706T09

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

706/709 Deskbook

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Interactive Self-study CPE

Companion to PPC's
706/709 Deskbook

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

INTRODUCTION

Companion to PPC's 706/709 Deskbook consists of two interactive self-study CPE courses. These are companion courses to *PPC's 706/709 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2010**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of Form 706/709. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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Online Grading. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

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COMPANION TO PPC'S 706/709 Deskbook

COURSE 1

Form 706/709: Credits, Payments, and Other Taxes (706TG091)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses credits and payments related to Form 706/709. Lesson 1 covers Schedule P, Schedule Q, and other credits. Lesson 2 discusses tax payments and penalties for nonfiling and interest on unpaid taxes.
PUBLICATION/REVISION DATE:	November 2009
RECOMMENDED FOR:	Users of *PPC's 706/709 Deskbook*
PREREQUISITE/ADVANCE PREPARATION:	Experience with filing IRS Forms 706 and 709
CPE CREDIT:	7 QAS Hours, 7 Registry Hours 7 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **November 30, 2010**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Schedule P, Schedule Q, and Other Credits

Completion of this lesson will enable you to:
- Describe the following issues related to Schedule P: eligibility for and limitations of the foreign death tax credit, Form 706-CE, and estate tax treaties.
- Describe both how to claim the credit for tax on prior transfers on Schedule Q and credits that are claimed against gross estate tax to determine net tax payable.
- Calculate taxes under the first and second limitations.

Lesson 2—Tax Payments and Penalties and Interest

Completion of this lesson will enable you to:
- Describe the mechanics of requesting an extension of time to pay estate tax.
- Identify the eligibility requirements for closely held businesses to qualify for the Section 6166 election and how to make the 6166 election, and calculate the portion of estate tax eligible for installment payments.
- Describe how to extend the payment of estate tax attributable to a remainder interest and the redemption of closely held stock for paying estate tax under IRC Sec. 303.
- Identify the executor's responsibilities for paying federal estate tax and the different types of tax liens, and discuss transferee liability and tax apportionment.

- Identify the various penalties related to Form 706, including failure to file, failure to pay, taxpayer accuracy, fraud, preparers and appraisers, and failure to produce records.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
706TG091 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

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Lesson 1: Schedule P, Schedule Q, and Other Credits

Introduction

The estate tax is imposed on the worldwide assets of a U.S. citizen or resident. As a result, the potential for double taxation exists when the decedent owned property subject to death taxes in another country. To minimize the impact of double taxation on these assets, IRC Sec. 2014 allows a credit against the gross estate tax for any estate, inheritance, legacy, or succession tax paid by the decedent's estate to a foreign country. In addition, a credit for death taxes may be allowable under more favorable terms when an estate tax treaty exists between the U.S. and the country taxing the decedent's property.

The amount of the credit is computed on Schedule P (Credit for Foreign Death Taxes) and carried to Form 706, Part 2, line 13. The death taxes paid to the foreign country must be converted to U.S. dollars by using the exchange rate in effect on the date of payment.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the following issues related to Schedule P: eligibility for and limitations of the foreign death tax credit, Form 706-CE, and estate tax treaties.
- Describe both how to claim the credit for tax on prior transfers on Schedule Q and credits that are claimed against gross estate tax to determine net tax payable.
- Calculate taxes under the first and second limitations.

Foreign Death Tax Credit Eligibility

The foreign death tax credit is allowed, subject to limitations described later in this lesson, against the estate tax of a decedent who was a U.S. citizen at the time of death. It is also allowed to the decedent's estate if the decedent was a U.S. resident at the time of death, but it is not allowed to the estate of a nonresident alien. The President is authorized to deny the credit to the estates of resident aliens if their native country does not allow a credit to the estate of U.S. citizens residing in that foreign country.

Eligible Residents

When determining a decedent's eligibility for the credit, a "resident" decedent is one who, at the time of his death, was domiciled in the U.S. For this purpose, the U.S. includes the 50 states and District of Columbia. A person's domicile is the place where the person lives, even for a brief period of time, if there is no present intention of leaving. Thus, both actual presence and an intention to remain indefinitely are prerequisites for establishing residency.

Eligible Foreign Taxes

A credit is allowed for any estate, inheritance, legacy, or succession tax paid to a foreign country with respect to property situated in that country and included in the decedent's gross estate. Taxes paid to a U.S. possession are also eligible for the credit. While the characterization of a foreign tax as an estate, inheritance, legacy, or succession tax is not always clear, such characterization is controlled by U.S. law. Unless the foreign tax is substantially equivalent to an estate, inheritance, legacy, or succession tax as that term is contemplated by U.S. law, a foreign death tax will not qualify for the credit.

Even though tax law says the foreign tax must be a "death" (i.e., estate, inheritance, etc.) tax, a treaty can allow other types of taxes paid to qualify for the foreign death tax credit. For example, Canada does not have an estate tax. However, the Canadian income tax laws deem a decedent to have disposed of his property at death at the property's fair market value. Thus, appreciated property is subject to Canadian income tax.

Previously, the IRS and the Tax Court denied a U.S. foreign death tax credit for income tax imposed at death on appreciated property. However, the U.S. and Canada Treaty allows estate tax credit for federal and provincial income taxes payable in Canada related to appreciated property at death.

Situs of Property

In order for a foreign death tax to be creditable, the property on which the tax is imposed must be situated in a foreign country. The situs of foreign property is determined in accordance with the principles of IRC Secs. 2104 and 2105 and the regulations thereunder, which are used to determine the situs of property of a nonresident decedent who is not a U.S. citizen or under provisions of a death tax treaty. Under these principles, real estate and tangible personal property is considered to be situated in the country where it is located. However, the determination of the situs of intangible property is dependent on the specific type of intangible.

<u>Corporate Stock.</u> Shares of corporate stock are considered to be situated in the country where the issuing corporation is incorporated. Thus, stock issued by a foreign corporation is deemed to be situated in the country where the corporation is incorporated.

Example 1A-1 Situs of stock issued by a foreign corporation.

At the time of his death, Floyd Larson owned 6,000 shares of stock in Fijutsi Inc., a corporation incorporated in Japan. He kept the stock in a safe deposit box in Los Angeles. The Japanese tax authority imposed $15,000 in death taxes on the value of the stock.

Shares of stock are considered to be situated in the country where the issuing corporation is incorporated regardless of where the actual shares are located. Thus, the shares of Fijutsi stock are considered situated in Japan even though they were physically located in a Los Angeles bank.

<u>Debt Obligations.</u> Generally, a bond, debenture, note, or other debt obligation is considered to be situated in the country where the issuer is located. Thus, an obligation issued by the U.S government, a state or political subdivision, or a domestic corporation will be considered situated in the U.S. regardless of where the note is held. Similarly, an obligation issued by a foreign government or corporation will be deemed to be situated in the foreign country. However, an obligation issued by a corporation (including a U.S. corporation) will not be considered property situated in the country where the corporation is located if at least 80% of the corporation's gross income for a three-year period is derived from sources outside the country. The three-year testing period ends with the close of the corporation's last tax year preceding the date of death.

Example 1A-2 Situs of bond issued by a foreign corporation.

At the time of her death, Rita Bailey owned a note with a $25,000 face value issued by a German corporation that for many years has derived the majority of its gross income within Germany. The note was bequeathed to her sister, Anita. Assume the German tax authority imposed a $4,000 inheritance tax on the transfer of the note to Anita.

The situs of a bond or note is determined by the location of the issuer of the debt instrument when more than 20% of the issuer's gross income for the three tax years preceding the date of death is derived from sources within the country where the issuer is located. Since the note owned by Rita was issued by a German corporation that derived most of its income from German sources, the note would be deemed to be situated in Germany.

<u>Cash in Bank.</u> Money deposited with domestic banks and savings and loans is treated as situated outside the U.S. if not effectively connected with a trade or business within the U.S. Similarly, funds deposited in a foreign bank in the foreign country imposing the tax are not considered to be situated in that country if not effectively connected with a trade or business in that country.

Example 1A-3 Situs of funds deposited with a foreign bank.

At the time of his death, Will Penny had $30,000 on deposit with a Swiss bank. Assume the funds were not effectively connected with a Swiss business and were subject to death taxes imposed by the Swiss tax authorities.

Money deposited with a foreign bank is deemed situated in the country of the depositor if the funds are not effectively connected with a foreign trade or business. Thus, the funds would be deemed situated in the U.S. and the death taxes would not be eligible for the foreign death tax credit unless creditable under a specific treaty.

Deposits with a foreign branch of a domestic banking institution are considered to be situated in the U.S. unless effectively connected with a foreign trade or business. Likewise, deposits with a domestic branch of a foreign bank have a foreign situs unless effectively connected with a U.S. trade or business.

Special Limitations Period

The credit for foreign death taxes is limited to taxes that are actually paid and for which a credit is claimed within the later of four years after the filing of the estate tax return, or:

1. any time before the expiration of any extension of time under IRC Sec. 6161 for paying the federal estate tax, or

2. if a timely petition for a redetermination of a deficiency has been filed with the Tax Court within 60 days after the Tax Court's final decision.

Limitations on the Amount of the Foreign Death Tax Credit

The credit for foreign death taxes is subject to two separate limitations. The "first limitation" limits the amount of the credit to the foreign death tax attributable to the foreign property. The "second limitation" limits the credit to the amount of federal estate tax attributable to the foreign property. These two limitations determine the extent to which the decedent's property is subject to double taxation.

The values used in computing the first limitation are those determined for purposes of the foreign death tax. The foreign death tax should be converted to U.S. dollars before the first limitation is computed, using the exchange rate in effect at the time each payment of tax is made. Conversely, the values used in computing the second limitation are those determined for federal estate tax purposes.

First Limitation

The amount of the foreign death tax credit is limited to the amount of foreign death tax (1) attributable to property situated in the country imposing the tax, and (2) included in the decedent's gross estate. The first limitation can be expressed as follows:

$$\frac{\text{Value of property situated in foreign country subject to foreign death tax}}{\text{Value of all property subject to foreign death tax}} \times \text{Amount of foreign death tax}$$

The first limitation generally will not apply unless the property subject to tax in a foreign country is not situated in that country under the rules for determining situs or the property (or an interest in property) is subject to foreign tax but not included in the decedent's gross estate.

Example 1B-1 Credit limited when property subject to tax is not situated in a foreign country.

At the time of his death, Jerry Wills, a U.S. citizen, owned stock in Blue Mountain, Inc. (BM), a Jamaican corporation valued at $220,000. Jerry also had $60,000 deposited in a bank in Jamaica and $3 million of property located in the U.S. Jerry's daughter received his entire estate. Assume, under the situs rules, the BM stock is deemed to be situated in Jamaica. Furthermore, assume the $60,000 bank account in Jamaica was not considered situated in that country even though it was subject to death taxes. If Jamaica imposes a 15% inheritance tax, the amount of the inheritance tax is as follows:

Value of stock	$ 220,000
Value of bank account	60,000
Total	280,000
Rate	× 15%
Tax	$ 42,000

The total foreign inheritance tax paid by the daughter is $42,000. Applying the first limitation, the amount available for the foreign death tax credit is $33,000, computed as follows:

$$\frac{\text{Value of property situated in foreign country subject to foreign death tax}}{\text{Value of all property subject to foreign death tax}} \times \text{Amount of foreign death tax}$$

or

$$\frac{\$\,220{,}000}{\$\,280{,}000} \times \$\,42{,}000 = \$33{,}000$$

The amount of the bank account was excluded from the numerator because under the rules for determining situs the property was not situated in Jamaica. For this reason, the first limitation does not avoid double taxation of the bank account.

Second Limitation

The second limitation limits the foreign death tax credit to the amount of federal estate tax attributable to the foreign property. The second limitation applies a fraction to the gross federal estate tax reduced by the applicable credit amount and any credit for gift tax. The numerator of this fraction is the adjusted value of the foreign property subject to foreign death taxes and included in the gross estate. The denominator is the value of the gross estate reduced by the total amount allowed as a charitable or marital deduction. The formula for computing the second limitation is as follows:

$$\frac{\text{Adjusted value of foreign property subject to tax and included in the gross estate}}{\text{Adjusted value of gross estate}} \times \text{Federal estate tax less applicable credit amount and any credit for gift tax}$$

Translating this formula to line numbers on Schedule P results in the following:

$$\frac{\text{Schedule P, line 3}}{\text{Schedule P, line 2}} \times \text{Schedule P, line 4}$$

The regulations require that certain adjustments be made to the numerator of the fraction. To prevent the estate from claiming a deduction and credit for the same property, the value of the foreign property subject to tax (i.e., the numerator) must be adjusted if the estate claimed a deduction for foreign taxes on charitable transfers under IRC Sec. 2053(d). If a deduction was claimed, the numerator must be reduced by the value of the property for which a deduction was claimed.

