that allow life insurance proceeds to be received tax free before death do not apply to a taxpayer other than the insured unless the taxpayer has an insurable interest in the insured as a director, officer, or employee of the taxpayer or if the insured has a financial interest in a trade or business of the taxpayer.\textsuperscript{33}

A relatively new industry of purchasers of life insurance policies has recently emerged. The purchasers of life settlements, sometimes called life settlement companies or life settlement providers, generally are institutions that either hold the policies to maturity and collect the net death benefits or resell policies—or sell interests in multiple, bundled policies—to hedge funds or other investors. In exchange, the insured receives a lump sum payment. The amount the insured will receive in this secondary market depends on a range of factors, including age, health, and the terms and conditions of the policy—but it is generally more than the policy's cash surrender value and less than the net death benefit.

When a person sells a life insurance policy on his or her own life, whoever buys it is acquiring a financial interest in the seller’s death. In addition to paying a lump sum for the policy, the buyer agrees to pay any additional premiums that might be required to support the cost of the policy for as long as the insured lives. In exchange, the buyer will receive the death benefit when the insured dies. Because the policy was acquired in a transfer for value, the amount of the proceeds received upon the death of the insured in excess of the amount paid for the policy by the buyer is taxable income to the buyer of the policy.

01 Life Settlements—The Purchaser

Life settlements offer an option for some insured individuals who no longer want or need a life insurance policy. Rather than selling the policy back to the originating insurance company at less than market value, or allowing it to lapse and forfeiting the value, life settlements provide a potentially more gratifying exit strategy for the policy owner. Although there is a historical connection between the life settlement and the viatical settlement markets, there is a definite distinction between the two concepts. Viatical settlements are related to terminally ill insured parties, while life settlements involve insureds who are not suffering from any terminal illness, nor do they have chronic or catastrophic medical conditions. The type of policies transacted in a life settlement most frequently are universal life policies, including variable universal life, as well as convertible term insurance and survivorship policies. Policies are typically purchased by institutional investors who are seeking long-term investments for portfolio diversification and to achieve relatively low levels of risk and volatility.

The typical life settlement involves the sale of an existing policy that has been owned for several years. The policy was not purchased with the intention to sell it, but for personal or business reasons, and that reason no longer exists. The suitable client for a life settlement is either a person over age 60 with a

\begin{itemize}
  \item \textsuperscript{31} IRC Section 101(g)(2)(B).
  \item \textsuperscript{32} IRC Section 101(g)(3)(A).
  \item \textsuperscript{33} IRC Section 101(g)(5).
\end{itemize}
health issue or anyone over age 75, with or without a health issue. Ordinarily, a life settlement transac-
tion involves an evaluation of the client's policy followed by purchase proposals from several settlement
providers based on the specific characteristics of the life insurance policy and the medical condition of
the insured. The providers' bids are evaluated by the client and his or her advisers to determine which of-
fer best meets the client's needs. Once accepted, contracts are executed to transfer ownership of the poli-
cy to the investor and funds are transferred to the seller. The investor then has the obligation to make fu-
ture premium payments and ultimately collects the benefit when the policy matures.

From the perspective of the purchaser, according to Rev. Rul. 2008-14, IRB 2009-21, 1031, in a life set-
tlement arrangement, the purchase of the policy was a transfer for a valuable consideration within the
meaning of IRC Section 101(a)(2) and neither the carryover basis exception nor the exception for trans-
fers involving parties related to the insured applied. Accordingly, the exclusion for amounts received by
reason of the insured's death was limited to the sum of the actual value of the consideration paid for the
transfer and other amounts paid by the purchaser (premiums paid). The purchaser had to include in gross
income the death benefit received minus the amount excluded under Sec. 101. The entire amount was
ordinary income because the receipt of a death benefit from the insurer under the terms of the contract
did not qualify as a sale or exchange.

.02 Life Settlements—The Seller

In an effort to clarify the questions raised concerning the tax ramifications of life settlements, the IRS is-
2009-13 concentrates on the tax consequences to the insured party while Rev. Rul. 2009-14 deals with
the institutional investor.

Rev. Rul. 2009-13—Situation 1. Where there is a surrender by the insured of a cash value life insurance
contract, the insured must recognize income on the surrender of the contract based on the excess of the
cash surrender value over the "investment in the contract." In this case, the amount is ordinary income
because, pursuant to Rev. Rul. 64-51, 1961-1 CB 322, proceeds received at the surrender or maturity of
a life insurance policy constitute ordinary income to the extent the proceeds exceed the cost of the poli-
cy.

Rev. Rul. 2009-13—Situation 2. Where there is a sale, rather than the surrender, of a life insurance con-
tract, it is necessary to determine the amount realized from the sale and the insured’s adjusted basis in
the contract (IRC Section 1001). With respect to basis, generally the Code provides that the adjusted ba-
sis for determining gain or loss is the cost of the property sold subject to adjustments for expenditures,
receipts, losses, or other items properly chargeable to capital. Recognizing the dual investment and in-
surance characteristics of an insurance contract, the IRS determined that it is necessary to reduce the ba-
sis of a life insurance contract by the portion of the premiums paid prior to sale that are allocable to the
provision of insurance.

The amount taxable as ordinary income on a sale of the policy is limited to the amount that would be
recognized as ordinary income if the contract were surrendered. This would be the "inside build-
up" under the contract. Accordingly, if the income recognized on the sale or exchange of a life insurance
contract exceeds the amount of the inside build-up, the excess may qualify as capital gain. Because the
life insurance contract was deemed to be a capital asset in the purchaser's hands and was held by the in-
sured for more than one year, the gain was long-term capital gain.
Rev. Rul. 2009-13—Situation 3. Where a term life insurance policy is involved, the cost of the insurance was presumed to equal the monthly premium under the contract, so that the insured’s adjusted basis in the contract is the total premiums paid, less the cost of insurance protection. Thus, in the case of a term insurance policy, adjusted basis is equal to the amount of unearned premiums. Because a term life insurance contract has no cash surrender value, there is little to allocate to adjust the basis, so most of the sale price will be gain.

Rev. Rul. 2009-14 involves the tax consequences of the sale of an insurance policy from the perspective of an institutional investor in a life settlement transaction. The purchaser had no insurable interest in the insured's life and, except for the purchase of the contract, had no relationship with the insured and would not suffer any economic loss on the insured’s death. The purchase was made with a profit motive and the property in the purchaser’s hands was a capital asset. The purchaser’s basis in the policy is the amount paid to the insured to acquire the policy, plus premiums paid to keep the policy in force. The life insurance contract was a capital asset and was held for more than one year, so that the gain recognized on the sale of the contract was long-term capital gain.

.03 Sale of Policy by a Terminally Ill Insured

There are companies that are in the business of buying the life insurance policies of terminally ill insureds. They may pay as much as 75 percent to 80 percent of the death benefit. Apparently, those companies will determine the purchase price according to the cost of funds at the time of the purchase, the life expectancy of the insured as determined by the buyer's physicians, the expense of the premiums that the buyer will have to pay and, of course, an expectation of a profit factor.

A financial planner who has a client with an offer to buy his or her life insurance policies should do the following:

1. Check the loan value of the policies.
2. Check the cash value.
3. Consult with the insured and members of his or her family, business associates, and so on, as to other more attractive sources of funds.
4. Check for any adverse effect on children, spouse, or other dependents who are in need of funds.
5. Ascertain the consequences to the individual's existing medical benefits.
6. Explain the income tax consequences.
7. Consider estate tax consequences if the policy is transferred within three years of death for less than full and adequate consideration.
8. Ascertain as best as possible whether the terminally ill insured is mentally competent to enter into such a transaction.

9. Check the effect, if any, on estate liquidity. Absent the above possible negative effects, the proceeds of the sale of the insurance policy may go towards enhancing the quality of the insured's remaining life.

A terminally ill individual is defined as an individual whom a physician has certified as having an illness or physical condition expected to result in death in 24 months or less after the date of certification. A chronically ill individual is one who cannot perform at least two activities of daily living for a period of at least 90 days. A chronically ill individual does not include a terminally ill individual.

.04 Taxation of Viatical Settlements

A viatical settlement made to an individual considered terminally ill (under HIPAA, one who has a life expectancy of 24 months or less) is entirely tax free. To obtain this tax-free status:

The policyholder must be individual (not a business).

The viatical settlement company is licensed by the state in which the policy holder resides or, if there is no licensing requirement, complies with certain requirements stated in the Health Insurance Portability and Accountability Act (HIPAA).

This favorable tax treatment generally applies only to individuals—and does not apply to companies selling life insurance policies covering the lives of their employees.

A viatical settlement made to an individual who is considered chronically ill receives a different tax treatment. In order for money received by a chronically ill person to be tax free, the proceeds must be used for those costs incurred for long-term care services that are not compensated by insurance. Otherwise, benefits not used for long-term care received in excess of an annually-adjusted limit are subject to taxation (IRC Section 101(g)).

.05 Settlement Options

As a general rule, on the insured’s death, life insurance proceeds are exempt from income tax when paid in a lump sum to the beneficiary. However, payments under settlement options will be partly taxable. The interest on proceeds left with the insurance company is taxable to the beneficiary when paid or cred-

34 IRC Sections 101(g)(4)(B) and 7702B(c)(2)(A).

35 IRC Section 101(g)(4)(B).

36 IRC Section 101(a).
ited.\(^\text{37}\) If the insurance company is to make installment payments, the exempt proceeds are prorated over the anticipated installments. The excess over the amount prorated is taxable income to the recipient.

Calculating the income tax liabilities under settlement options when a policy has more than one beneficiary or has guaranteed payments is complex. In such cases, the insurance company is generally the best source for providing accurate figures.

.06 Deductibility of Premiums

In general, life insurance premium payments are not deductible for income tax purposes even if the policy has a bona fide business purpose.\(^\text{38}\) However, a business may deduct premiums paid on employee-owned policies that are treated as taxable compensation to the employee.\(^\text{39}\) This also includes a group term life insurance policy, even though the premiums paid by the employer are not included in the employee’s gross income if the face amount of the policy is $50,000 or less.\(^\text{40}\) The employee must recognize gross income on the value of the premiums paid by the employer for the excess of the face amount of the policy over $50,000.\(^\text{41}\)

¶715 Life Insurance and the Estate Tax

Purchasing a $100,000 life insurance policy loses some of its luster if the most that the beneficiaries can receive is $100,000 less the applicable estate tax. This situation may occur if the individual insured has a taxable estate that is greater than the basic exclusion amount ($5,490,000 in 2017 under IRC Section 2010(c) indexed annually for inflation), and the decedent owns a $100,000 policy at the time of his or her death.

To make sure beneficiaries receive the intended amount without reduction by estate taxes, the insured can transfer the policy and all incidents of ownership directly to the intended beneficiaries or to an irrevocable trust. The transfer must occur more than three years before death to avoid inclusion in the insured’s gross estate under IRC Section 2035. Then, IRC Section 2042 takes the proceeds out of the decedent’s gross estate. The transfer of the incidents of ownership can be tricky and can include a possible gift tax.

Life insurance frequently is carried to make cash available for the payment of estate taxes and administration expenses. Life insurance also provides immediate funds for the beneficiaries. The insurance might be made payable to the executor of the estate or to other beneficiaries with the intention that they apply as much of the proceeds as needed to pay federal estate taxes and other designated estate expenses. To achieve this goal, the insured must not only transfer all incidents of ownership in the policy be-

\[\text{37} \text{ IRC Section 61(a) and Regulation Section 1.451-2(a).}\]

\[\text{38} \text{ IRC Section 264(a).}\]

\[\text{39} \text{ IRC Section 79(a).}\]

\[\text{40} \text{ IRC Section 162(a).}\]

\[\text{41} \text{ IRC Section 79(a) and Regulation Section 1.79-3(d)(2).}\]
fore his or her death, as already indicated, but must also make sure that the beneficiary is not under a legal obligation to make use of the insurance proceeds to pay estate taxes or other estate obligations. If the beneficiary had such obligation, the policy would become an asset of the estate, taxable as such, and the objective of keeping the insurance proceeds out of the estate is frustrated. Ordinarily, this problem does not arise when the policy beneficiary is a living person, but it can arise when the beneficiary is the insured’s estate (not a recommended beneficiary) or a revocable trust created by the insured.

If life insurance proceeds intended for the payment of estate taxes are to be made payable to the executor, much larger amounts of insurance coverage will be required than if the proceeds were payable to another beneficiary. The insurance made payable to the executor for the purpose of paying estate taxes will itself operate to increase estate taxes and, in turn, require more insurance to pay the additional tax. Life insurance payable to one’s estate means it will be included as an estate asset and subjected to the federal estate tax.

.01 Transfer of All Incidents of Ownership

To keep the insurance proceeds out of the insured’s estate, the insured must name a beneficiary other than his or her executor (in the capacity of the estate executor, not as an individual relative who also happens to be the executor, such as a spouse or a child), avoid the three-year rule of IRC Section 2035, and surrender all incidents of ownership in the policy. The insured must transfer the policy and give up all and any powers over the policy and its benefits. The term *incidents of ownership* includes the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge the policy for a loan, or to borrow against the cash surrender value. The regulations also include powers over the choice of a settlement option and the retention of a possible reversionary interest in the policy or its proceeds by the insured as incidents of ownership.\(^\text{42}\)

In Revenue Ruling 84-179,\(^\text{43}\) the IRS ruled that a decedent will not be deemed to have incidents of ownership over an insurance policy on his or her life under the following conditions:

- The powers are held in a fiduciary capacity and are not exercisable for the insured’s personal benefit.
- The insured did not transfer the policy or any consideration for purchasing or maintaining it to the trust from personal assets.
- The devolution of the powers to the decedent was not part of a prearranged plan involving the decedent’s participation.

Revenue Ruling 84-179, however, goes on to state that a decedent will be deemed to have incidents of ownership over an insurance policy on his or her life when the powers are held in a fiduciary capacity and when the insured transferred the policy or any of the consideration for purchasing and maintaining the policy to the trust. Also, situations in which the decedent’s powers could have been exercised for his or her benefit will constitute incidents of ownership in the policy, without regard to how the powers

\(^{42}\) Regulation Section 20.2042-1(c).

\(^{43}\) 1984-2 CB 195.
were acquired or whether the decedent transferred property to the trust. Thus, if the decedent transfers policies then reacquires powers over such insurance policies in an individual capacity, the powers will constitute incidents of ownership, although the decedent is a transferee. The insured should not be a trustee of a trust to which a life insurance policy on the insured’s life has been transferred.

A grantor’s retention of the power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held in trust by substituting other assets of equivalent value will not, by itself, cause the value of the insurance policy to be includible in the grantor’s gross estate under IRC Section 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor’s compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.\(^44\)

There are also special rules under which the controlling shareholder of a corporation holding a policy on his or her life may be treated as possessing incidents of ownership in the policy by reason of his or her ability to control the corporation. This particular aspect is addressed separately in chapter 18, "Closely Held Businesses—Choice of Business Form," which deals with planning for the owner of an interest in a closely-held corporation.

Special considerations apply to the transfer of interests in group-term insurance as an employee benefit. These issues are addressed in chapter 9, "Employee Benefits."

### .02 Three-Year Rule

A gift of a life insurance policy made by the insured within three years of death results in the entire proceeds of the policy,\(^45\) and any gift tax paid thereon,\(^46\) being included in the insured’s gross estate. In addition, if a decedent transfers a life insurance policy more than three years before death but retains incidents of ownership in the policy until death or releases them within three years of death, the life insurance proceeds will be includible in the decedent’s gross estate.\(^47\)

The U.S. Courts of Appeals for the Sixth and Tenth Circuits have held that the gross estate does not include the proceeds of life insurance policies purchased by life insurance trusts themselves within three years of death, provided the decedent did not possess any incidents of ownership in the policies. Both

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\(^{44}\) Revenue Ruling 2011-28, IRB 2011-49 (December 5, 2011).

\(^{45}\) IRC Section 2035(a).

\(^{46}\) IRC Section 2035(b).

\(^{47}\) IRC Sections 2042(2) and 2035(a).
courts also held that the payment of premiums by the insured within three years of death did not constitute an incident of ownership.48 Although the insureds in these cases never actually possessed any incidents of ownership in the policies on their lives, the IRS tried to include the proceeds in their gross estates under a constructive transfer theory, as if the insureds had purchased the insurance and transferred it to the trust. Although the IRS disagrees with these cases, it announced that it would no longer litigate the issue. This procedure of acquiring the life insurance policy by the trust from its inception and never having the insured act as the policy owner has become a safe harbor and the recommended way to avoid application of the three-year look-back rule for newly acquired policies. Confirm that the new policy is never issued to the insured in these situations.

IRC Section 2035(a) addresses nothing about gifts of premiums on life insurance policies made within three years of death. It refers only to IRC Section 2042, which applies only to life insurance policy proceeds. Thus, premiums paid by the insured on a life insurance policy within three years of death will not be includible in his or her gross estate under IRC Section 2035(a).

.03 Effects of Community Property Laws

If a decedent owned a life insurance policy as community property, the decedent’s gross estate includes only one half of the proceeds whether the proceeds are payable to the decedent’s estate49 or to another beneficiary.50

The IRS ruled in Revenue Ruling 2003-4051 that when a decedent purchased a life insurance policy during marriage in the state of Louisiana, named the decedent as the owner of the policy, and did not transfer ownership of the policy, the policy is presumed to be community property under Louisiana law. Therefore, one half of the proceeds of the policy are included in the decedent’s gross estate. However, if the decedent paid the premiums partly with community funds and partly with separate funds, the calculation of the amount included in the decedent’s gross estate is more complex. This situation could occur if the decedent purchased the policy while single or while living in a state that was not a community property state. The courts have used two alternative approaches to calculate the amount of life insurance proceeds to include in the decedent’s gross estate in these circumstances.

The first approach is called the reimbursement approach. This approach is based on the inception of title doctrine and is followed in Texas, Louisiana, and New Mexico. Under the inception of title doctrine, separate property remains separate property even if the owner used community funds to pay for part of its cost. However, the marital community has a claim for reimbursement for the amount paid with community property. In such cases, the proceeds of the life insurance minus the amount of premiums paid for with community funds are included in the decedent’s gross estate under IRC Section 2042. The decedent’s gross estate also includes one half of the premiums paid with community funds under IRC Sec-

48 J. Leder Est., 893 F.2d 237 (10th Cir. 1990) and E. Headrick Est., 918 F.2d 1263 (6th Cir. 1990).
49 Regulation Section 20.2042-1(b)(2).
50 Regulation Section 20.2042-1(c)(5).
In these circumstances, an estate is not allowed a deduction under IRC Section 2053(a) for the community’s claim for reimbursement because the claim is against the insurance proceeds rather than against the estate.

The second approach is called the tracing approach. Under this approach, the amount included in the decedent’s gross estate is equal to the proceeds multiplied by a fraction. The numerator of the fraction is the sum of the premiums paid with the decedent’s separate funds and one-half of the decedent’s premiums paid with community funds. The denominator is the total premiums paid.53 The states of California and Washington follow the tracing approach.