In addition to the adjustment required when foreign death taxes are claimed as a deduction, another adjustment may be required if a charitable or marital deduction is allowed. The value of the foreign property (i.e., the numerator) must be reduced if the property is bequeathed to a surviving spouse or a charity. If the property is a specific bequest, the numerator is reduced by the value of the foreign property bequeathed. If foreign property is a portion of a marital or charitable bequest, the reduction is a proportionate amount of the charitable or marital deduction.

Example 1B-2 Foreign property bequeathed to a surviving spouse.

Ann Blanks, a U.S. citizen and resident, died in June 2009. At the time of death, her gross estate was valued at $4,650,000 and included $200,000 of stock in a German corporation, which Ann bequeathed to her husband, Bruce. Bruce also received the residence and life insurance proceeds valued at $300,000. The gross estate tax before reduction for any credits was $1,748,300. The estate tax was reduced by the full applicable credit amount ($1,455,800). In addition, the estate paid $34,000 of foreign death taxes attributable to the German stock.

The first step in calculating the second limitation is to determine the amount of estate tax reduced by the applicable credit amount and any credit for gift taxes paid. The amount of Ann's estate tax after reduction for these credits is $292,500 ($1,748,300 − $1,455,800). This amount is entered on Schedule P, line 4.

The next step is to calculate the fraction that limits the amount of the credit. The denominator of this fraction is the value of the gross estate reduced by the amount claimed for the marital and charitable deductions. Thus, the denominator of the fraction is $4,150,000 ($4,650,000 − $500,000). This amount is entered on Schedule P, line 2.

The numerator of the fraction is the value of foreign property subject to tax and included in the gross estate for federal estate tax purposes. The German stock is the only foreign property subject to tax and included in Ann's gross estate. However, the value of this property must be reduced by any portion of the amount for which a marital deduction was claimed. Since the entire $200,000 of German stock was bequeathed to Ann's husband in a transfer eligible for the marital deduction, the adjusted value of the foreign property included in Ann's gross estate (i.e., the numerator) would be $0 ($200,000 − $200,000). This amount would be entered on Schedule P, line 3.

Thus, Ann's estate would not be entitled to a credit for foreign death taxes because the second limitation limits the amount of the credit to $ -0- computed as follows:

$$\frac{\$\text{-0-}\ \text{(Schedule P, line 3)}}{\$4{,}150{,}000\ \text{(Schedule P, line 2)}} \times \$292{,}500\ \text{(Schedule P, line 4)} = \$\text{-0-}$$

Deducting Foreign Death Taxes Paid on Charitable Transfers

Generally, federal and foreign death taxes (estate, succession, legacy, or inheritance taxes imposed by reason of death) are not deductible. However, instead of claiming the credit against estate tax, IRC Sec. 2053(d) allows the executor to elect to deduct foreign death taxes (imposed by and actually paid to a foreign government) on a charitable transfer if the following requirements are met:

1. The foreign death taxes are attributable to a transfer made to a charity described in IRC Sec. 2055 or 2106(a)(2).

2. The executor elects, in writing, to deduct the taxes in lieu of claiming the credit against the estate tax.

3. Either (a) the decrease in the estate tax resulting from the deduction of the taxes is solely for the benefit of the charity, or (b) the federal estate tax is equitably apportioned among all beneficiaries of the gross estate. Equitable apportionment means the beneficiary's share of tax is based on the net amount of the beneficiary's share of the gross estate subject to the tax (after deductions and credits).

The amount of the foreign death tax attributable to a charitable transfer is the tax directly imposed on the charitable transfer under foreign law. If the foreign death tax is imposed on the decedent's entire estate (as opposed to a direct tax on the charitable transfer), the amount deemed imposed on the charitable transfer is determined as follows:

$$\frac{\text{Value of charitable transfer}}{\text{Total estate property subject to foreign death tax}} \times \text{Total foreign death tax}$$

In the preceding formula, the value of the charitable transfer should be reduced by the amount of any deduction or exclusion allowed for charitable transfers when computing the amount of foreign death tax. Likewise, the value of total estate property should be reduced by all deductions and exclusions allowed in computing the foreign death tax.

Form 706-CE: Applying for Certification of Foreign Death Taxes Paid

Filing Requirements

Form 706-CE (Certificate of Payment of Foreign Death Tax) must be filed before any credit for foreign death taxes will be allowed. Form 706-CE is submitted to the tax official of the foreign government where the tax was paid requesting certification of—

1. the full amount of the tax before allowance for any credit, remission, or relief;
2. the amount of any credit, allowance, remission, or relief;
3. the net foreign tax payable after any such allowance (Form 706-CE, line 4);
4. the date on which the foreign tax was paid (if paid in installments, provide the date for all partial payments) (Form 706-CE, line 4); and
5. a list of the property situated in the foreign country and subjected to its tax, including descriptions and values (Form 706-CE, line 5).

Example 1C-1 Filing Form 706-CE to request certification of taxes paid.

At the time of his death, Tim Tyler owned a mountain chalet in Switzerland. As a result of owning this real estate, Tim's estate paid 129,000 francs in Swiss death taxes. The estate will claim a credit for the amount of foreign death taxes paid.

Since the estate will claim a credit for the death taxes paid, it must file Form 706-CE (Certificate of Payment of Foreign Death Tax) before any credit will be allowed.

The Form 706-CE instructions state the form is to be prepared in triplicate for *each* foreign death tax being claimed as a credit. The original and one copy should be sent to the tax official of the foreign government where the tax was paid. The foreign tax official should be asked to certify the form and forward a signed copy to the IRS Center, Cincinnati, OH 45999. See the Form 706-CE instructions for where to send if the decedent was a nonresident U.S. citizen. The third copy is retained by the executor.

Refund of Foreign Death Taxes

A person receiving a refund of foreign death taxes for which a credit was claimed must notify the IRS Center where the decedent's Form 706 or Form 706-NA was filed within 30 days of receiving the refund and pay any additional estate tax due. The notification should contain the following information:

1. Decedent's name and date of death.
2. Description of property with respect to which the refund was made.
3. Amount of refund (exclusive of interest) and amount of interest paid on the refund.
4. Date of refund.
5. Name and address of person receiving the refund.

Any tax due as a result of a foreign taxes refund will not be subject to interest for the period prior to receiving the refund except to the extent the foreign government paid interest on the refund of the foreign taxes.

How to Compute the Foreign Death Tax Credit under an Estate Tax Treaty

The credit for foreign death taxes may be allowable under either IRC Sec. 2014 or the provisions of an estate tax treaty. If the provisions of a treaty apply to the estate of a U.S. citizen or resident, a credit is authorized for the payment of foreign death taxes specified in the treaty. When a credit is allowable under IRC Sec. 2014 or a treaty, the estate may claim the provisions that yield the most beneficial result.

If the estate is subject to death taxes imposed by both a foreign country with which the U.S. has a treaty and one or more of its possessions or political subdivisions, the allowable credit is the larger of—

1. a credit for the combined taxes paid, determined under the treaty;

2. a credit for the combined taxes paid, determined under IRC Sec. 2014; or

3. a credit determined for the taxes allowable under the treaty *plus* a credit determined under IRC Sec. 2014 for the taxes paid to the possession or political subdivision not covered by the treaty.

Estate tax treaties are presently in force with the following countries: Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Switzerland, and the United Kingdom.

Example 1D-1 Computing the credit under a treaty.

Don Wood, a U.S. citizen, was domiciled in France at the time of his death in 2009. His gross estate consisted of 400 shares of Leaning Towers, Inc. (LT), a French corporation, valued at $900,000; $491,000 in U.S. bonds held in a French bank; $ 2,500,000 of real estate located in the U.S., and $405,000 in U.S. money market accounts effectively connected to the U.S. Expenses incurred by the estate were $50,000. The gross estate tax before credits was $1,791,500. Thus, the net estate tax before any foreign death tax credit is $335,700 ($1,791,500 − $1,455,800).

The estate tax treaty between the U.S. and France allows a credit for succession taxes imposed by the French tax authorities. Furthermore, assume France imposed a $150,000 succession tax on the stocks and bonds. Under the rules for determining the situs of property, the shares of stock in LT will be deemed to be situated in France. The bonds, since issued by the U.S. government, will be deemed situated in the country of the issuer (i.e., the U.S.).

As a result, the amount of foreign tax credit under IRC Sec. 2014 is computed as follows:

1. First limitation [($900,000 ÷ $1,391,000) × $150,000]	$ 97,053
2. Second limitation [($900,000 ÷ $4,296,000) × $335,700]	$ 70,328
3. Credit under IRC Sec. 2014 (lesser of 1 or 2)	$ 70,328

Under the estate tax treaty, the amount of the credit is computed as follows:

1. French tax attributable to property situated in France and subjected to tax by both France and the U.S. [($1,391,000 ÷ $1,391,000) × $150,000]	$ 150,000
2. Federal estate tax attributable to property situated in France and subjected to tax by both countries [($1,391,000 ÷ $4,296,000) × $335,700]	$ 108,696
3. Credit (lesser of 1 or 2)	$ 108,696

The amount of of foreign death tax credit allowed under the estate tax treaty is larger than the amount allowed under IRC Sec. 2014. Therefore, the estate can claim a foreign death tax credit of $108,696.

Credit for Prior Transfers and Foreign Death Tax Credit

The regulations note that in some cases the higher credit may not yield the lowest tax. This can occur when the estate is entitled to the credit under IRC Sec. 2013 for federal estate tax on property transferred to the decedent in addition to the foreign death tax credit. Since the Section 2013 credit may differ depending on whether the statutory or treaty credit is claimed, the advantage of the higher of the two foreign death tax credits may be more than offset by a reduction in the Section 2013 credit. Where the estate is entitled to the Section 2013 credit and the foreign death tax credit for taxes paid to a treaty country, tax computations using both the statutory and treaty credit should be made to determine which produces the lower estate tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following IRC Sections allows the credit for the foreign death tax credit?

   a. IRC Sec. 2014.

   b. IRC Sec. 2053.

   c. IRC Sec. 2013.

2. Which of the following is used to report the credit for foreign death taxes?

   a. Schedule P.

   b. Schedule Q.

3. According to tax law, taxes paid to a foreign country with respect to property situated in that country and included in the decedent's gross estate, may qualify for a tax credit if the foreign tax is a death tax. However, which of the following can allow other types of taxes paid to qualify for the foreign death tax credit?

   a. A treaty.

   b. Form 706-CE.

4. The credit for foreign death taxes is subject to two limitations. Under the second limitation, regulations require that certain adjustments be made to the numerator of the formula use to compute the limitation. Under which of the following circumstances would the numerator of the formula would be reduced by the value of the foreign property bequeathed?

   a. If a deduction is claimed.

   b. If the property is a specific bequest.

   c. If foreign property is a portion of a charitable bequest.

   d. If foreign property is a portion of a marital bequest.

5. Once a taxpayer has received a refund for foreign death taxes for which a credit was claimed, they must notify which of the following to pay any additional estate tax due?

   a. IRS Center where the decedent's Form 706-NA was filed.

   b. Tax official of the foreign government where the tax was paid.

   c. Tax Court within 60 days.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following IRC Sections allows the credit for the foreign death tax credit? **(Page 3)**

   a. IRC Sec. 2014. [This answer is correct. IRC Sec. 2014 allows a credit against the gross estate tax for any estate, inheritance, legacy, or succession tax paid by the decedent's estate to a foreign country. In addition, a credit for death taxes may be allowable under more favorable terms when an estate tax treaty exists between the U.S. and the country taxing the decedent's property.]

   b. IRC Sec. 2053. [This answer is incorrect. IRC Sec. 2053 covers deductions for foreign taxes on charitable transfers.]

   c. IRC Sec. 2013. [This answer is incorrect. IRC Sec. 2013 describes a credit for federal estate tax on property transferred to the decedent that is in addition to the foreign tax credit.]

2. Which of the following is used to report the credit for foreign death taxes? **(Page 3)**

   a. Schedule P. [This answer is correct. The amount of the credit is claimed on Schedule P (Credit for Foreign Death Taxes) and carried to Form 706, Part 2, line 13. The death taxes paid to the foreign country must be converted to U.S. dollars by using the exchange rate in effect on the date of payment.]

   b. Schedule Q. [This answer is incorrect. The amount for credit for tax on prior transfers is claimed on Schedule Q.]

3. According to tax law, taxes paid to a foreign country with respect to property situated in that country and included in the decedent's gross estate may qualify for a tax credit if the foreign tax is a death tax. However, which of the following can allow other types of taxes paid to qualify for the foreign death tax credit? **(Page 3)**

   a. A treaty. [This answer is correct. For example, Canada does not have an estate tax. However, appreciated property in a decedent's estate is subject to Canadian income tax because the Canadian income tax laws deem a decedent to have disposed of his property at death at the property's fair market value.]

   b. Form 706-CE. [This answer is incorrect. Form 706-CE is a form that must be filed before any credit for foreign death taxes will be allowed.]

4. The credit for foreign death taxes is subject to two limitations. Under the second limitation, regulations require that certain adjustments be made to the numerator of the formula used to compute the limitation. Under which of the following circumstances would the numerator of the formula be reduced by the value of the foreign property bequeathed? **(Page 5)**

   a. If a deduction is claimed. [This answer is incorrect. If a deduction is claimed, the numerator must be reduced by the value of the property for which a deduction was claimed.]

   b. If the property is a specific bequest. [This answer is correct. The regulations require that certain adjustments be made to the numerator of the faction used to calculate the second limitation. The value of the foreign property (i.e., the numerator) must be reduced if the property is bequeathed to a surviving spouse or a charity. If the property is a specific bequest, the numerator is reduced by the value of the foreign property bequeathed.]

   c. If foreign property is a portion of a charitable bequest. [This answer is incorrect. If foreign property is a portion of a charitable bequest, the reduction is a proportionate amount of the charitable deduction.]

   d. If foreign property is a portion of a marital bequest. [This answer is incorrect. If a foreign property is a portion of a marital bequest, the reduction is a proportionate amount of the marital deduction.]

5. Once a taxpayer has received a refund for foreign death taxes for which a credit was claimed, they must notify which of the following to pay any additional estate tax due. **(Page 8)**

   a. IRS Center where the decedent's Form 706-NA was filed. [This answer is correct. Whether or not additional estate tax is due, if a person receives a refund of foreign death taxes for which he or she claimed a credit, within 30 days of receiving the refund, he or she must notify the IRS Center where the decedent's Form 706 or Form 706-NA was filed.]

   b. Tax official of the foreign government where the tax was paid. [This answer is incorrect. This submission is not part of the notification related to paying additional estate tax. Form 706-CE is submitted to the tax official of the foreign government where the tax was paid.]

   c. Tax Court within 60 days. [This answer is incorrect. Filing with the Tax Court within 60 days for a credit for foreign death taxes paid is one of the criteria for the Special Limitations Period. The Tax Court does not need to be notified when the refund is received under normal filing procedures.]

How to Claim the Credit for Tax on Prior Transfers Claim

A decedent's estate (the recipient) is allowed a credit against the estate tax for federal estate taxes paid on the transfer of property to the recipient from a transferor who died within the 10-year period before or the two-year period after the recipient's death. However, if the transferee was the transferor's surviving spouse, no credit will be allowed to the extent a marital deduction was allowed on the transferor's estate tax return.

The amount of the credit is calculated and reported by the recipient's estate on Schedule Q (Credit for Tax on Prior Transfers). The limitations imposed on the credit are computed using the Schedule Q worksheet provided on the last page of the Form 706 instructions. The credit reported on Schedule Q is carried to line 14 on page 1 of Form 706 where it is claimed as a reduction to the estate tax.

Form 706-NA is used to compute estate and generation-skipping transfer tax liability for nonresident alien decedents. The credit for tax on prior transfers is reported on Schedule Q and carried to line 10 on page 1 of Form 706-NA where it is claimed as a reduction to the estate tax.

Eligible Property

The term *property* includes any beneficial interest (i.e., legal or equitable) in property. It does not include an interest in which the recipient receives only bare legal title, as in the case of a trustee. The holder of a general power of appointment is considered the beneficial owner of property subject to the power of appointment. However, the holder of a limited power of appointment over property does not have a beneficial interest in the property.

The recipient does not have to receive an ownership interest in the entire property to claim a credit for tax on a prior transfer. The credit is also allowed for an interest in an annuity, life estate, term for years, remainder, or other future interest. Thus, the value of a life estate is eligible for the credit, even though it is not includable in the recipient's gross estate.

> **Example 1E-1 Life estate not included in gross estate.**
>
> Maggie inherits a life estate in 100 acres of real property from her aunt. The life estate has a $1 million value and her aunt paid estate taxes related to the life estate. Maggie died 14 months later. The life estate is not included in Maggie's gross estate. However, Maggie's estate is entitled to a credit because of the prior transfer.

Valuation of Property

For the credit to be allowed, the transferred property's value must be determinable and greater than zero. Valuation is rarely a problem when the recipient receives an entire or fractional interest in property. The value of the property is determined using normal valuation principles for the type of property involved. While the standard life expectancy tables are applicable to most life estates, the IRS has said there are times when the actual facts of an individual's condition are so exceptional as to justify departure from the actuarial tables.

A departure from the actuarial tables is justified, for example, when life estates are created by simultaneous deaths. In that situation, a life estate's value is the amount a willing buyer with knowledge of all relevant facts would pay. If the life estates had a zero value, credits for the tax on prior transfers would not be applicable. Such was the case for a married couple who were presumed to have died simultaneously in a plane crash. Each decedent's will created a trust that provided a surviving spouse with a life estate. For each estate tax return, the executor included a life estate (valued using the Section 7520 tables) in determining a credit for tax on prior transfers. However, the Tax Court held that the credit was not available since an informed buyer would recognize the high probability of a short survival from such a crash and would not pay anything for the life estates.

The valuation tables also may not be used to value transfers if the recipient of a life estate is terminally ill at the time of the transfer. An individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within one year. If the individual is terminally ill, the actual life expectancy must be used to value the life estate. However, if the individual survives for 18 months or longer after the transfer, he or she is presumed not to have been terminally ill on the date of the transfer (and presumably the tables can be used on an amended return to revalue the transfer).

However, Reg. 20.7520-3(b)(3)(iii) and (4), Example 2, indicates that IRC Sec. 7520 tables may not be used to value an annuity, income interest, remainder interest, or reversionary interest if the decedent, and the individual who is the measuring life, die as a result of a common accident.

A life estate in a discretionary trust may also be difficult to value. Generally, the income beneficiary must have a fixed right to all or a specific portion of the trust income for life in order for the value of a life interest in a trust to be determinable. When the trustee has the discretionary power to sprinkle income among several beneficiaries, the value of the income interest is not ascertainable and no credit is allowed. Likewise, when the trustee possesses the discretionary power to distribute or accumulate income for the benefit of the income beneficiary, the beneficiary's life estate cannot be valued according to recognized principles and no credit is allowed for such interest.

Example 1E-2 Discretionary income interest in trust cannot be valued.

The independent trustee of a testamentary trust has the discretionary power to distribute income among three children or to accumulate such income. The income interest cannot be valued since the trustee has the discretion to distribute or accumulate such income. Since the income interest cannot be valued for any of the three children, the credit would not be available to any of the children's estates.

Example 1E-3 Trust income must be distributed equally.

The independent trustee of a testamentary trust must distribute all the trust's income equally among three children. Because the income interest must be distributed equally, it can be valued. Since the income interest can be valued, the credit would be available to any of the children's estates.

Furthermore, the value of an income interest is not determinable if the trustee has the power to invest the trust's assets so as to not generate income or to invade corpus for the benefit of another beneficiary. However, if the trustee's power to invade is limited by an ascertainable standard, the value of the life estate is determinable and will be eligible for the credit.

Example 1E-4 Trustee's powers limited to ascertainable standard.

The independent trustee of a testamentary trust must distribute income equally among three children. The trustee has the power to invade corpus for the benefit of any of the three children for educational and medical expenditures. Since the power is limited to an ascertainable standard, the interest in the trust can be valued. Therefore, the credit would be available to any of the children's estates.

Eligible Transfers

For an estate to claim the credit for tax on prior transfers, there must have been a transfer of property from the transferor to the recipient. A transfer includes any transfer of property (or an interest in property) under circumstances where the property (or interest) was included in the transferor's estate. Thus, property received as a result of the exercise of a power of appointment is deemed to be transferred from the person who exercised the power (i.e., the holder), not the power's creator. Accordingly, the credit is available if the property is included in the holder's gross estate.

Example 1E-5 Property transferred by exercise of a power of appointment.

At the time of his death, Clay was the life income beneficiary of a trust established by his father. Pursuant to the trust instrument, Clay was granted a testamentary general power of appointment over trust property. As a result of possessing a general power of appointment over the trust property at his death, the value of the trust was included in Clay's gross estate. Clay exercised his testamentary power by appointing trust property to his brother, Sid. Four years later, Sid died.

To be eligible for the credit, there must be a transfer of property included in the transferor's (Clay's) estate from the transferor to the recipient. Clay's testamentary exercise of the power of appointment was a transfer of property that was included in his gross estate. Therefore, Sid's estate will be entitled to claim a credit for tax on prior transfers.

Additional examples of transfers include property received from the transferor (1) as a spouse under dower or curtesy laws, (2) as a surviving tenant of a tenancy by the entirety or joint tenancy with survivorship rights, (3) as the beneficiary of a life insurance policy, (4) as the survivor under an annuity contract, (5) as the donee of a general power of appointment, or (6) as a remainderman under the release of a general power of appointment over property included in the gross estate of the donee of the power.

Example 1E-6 Transfer of life insurance proceeds.

Toni Gray died in 2005. The proceeds of a life insurance policy she owned were included in her gross estate. Pursuant to the life insurance contract, her son, Norm, was the beneficiary of the insurance proceeds. Norm died in 2009. Since the property received from his mother was included in her gross estate, Norm's estate is entitled to claim a credit for tax on prior transfers based on the amount of the proceeds he received.

The transferred property does not have to be identified or included in the recipient's estate to be eligible for the credit. In fact, it does not even have to exist at the time of death (e.g., a bequest of stock the recipient/decedent sold and spent). What matters is that the property transferred to the decedent was subject to federal estate tax in the transferor's estate, and the transferor died within the prescribed period of time.

Example 1E-7 Transferred property not included in transferee's gross estate.

Linda and June Wyatt purchased a parcel of real estate as joint tenants with the right of survivorship. June died in 2004 when the real estate was valued at $200,000. Since she provided half of the purchase price, $100,000 (half the real estate's value) was included in her gross estate. As surviving joint tenant, Linda received June's interest in the real estate. Linda sold the real estate for $210,000 in 2006 and invested the proceeds in derivatives. Her entire investment had been lost at the time of her death in 2009.

Even though the value of the property is not included in Linda's gross estate, her estate will be entitled to a credit for tax on prior transfers for the portion of the real estate inherited from June as surviving joint tenant. The transferred property does not have to be identified or included in the decedent's estate to be eligible for the credit.

Transfers eligible for the credit were usually made by a transferor who has predeceased the decedent by ten or fewer years. However, it is possible to claim the credit for a transfer from a transferor who dies within two years after the decedent, as shown in Example 1E-8.

Example 1E-8 Transfer within two years following decedent's death.

Annie Gustafson transferred property to a trust with a term of 15 years. The remainder interest in the trust was to pass to her brother Walter at the end of the trust's term. Walter died six years after the transfer to the trust. Since the remainder interest in Annie's trust was vested in Walter at the time of his death, its value was included in Walter's estate.

Annie died sixteen months after Walter died. The value of the trust was included in her estate. Walter's estate was accordingly entitled to the credit for the prior transfer of the remainder interest. If Annie had outlived Walter by more than two years, Walter's estate would have received no credit.

Percentage Reduction

The amount of allowable credit (i.e., after application of the first and second limitation) is subject to reduction based on the length of time that has elapsed since the property was transferred. If the transferor died within the two-year period before or after the recipient's death, the amount of the credit allowed is 100% of the credit allowable after application of the first and second limitation. If the transferor died more than two years *after* the recipient's date of death, no credit is allowed. If the transferor died more than two years *before* the recipient, the percentage of the credit allowable after applying the first and second limitation is determined using the following table:

Period of Time Exceeding	Not Exceeding	Percent Allowable
2 years	4 years	80
4 years	6 years	60
6 years	8 years	40
8 years	10 years	20
10 years	—	none

The percentage reduction is accounted for on line 4 of Schedule Q (i.e., the first and second limitation amounts are carried over in full from the Schedule Q worksheet to lines 1 and 2 of Schedule Q).