720 Life Insurance and the Gift Tax

When a person transfers a life insurance policy in a noncommercial setting, a taxable gift occurs. The value of the gift is the cost of replacing the policy, its cash surrender value, or its loan value. This cost is usually low compared to the value of the policy when it matures (that is, at death or when it is paid up). The cost is derived from the interpolated reserve value at the date of the gift, plus a proportionate part of the last premium paid covering a period after the date of the gift.54 The insurance company (or its agent) can supply the figures, on Form 712, on request.55

The financial planner should examine Form 712 carefully. Where a policy is “complex,” involving investment assumptions, various guarantees that deplete the cash value, possible surrender charges, universal life or variable life insurance issues, and so on, the value provided by the insurance company can be questioned—and even challenged, especially if the Form 712 is issued in a case where gift or estate tax liability is involved. The planner should give Form 712 appropriate deference, but if there is a strong view that the value assigned by the insurance company is not correct, further consideration is warranted.

Suppose the insured pays a premium on a policy where proceeds are payable to beneficiaries other than the insured’s estate, and the insured has no power to control the economic benefits of the policy. The insured has made a taxable gift to the beneficiaries, to the extent of the premium paid, although the rights of the beneficiaries are conditioned on surviving the insured.56

The $14,000 annual exclusion (for 2017 and indexed annually for inflation) is available for gifts of a present interest in property. An outright gift of an insurance policy will not be viewed as a gift of a fu-

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53 Scott v. Commissioner, 374 F.2d 154 (9th Cir. 1967).
54 Regulation Section 25.2512-6(a).
56 Regulation Section 25.2511-1(h)(8).
57 IRC Section 2503(b)(1).
58 IRC Section 2503(b)(2).
The same rule applies to outright gifts of cash by the donor to be used to pay premiums. The annual exclusion applies to both the policy itself and to premium payments in such a situation. The premium payments are treated as though the money had been paid to the policy owner who then paid it to the insurance company.

Generally, a taxable gift occurs when a life insurance policy is assigned to a trust or the insured pays a premium on a policy held by an irrevocable trust. In such case, the gift will generally be treated as a gift of a future interest for which no annual exclusion is allowed (see the discussion in ¶660.04 of the use of Crummey powers to establish a present interest in a trust). Life insurance trusts typically include Crummey withdrawal powers designed to allow some or all of the premiums paid by the insured to qualify for the gift tax present interest exclusion. The law provides no special exception as it does in the case of a trust for a minor meeting the requirements of IRC Section 2503(c) (that is, the trust may use income and corpus for the minor’s benefit and pay unused amounts to the minor on attaining age 21 (¶425). A Crummey power needs to be included in trusts when life insurance is involved as a trust asset.

Any unused portion of the unified credit of the insured donor is also available to offset any gift tax liability. Given the lifetime gift tax exclusion in 2017 ($5,490,000) indexed annually for inflation, transfers of life insurance policies and premium payments by the insured should be encouraged. Even if the Crummey power procedures are not followed, most taxpayers will never pay transfer taxes, so those persons with moderate estates below the federal exclusion amount may decide to not pay strict attention to the Crummey procedural requirements.

.01 Doubling the Unified Credit and Annual Exclusion Split Gifts

If the donor’s spouse consents to a gift of a policy or to the payment of premiums, each spouse is entitled to his or her own annual exclusion and may draw upon his or her own available unified credit. In addition, the couple may elect gift splitting. If the couple elects gift splitting, IRC Section 2513(a) treats the gift as made one half by each spouse, regardless of which spouse furnishes the consideration. Gifts of community property interests are deemed to be split. (See the discussion of gift-splitting in chapter 4.)

.02 Marital Deduction

On a gift of the policy or premiums to the donor’s United States citizen spouse, the unlimited gift tax marital deduction is available (¶405). The donor does not have to rely on the annual gift tax exclusion and the unified credit for such gifts. If the donor’s spouse is not a U.S. citizen, the unlimited gift tax marital deduction is not available. Instead, an enhanced spousal present interest exclusion of $149,000 (for 2017, indexed annually for inflation) is available.

59 Regulation Section 25.2503-3(a).
60 IRC Section 2505.
61 IRC Section 2513.
62 IRC Section 2523(a).
.03 Estate Tax Consequences on Death of Owner of Policy Before or Simultaneously With Insured

When a policy owner who is not the insured dies before the insured, only the value of the policy (at that time) is included in the policy owner’s gross estate.\textsuperscript{63} The generally applicable estate tax rule is that the value is determined by adding the interpolated terminal reserve value (the insurer will provide the figure) at the date of the decedent’s death to the proportionate part of the gross premium last paid before the date of the decedent’s death covering the period extending beyond that date.\textsuperscript{64} This same rule has been applied where the insured and the owner of the policy die simultaneously.\textsuperscript{65}

The interpolated terminal reserve is described as “the reserve which the insurance company enters on its books against its liability on the contracts.” Unfortunately, that can be a very subjective valuation by the insurance company that may not bear a direct correlation to the premiums paid, cash surrender value, or any possible surrender charges.\textsuperscript{66}

\section*{725 Practical Considerations Affecting Gifts of Life Insurance}

Avoiding the estate tax by a timely transfer of a life insurance policy and all incidents of ownership is not especially difficult. The difficult question for the insured might be whether or not he or she wants to give up the cash value in the policy. The insured might also have to give up the opportunity to take low interest loans against the cash value of the policy that become so attractive when interest rates rise.

An insured can have the cash and loan value and, at the same time, remove much of the insurance proceeds from the gross estate if he or she is insurable. The insured can convert the existing policy to paid-up insurance. The proceeds of that policy would remain includible in the insured’s gross estate. Then, the spouse or other intended beneficiary could take out a new policy on the insured’s life and finance it with the premium money no longer needed for the converted policy. However, the total death benefit coverage of both policies might be less than the amount of the single policy before conversion to paid-up insurance, even though the same number of premium dollars is paid under this new plan. Thus, the insured should check all of the figures carefully before deciding. This assumes, of course, that the underwriting of the insured’s health is favorable so that a new policy is available. Assume the cost of a new policy will be higher than the existing policy.

Given a choice between policies to be gifted, low value policies may be prime candidates. Term policies, individual or group, have low gift tax values. The annual exclusion of $14,000 (for 2017\textsuperscript{67} and indexed annually for inflation\textsuperscript{68}) per donee applies to gifts of present interests.

\begin{itemize}
\item \textsuperscript{63} IRC Section 2033.
\item \textsuperscript{64} Regulation Section 20.2031-8(a)(2).
\item \textsuperscript{65} Revenue Ruling 77-181, 1977-1 CB 272.
\item \textsuperscript{66} Regulation 25.2512-6.
\item \textsuperscript{67} IRC Section 2503(b)(1).
\item \textsuperscript{68} IRC Section 2503(b)(2).
\end{itemize}
Whether an individual is using the new policy approach or is assigning an existing policy, he or she must decide who is to own the policy. If an individual is made the owner and dies before the insured, the date of death value of the policy will be includible in the policy owner’s gross estate. This result is not desirable. The insured can try two things to avoid it: (1) put the ownership of the policy in the name of a younger family member (rather than in the hands of the insured’s spouse) if the spouse’s life expectancy is shorter or not much longer than the insured’s life expectancy, or (2) place the policy in a trust. The trust alternative is often the better planning choice. (See ¶735 for a discussion of life insurance trusts.)

Planning Pointer.

The insured’s spouse owns the policy and designates the trustee of a revocable trust created by the insured as beneficiary. On the insured’s death, the proceeds are paid to the trustee. Under the terms of the trust, the surviving spouse is entitled to the income for life. If the surviving spouse has the power to change the beneficiaries, but does not do so before the death of the insured, the IRS maintains the position that the surviving spouse made a gift of the proceeds, less the surviving spouse’s life income interest, to the children when the insured died. In addition, gift splitting will not apply because the gift took place at the exact instant of death. At that same instant of death, the marital relationship, upon which gift splitting depends, ceased.

Rather than make the spouse the policy owner and the children the beneficiaries, the spouse should be the policy owner and the beneficiary of the policy proceeds. The surviving spouse can then make gifts of the proceeds to the children to make the best use of the annual exclusion and unified credit.

Planning Pointer.

An insurance policy to be transferred might be subject to a bank loan, and the lender may be able to apply the insurance proceeds against the loan. Under the law of some states, the beneficiary may be able to compel the decedent’s estate to pay him or her an amount equivalent to the insurance proceeds taken by the lender. The effect might be a windfall for the policy beneficiary, contrary to what the insured might have intended. To avoid this result, the loan agreement or the will (or both if possible) should contain appropriate provisions that reflect the intent of the borrower-testator.

¶730 Who Should Be Named Beneficiary?

The owner of a life insurance policy is free to name almost anyone as a beneficiary. The choice normally involves deciding whether to name the estate or executor of the insured, the trustee of a trust that the insured might have set up during his or her lifetime or in a will, or one or more individuals as a beneficiary. This chapter does not address the naming of a charity or a corporation as a beneficiary because these issues are addressed elsewhere in this publication (see ¶525 with respect to charities and ¶1950 with respect to corporations).

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69 Revenue Ruling 81-166, 1981-1 CB 477.

70 Revenue Ruling 73-207, 1973-1 CB 409.

71 IRC Section 2503(b).
If the insurance proceeds are payable to the estate or the executor, they are included in the decedent’s gross estate. Where that is done, the proceeds become a part of the probate estate and are subject to such charges as executor’s commissions and attorney’s fees. Where the insurance proceeds are so paid, concern may also arise about the proceeds becoming available to claims of the decedent’s creditors. Because the proceeds go to pay items that are deductible from the gross estate (debts, funeral expenses, taxes, and administration expenses), the proceeds may be offset at least in part by the deductions. Naming the estate or executor as beneficiary will not cause any federal estate tax if the estate has no estate tax liability because of the availability of the marital deduction or the available applicable credit amount (unified credit). Be careful, however, if the decedent’s estate is subject to a state estate tax with an exemption well below the federal estate tax exclusion.

From a practical standpoint, naming the estate as the beneficiary can make sense in some cases in order to provide the estate with liquidity. However, naming a responsible individual or a trustee to serve as beneficiary is preferable if the individual or trustee will make the proceeds available to meet the estate’s liquidity needs. The proceeds will not be included in the probate estate and can still meet its liquidity needs.