Example 1E-9 Percentage of credit allowable based on transferor's date of death.

Barry Reid died in 2004. Pursuant to his will, Barry left $200,000 in securities to his son, Bill. Bill died unexpectedly in 2009. Assume the amount of Barry's estate tax attributable to the securities (i.e., the first limitation) was $76,000. Further assume the amount of Bill's estate tax attributable to the value of the transferred property (i.e., the second limitation) was $86,000. Thus, the credit allowable before the percentage reduction is the smaller of the first or second limitation, or $76,000. Since Barry died five years before Bill, 60% of the credit is allowed. Thus, Bill's estate is entitled to a $45,600 (60% × $76,000) credit for tax on prior transfers.

The First Limitation: Computing the Transferor's Tax on Prior Transfers

The first limitation on the amount of credit for tax on prior transfers limits the credit to the transferor's estate tax attributable to the transferred property. The limitation is computed by multiplying the transferor's estate tax (as adjusted) by a fraction. The numerator of the fraction is the net value of the transferred property, and the transferor's adjusted taxable estate is the denominator. This first limitation, expressed as a fraction, is as follows:

$$\frac{\text{Net value of transferred property}}{\text{Transferor's adjusted taxable estate}} \times \text{Adjusted estate tax}$$

Net Value of Transferred Property

The first limitation limits the amount of the credit to the amount of the transferor's estate tax attributable to the transferred property. When determining the amount of estate tax attributable to the transferred property, only the net value of the transferred property subject to estate tax in the transferor's gross estate is used. This net value is the value at which the property was included in the transferor's gross estate, reduced by the amount of taxes, expenses, and debts charged against the property. In addition, the value must be reduced by the amount of any marital deduction claimed for the property in the transferor's estate. The net value of the transferred property is computed on lines 1 through 7 of the Schedule Q worksheet.

Reduction for Death Taxes. The value of the property must be reduced by the amount of death taxes charged against the property. Death taxes include federal estate taxes and any other estate, inheritance, legacy, or succession taxes payable from the transferred property (e.g., state death taxes). If the transferor's will or local law specifies the taxes are to be paid from other property, the value of the transferred property is not reduced to the extent the taxes are in fact paid with other property. The amount of death taxes charged against the transferred property is entered on line 2 of the Schedule Q worksheet.

Reduction for Encumbrances. The value of transferred property is reduced by the amount of any encumbrance on the property. Thus, when property is transferred subject to a mortgage, the value of the transfer is the value of the transferred property less the outstanding mortgage. However, if the transferor's will requires the executor to pay off the outstanding mortgage, the amount paid to retire the mortgage is treated as additional transferred property eligible for the credit. The amount of any encumbrance on the transferred property is entered on line 3 of the Schedule Q worksheet.

Example 1F-1 Value of transferred property reduced by encumbrances.

Ruby Warton inherited two parcels of real estate from her brother, Randy. One is a parking lot in downtown Houston worth $550,000 and subject to a recourse debt with an outstanding balance of $240,000. The other is vacant land worth $150,000 with an outstanding nonrecourse liability of $50,000. Randy's will provided that all outstanding recourse liabilities were to be paid with other estate funds.

Ruby died in 2009. When determining the net value of the property transferred to Ruby, the value of the property is reduced by the amount of the outstanding liabilities. However, since Randy's will required the executor to pay the $240,000 recourse debt with other estate funds, this amount will be considered an additional property interest received by Ruby. Thus, the total net value of property transferred to Ruby is $650,000, determined as follows:

Item	Description	Amount
1	Parking lot valued at $550,000 and subject to $240,000 liability	$ 310,000
2	Payment of outstanding liability on parking lot	240,000
3	Vacant land valued at $150,000 and subject to $50,000 liability	100,000
Total		$ 650,000

Because the debt on the vacant land is nonrecourse, the value of the property would have been reported in Randy's estate tax return net of the liability. Thus, the net value of this property ($100,000) should be reported on line 1 of the Schedule Q worksheet. The value of the parking lot ($550,000) and payment of the recourse debt ($240,000) would also be included on line 1. The recourse debt outstanding on the parking lot ($240,000) would be entered on line 3. Assuming no other reductions, the net value of the transferred property ($650,000) would be entered on line 7 of the worksheet.

Reduction for Obligation Imposed. The value of transferred property is reduced by the amount of any obligation imposed by the transferor and incurred by the decedent. Thus, when a bequest to the transferee is conditional on the transferee paying a specified amount to a third person, the value of the transferred property is reduced by the amount of the required payment. For example, a requirement that a surviving spouse must relinquish community property rights in order to take property under the transferor's will is an obligation imposed on the transfer. The amount of any obligation imposed on a transfer should be entered on line 4 of the Schedule Q worksheet.

Example 1F-2 Widow's forced election is an obligation imposed on the transfer.

Hal Barr died in 2009. At the time of his death, Hal and his wife, Ruth, were domiciled in Texas. Prior to moving to Texas, the Barrs lived in Kansas. Hal's will specified that Ruth would receive $1,000,000 in cash and property from his estate. As a condition of the bequest, Ruth had to give up her interest in community property. Ruth's community property interest was valued at $750,000 when Hal died. Ruth elected to take the property under Hal's will. Since Ruth was required to relinquish her interest in community property ($750,000) as a condition to taking property under Hal's will, the net value of the transfer is $250,000 ($1,000,000 – $750,000). The amount of the obligation imposed on the transfer ($750,000) would be entered on line 4 of the Schedule Q worksheet.

Reduction for Administration Expenses. When the transferred property represents an interest in the residual estate and this interest is charged with transmission expenses, these expenses reduce the value of the property whether they are deducted on Form 706 or Form 1041. Management expenses would not reduce the transferred property unless they were deducted on Form 706 and charged to such property in whole or in part.

If the transferred property consists of all or a portion of the transferor's residual estate, its value is determined by subtracting allowable transmission administration expenses, whether deducted on Form 706 or Form 1041, from the value of the residual estate. As a management expense, postdeath interest accruing on an obligation of the residual estate does not reduce the value of the residual bequest. When a recipient receives a portion of the transferor's residual estate, the net value of the residual estate is reported on line 1. Administration expenses deducted in arriving at the value of the residual estate need no further reduction on the worksheet.

Example 1F-3 Determining the net value of transferred property.

Brad Petry's father, Wayne, passed away on March 6, 2002. Pursuant to his father's will, Brad and his sister, Cheryl, were the only beneficiaries of the estate. Cheryl received a $200,000 specific bequest. Brad was the residual beneficiary of his father's estate. A review of the estate tax return filed by his father's estate revealed the following assets, liabilities, and expenses.

Residual Estate	Value
Gross estate	$ 1,500,000
Less:	
Outstanding liabilities	(150,000)
Administration expenses	(25,000)
Taxable estate	1,325,000
Less:	
State death taxes	(39,900)
Federal estate taxes	(94,850)
Estate assets available for distribution	1,190,250
Less: Specific bequest	(200,000)
Residual estate	$ 990,250

Wayne's will specified that all state and federal estate taxes and administration expenses were to be paid from the assets of the residual estate (i.e., Brad's share). However, the remaining assets of the residual estate were distributed to Brad subject to the liabilities.

Brad died in January 2009. For computing the amount of the credit for tax on prior transfers, the value of the transferred property would be $990,250, the net value of property Brad received.

Reduction for Marital Deduction. To ensure a credit is not taken for property that is not subject to tax in the transferor's estate, the value of property eligible for the credit must be reduced by the amount of the marital deduction allowed on the transfer. Thus, no credit is allowed for property received by the surviving spouse for which the transferor's estate claimed a marital deduction. The amount of marital deduction claimed on property otherwise eligible for the credit is entered on line 5 of the Schedule Q worksheet.

Adjusted Estate Tax

The transferor's adjusted federal estate tax is the amount of federal estate tax paid by the transferor's estate, increased by the amount of any credit allowed the transferor's estate for gift tax paid on pre-1977 gifts or for taxes paid on prior transfers. However, the transferor's federal estate tax is increased by the credit for tax on prior transfers only if the transferor acquired property from a person who also died within 10 years before the death of the decedent/transferee.

Example 1F-4 Determining the transferor's adjusted estate tax.

Assume the same facts as in Example 1F-3. In addition, Wayne's estate claimed no credit for the gift taxes paid on pre-1977 gifts or for taxes paid on prior transfers. Thus, the net federal estate tax paid by his estate would be $94,850. This amount would be entered on line 16 of the Schedule Q worksheet. No amount would be entered on lines 17 and 18 since these credits were not claimed by Wayne's estate. Thus, Wayne's adjusted estate tax would be $94,850.

If the transferor's federal estate tax is being paid in installments under IRC Sec. 6166, only the installments actually paid are used to compute the credit for tax on prior transfers for the estate of the transferee. As the transferor's estate makes the installment payments, the first limitation and the amount of the credit increase.

Example 1F-5 Transferor's estate tax paid on the installment basis under IRC Sec. 6166.

Gary Walk died in 2007. At the time of his death, Gary owned all of the outstanding shares of a closely held corporation. These shares were bequeathed to Gary's son, Hank. Gary's executor elected under IRC Sec.

6166 to pay the estate tax in ten installments. The federal estate tax was $300,000, of which $200,000 qualified for installment payments. At the time the estate tax return was filed, the executor paid $120,000 (the portion of the tax that did not qualify plus the first installment). Two years later, Hank died unexpectedly. At the time Hank's estate return was due, two additional installments had been paid by Gary's executor (i.e., a total of $160,000 had been paid).

To determine the amount of Gary's estate tax attributable to the transferred stock (i.e., the first limitation), only the portion of the tax actually paid at Hank's death can be used ($160,000). This amount would be entered on line 10 of the Schedule Q worksheet. Subsequent installment payments will increase the first limitation and the amount of the credit for tax on prior transfers.

The Second Limitation: Computing the Transferee's Tax on Prior Transfers

The second limitation limits the amount of the credit to the transferee's federal estate tax attributable to the value of the transferred property. The limitation is calculated by taking the difference between:

1. the transferee's net estate tax after deducting the applicable credit amount, credit for gift tax on pre-1977 transfers, and the credit for foreign death taxes other than the credit under a treaty (i.e., the "actual tax"); and

2. the transferee's net estate tax, computed by excluding the value of the transferred property from the gross estate, after deducting the applicable credit amount, credit for gift tax on pre-1977 transfers, and the credit for foreign death taxes other than the credit under a treaty (i.e., the "hypothetical tax"). Further adjustment is required if the transferee's estate claimed a charitable deduction. Under very limited circumstances relating to the 1981 marital deduction transition rules, the marital deduction may be adjusted.

Transferee's *Actual* Tax

The transferee's *actual* tax is determined by subtracting the applicable credit amount, credit for gift taxes paid on pre-1977 gifts, and the credit for foreign death taxes from the gross estate tax. No reduction is allowed for the credit for tax on prior transfers or any credit for foreign death taxes claimed under a treaty provision.

Example 1G-1 Computing the transferee's *actual* tax.

Brad Petry's father, Wayne, died on March 6, 2002. Pursuant to his father's will, Brad and his sister Cheryl were the only beneficiaries of the estate. Cheryl received a $200,000 specific bequest. Brad was the residual beneficiary of his father's estate. As residual beneficiary, Brad received $990,250 from his father's residual estate (see Example 1F-3).

Brad died in January 2009. His net estate tax after credits was $222,750, computed as follows:

Gross estate	$ 4,600,000
Less:	
Debts and expenses	(205,000)
Charitable deduction	(50,000)
Marital deduction	(350,000)
Taxable estate	$ 3,995,000
Gross estate tax	$ 1,678,550
Less:	
Applicable credit amount	(1,455,800)
Net federal estate tax	$ 222,750

Brad's *actual* tax for computing the second limitation on the tax on prior transfers is determined by subtracting the applicable credit amount, credit for gift taxes paid on pre-1977 gifts, and the credit for foreign death taxes (computed under IRC Sec. 2014) from the gross estate tax. Thus, his *actual* tax for purposes of the second limitation is also $222,750. This amount should be entered on line 21 of the Schedule Q worksheet.

Transferee's *Hypothetical* Tax

The transferee's *hypothetical* tax is the net estate tax payable computed by excluding an amount equal to the value of the transferred property from the gross estate and not claiming the credit for tax on prior transfers or the foreign tax credit computed under a treaty provision.

Marital Deduction. Generally, the entire amount of any marital deduction claimed on the transferee's estate tax return is deductible when computing the hypothetical estate tax. However, if the transferee's estate claims a marital deduction under the transitional rule for certain wills executed before September 12, 1981, the marital deduction is limited to the greater of $250,000 or half the transferee's "reduced" adjusted gross estate.

Modified Charitable Deduction. The amount of any charitable deduction claimed by the transferee's estate must be reduced before the hypothetical tax can be calculated. The amount of the reduction is determined by multiplying the charitable deduction by a fraction—the numerator is the value of the transferred property, and the denominator is the value of the transferee's gross estate, reduced by the amount of deductions claimed for expenses, indebtedness, taxes, losses, etc., allowed under IRC Sec. 2053, 2054, or 2106(a)(1). The amount of this reduction can be computed using the following formula:

$$\frac{\text{Value of transferred property}}{\begin{array}{c}\text{Gross estate less deductions}\\ \text{allowable under IRC Secs. 2053}\\ \text{and 2054 (debts, expenses, etc.)}\end{array}} \times \text{Charitable deduction}$$

The value of the transferred property is the net value subject to estate tax in the transferor's gross estate. This net value is the value at which the property was included in the transferor's gross estate, reduced by the amount of taxes, expenses, and debts charged against the property. In addition, the value must be reduced by the amount of any marital deduction claimed for the property in the transferor's estate.

Example 1G-2 Computing the estate's modified charitable deduction.

Assume the same facts as in Example 1G-1. Since Brad's estate claimed a charitable deduction, the amount of this deduction must be reduced before Brad's hypothetical estate tax can be calculated. The amount of the reduction in the charitable deduction is determined by multiplying the charitable deduction claimed by the estate by the following fraction:

$$\frac{\text{Value of transferred property}}{\begin{array}{c}\text{Gross estate less deductions}\\ \text{allowable under IRC Secs. 2053}\\ \text{and 2054 (debts, expenses, etc.)}\end{array}} = \frac{\$990{,}250}{(\$4{,}600{,}000 - \$205{,}000)} = 22.531\%$$

Thus, the reduction in the charitable deduction is $11,266 ($50,000 × 22.531%) and the amount of the charitable deduction for purposes of computing the hypothetical estate tax is $38,734 ($50,000 − $11,266).

Example 1G-3 Computing the transferee's hypothetical estate tax.

Assume the same facts as in Example 1G-2. Once the modified charitable deduction has been calculated, the amount of the transferee's hypothetical estate tax can be calculated by reducing the gross estate by the net value of the transferred property and substituting the modified charitable deduction. Thus, Brad's hypothetical estate tax is determined as follows:

Gross estate	$ 4,600,000
Less: Net value of transferred property	(990,250)
Reduced gross estate	3,609,750
Less:	

Debts and expenses	(205,000)
Modified charitable deduction	(38,734)
Marital deduction	(350,000)
Hypothetical taxable estate	$ 3,016,016
Hypothetical gross estate tax	$ 1,238,007
Less:	
Applicable credit amount	(1,455,800)
Hypothetical net estate tax	$ -0-

Since Brad's hypothetical net estate tax was $-0-, the second limitation on the credit for tax on prior transfers would limit the credit to $222,750, the difference between the "actual" net estate tax and the "hypothetical" net estate tax ($222,750 − $-0-). This amount should be entered on Schedule Q, Part 2, line 1. Since Brad and his father died five years apart, 40% of the limited credit would be allowed. Thus, Brad's estate would claim a credit of $31,565 ($78,912 × 40%).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. A tax credit may be claimed on prior transfers. What is the allowable credit if a transferor dies within a two-year period before or after the recipient's death?

   a. No credit is allowed.

   b. The credit is determined using the Schedule Q worksheet.

   c. 100% of the credit allowable after the application of the first and second limits.

7. In regards to eligible transfers, the requirements for an estate to claim the credit for tax on prior transfers include which of the following?

   a. There must have been a transfer of property from the transferor to the recipient.

   b. The transferred property must be identified in the recipient's estate.

   c. The transferred property must be included in the recipient's estate.

   d. The transferred property must exist at the time of death.

8. The following scenario is an example of which of the following?

   Joe McMillan died in 2009. At the time of his death, Joe and his wife, Libby, were domiciled in Washington. Prior to moving to Washington, the McMillans lived in Boston. Joe's will specified that Libby would receive $1,000,000 in cash and property from his estate. As a condition of the bequest, Libby had to give up her interest in community property. Libby's community property interest was valued at $750,000 when Joe died. Libby elected to take the property under Joel's will. Since Libby was required to relinquish her interest in community property ($750,000) as a condition to taking property under Joe's will, the net value of the transfer is $250,000 ($1,000,000 − $750,000).

   a. Reduction for obligation imposed.

   b. Reduction for encumbrances.

   c. Reduction for death taxes.

   d. Reduction for marital deduction.

9. If transferred property consists of all or a portion of the transferor's residual estate, what computation is used to determine the property's value?

   a. Subtracting the credit for gift taxes paid on pre-1977 gifts, the applicable credit amount, and the credit for foreign death taxes from the gross estate tax.

   b. Subtracting allowable transmission administration expenses from the value of the residual estate.

10. Diana's father died on February 2, 2002. Pursuant to her father's will, Diana and her sister, Joan, were the only beneficiaries of the estate. Joan received a $200,000 specific bequest. Diana was the residual beneficiary of her father's estate, and she received $990,250. In April 2009, Diana died. Using the information below, calculate Diana's net estate tax after credits:

Gross estate:	$	4,600,000
Debts and expenses:	$	205,000
Charitable deduction:	$	50,000
Marital deduction:	$	350,000
Gross estate tax:	$	1,678,550
Applicable credit amount:	$	1,455,800

a. $0.

b. $222,750.

c. $2,539,200.

d. $3,995,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. A tax credit may be claimed on prior transfers. What is the allowable credit if a transferor dies within a two-year period before or after the recipient's death? **(Page 14)**

   a. No credit is allowed. [This answer is incorrect. No credit is allowed if the transferor died more than two years after the recipient's date of death.]

   b. The credit is determined using the Schedule Q worksheet. [This answer is incorrect. If the transferor dies more than two years before the recipient, the percentage credit allowable after applying the first and second limitation is determined using the Schedule Q worksheet.]

   c. 100% of the credit allowable after the application of the first and second limits. [This answer is correct. When computing the credit on the tax for prior transfers on Schedule Q, 100% of the credit is allowable after the application of the first and second limitation in the situation described above.]

7. In regards to eligible transfers, the requirements for an estate to claim the credit for tax on prior transfers include which of the following? **(Page 14)**

   a. There must have been a transfer of property from the transferor to the recipient. [This answer is correct. A transfer includes any transfer of property (or an interest in property) under circumstances where the property (or interest) was included in the transferor's estate. Such a transfer must occur for the estate to claim the tax credit discussed above.]

   b. The transferred property must be identified in the recipient's estate. [This answer is incorrect. The transferred property does not have to be identified in the recipient's estate to be eligible for the credit. What matters is that the property transferred to the decedent was subject to federal estate tax in the transferor's estate, and the transferor died within the prescribed period of time.]

   c. The transferred property must be included in the recipient's estate. [This answer is incorrect. The transferred property does not have to be included in the recipient's estate to be eligible for the credit. The important requirements are that the property transferred to the decedent was subject to federal estate tax in the transferor's estate, and the transferor died within the prescribed period of time.]

   d. The transferred property must exist at the time of death. [This answer is incorrect. The property does not have to exist at the time of death (e.g., a bequest of stock the recipient/decedent sold and spent). What matters is that the transferor died within the prescribed period of time, and that the property transferred to the decedent was subject to federal estate tax in the transferor's estate.]

8. The following scenario is an example of which of the following? **(Page 17)**

   Joe McMillan died in 2009. At the time of his death, Joe and his wife, Libby, were domiciled in Washington. Prior to moving to Washington, the McMillans lived in Boston. Joe's will specified that Libby would receive $1,000,000 in cash and property from his estate. As a condition of the bequest, Libby had to give up her interest in community property. Libby's community property interest was valued at $750,000 when Joe died. Libby elected to take the property under Joel's will. Since Libby was required to relinquish her interest in community property ($750,000) as a condition to taking property under Joe's will, the net value of the transfer is $250,000 ($1,000,000 − $750,000).

   a. Reduction for obligation imposed. [This answer is correct. The value of transferred property is reduced by the amount of any obligation imposed by the transferor and incurred by the decedent. Thus, when a bequest to the transferee is conditional on the transferee paying a specified amount to a third person, the value of the transferred property is reduced by the amount of the required payment.]

b. Reduction for encumbrances. [This answer is incorrect. The value of transferred property is reduced by the amount of any encumbrance on the property. This is not the case in the example provided.]

c. Reduction for death taxes. [This answer is incorrect. The value of the property must be reduced by the amount of death taxes charged against the property. In this scenario, the reduction is not due to death taxes.]

d. Reduction for marital deduction. [This answer is incorrect. The facts of the scenario would need to be altered before the reduction for marital deduction would apply. In the case of a reduction for marital deduction, the value of property eligible for the credit must be reduced by the amount of the marital deduction allowed on the transfer.]

9. If transferred property consists of all or a portion of the transferor's residual estate, what computation is used to determine the property's value? **(Page 17)**

a. Subtracting the credit for gift taxes paid on pre-1977 gifts, the applicable credit amount, and the credit for foreign death taxes from the gross estate tax. [This answer is incorrect. This computation is used to determine the transferee's actual tax.]

b. Subtracting allowable transmission administration expenses from the value of the residual estate. [This answer is correct. When the transferred property represents an interest in the residual estate and this interest is charged with transmission expenses, these expenses reduce the value of the property whether they are deducted on Form 706 or Form 1041. In the circumstances described above, value is determined by subtracting allowable transmission administration expenses, whether deducted on Form 706 or Form 1041, from the value of the residual estate.]

10. Diana's father died on February 2, 2002. Pursuant to her father's will, Diana and her sister, Joan, were the only beneficiaries of the estate. Joan received a $200,000 specific bequest. Diana was the residual beneficiary of her father's estate, and she received $990,250. In April 2009, Diana died. Using the information below, calculate Diana's net estate tax after credits. **(Page 20)**

Gross estate:	$	4,600,000
Debts and expenses:	$	205,000
Charitable deduction:	$	50,000
Marital deduction:	$	350,000
Gross estate tax:	$	1,678,550
Applicable credit amount:	$	1,455,800

a. $0. [This answer is incorrect. Diana's net estate tax after credits would be more than zero.]

b. **$222,750. [This answer is correct. The formula for calculating the net estate tax is to start with the gross estate, subtract debts and expenses, charitable deduction, and marital deduction. The next step is to calculate the gross estate tax and subtract the applicable credit amount.]**

c. $2,539,200. [This answer is incorrect. This is the applicable credit amount subtracted from the amount of Diana's taxable estate, which is not the correct calculation for the net estate tax.]

d. $3,995,000. [This answer is incorrect. This is the taxable estate amount, which is calculated by taking the gross estate and subtracting the debts and expenses, the charitable deduction, and the marital deduction.]

Credits against the Gross Estate Tax

The following credits can be claimed against the gross estate tax to determine the net estate tax payable:

1. Applicable credit amount (IRC Sec. 2010).
2. Credit for pre-1977 federal gift tax (IRC Sec. 2012).
3. Credit for tax on prior transfers (IRC Sec. 2013).
4. Credit for foreign death taxes (IRC Sec. 2014).
5. Canadian marital credit.

The Canadian marital credit is reported on Form 706, line 15. However, a discussion of the Canadian marital credit is beyond the scope of this course. See the instructions to Form 706 and the 1995 Canadian income tax treaty protocol for details on computing the credit.

A decedent's estate is allowed an applicable credit amount of up to $1,455,800 (for 2009) against the amount of its combined estate and gift tax liability. The credit exempts estates of $3.5 million (for 2009) from federal estate tax liability. The amount claimed may not exceed the amount of tax imposed. Thus, any unused applicable credit amount cannot be claimed as a refund.