The beneficiary or trustee could make the funds available to the estate either by lending cash or buying estate assets. If the client is not sure that there is an individual on whom he or she can rely, the client should use a trust, with a trustee who is authorized to help the estate and who has no adverse interest that would inhibit the trustee (that is, the trustee is not a trust beneficiary nor related to one). However, the client should not require the trustee to help the estate; the proceeds might then be deemed to be receivable by the insured’s probate estate and therefore includible in the gross estate. This result is the very thing the client wants to avoid from an estate tax standpoint. Although the estate might not be subject to the federal estate tax, state death taxes and illiquid assets might create a need for liquidity provided by life insurance. In such a case, keeping the proceeds out of the probate estate is advisable.

Once beyond the matter of supplying the estate’s liquidity needs, the client should begin to think about individual needs. The client will want the proceeds to go to, or be used on behalf of, those persons the policy owner chooses to benefit.

Generally, the most common path for a married individual will be to name his or her spouse as the beneficiary, with the children named as contingent beneficiaries. This path avoids probate and usually avoids state death taxes. An assignment of the policy and all incidents of ownership to the spouse are not necessary to avoid federal estate taxes because of the unlimited marital deduction.
If the children are to be named as primary, or even contingent, beneficiaries, and some of them are minors, the financial planner should urge the client to consider either guardianships or, even better, trusts. An insurance company is not likely to pay the life insurance proceeds without the appointment of a legal guardian for each minor. The requirement to name a guardian will cause additional expenses and complications. Alternatively, consider naming a trust for the benefit of the children with an age of disposition of the proceeds beyond the minority of the children named as beneficiaries. Such a trust can give the trustee discretion to make payments of income or principal to meet the needs of each beneficiary.

A client should think carefully before naming specific children as beneficiaries if the client might have or adopt additional children. If a client names Tom, Dick, and Harry as beneficiaries and then Mary is born, she will be left out, although Mary might have the greatest financial need.

The better way to name children as beneficiaries is to list the beneficiaries as follows: Tom, Dick, and Harry, children of the insured, and any other children of the insured hereafter born or legally adopted.

If the children of a deceased child are to take the parent’s share, the beneficiary designation should also state as follows: The children of a deceased child of the insured shall be entitled to receive their parent’s share, equally. Drafters may use the words "per stirpes" to accomplish this designation. If stepchildren or children informally adopted are to be designated, they should be specifically named; the insured should not rely on their being included in a general designation of children of the insured.

If the proceeds are substantial, using a trust as beneficiary offers many advantages, as described in ¶735. Only a trust is flexible enough to meet changing circumstances and needs. Only a trust can conclusively protect against a second estate tax when the primary trust beneficiary dies.

¶735 The Insurance Trust

The life insurance trust combines two pillars of estate planning—life insurance and the trust.

A life insurance trust is usually a living (inter vivos) trust, which may be revocable or irrevocable, funded or unfunded. The category also includes trusts set up by a will (testamentary trusts) to receive, hold, and distribute life insurance proceeds.

Naming a trust as beneficiary offers many distinct advantages, whether it owns the policies or not. Among these advantages are the following:

- Greater flexibility in handling distributions of the proceeds and income than would be possible under insurance settlement options
- Restrictions and limitations on the use of the funds for the beneficiaries that might be included in the trust
- Possible elimination of the inconvenience and expense of guardians for minor beneficiaries
- Elimination of a second estate tax on the deaths of life insurance beneficiaries
- Authorization for the accumulation of some or all of the income, subject to possible state law restrictions and limitations
• Broad investment discretion on the trustee’s part

• Asset protection

All of these factors are important. If the proceeds are to be used for the benefit of a surviving spouse and children, only a trust allows the use of the funds in accordance with the needs of the individual beneficiaries. The insured will not know, for example, when or if the surviving spouse will remarry and no longer need the insurance money; which child will become financially independent; which child will struggle to make ends meet; which children will have their own children and which children will not have children; who will be sick, disabled, or institutionalized; and who will be able to handle money wisely. Only a trustee knows these things as they occur and can make informed, intelligent distributions and impose needed restrictions, as the insured might have done.

Setting up a trust involves legal expenses in its creation. The ongoing expenses of administering a trust include the trustee’s fees and expenses, legal expenses, and accounting fees. These expenses are usually nominal, for a life insurance trust, before the insured dies.

Some states may require the policy owner to assign the policies to the trustee in order to have a valid trust with no other assets, rather than simply depositing the policies with the trustee. As long as the settlor retains the power to revoke the trust, the assignment does not lessen the settlor’s practical control, nor will it alter the tax consequences (that is, the insured-settlor of a revocable trust will have the life insurance policy proceeds included in his or her estate).

Funding a revocable life insurance trust provides no income tax advantages because any trust income would be taxable to the settlor under IRC Section 676. Thus, the settlor receives no income-splitting tax advantage in transferring income-producing property to the trust, which will use the income to pay premiums.

If the trust is funded, the settlor has the opportunity to see how the trustee manages money. The settlor can make changes if dissatisfied with the performance of the trustee. With an unfunded trust, the settlor cannot evaluate the trustee’s ability to manage money.

The proceeds payable to the trust can be made to qualify for the marital deduction,77 if the settlor sets the trust up to do so. If the surviving spouse is simply given a life income interest with the remainder given to the children, the marital deduction requirements may be satisfied if certain conditions are met under the Qualified Terminable Interest Property (QTIP) exception to the terminable interest rule.78 See ¶1205 on the requirements for the marital deduction and ¶1215 on when a settlor might not want assets to qualify for the marital deduction.

Funding a revocable trust does not cause a completed gift. Thus, no gift tax is due on a transfer of assets to a revocable trust.

77 IRC Section 2056(a).

78 IRC Section 2056(b)(7).
The irrevocable life insurance trust, like a revocable trust, avoids probate and can do all of the good things that trusts generally can do in terms of protecting the interests of the beneficiaries and carrying out the settlor’s directions. An irrevocable trust has the added advantage of potential estate tax savings, albeit with loss of control over the policy and a possible gift tax cost.

If the trust is unfunded, the settlor generally will later contribute funds to pay premiums on the policy. With a funded trust, the settlor transfers cash or property to the trust along with the policy and the trust uses those resources and their earnings to pay the premiums. In either event, the premiums usually are paid with after-tax dollars. With an unfunded trust, that result is obvious. With a funded trust, the settlor is taxable on the trust income if the trust may use the income, without the approval or consent of any adverse party, to pay the insurance premiums on the lives of either the settlor or the settlor’s spouse (unless the policies are payable irrevocably to a qualified charity). The trust could be funded and yet not provide for premium payments from trust income or for the beneficiary to pay the premiums from trust income. In that case, income is not taxable to the settlor to the extent such payments are made by the beneficiary or, at the beneficiary’s direction, out of trust income.

It is no longer a tax disadvantage that the income of a funded trust that carries insurance on the life of the settlor is taxed to the settlor, rather than to the trust. The income tax brackets for trusts are now so compressed that income shifting to the trust no longer affords tax-saving potential.

The real value of the irrevocable trust is the avoidance of federal estate taxes, probate, and state death taxes. To avoid the federal estate tax, two things to consider are (1) the insured’s retention or possession of incidents of ownership in the policy at the time of death, and (2) the transfer of the policy or the relinquishment of all incidents of ownership in the policy within three years of death under IRC Section 2035 (¶430, ¶715.02).

The first problem is not too difficult to handle if everything goes according to plan. The policy is assigned to the insurance trust together with all incidents of ownership, the insured gives up all control over the policy and the trust, and the trust beneficiary dutifully survives the settlor-insured. A problem could occur if the beneficiary does not survive and the deceased beneficiary’s interests in the policy revert to the settlor as the beneficiary’s heir or trustee. See the discussion in ¶715 dealing with the ramifications of the problem under the "Transfer of All Incidents of Ownership" heading.

The safest course is to arrange things so that the settlor will never become the owner of the policy or serve as a trustee once the transfer to the trust has occurred. One solution might be to appoint the insured as co-trustee, but bar the insured from exercising any rights, powers, options, or privileges with regard to the insurance. If these plans fail, the insured must again dispose of the after-acquired incidents of ownership as fast as possible.

79 IRC Section 677(a).

80 IRC Section 2042(2).
As for IRC Section 2035, no problem occurs if the insured lives three years or more after an effective transfer of the policy to the trust. If the decedent makes the transfer within three years of death, the proceeds will be includible in his or her gross estate in accordance with the rules discussed in ¶715.

Assuming there are no problems in keeping the insurance proceeds out of the settlor’s gross estate, can an irrevocable trust provide other benefits? The answer is yes. The trust can save taxes, help with any liquidity problems of the estate, provide good management, asset protection and avoid probate. The financial planner should assist the client in determining how much these benefits are worth. The financial planner should also consider the disadvantages.

How much can one save in taxes? That question is certainly relevant. When the estate will not have an estate tax liability because of the unlimited marital deduction,81 the charitable deduction,82 and the unified credit,83 the only possible taxes to be saved are state inheritance or state estate taxes, if applicable.

What are the net savings, taking into consideration gift tax liabilities, if any? An assignment of policies to an irrevocable trust constitutes a gift. The value of the gift is the cash replacement value of the policy (in technical terms, the interpolated terminal reserve), less unearned premiums. Each premium thereafter paid by the settlor is an additional gift. Usually, the trust is set up so that the annual gift tax exclusion will not be available because the premium payment gifts will be of future interests.84 However, there are planning strategies to avoid gift tax problems.

The client can avoid the gift tax problems by transferring policies that have no value, such as whole life policies from which the client has borrowed the cash values before making the gift, or group-term life insurance policies. However, the problem of how to pay the premiums remains if the trust is unfunded. The settlor can make gifts of the annual premiums to the trust. Because gifts to a trust are not gifts of a present interest in property, they are not eligible for the annual gift tax exclusion unless the trust includes a properly drafted Crummey power provision, and appropriate compliance with Crummey power notice provisions is observed. As previously discussed, the inclusion in the trust document of Crummey powers typically addresses the present interest exclusion issue for premium payments. As an alternative, the trust can borrow against the cash value to pay premiums. Given the large transfer tax exclusion available under current law ($5,490,000 in 2017, indexed annually for inflation), making a taxable gift to fund the trust may be a good plan.

The financial planner should also address the practical aspects associated with irrevocability. Many things can happen after an irrevocable trust is set up in a world in which almost everything else is revocable, including marriage, family relationships, values, and desires. How comfortable is the settlor with his or her future personal relationships? If the trust is unfunded, the financial planner should ask who is going to pay the premiums if the settlor cannot or will not.

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81 IRC Section 2056(a).
82 IRC Section 2055(a).
83 IRC Section 2010.
84 IRC Section 2503(b)(1).
Although an irrevocable life insurance trust might be an appropriate vehicle in some situations, the financial planner should advise the client of the possible consequences. Once the client sets up an irrevocable trust, the decision is generally irreversible.

If placing a life insurance policy in an irrevocable trust turns out to have been ill-advised, one option is to buy the policy from the trust. This, however, raises the possibility of income taxes on the life insurance proceeds. Gross income generally does not include amounts received under a life insurance contract paid by reason of the death of the insured.\(^\text{85}\) However, if a life insurance contract is transferred for valuable consideration, the income exclusion is limited to the amount of the consideration paid for the policy plus premiums and other amounts subsequently paid by the transferee.\(^\text{86}\) Fortunately, there are exceptions to this transfer-for-value rule, including an exception for transfers to the insured. Therefore, a client could buy a policy on his or her own life from an irrevocable trust for cash without triggering the transfer-for-value rule. Moreover, an IRS revenue ruling provides that the exception to this rule applies when a grantor trust purchases a policy on the grantor’s life from a nongrantor trust.\(^\text{87}\) The ruling also provides that the transfer of a policy on an individual’s life from one grantor trust to another grantor trust for cash does not trigger the transfer-for-value rule.

Another option to consider is decanting the trust. Decanting is the term primarily used to describe the act of distributing trust property from one trust to another under the trustee’s discretionary power to make distributions to, or for the benefit of, one or more beneficiaries. Often this power to distribute trust corpus is called the power to invade a trust. With decanting, instead of exercising an invasion power by making payment directly to or for a beneficiary, a trustee can now pay the assets over to a new trust for the beneficiary. This power enables a trustee to address a variety of potential issues, including favorable tax planning, changes to trust management, or state law issues. Finally, the most valuable benefit of trust decanting is its ability to make corrections or adjustments in an irrevocable trust setting. A number of states have passed specific statutes that allow decanting of a trust. Decanting can be used to modernize or improve outdated trust provisions, address changed circumstances involving the beneficiaries without being required to obtain court approval, correct errors that might have been made in drafting, and deal with trustee or administrative changes. The financial planner must determine if the state law governing the trust permits decanting.

.02 Checklist for Creating an Insurance Trust

Use the following checklist as a reference as you set up an insurance trust.

1. Group life insurance should be kept out of the insured’s estate. Assign the policy to an irrevocable trust and assure that the right to convert it to an individual policy is assigned.

2. The trustee’s power and responsibility for premium payments in a funded trust should be clearly described in order to address using income from funding property, invading principal (corpus),

\(^{85}\) IRC Section 101(a)(1).

\(^{86}\) IRC Section 101(a)(2).

the right to borrow against policies with cash value, and notifying beneficiaries and the grantor if premium deficiencies exist.

3. The trust should allow the purchase of additional policies, if desired.

4. The insured should never be a trustee of an insurance trust the insured has created, except possibly as a co-trustee with no rights or powers as to the insurance. The insured should assign all rights to the policies to avoid retaining any incidents of ownership.

5. The trust beneficiary or beneficiaries should be given some present right of withdrawal in the trust to take advantage of the present interest gift tax exclusion (Crummey powers).

6. The trust should authorize legal proceedings by the trustee to collect the insurance proceeds. The trust should indemnify the trustee for the costs of such proceedings.

7. To avoid later problems, the financial planner should advise the client about the marital deduction rules when setting up a trust.

8. All policies in the trust should be described accurately, including number, company, face amount, and name of the insured. The grantor should initial the policy schedule, if such a schedule is attached to the trust.

9. If a trust is created, make sure the policy is actually transferred to the trust after the trust is signed by the settlor and the trustee.

10. Review the trust document to be certain its terms address favorably the issues involving a spouse, children, and other heirs, as well as succession of trustees and sufficient flexibility to permit possibly dealing with unforeseen future circumstances.

¶740 How Much Insurance?

How much insurance should a client have? That question is one of the most important and difficult questions clients often ask a financial planner. See the checklist at ¶765, “Determining How Much Life Insurance to Carry.”

The financial planner must consider the client’s subjective goals; present and future needs; present and future earnings, assets, liabilities, income, estate, and gift taxes; and the effects of estate planning. In the end, the best answer is still an estimate. Yet, the approach to this question is clear. How much insurance is required to meet objectives and responsibilities? How much insurance can the client afford? These questions are basic. For many people, the need is likely to be greater than what they can afford. They will need to strike a balance between their needs and their ability to pay premiums. Purely subjective factors can also affect the decision. The best the financial planner can do is to help the client understand the factors to consider in the decision.

One source of difficulty is that people tend to view insurance in isolation. Insurance is only one component of what should be an overall, integrated financial plan. Unfortunately, seldom does a client have an ideal financial plan. The client might feel a need for more insurance. The client might not fully understand his or her existing insurance policies or how they work. The main purpose of life insurance is to replace lost earnings in the event of a premature death. To supply that need, one may, for example, apply a basic rule of thumb, which is 10 times earnings. If that much insurance produces too large a premium
Gather information about the family, personal objectives, assets and liabilities, and the existing estate plan.

Tally the assets and liabilities and project those values 5 or 10 years from now (anything longer is pure speculation). Compute federal estate taxes, state death taxes, and administration costs as if the client were to die tomorrow. If the client is married, make the computation with and without the marital deduction. Consider additional insurance for the client’s spouse to cover any loss of the marital deduction. Compute estimates of Social Security benefits for the surviving spouse and the client’s dependents. Add to the cost estimate debts and funeral expenses, which have to be paid within a short time after death. Consider the family’s cash needs when the client dies.

Now subtract the value of the liquid assets that will be available to satisfy the liquidity needs of the estate and the beneficiaries. The difference is an estimate of the amount of insurance required under the existing plan.

Assess the effect of the disposition of those liquid assets on the family income available to maintain the family’s standard of living. Add back those liquid assets required to maintain living standards. The result is a closer estimate of the insurance required for this purpose.

Next, determine the current and future needs and important desires of the family. If the existing plan does not provide sufficient liquidity to meet those needs, the client will need additional life insurance.

After the likely effects of the existing plan and the client’s desires are decided, make a complete analysis of the existing plan. Determine if and how the client can make better use of existing and projected assets to bring the client closer to reaching the family goals.

After developing a new, better insurance plan, the next step is to measure the shortfall, if any, from the desired goal. If the life insurance is still inadequate to meet the client’s goals, the financial planner can advise the client to consider the purchase of more insurance, if he or she can afford it. What kind of insurance remains to be determined. The amount will depend on the size of the shortfall and the expected return. Estimate the added income required and capitalize it by using a fairly conservative after-tax yield.

The client is not likely to acquire new assets to supply plan deficiencies quickly except by life insurance. Thus, the financial planner should consider some form of life insurance that will meet the client’s objectives if he or she should die before acquiring the needed assets. The financial planner might suggest new life insurance from the standpoint of type, amount, ownership, beneficiary designations, and the funds available to pay the premiums.

A financial planner should help the client explore various ways to pay for life insurance premiums. The client could use funds in a savings account, borrow against liquid assets, use personal credit, borrow on the insurance policy itself, or borrow on existing policies. A financial planner should also explore income tax saving approaches in paying for life insurance. These approaches include shifting income to a trust set up by someone other than the insured, and making gifts to family members in lower income tax brackets. The family members can use the income from the gifts to buy the life insurance. Other possi-
bilites exist for the client who is engaged in business in the corporate or partnership form. The corporation or partnership could pay the premiums. The client could transfer income-yielding stocks to a C corporation to realize the benefits of the 70 percent dividends-received deduction. However, the client should be careful not to have the C corporation realize so much dividend income that the corporation is subject to the personal holding company tax. With qualified dividends received by many individuals now taxed at 15 percent or 20 percent (0 percent for taxpayers in the 10 percent or 15 percent tax bracket), there is less incentive to place common stocks in small corporations. The corporation could provide group insurance to the employee-shareholder at a lower after-tax cost than would be possible for the shareholder’s individual policy. Qualified pension and profit-sharing plans may also be the source of inexpensive insurance for participants.

These techniques are just some of the tax-saving possibilities. A financial planner with ingenuity and creativity can develop other tax-saving strategies. Consider large gifts to fund a life insurance trust with the high lifetime gift tax exclusion of $5,490,000 available in 2017, indexed annually for inflation.

A client can increase investment yields by converting assets with low yields into assets with higher yields, although such a conversion is very difficult in the low-yield environment of 2017. The financial planner might help the client discover additional sources of earned income. In short, a competent financial planner can find a way for a client to pay for needed life insurance.

¶745 Financed Insurance

Over the years, Congress has restricted tax benefits for financed insurance and minimum deposit insurance. Congress has also restricted the deductibility of interest incurred on a loan to purchase a life insurance policy.