The estate tax is scheduled for repeal for decedents dying in 2010. However, Congress must act to permanently repeal the estate tax. Otherwise, it is reinstated in 2011. Total estate tax repeal is doubtful. Practitioners should monitor legislation.

Gifts Made after September 8, 1976 and before January 1, 1977

The applicable credit amount must be reduced by 20% of the amount of the $30,000 specific lifetime exclusion allowed for gifts made after September 8, 1976, and before January 1, 1977. (This reduction minimizes the benefit received by taxpayers who claimed their full specific lifetime exemption in anticipation of the enactment of the applicable credit amount.) Since the maximum specific lifetime exemption allowed was $30,000, the maximum reduction is $6,000 ($30,000 × 20%).

Example 1G-4 Reducing the applicable credit amount for exemption claimed on certain pre-1977 gifts.

Harvey Walls died in 2009. His estate tax liability before the applicable credit amount was $2 million Harvey's lifetime gift was a $15,000 gift to his daughter on October 1, 1976. He elected to use $15,000 of his lifetime exemption for the gift.

Normally, Harvey's estate would be entitled to the full $1,455,800 applicable credit amount. However, because he claimed a portion of his specific lifetime exemption on a gift made after September 8, 1976, and before 1977, his applicable credit amount must be reduced by $3,000 ($15,000 × 20%). This reduction is reported on Part 2 (Tax Computation), line 10.

The Credit Allowed for Gift Taxes on Pre-1977 Gifts

Overview

Prior to the unification of the estate and gift tax systems in 1977, a credit was allowed to a decedent's estate for gift taxes paid by the decedent on an asset included in the decedent's estate. The purpose of the credit was to eliminate the impact of double taxation on an asset subject to both estate and gift tax. With the unification of the transfer tax system in 1977, the need for this credit diminished, and it was repealed for all post-1976 gifts.

However, for gifts made before 1977, a credit is allowed against the estate tax for the gift taxes paid on a gift made by the decedent *if* the gifted property is included in the decedent's gross estate.

Example 1G-5 Transfer with a retained life estate.

In 1975, Bill Peters transferred a remainder interest in an apartment complex. He retained an income interest in the property for life. The transfer was a taxable gift and was reported on a gift tax return. Bill died in 2009, and the value of the apartment complex was included in his estate under IRC Sec. 2036(a). Subject to the limitations described below, Bill's estate is entitled to a credit for the gift tax paid in 1975.

Example 1G-6 Gifted property bequeathed back to donor.

In 1974, Leo Wilson transferred unimproved real estate to his daughter in a transaction subject to the gift tax. Leo retained no interest in the property transferred. His daughter died in 1995 and, pursuant to her will, the real estate was transferred back to Leo. Leo still owned the property when he died in 2009.

Even though the gifted property is included in Leo's estate at his death, his estate is not entitled to a credit for gift taxes paid on the transfer of the property to his daughter. The property was included in his estate as a result of his daughter's bequest, not due to any retained interest in the property at the time of the original gift.

Limitation on Amount of Credit

The credit for the gift tax paid is limited to the lesser of all of the following:

1. the amount of gift tax paid on the gift included in the gross estate (first limitation), or
2. the amount of estate tax attributable to including the gift in the gross estate (second limitation).

First Limitation. The first limitation limits the amount of the credit to the gift taxes paid on the gift included in the gross estate. Thus, if the gift included in the gross estate was the only one made in a given calendar quarter (or year), the first limitation limits the credit to the gift tax paid. If the included gift is one of several made during the calendar quarter (or year), the first limitation limits the credit to a fraction of the gift taxes paid for that quarter (or year). The numerator is the amount of the gift (reduced by the related annual exclusion, marital deduction, or charitable deduction claimed) at the date of gift value. The denominator is the total taxable gifts increased by the specific exemption allowed. The first limitation is computed on Form 4808, lines 1–12. The formula for the first limitation is as follows:

$$\frac{\text{Amount of gift (reduced by the related annual exclusion or marital or charitable deduction claimed)}}{\text{Total taxable gifts plus the specific exemption allowed}} \times \text{Gift taxes paid}$$

Example 1G-7 Credit limited to gift tax paid on the included gift.

Ron Watt died in 2009. Included in Ron's gross estate is a parcel of real estate that he gifted to his son in 1970 and in which he retained a life estate. A review of Ron's 1970 Form 709 revealed the following taxable gifts:

Gift of remainder interest to son	$ 55,000
Gift to daughter	35,000
Total gifts	90,000
Less: annual exclusion on gift to daughter	(3,000)
Taxable gifts	$ 87,000
Gift tax paid	$ 12,795

The first limitation would limit the amount of the credit to $8,089 computed as follows:

$$(\$55{,}000 \div \$87{,}000) \times \$12{,}795 = \$8{,}089$$

A copy of Form 4808, or a similar calculation as well as Ron's gift tax returns (Form 709), should be attached to the estate tax return.

The IRS has ruled that the general principle that deductions or credits for taxes paid are available only to the person who paid the tax is not applicable to the credit for gift taxes paid; therefore, the credit can be claimed even if the gift tax was paid by the donee. The IRS ruled that neither the Code nor the regulations preclude the applicability of the credit in such situation. In fact, since IRC Sec. 2012 was enacted to avoid the double taxation that results when gift and estate taxes are paid on the same item of property, "the purpose of the section would be obstructed if the credit was limited to situations in which the gift tax was paid by the donor."

Second Limitation. The second limitation limits the credit to the amount of estate tax attributable to the gift being included in the donor's gross estate. The estate tax attributable to the inclusion of the gifted asset in the donor's gross estate is a fraction of the gross estate tax. The numerator is the value of the gift less the gift tax annual exclusion and the related marital and charitable deduction. The denominator is the value of the gross estate less the amounts allowed for marital and charitable deductions. This fraction is multiplied by the gross estate tax less the applicable credit amount. The second limitation is expressed as follows:

$$\frac{\text{Value of gift less the related annual exclusion and marital or charitable deduction}}{\text{Value of gross estate less marital and charitable deduction}} \times \begin{array}{c}\text{Gross estate tax less}\\ \text{applicable credit amount}\end{array}$$

For purposes of the second limitation, the *value of the gift* is the lesser of the value used for gift tax purposes or the estate tax value of the gifted asset. This amount is reduced by all or a portion of the annual exclusion allowed for gift tax purposes and any amounts allowed as a charitable or marital deduction. The value of the gift is reduced by the entire gift tax exclusion if the gift tax value is lower than the estate tax value. If the estate tax value is lower, the value of the gift (i.e., the estate tax value) is reduced by a portion of the exclusion computed by multiplying the exclusion by the ratio of the estate tax value to the gift tax value.

Example 1G-8 Value of the gift used for the second limitation.

Rhoda Barnet gifted a remainder interest valued at $300,000 to her five children in 1974. Rhoda's retained interest in the gifted property caused the value of the property to be included in her estate when she died in 2009. The estate tax value of the property was $270,000.

Since the estate tax value of the gifted asset is less than the gift tax value, the gift would be valued at the estate tax value ($270,000) for computing the second limitation. No further adjustment to the value is required since the initial transfer did not qualify for the annual exclusion (i.e., it was not a gift of a present interest).

Many transfers qualifying for the credit for gift taxes involve the transfer of a remainder interest coupled with the retention of the income interest by the transferor. In these cases, the value of the gift (i.e., the remainder interest) at the time of the transfer is determined using an actuarial factor discounting the value of the property transferred by the income interest retained by the transferor. When a decedent makes a gift of a remainder interest in property (usually to a trust) and the value of the property is subsequently included in his or her gross estate, the value of the gift for purposes of the "second limitation" is the value of the property on the date of transfer or on the date of the decedent's death, whichever is lower, multiplied by an actuarial factor that represents the present worth of the remainder interest at the time of transfer.

Example 1G-9 Actuarial factor used to value a gift.

John Wood transferred $100,000 of stock to a trust in 1974, but retained the right to the net income from the trust for life. At his death, the remainder interest in the trust was to be distributed to his son. John died in 2009 when the value of the trust was $80,000. The entire value of the trust was included in his estate under IRC Sec. 2036. A review of the gift tax return filed in 1974 showed the gift was reported as follows:

Value of property transferred	$ 100,000
Less: value of income interest ($100,000 × .39679)	(39,679)
Value of remainder interest	60,321
Less: annual exclusion	—
Taxable gift	$ 60,321
Gift tax paid	$ 7,192

When computing the "second limitation," the transferred property is included at the gift tax or estate tax value, whichever is lower, multiplied by the factor for determining the remainder interest. Since the estate tax value is lower, the value of the property for purposes of the second limitation is $48,257 [$80,000 × (1 − .39679)]. This amount would be entered on Form 4808 (or the calculation worksheet), line 13.

If an annual exclusion was allowed on the initial transfer (i.e., if the transfer was a present interest), the estate tax value of the gift less an allocable portion of the exclusion would be entered on Form 4808 (or the calculation worksheet), line 14. The allocable portion of the exclusion would be computed by multiplying the annual exclusion by the ratio of the estate tax value to the gift tax value.

Example 1G-10 Credit limited to estate tax attributable to a gift.

Assume the same facts as in Example 1G-9. Also, assume John died in 2009 with a gross estate valued at $5 million (including the $80,000 value of the gifted property). Expenses and debts against the estate totaled $50,000. John's son was the sole beneficiary of the estate. John's federal estate tax liability, before credit for gift taxes paid, is $652,500 computed as follows:

Gross estate	$ 5,000,000
Expenses	(50,000)
Taxable estate	$ 4,950,000
Gross estate tax	$ 2,108,300
Applicable credit amount	(1,455,800)
Net federal estate tax	$ 652,500

The amount of John's credit for gift taxes would be computed as follows:

First Limitation: Since the only gift John made in 1974 was the gift of the property to his son, the gift taxes attributable to the property included in his estate would equal the gift taxes paid in 1974 (i.e., $7,192).

Second Limitation: The second limitation limits the amount of the credit to the amount of estate tax attributable to the inclusion of the gift in the donor's gross estate. This limitation is computed as follows:

$$\frac{\$48{,}257 \text{ (see Example 1H-5)}}{\$5{,}000{,}000} \times \$652{,}500 = \$6{,}298$$

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. With respect to gifts made before 1977, a credit is allowed under ___________ against the federal estate tax for gift tax paid on a gift by the decedent of property subsequently included in the decedent's gross estate.

    a. IRC Sec. 2010.

    b. IRC Sec. 2012.

    c. IRC Sec. 2013.

    d. IRC Sec. 2014.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. With respect to gifts made before 1977, a credit is allowed under ___________ against the federal estate tax for gift tax paid on a gift by the decedent of property subsequently included in the decedent's gross estate. **(Page 27)**

    a. IRC Sec. 2010. [This answer is incorrect. Under IRC Sec. 2010, a decedent's estate is allowed a specified applicable credit amount against the amount of its combined estate and gift tax liability.]

    b. IRC Sec. 2012. [This answer is correct. Prior to the unification of the estate and gift tax systems in 1977, a credit was allowed to a decedent's estate for gift taxes paid by the decedent on an asset included in the decedent's estate. The purpose of the credit was to eliminate the impact of double taxation on an asset subject to both estate and gift tax. With the unification of the transfer tax system in 1977, the need for this credit diminished, and it was repealed for all post-1976 gifts.]

    c. IRC Sec. 2013. [This answer is incorrect. Under IRC Sec. 2013, a decedent's estate (the recipient) is allowed a credit for all or a portion of the estate taxes paid on property transferred from another decedent (the transferor).]

    d. IRC Sec. 2014. [This answer is incorrect. IRC Sec. 2014 allows a credit against the gross estate tax for any estate, inheritance, legacy, or succession tax paid by the decedent's estate to a foreign country.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (706TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. In order for a foreign death tax to be creditable, the property on which the tax is imposed must be situated—

   a. In a foreign country.

   b. In the United States.

   c. In the country where the corporation issuing stock is incorporated.

   d. In the country where the debt obligation issuer is located.

2. Which of the following forms must be filed before any credit for foreign death taxes are allowed?

   a. Form 706-NA.

   b. Form 706-A.

   c. Form 706-CE.

   d. Do not select this answer choice.