For some time, a rule has barred deductions for interest paid on financed life insurance unless four of the first seven premiums were paid without borrowing. Personal interest is currently not deductible at all, except for qualified residence interest.

A client may deduct interest on a life insurance loan if the client uses the loan proceeds for outside investment purposes, subject to the special limitation on deductions for investment interest. A client may also deduct interest on loans used for business purposes. However, the amount of business interest that is deductible on a policy covering the life of any officer, employee, or other person with a financial interest in a business is limited to the interest on the first $50,000 borrowed from or against the policy. These rules do not help an individual to purchase cash value life insurance at low cost.

88 IRC Section 243(a)(1).
89 IRC Section 163(h).
90 IRC Sections 163(a) and 163(h)(2)(B).
91 IRC Section 163(d).
92 IRC Sections 264(a)(4) and 264(e)(1).
Another threat to financed insurance is the seven-pay test (referring to the required payment of seven premiums). If the policy fails this test, it will be treated as a modified endowment contract (MEC). In that case, policy loans are treated as distributions (¶701).

Financed insurance will most likely not satisfy the seven-pay test. The amount paid under this test means the premium payable under the contract is reduced by the amounts received under the contract that are not received as an annuity to the extent that such amounts are not includible in gross income and are not attributable to a reduction in the originally scheduled death benefit. Loans from a policy would seem to fall within this statement. To satisfy the seven-pay test, the premiums paid by themselves, without borrowed amounts (or dividends), would need to be sufficient to satisfy the test.

Loans and withdrawals from modified endowment policies are taxed to the extent of earnings within the policy.93 Thus, the first amounts withdrawn or borrowed become taxable to the policyholder. Not only is the borrower denied an interest deduction, but he or she is also taxed on the amount borrowed to the extent of the earnings withdrawn.

If the policy satisfies the seven-pay test, the taxpayer or policyholder is able to escape this tax rule. However, the seven payments required without borrowing defeat the basic concept behind financed insurance or minimum deposit insurance.

¶750 Settlement Options or How Insurance Proceeds May Be Made Payable

A life insurance policy owner can avoid permitting the beneficiary from spending the entire proceeds in a short time. Instead of allowing the proceeds to be payable in one lump sum, the policy can require a series of payments. The basic settlement options are as follows:

- **Interest option.** The proceeds are left with the insurer and the insurer pays only interest to the beneficiary for a limited period. At the end of that period, the policy owner may choose another option. A policy owner might use this option, for example, for the period while the surviving spouse with dependent children is collecting Social Security benefits. The conversion would take place when the Social Security benefits for the children end.

- **Fixed period option.** Under the fixed period option, the proceeds are payable in equal installments over a fixed period with a guaranteed rate of interest.

- **Fixed income option.** The fixed income option provides for payment of a fixed amount for each installment. This option differs from the fixed period option because the payment is fixed instead of the period. A variation is to provide for a fixed payment for a fixed period, to a specified date, or when the beneficiary has reached a certain age. At that time, the insurance company would pay the remaining balance under another option, including cash.

- **Life income option.** The life income option provides an annuity for life. It assures that the payments will not end before the beneficiary’s death. The three types of the life income option are (1) for the life of the annuitant; (2) for the annuitant’s life, with a certain number of installments

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93 IRC Sections 72(e)(10)(A) and 72(e)(2)(B).
guaranteed; and (3) the refund annuity option, which provides that if the annuitant dies before receiving the principal sum, the balance will be paid to a second beneficiary.

Actuarially, the payoff for the insurance company under these various options is likely to be the same. However, the individual must decide which of the options will provide the best return to the insured and to the beneficiaries. The insurance company computes the odds for the various options in terms of the monthly payoff per $1,000 of insurance proceeds. The odds vary with the insured’s age, gender, and with the particular insurer.

.01 Deciding What Options to Use

The settlement options and how they work in the abstract is only one consideration. The financial planner must evaluate how they work in a practical context, when they are useful, and when they are not beneficial.

The settlement options do not describe investment yields, how insurance companies calculate the payouts, and why a lump sum cash payment to an individual or a trust might be more advantageous. Insurers use different mortality tables for computing insurance premiums and for calculating the amount to be paid to a beneficiary under a settlement option. As might be expected, a person who applies for life insurance is assigned a lower life expectancy (higher premium) than a person who applies for an annuity. The annuity payout will be less than if the insurance company used the lower life insurance expectancies. The justification offered for the disparity is that annuitants live longer. Of course, a form of adverse selection works against the insurance company. If an individual believes death is imminent, he or she will want all the insurance available today and will want no part of a lifetime annuity. However, if an individual expects to live for a long time, an annuity may be preferred over life insurance.

The proceeds retained by the insurance company are not held in trust. Only a debtor-creditor relationship exists between the company and the beneficiary. Therefore, unless the insurance company operates in a state that guarantees payments, the beneficiary will likely receive little if the insurance company becomes insolvent or files for bankruptcy protection. Generally, money due from an insurance company under a settlement option is not like money in a bank that is insured by the Federal Deposit Insurance Corporation (FDIC).

Because the relationship is only that of debtor and creditor, the beneficiary does not ordinarily receive the benefit of any appreciation in the retained proceeds invested by the insurer. The capital gains and interest income belong to the insurance company. However, some companies provide for the payment of excess interest under some settlement options so that the beneficiary may realize some of the investment earnings. Some policies associated with a family of mutual funds actually offer capital growth.

Settlement options should not be used with the expectation of receiving high yields. Providing a high yield is not their function. Although life insurance as an investment has some tax shelter aspects, settlement options do not include any tax shelter. The most important aspect of settlement options is safety. Despite the possibility of bankruptcy, insurance carriers have been relatively safe over the years. State legislation creating a guaranty further strengthens the safety factor.

Some of the features that provide safety also make for rigidity. Settlement options can never provide the flexibility possible with a trust. No insurance company can stand over its thousands of beneficiaries and spread income to them according to their needs as the insured would wish. If clients want flexibility, they should set up a trust.
Another factor about settlement options is that leaving proceeds with the insurance company can distort an overall estate plan. If the client has a number of insurance policies, a choice of different settlement options can produce unpredictable results. What happens if a particular policy is allowed to lapse? The client should consider how to replace the proceeds that would otherwise go to the beneficiaries.

An integrated, unified estate plan is usually the better way. In certain circumstances, settlement options make sense. Generally, settlement options make sense when the insurance proceeds are relatively small and are intended to provide for a single family member’s limited needs. In those circumstances, a trust might be preferable in the abstract, but may cost too much for the limited benefits.

.02 Settlement Options and the Marital Deduction

Settlement options pose a threat to qualifying life insurance proceeds for the marital deduction.\(^ {94}\) To qualify for the marital deduction, the surviving spouse must generally be the unconditional beneficiary. If the proceeds are not payable outright and the policy owner must name a successor beneficiary, the proceeds may still qualify for the marital deduction if any of the following conditions is satisfied:

- No part of any remainder interest created goes to anyone other than the surviving spouse or his or her estate.

- The beneficiary provisions meet all five of the following conditions: (1) the payments must be unconditionally payable only to the surviving spouse; (2) interest installment payments must be payable annually, or, more frequently, commencing no later than 13 months after the insured’s death; (3) the surviving spouse must have the power to appoint all proceeds held by the insurance company in favor of himself or herself (or his or her estate); (4) this power must be unconditional; and (5) no other person may have any power of appointment over any part of the proceeds that could permit appointment to a person other than the surviving spouse.

- The payout is set up to qualify for the QTIP exception to the terminable interest rule,\(^ {95}\) as discussed in ¶1210.

The simpler way of assuring that the proceeds will qualify for the marital deduction is for the insured not to elect any settlement options. Rather, the policy should allow the proceeds to go to the survivor in a lump sum, in the expectation or hope that the survivor will choose the settlement option that the insured desired. The risk is that the surviving spouse will take the lump sum and spend it quickly.

¶755 Replacing Policies in Force

The reasons why replacing an existing policy with a new one may not be in the best interest of the insured are as follows:

- The insured will have to pay new acquisition costs.

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\(^ {94}\) IRC Section 2056(a).

\(^ {95}\) IRC Section 2056(b)(7).
• Because the insured will have to pay new acquisition costs and because of other factors, the existing policy tends to increase in cost with age (although revised mortality tables and general marketing by insurance companies could lead to a result other than a higher premium).

• Underwriting could cause premium increases due to changes in health and aging of the insured.

• The new policy will most likely have to pass through a contestable period, which may already have passed with the old policy.

• Even if the replacement policy provides for dividends, it may be years before they match those payable under the old policy.

• If a cash value policy is cashed in and the proceeds are transferred into a replacement policy, seldom, if ever, will the new policy’s cash value equal that of the old policy.

• If the replacement policy is of a different type from the old policy, it will not, in most cases, fulfill the needs that prompted the purchase of the old policy, assuming those needs remain the same.

Some state insurance departments have adopted replacement regulations that require full disclosure of all material facts to the policyholder.

The changing circumstances of an insured might require changes in his or her insurance portfolio. Some insurance companies have developed adjustable life, universal life, and other flexible premium policies to accommodate such changing circumstances as discussed in ¶705.

The more traditional forms of insurance provide a certain amount of flexibility similar to flexible premium policies. For example, in years when the insured might find paying premiums to be difficult, he or she may borrow against cash value at relatively low interest rates. Also, the insured can purchase the disability waiver of premium, the guaranteed increase provision, and the accidental death benefit (included in adjustable life).

IRC Section 1035(a)(1) permits a tax-free exchange of one policy for another on the life of the same insured. For policies subject to outstanding loans, the financial planner should make sure that the loan cancellation does not result in gross income to the insured (when the loan on the old policy is extinguished). The client can avoid income tax if the insurance company issues the new policy subject to a loan in the amount of the old loan, assuming the new policy has enough loan value.

¶760 What Should Be Done With Life Insurance in the New High Transfer Tax Exclusion Environment?

.01 Why Was Life Insurance Acquired?

Persons of moderate wealth will no longer need life insurance to fund the federal estate tax payment obligation. If that was the only reason life insurance was acquired, and if the client sees no other benefit in retaining it, the client may opt to cancel the policy. There is anecdotal evidence that many persons have done just that in the post-ATRA planning environment.

If life insurance was acquired for more traditional planning reasons, such as financial security for heirs, education funding, and the like, its central focus was not to be a source of death tax payment, so it re-
mains a viable asset for the purposes acquired. If the traditional reasons have changed, the planner should explore the continued viability of life insurance with the client.

**02 The Role of Life Insurance in Any Estate Plan**

Life insurance is an asset possessed by virtually all clients to some extent. Assume that there is no need to retain life insurance to pay federal estate tax liabilities. What should be discussed with the client as to the ongoing role of life insurance in an estate plan?

The core reasons that most persons acquired life insurance were never to use it as a source of tax payment. That was always a secondary objective, and one more appropriate for high net worth families, not families of moderate wealth. The post-ATRA planning environment has not changed the reasons most people acquire life insurance, namely the following:

- To create an estate for the financial support and security of a family in the event of premature death
- To provide financial support for a surviving spouse and educational funding for young children
- To provide a readily available source of liquidity to pay debts, address funeral and administration expenses, fund bequests, and, where necessary, fund buyout agreements and other possible contractual obligations

There may be a need to preserve permanent life insurance to pay for state estate tax liabilities for those clients domiciled in decoupled states. This may not be a strong motivating factor for clients who may argue that a surviving spouse may move to a non-decoupled state, or that the state of current domicile may eliminate its estate tax. Some clients may decide that life insurance is the easy way to pay for state estate tax liabilities without doing other more complex planning, and they may maintain a policy for this purpose, while others will embrace the concept of comprehensive planning to avoid state estate taxes and decide that life insurance protection for this purpose is not necessary.

Despite the client’s best efforts to engage in comprehensive planning, it is possible that not all assets owned by a decedent will achieve the optimal basis step-up. In such a situation, life insurance policies benefitting the client’s children may be used to pay for the income tax cost the children will bear when the low basis assets are acquired by them and subsequently sold.

It may be advantageous for non-tax reasons to gift some low basis assets during lifetime and accept the carryover basis result. The life insurance payable to the heirs at death can provide a source of income tax payment if these assets are liquidated. Planning may have favored a bypass credit shelter trust for a surviving spouse which resulted in a basis step up at the first death, but not at the second death when the children inherit property still bearing the first decedent’s date of death basis. The sale of the trust assets by the children will result in capital gains to them.

Life insurance can be used to provide direct bequests to children from a prior marriage. This may satisfy the client’s desire to provide for specific children without having to address the blended family concerns of trusts or dividing assets between the current spouse and children of that marriage and the children of an earlier marriage. Insurance left to the children so that the balance of the insured’s estate can be left outright to the surviving spouse may be advisable both to maintain simplicity and to achieve a full basis step up for the assets passing to the spouse.
The planner may consider recommending the acquisition of additional life insurance as an excellent income tax shelter. Permanent life insurance has significant income tax advantages as the result of the higher income tax rates and the 3.8 percent tax on net investment income. The build-up of cash value within a permanent life insurance policy is not considered net investment income and is not taxable to the policy owner. For the client in a high income tax bracket unconcerned about federal estate taxes, the favorable income tax treatment of life insurance (that is, the tax-free build-up of cash values and the ability to access that cash value in a tax-advantaged manner through policy loans) may become an attractive planning option.

Access to cash values within a life insurance policy is possible even if the policy is held in an irrevocable trust, assuming the trust is properly drafted. Language can be included in an irrevocable trust authorizing an independent trustee to borrow the cash value and distribute it to the trust beneficiaries. Such distribution should be income-tax free to the recipients.

If one spouse is the insured who creates the trust and the other spouse is the primary trust beneficiary, the borrowing and distribution by the trustee can be for the benefit of the beneficiary spouse—with the insured spouse having no adverse tax effect from the availability of funds to the marital relationship.

So long as the withdrawals do not exceed the income tax basis in the policy based on the premiums paid by the insured, withdrawals to the extent of the income tax basis are not subject to income tax. If additional cash is needed beyond the income tax basis, such cash should be withdrawn as policy loans to avoid income tax implications. For these income tax rules to apply, the policy must not be characterized as a modified endowment contract and should not be surrendered. Should the insured die with the policy in force, any cash value above the income tax basis not previously withdrawn is also not subject to income tax, even if the policy is then characterized as a modified endowment contract.

With the concern about the federal estate tax alleviated for the moderate wealth taxpayer, there is less reason to feel compelled to transfer a life insurance policy to an irrevocable trust. Retaining ownership of the policy allows the policy owner to access policy features such as long term care riders or other benefits, and to withdraw cash values as needed without having to look to trustees or strain the language of a trust to secure a withdrawal from the policy. Retaining the policy does, however, create a risk that creditors of the insured’s estate could be satisfied from the policy proceeds.

As many life insurance sales persons are quick to point out, compare the return generated by a permanent life insurance policy with other investment returns realized by a client through his or her portfolio. The insurance policy return has exceeded interest rate returns on bank and money market funds, is often favorably compared with average dividend yields, and, depending on investment performance, may be favorably compared with the client’s portfolio growth. Certainly acquiring or retaining some life insurance as part of a person’s investment profile is both a good hedge against the volatility of other investments and, now more than ever, a tax-favored investment in the post-ATRA environment.

.03 Use Life Insurance More Aggressively in Planning

Consider the situation of a client who created and owns a successful business. Pre-ATRA planning would have suggested giving away pieces of the business during lifetime to avoid federal estate tax and to secure minority interest and other discounts as the gifts are made. Now, if the client’s net worth is below the federal estate tax threshold, consider leaving the business in the hands of the owner to assure a stepped-up basis on death, especially if it is likely to be retained by the surviving family members. To protect against any possible state estate tax, have the client acquire a life insurance policy that could be
used, if necessary, to cover the state estate tax liability, allowing the business interest to pass untaxed to the intended beneficiary.

Similar considerations favoring life insurance ownership would apply if the asset owned by the senior family member was appreciated real estate, rather than a business interest.

Where family business succession planning is a potentially difficult issue as one family member is an appropriate successor to the business interest and other family members are loved equally but not seen as appropriate business successors, using life insurance to equalize benefits among heirs becomes an even more attractive option when the life insurance proceeds left to heirs will avoid estate tax. The business interest can be held until death, thus assuring a date of death basis to the chosen heir and be specifically bequeathed to the intended beneficiary. If other children are residuary beneficiaries of the estate and named beneficiaries of life insurance policies, there is a greater likelihood that equalization of benefits can be achieved absent concerns about whose share of the estate will be reduced through tax payments.

.04 What Should be Done with Life Insurance Trusts?

If the client’s estate is approaching the level where state or federal estate tax liability is becoming a possibility, an irrevocable trust to hold life insurance policies and remove them from the taxable estate remains a viable planning option.

If the traditional non-tax reasons for using a trust are present, an irrevocable trust to hold life insurance policies can be recommended by the financial planner. Life insurance is typically an easy asset to persuade clients to gift, since they do not see themselves enjoying the benefits of the proceeds of the policy, and absent a cash need, do not plan to withdraw the cash value. There is no carryover basis or basis step-up issue for a life insurance policy, so no detriment in giving it away during lifetime.

In smaller estates, consider whether there is appropriate justification for a life insurance trust. There are administrative and tax return preparation costs associated with a trust that may not be necessary. Absent the need for the protective benefits of a trust, consider just giving the life insurance policies to heirs while the insured is alive. The insured can keep making premium payments as an annual gift, but the policy will be removed from the insured’s estate, along with any issues of probate, potential claims of the estate’s creditors and the costs and administrative burdens of dealing with the policy after the insured’s death.

The client may have purchased survivorship life insurance and placed the policy into a trust. The purpose of the insurance was specifically to have a fund to pay federal estate taxes at the second death of a married couple. In light of the increased applicable exclusion and portability, the insurance may no longer be needed for that purpose. What should be done with the policy and the trust that holds it? Options include the following:

- Cancel the policy and have the trustee receive the cash value and administer it in accordance with the terms of the trust. That is an easy solution to suggest—but attention must be paid to the terms of the trust and the responsibilities of the trustee.

- Consider a tax-free exchange of the policy for a qualified annuity or another insurance policy that could offer more attractive terms (such as faster cash value build up that can be withdrawn) than the second-to-die policy offers.
• Keep the existing policy but stop paying additional premiums and make the policy a paid-up policy based on the premiums paid to date.

• Consider the status of the life insurance policy in the context of the annual administrative ritual of the trustee’s receiving the premium notice, receiving a check from the insured, addressing the annual Crummey notice issues, and so on. Assuming the client followed the correct Crummey notice procedures, is it necessary to continue to do so?

• In the worst case, an insurance trust will omit all references to rights of withdrawal and Crummey powers. Here, the premium payments by the insured will be viewed as future interest gifts, and a gift tax return will be required to be filed. Given the applicable exclusion and portability, the typical client will never have to pay gift tax or other federal transfer tax, so dispensing with the "Crummey dance" may be administratively favored with no adverse consequence.

• If there is a desire to respect the Crummey withdrawal opportunity and avoid the gift tax return filing, consider a written waiver of all future withdrawal rights. Alternatively, it has been suggested that the client sign a one-time waiver stating that all Crummey rights in the future need be only given verbally. If this is done, be sure the trust document permits notices to be given verbally. Although these alternatives may not have the blessing of established law, it can be argued that these suggestions are reasonable compliance with the Crummey procedures—and perhaps most importantly, if there will not be any transfer tax issues, no one will ever have to address any of these issues.