3. Which of the following statements regarding computing the foreign death tax credit under an estate tax treaty is most accurate?

   a. The credit for foreign death taxes is only allowed under the provisions of an estate tax treaty.

   b. If the provisions of a treaty apply to the estate of a U.S citizen or resident, a credit is authorized for the payment of foreign death taxes specified in the treaty.

   c. Estate tax treaties are presently not in force in Canada and South Africa.

   d. An estate can only take the smallest foreign death tax credit to which it is entitled.

4. The term *transferee* means the decedent for whose estate this return is filed. No credit is allowed for property received from the transferor if the transferee is which of the following?

   a. Spouse.

   b. Sibling.

   c. Child.

   d. Parent.

5. For the credit for tax on prior transfers to be allowed, the value of the property transferred must be determinable. Part of the determination of value includes the standard life expectancy tables. When is a departure from the actuarial table justified?

   a. When the property value equals zero.

   b. When a terminally ill recipient survives for 18 months after the transfer.

   c. When there are simultaneous deaths.

   d. When the trustee can invest the trust's assets and generate income for another beneficiary.

6. Bobby inherits two parcels of real estate from his grandmother, Sue. One is a parking lot worth $1,100,000 and subject to a recourse debt with an outstanding balance of $480,000. The other is vacant land worth $300,000 with an outstanding nonrecourse liability of $100,000. Sue's will provides that all outstanding recourse liabilities must be paid with other funds from the estate. Bobby dies in 2009. Assuming there are no other reductions than those described above, what amount would be entered on line 7 of the Schedule Q for Bobby's estate?

   a. $480,000.

   b. $620,000.

   c. $1,300,000.

   d. $1,780,000.

7. When Geoff, a U.S. citizen, died, he owned stock in SwarleyCo, a Jamaican corporation valued at $220,000. Geoff also had $60,000 deposited in a bank in Jamaica and $3 million of property located in the U.S. Rosemary, Geoff's daughter, received his entire estate. Assume, under the situs rules, the SwarleyCo stock is deemed to be situated in Jamaica. Furthermore, assume the $60,000 bank account in Jamaica was not considered situated in that country, despite the fact that it was subject to death taxes. If the inheritance tax imposed by Jamaica is 15%, what amount is available for Rosemary's foreign death tax credit after the first limitation is applied?

   a. $33,000.

   b. $42,000.

   c. $53,455.

   d. $280,000.

8. Bethany, who is both a U.S. citizen and a U.S. resident, died in June 2009. At the time of Bethany's death, her gross estate was valued at $4,650,000 and included $200,000 of stock in a German corporation, which she bequeathed to her husband, Andrew. Andrew also received the residence and life insurance proceeds valued at $300,000. Bethany's gross estate before reduction for any credits was $1,748,300. The estate tax was reduced by the full applicable credit amount ($1,455,800). In addition, the estate paid $34,000 of foreign death taxes attributable to the German stock. Based on the second limitation, is Bethany's estate entitled to a credit for foreign death taxes?

   a. Yes.

   b. No.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

9. What is the applicable credit amount a decedent's estate is allowed for 2009 against the amount of its combined estate and gift tax liability?

   a. $30,000.

   b. $1,000,000.

   c. $1,455,800.

   d. $3,500,000.

10. What is the specific lifetime exclusion allowed for gifts made after September 8, 1976, and before January 1, 1977?

    a. $30,000.

    b. $1,000,000.

    c. $1,455,800.

    d. $3,500,000.

11. The purpose of the first limitation is to limit the amount of the credit to the gift taxes paid on the gift included in the gross estate. If the gift included in the gross estate was the only one made in a given calendar quarter, the first limitation does which of the following?

    a. Limits the credit to a fraction of the gift taxes paid for that quarter.

    b. Limits the amount of the credit to the amount of estate tax attributable to the inclusion of the gifts in the donor's gross estate.

    c. Limits the credit to the gift tax paid.

    d. Limits the credit to the transferor's estate tax attributable to the transferred property.

Lesson 2: Tax Payments, and Penalties and Interest

Introduction

It is the executor's responsibility to pay the estate tax liability when due. Generally, the tax is due on or before the original due date for filing the estate tax return. However, the IRS may grant an extension of time to pay the tax if the executor can demonstrate reasonable cause for the additional time to pay. An extension to file the estate tax return does not extend the time for paying the tax.

The estate may also elect to pay the estate tax liability attributable to a closely held business in installments over a period not to exceed 14 years. Although the tax paid in installments is subject to interest, a portion of the amount deferred may be eligible for a special 2% interest rate. To qualify for deferral, the value of the closely held business must generally exceed 35% of the value of the gross estate less certain debts and expenses. The election to pay the tax in installments is also available for estate tax deficiencies assessed by the IRS.

When a reversionary or remainder interest is included in the decedent's estate, the portion of the tax attributable to the remainder or reversionary interest can be deferred for up to six months after the preceding interest in the property terminates. This provision alleviates the need for the funds to pay the tax on an asset not yet received by the estate.

Also, an executor may be able to obtain funds to pay the tax at a reduced cost. Amounts received from the redemption of a decedent's stock in a closely held corporation are treated as proceeds from the sale of the stock to the corporation, rather than as a dividend. Thus, the proceeds are subject to capital gain treatment to the extent they exceed the decedent's stepped up basis in the stock.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the mechanics of requesting an extension of time to pay estate tax.
- Identify the eligibility requirements for closely held businesses to qualify for the Section 6166 election and how to make the 6166 election, and calculate the portion of estate tax eligible for installment payments.
- Describe how to extend the payment of estate tax attributable to a remainder interest and the redemption of closely held stock for paying estate tax under IRC Sec. 303.
- Identify the executor's responsibilities for paying federal estate tax and the different types of tax liens, and discuss transferee liability and tax apportionment.
- Identify the various penalties related to Form 706, including failure to file, failure to pay, taxpayer accuracy, fraud, preparers and appraisers, and failure to produce records.

Extension of Time to Pay the Estate Tax

Generally, the estate tax liability is due on or before the original due date for filing the estate tax return. An extension of time to file the estate tax return does not extend the time for paying the tax. However, an extension of time to pay the tax can be requested on Form 4768 [Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes].

Reasonable Cause

The IRS has the discretionary authority to grant up to an additional 12 months of time to pay an estate tax liability. If the executor can show reasonable cause for extending the estate tax payment, the IRS may extend the time for payment for up to 10 years. (A discretionary extension of time to pay a *deficiency* for reasonable cause may be granted, for one year at a time, up to a maximum of four years.) Examples of reasonable cause include the following:

1. The estate includes enough liquid assets (cash or assets readily convertible to cash) to pay the estate tax on the due date. However, the liquid assets are located in several jurisdictions and are not within the

executor's immediate control. Thus, the executor cannot readily collect all the assets, even with the exercise of due diligence.

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

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

4. Despite the executor's reasonable efforts to convert the decedent's assets (other than an interest in a closely held business) into cash, the estate would have to borrow at an interest rate higher than generally available to have enough funds to pay the estate tax when due, provide a reasonable allowance for the decedent's surviving spouse and dependent children while the estate is being administered, and satisfy claims against the estate that are due and payable.

5. A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of IRC Sec. 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, IRC Sec. 6166 does not apply. Furthermore, sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its FMV, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.

6. To pay the tax when otherwise due, the assets that must be liquidated can only be sold at sacrifice prices or in a depressed market.

When reasonable cause exists, the 10-year extension is available for extending the payment of the estate tax shown on the return, as well as any portion of an installment payment of tax under IRC Sec. 6166. However, the extension of time must be requested on a yearly basis (i.e., each year a taxpayer can request an additional 12 months to pay the estate tax, but the total extension cannot exceed 10 years).

Example 2A-1 Requesting an extension of time to pay the estate tax under IRC Sec. 6161(a).

Jerry Price died on March 12, 2009. The bulk of Jerry's estate is comprised of a closely held business and other illiquid assets (e.g., real estate). The value of the business was not high enough to qualify the estate for the installment payment of estate tax under IRC Sec. 6166(a). Although the business could be sold to obtain funds for the payment of the tax, the executor wants to obtain the funds from other estate assets so the decedent's heirs can continue to operate the business. Thus, the funds to pay the estate tax liability were unavailable at December 1, 2009. Jerry's executor estimates that sufficient funds will be available in the next 12 months, and thus, he requests a 12-month extension to pay the estate tax. Assuming the estate's inability to obtain funds to pay the liability is reasonable cause for the extension, the 12-month extension of time to pay should be granted. The executor requests an extension to pay by filing Form 4768 and completing Part III. In addition, an explanation of why the extension is necessary should be attached to the form.

Filing Requirements

Requests for an extension of time to pay the estate tax under IRC Sec. 6161 are made on Form 4768. An extension of time to pay the tax can be requested for the estate tax liability or an installment payment of the liability under IRC Sec. 6166. The request is made by completing Part III and entering the requested payment date in the space provided. If the taxes cannot be determined because the gross estate is unascertainable, check the designated box. A statement detailing why the extension of time to pay the tax is necessary (i.e., reasonable cause) should be attached to Form 4768.

Generally, an extension to pay will be granted only for the amount of the cash shortage (the difference between the estimated estate tax due and available cash). The remainder of the estate tax is due with the application. Enter the amount of the estate tax liability on Part IV, line 1. If the estate tax return has been filed, attach a copy of the return to the extension request. If no return has been filed, enter an estimate of the tax liability on line 1. In addition, attach a statement of the estate's assets and prior distributions of assets, and a plan for payment of the tax during the extension period.

Interest on the balance of the estate tax will be charged during the period of extension.

Due Date. Form 4768 must be filed on or before the due date of the estate tax return. An application for an extension of time to pay estate tax applied for after the estate tax due date will generally not be considered by the IRS.

How to File and Filing Location. According to the instructions, a separate Form 4768 is required to request an extension of time to pay—

1. The tax due on the original Form 706,

2. The tax due as a result of an amended or supplemental Form 706,

3. The additional tax due as a result of the examination by the IRS of the Form 706, or

4. The tax due through a section 6166 installment payment.

When requesting an extension of time to pay, do not send Form 4768 with Form 706; rather, it must be mailed in a separate envelope. File an extension request at the Department of the Treasury, Internal Revenue Service Center, Cincinnati, OH 45999.

Appeal Denial of Request. If a request for an extension of time to pay is denied, the executor may make a written appeal by sending the appeal via registered or certified mail to the address as advised on Form 4768, page 2, Part V that will be returned to the executor by the IRS. (Part V, completed by the IRS, will provide the reason for the denial and the return address to which the executor may send the written appeal.) The appeal must be made within 10 days after the denial is mailed to the executor. The appeal is considered filed on the date it is postmarked.

Bond. The IRS can, as a condition to the granting of an extension of time for payment of any tax or deficiency, require a bond not exceeding twice the amount of the tax.

Consequences of Obtaining a Payment Extension

As noted previously, the IRS can grant an extension of time to pay estate tax under (1) IRC Sec. 6161 (relating to discretionary extensions of time to pay tax), (2) IRC Sec. 6163 (relating to the value of reversionary or remainder interests), or (3) IRC Sec. 6166 (relating to an interest in a closely held business). If the IRS grants an extension of time to pay estate tax under one of these Code Sections, the running of the ten-year limitations period the IRS has to collect the estate tax is suspended for a corresponding length of time.

Estate Tax Deficiency

The IRS may grant an extension of up to four years to pay an estate tax deficiency (i.e., a deficiency assessed by the IRS) if the executor demonstrates reasonable cause for the extension. The deficiency must not be due to negligence, intentional disregard of rules and regulations, or fraud. Complete Form 4768 to request the extension of time to pay the deficiency. It is recommended that the executor attach a statement that explains the origin of the deficiency and why the estate requires additional time to pay the tax. The extension should be filed on or before the due date for paying the estate tax deficiency, as shown on the notice and demand for payment issued by the IRS.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Which of the following forms is used to file for an extension of time to pay the estate tax?

    a. Form 4810.

    b. Form 4808.

    c. Form 4768.

13. Which of the following statements regarding filing requirements is most accurate?

    a. Form 4768 must be attached and sent with Form 706 when requesting and extension of time to pay.

    b. An application for an extension of time to pay estate tax applied after the estate tax is due generally will be considered by the IRS if there is reasonable cause.

    c. Generally, the IRS will only grant an extension to pay for the amount of the cash shortage.

    d. The IRS can require a bond that cannot exceed the amount of the tax when granting and extension of time for payment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. Which of the following forms is used to file for an extension of time to pay the estate tax? **(Page 37)**

    a. Form 4810. [This answer is incorrect. Form 4810 [Request for Prompt Assessment under Internal Revenue Code Section 6501(d)] must be filed after the return is filed when requesting a prompt assessment for the decedent's income and gift taxes.]

    b. Form 4808. [This answer is incorrect. Form 4808 is used to compute the first limitation for the credit for gift taxes on pre-1977 gifts.]

    c. Form 4768. [This answer is correct. Form 4768 [Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes] is used to request an extension of time to pay the estate tax under the Internal Revenue Code.]