• Another suggestion could be to simply fund the trust with enough cash to pay the annual premiums for a number of years and ignore the present interest gift tax concerns that the Crummey power is intended to address. If transfer tax will not be an issue for the client, the excess gift to fund the trust will not prove to be a problem.

• Include provisions in a life insurance trust to have it classified as a grantor trust. If the trust will own assets other than cash and life insurance, being deemed a grantor trust will allow the tax-free substitution of properties. Even if the trust will hold only life insurance, grantor trust status is still desirable as the trust will not be subject to the transfer for value rule if there is any transfer of the life insurance policies to the trust, even if the transfer is made for consideration.

A life insurance audit plan is presented in exhibit 7-2.

**Exhibit 7-2: Life Insurance Audit Plan**

The following life insurance audit plan was developed by Lee Slavutin to help you make the most of planning meetings with clients to ensure that their insurance policies are in order. Access the recorded webcast and presentation materials for "Insurance Analysis & Implementation: What CPA Financial Planners Need to Know" at aicpa.org/PFP/webseminars.
<table>
<thead>
<tr>
<th>Insurance Company</th>
<th>Policy Number</th>
<th>Policy Owner</th>
<th>Beneficiary</th>
<th>Policy Type</th>
<th>Annual Premium</th>
<th>Cash Value</th>
<th>Death Benefit</th>
<th>Issue Year</th>
<th>Policy Anniversary</th>
<th>Outstanding Loan</th>
</tr>
</thead>
</table>

**Appendix 2G**

*Life Insurance Inventory (See section 203)*

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APPENDIX 2H
Checklist for the Policy Checkup
(See section 203)

The planner may use this checklist when performing a life insurance policy checkup.

<table>
<thead>
<tr>
<th></th>
<th>Yes, No, or N/A</th>
<th>Initials</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Have all the policies been located? (See paragraph 203.5.)</td>
<td></td>
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<tr>
<td></td>
<td>a. Any group or association policies?</td>
<td></td>
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<tr>
<td></td>
<td>b. Any buy sell or corporate-owned policies?</td>
<td></td>
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<td></td>
<td>c. Any policies in a retirement plan?</td>
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<td></td>
<td>d. Any special riders on any policies?</td>
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<tr>
<td>2.</td>
<td>Has a complete inventory of all policy data been assembled? (See Appendix 2G.)</td>
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<tr>
<td>3.</td>
<td>Has a calendar of premium due dates been created?</td>
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<tr>
<td>4.</td>
<td>What are the financial strength ratings of each insurance company? (See section 304.)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>a. A.M. Best rating?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. Fitch rating?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. Moody’s rating?</td>
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<tr>
<td></td>
<td>d. Standard &amp; Poor’s rating?</td>
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</tr>
<tr>
<td></td>
<td>e. Any recent downgrades?</td>
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<tr>
<td></td>
<td>f. Comdex score?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>g. Is the company in the 85+ percentile by Comdex score?</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>Who is the owner of each policy? (See paragraph 203.17 and section 503.)</td>
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<tr>
<td></td>
<td>a. Is the insured the owner?</td>
<td></td>
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<tr>
<td></td>
<td>b. Has the insured relinquished incidents of ownership?</td>
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<td></td>
<td>c. Has an irrevocable insurance trust been considered?</td>
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<td></td>
<td>d. Have all trusts been reviewed by an attorney?</td>
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<tr>
<td></td>
<td>e. Do the trusts have Crummey powers?</td>
<td></td>
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<tr>
<td></td>
<td>f. Have Crummey letters been sent out annually?</td>
<td></td>
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<tr>
<td></td>
<td>g. Has any policy been transferred?</td>
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<tr>
<td></td>
<td>h. Has transfer for value been triggered inadvertently?</td>
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<tr>
<td>6.</td>
<td>Who is the beneficiary of each policy? (See section 502.)</td>
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<td></td>
<td>a. Has the client been divorced?</td>
<td></td>
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<tr>
<td></td>
<td>b. Is an ex-spouse a beneficiary?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. Are minor children beneficiaries?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>d. Does the client’s will create a testamentary trust for minor children?</td>
<td></td>
</tr>
</tbody>
</table>
7. Is the amount of coverage adequate? (See section 201.)
   a. Has the human life value been calculated? (See Appendix 2D.)
   b. Does a young income earner have coverage sufficient to replace all of his or her income?
   c. Is buy/sell insurance adequate?
   d. Has the business value been updated?
   e. Has estate liquidity been addressed?

8. Are the premiums adequate? (See sections 304 and 306.)
   a. Are in-force illustrations obtained annually?
   b. Will the current premium maintain the policy beyond age 100?
   c. Will the current premium maintain the policy if interest rates drop by 1%?

9. Is the policy competitively priced? (See section 304.)
   a. Does the policy pricing compare favorably with comparable policies from other highly rated carriers?

10. Has the health of the client improved? (See paragraph 203.26.)
    a. Stopped smoking?
    b. Lowered cholesterol?
    c. Lowered blood pressure?
    d. Has the premium been reduced to reflect improved health?
    e. Will the policy maturity age be outlived?

11. Has a life settlement been considered? (See section 509.)
    a. Is the client over age 70?
    b. Is the client considering either replacing or canceling a policy?

12. Have relevant income tax rules been considered? (See Chapter 4.)
    a. Are any of the policies “grandfathered” for tax benefits?
    b. Will a policy replacement or modification cause loss of tax benefits?
    c. Is any policy a pre-1988 single premium whole life policy?
    d. Is any policy subject to the old favorable split dollar rules?

13. Has a sale to a life settlement company been considered? (See section 508.)
    a. Is the client terminally or chronically ill?
    b. Have the client’s cash needs been considered?
Checklist: Determining How Much Life Insurance to Carry

How much insurance a person should carry is one of the most important questions the financial planner may be required to answer. The answer involves subjective goals, present and future needs and earnings, assets, liabilities, social security and pension benefits, income, estate and gift taxes, and the prospect of continuing inflation. Ultimately, the best answer may be something of an educated guess.

How much insurance is required to meet objectives and responsibilities? How much can the estate owner afford to carry? These questions are basic. For most, the need will be greater than the amount of coverage they can afford, and it will be necessary to strike a balance.

One source of difficulty is that people tend to view insurance in isolation. That should not be done. Insurance is only one component of what should be an overall, integrated financial and estate plan.

The individual's personal situation will affect his or her insurance needs.

Once the individual's personal situation has been considered, the following steps should be taken to determine the amount of insurance required.

1. Gather information about the family, the ages of the individual members, their educational goals, their earning capacities, and their personal resources, if any.

2. List the individual's assets and their estimated values. Include in this list savings accounts, securities, equity in real estate, and other investments. Do not include cash-on-hand, automobiles, personal effects and household goods. Pension benefits should be valued in terms of lump-sum distributions, less estimated taxes. Include IRA accounts based on amount presently in the account, less estimated taxes. Include permanent and employee group-term life insurance at face value, but note that the value of the group-term life insurance may disappear with a job change. Subtract liabilities. Segregate liquid assets that will be available for the discharge of debts and transfer costs at death. Readily marketable securities are not always regarded as liquid assets. While they may be readily converted to cash, such conversion at a low point in the market may result in unnecessary loss.

3. Estimate transfer costs at death based on assets and liabilities (computed in item [2]), taking into account the intended marital bequest, if any, the unlimited marital deduction, the unused unified credit, debts, funeral expenses, estimated costs of administration, and uninsured medical expenses.

4. Subtract the estimated amount of transfer and other costs (as computed in item [3]) from the estimated liquid assets available (as computed in item [2]) to pay these items. If the transfer costs exceed the amount of liquid assets, this indicates an insurance need.

5. Estimate the size of the fund required to provide surviving dependents with adequate income:

   a. List 75 percent of the estate owner's present monthly take-home pay.

   b. Subtract the monthly social security benefits available to the survivor.

   c. Subtract any other monthly benefits the survivors will be entitled to receive.
d. Multiply the monthly income required by 12 to determine the annual income requirement.

e. Multiply the annual income requirement by the number of years until the youngest child reaches the age of 18 (a conservative estimate is that $200,000 is required to raise a child from infancy until age 18).

f. Adjust for inflation and earnings on the fund.

6. Estimate the amount required to provide an emergency fund for the survivors. Such fund should be available to provide for emergency medical expenses and unexpected living and housing expenses such as the replacement of major appliances and equipment, water-proofing, roofing, and gutters and leaders.

7. Estimate the amount required to provide for higher education for the children. Compute the cost for each child, and adjust for inflation and income yield for the number of years before the child will reach the junior year in college.

8. Assuming the fund required to provide the family with income until the youngest child reaches age 18 and the fund required to provide educational expenses are both in place, it is necessary to consider a fund: (a) to provide the surviving spouse with income until old-age social security benefits become available and (b) to supplement social security income on retirement.

   In connection with item 5(a), calculate the annual income needs of the surviving spouse based on current prices, and subtract the amount, if any, he or she could be expected to earn. Multiply that amount by the number of years from the time the youngest child attains age 18 to the age at which the survivor becomes eligible for social security benefits. Adjust that amount for inflation. In connection with item 5(b), a similar approach can be followed. Calculate the yearly income required, reducing this amount by social security benefits (and by earnings from employment that do not reduce social security benefits). Multiply that sum by the survivor's life expectancy at the time social security benefits will commence.

9. If the estate owner contributes to the maintenance of the home or renders other services to the family that the survivors may not be able to supply, a fund should be created to provide for such services. An estimate should be made of the monetary value of the services and the cost of replacement services over the estimated number of years needed.

Determine net worth from item (2). Subtract total needs. Any negative amount indicates the amount of insurance needed. The need may be even greater if the estate owner's job situation is such that he or she may reasonably be expected to lose the benefit of employee group insurance.

Assuming an insurance need exists, the estate owner and the financial planner must determine how to supply the need.