13. Which of the following statements regarding filing requirements is most accurate? **(Page 37)**

    a. Form 4768 must be attached and sent with Form 706 when requesting and extension of time to pay. [This answer is incorrect. Form 4768 requesting an extension of time to pay must be sent in a separate envelope from Form 706.]

    b. An application for an extension of time to pay estate tax applied after the estate tax is due generally will be considered by the IRS if there is reasonable cause. [This answer is incorrect. Form 4768 must be filed on or before the due date of the estate tax return. An application for an extension of time to pay estate tax applied for after the estate tax due date will generally not be considered by the IRS.]

    c. Generally, the IRS will only grant an extension to pay for the amount of the cash shortage. [This answer is correct. Generally, an extension to pay under the Internal Revenue Code will be granted only for the difference between the estimated estate tax due and available cash. The remainder of the estate tax is due with the application.]

    d. The IRS can require a bond that cannot exceed the amount of the tax when granting and extension of time for payment. [This answer is incorrect. The IRS can, as a condition to the granting of an extension of time for payment of any tax or deficiency, require a bond not exceeding twice the amount of the tax. The bond is not limited to the amount of the tax.]

Eligibility Requirements for Installment Payments of the Estate Tax under IRC Sec. 6166

When a decedent's estate includes an interest in a closely held business (the value of which exceeds 35% of the adjusted gross estate), the estate may elect to pay estate taxes attributable to such an interest by using the installment method. The installment payments can be spread over a period of up to 14 years, with interest only due the first four years and interest and principal due for the remainder of the deferral period. Furthermore, a reduced interest rate applies to the deferred taxes attributable to a specified amount of taxable business value.

Estates of Decedents Who Die after 1997

For estates of decedents who die after 1997, reduced and nondeductible interest rates apply to the deferred estate tax. A 2% rate applies to the deferred tax on the first $1 million in taxable value of the closely held business (i.e., the first $1 million in excess of the applicable exclusion amount). The $1 million is indexed to inflation in $10,000 increments and for 2009 has increased to $1.33 million. Thus in 2009, when the applicable exclusion amount is $3.5 million, the estate tax attributable to the value of the closely held business between $3.5 million and $4.83 million will be eligible for the 2% rate. The excess over the $1.33 million of tax deferral has an interest rate of 45% of the underpayment rate.

The value of the estate (including the closely held business) must exceed $3.5 million (i.e., the value sufficient to generate tax equal to $1,455,800 for 2009) before the 2% rate can be used. The 2% rate then will be applicable to the next $1.33 million of taxable closely held business value (for decedents dying in 2009), and 45% of the rate applicable to underpayments of tax will apply to the excess. Thus, $1.33 million of taxable value (or $598,500 in tax, which is the tentative tax on $4.83 million reduced by the $1,455,800 applicable credit amount) is the maximum amount eligible for the 2% interest rate.

Requirements for the Section 6166 Election

To qualify for the Section 6166 election, the following conditions must be met:

1. The decedent must have been a U.S. citizen or resident at the time of his or her death.

2. The decedent's business must have been a sole proprietorship or an interest in a partnership or corporation that meets certain closely held ownership requirements.

3. The closely held business must be an active trade or business.

4. The value of the closely held business interest must be more than 35% of the decedent's adjusted gross estate.

Interest in a Closely Held Business

Unlike the Section 303 redemption provisions that can apply to an interest in any corporation regardless of how the ownership interests are dispersed, the Section 6166 provisions apply only to closely held business interests. For this purpose, a closely held business interest (as determined immediately before the decedent's death) is—

1. An interest as a proprietor in a proprietorship carrying on a trade or business.

2. An interest as a partner in a partnership carrying on a trade or business if—

   a. 20% or more of the total capital interest of the partnership is included in the gross estate, or

   b. the partnership has 45 or fewer partners.

3. Stock in a corporation carrying on a trade or business if—

   a. 20% or more in value of the voting stock of such corporation is included in the gross estate, or

b. such corporation has 45 or fewer shareholders.

Although a limited liability company (LLC) is not specifically included within this definition, an interest in such an entity can presumably qualify as a closely held business interest because, for federal income tax purposes, an LLC is treated as a partnership or corporation. An interest in a joint venture operating a trade or business should also qualify, since it is treated as a partnership for federal income tax purposes.

Identifying a Closely Held Business. The definition of a closely held business interest is easy to apply to sole proprietorships, since any sole proprietorship will qualify as long as it involves an active trade or business. With respect to interests in partnerships and corporations, however, determining whether an entity is closely held is more complicated.

An interest in a partnership or corporation that operates an active trade or business qualifies as closely held when (1) it has 45 or fewer owners, or (2) at least 20% of the value of its capital interest or voting stock, as the case may be, is included in the decedent's estate. Thus, if no more than 45 shareholders or partners exist, the size of the decedent's interest in the business is immaterial for determining whether the business is closely held. When determining the number of owners, the following attribution rules apply:

1. An interest owned by a husband and wife is considered held by one owner if the interest is held as community property (or the income from the interest is community property), joint tenants, tenants by the entirety, or tenants in common.

2. Stock and partnership interests owned by the decedent's brothers, sisters, spouse, ancestors, or lineal descendants are deemed to be owned by the decedent.

3. Stock or a partnership interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for the entity's shareholders, partners, or present-interest beneficiaries, rather than by the entity itself.

The IRS has ruled that these attribution rules apply only for purposes of determining whether the 45-or-fewer-partners-or-shareholders rule has been met. This means they do not apply for purposes of meeting the 20% or 35% tests, or determining the amount of estate tax eligible for installment payment. However, they do apply for purposes of meeting the 20% ownership test if the election described in the following paragraph is made.

If a business has more than 45 owners, 20% of the value of its capital interests or voting stock must be included in the decedent's estate for the business to be considered closely held under IRC Sec. 6166. At the executor's election, both partnership capital interests and nonreadily tradable (i.e., not traded on a stock exchange or in an over-the-counter market) voting stock indirectly owned by the decedent under the attribution rules listed above can be used to satisfy the 20% requirement. However, the election is not without cost. The maximum deferral period of an electing estate is reduced from 14 years to nine years. Thus, the first principal payment on the deferred tax is payable when the estate return is due, rather than up to five years later, and the electing estate loses the reduced rate of 2%.

Example 2B-1 Satisfying the 20% of value test for determining closely held status.

Al Norvell died in 2009. At the time of his death, Al owned 1,600 shares of voting common and 220 shares of nonvoting preferred stock in Krum Foods, Inc. (KFI). The value of Al's common and preferred stock represents 16% and 22%, respectively, of his adjusted gross estate (i.e., the gross estate less funeral and administration expenses, debts, and uninsured losses).

KFI has more than 45 shareholders, although its stock is not publicly traded. One of these shareholders is Al's brother, Tim, who also owns 1,600 shares of KFI common stock. However, Tim does not own any preferred stock in KFI.

Al's executor wants to defer payment of the estate tax attributable to Al's interest in KFI. However, Al's KFI stock does not qualify as a closely held business interest because KFI has more than 45 shareholders, and Al owns less than 20% of the value of its voting stock.

To qualify KFI as a closely held business interest, Al's executor elects to treat Tim's KFI voting stock as owned by Al for determining whether his gross estate includes at least 20% of the value of the voting stock. As a result of this election, the estate tax attributable to Al's KFI stock qualifies for deferral, but only for a deferral period of nine years or less. In addition, because of the election, none of the interest the estate owes on the deferred taxes is eligible for the special reduced interest rate.

Active Trade or Business Requirement

Although Section 6166 treatment requires only that the proprietorship, partnership, or corporation carry on a trade or business, the IRS's position is that the trade or business must be active. To qualify for Section 6166 treatment, the decedent must have conducted an active trade or business or held interests in a partnership, LLC, or corporation that carries on an active trade or business, rather than "the mere management of passive investment assets."

Investment or Rental Activities. Rev. Rul. 2006-34 provides various safe harbors and a list of factors that may be used to help determine whether an owner's activities as to certain real property are sufficiently active to qualify for the Section 6166 active trade or business requirement. The ruling clarifies that the activities of agents and employees of the decedent (or the partnership, LLC, or corporation held by the decedent) can be taken into account when determining whether or not the trade or business is active. Furthermore, the ruling indicates that activities conducted by independent contractors will not prevent the business from qualifying, as long as these activities are not of such a nature that the activities of the decedent, partnership, LLC, or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property. Ltr. Rul. 200842012 illustrates how the IRS uses Rev. Rul. 2006—34 to determine whether a rental business is an active business.

Some of the factors (the list is not all-inclusive) to be considered when determining eligibility for Section 6166 treatment are—

1. The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;

2. Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;

3. The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;

4. The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

5. The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

6. The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.

Example 2B-2 Qualifying as a trade or business due to decedent's level of activity.

Al owned several small apartment complexes at the time of his death. He and several of his employees handled the day-to-day operation, management, and maintenance of the properties. They were responsible for negotiating and executing leases, collecting and crediting rental payments, paying property taxes, in addition to repairing and maintaining the properties. When he or an employee was unable to perform a repair, he personally selected a third-party independent contractor and approved the work performed.

Al's activities went beyond those of a mere investor collecting profits from a passive asset. His use of the contractors does not prevent his activities from qualifying as an active trade or business. Thus, Al's ownership of the properties qualifies as an interest in a closely held business for purposes of IRC Sec. 6166.

Example 2B-3 Failure to qualify as a trade or business due to level of activity.

At the time of John's death, he owned a small office plaza titled in his name. The plaza consisted of a cluster of buildings, each of which had multiple tenants. Rather than managing the details of the property management himself, John hired the Reliable Property Management Company (RPM) to lease, manage, and maintain the buildings. John had no ownership interest in RPM. In addition to providing a monthly accounting statement to John, the employees of RPM were responsible for advertising the property, showing the property, negotiating and administering leases, collecting the monthly rent and arranging for all necessary repair and maintenance services.

In determining whether John, as a sole proprietor, carried on an active trade or business with respect to his interest in the office plaza, the activities of RPM and its relationship to John are taken into account. Since John had no ownership of RPM and lacked any significant participation in oversight of the property, and since RPM and its employees provided all necessary services for the property, John was not considered active in a trade or business. Therefore, the interest in the office park does not qualify as an interest in a closely held business for purposes of IRC Sec. 6166.

Example 2B-4 Qualifying as a trade or business due to level of activity of company in which decedent owned significant interest.

Assume the same facts as Example 2B-3, except that John owned 20% of the RPM stock. Since RPM actively managed the office plaza, and because John owned a significant interest in RPM, the activities of RPM with regard to the property allow John's interest in the office plaza to qualify as an interest in a closely held business for purposes of IRC Sec. 6166.

Example 2B-5 Determining whether the level of activity in a partnership qualifies as a trade or business.

Christy died on April 1, 2009. At the time of death, her assets included a one percent general partner interest and a 20% limited partnership interest in a limited partnership. The limited partnership owned three strip malls that, collectively, made up 85% of the value of the limited partnership's assets. The partnership agreement required Christy, as the general partner, to provide the limited partnership with all services necessary to operate the limited partnership's business. Christy received an annual salary from the limited partnership for her services. Christy (either personally or with the assistance of employees or agents) performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing, and approving the work of third-party independent contractors for such work), and making decisions regarding renovations of the three strip malls.

Determining whether the limited partnership was carrying on a trade or business for purposes of IRC Sec. 6166 is made with reference to the partnership's activities. Because the limited partnership, rather than Christy, owned the interest in the strip malls, the nature and level of the activities of the limited partnership must be evaluated. The limited partnership handled the day-to-day operations and management of the strip malls. The activities of Christy, on behalf of the limited partnership, included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing, and approving the work of third-party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. Thus, the limited partnership carried on an active trade or business, and Christy's interest in the limited partnership qualifies as an interest in a closely held business for purposes of IRC Sec. 6166.

<u>Oil and Gas Interests.</u> A working interest in an oil and gas property qualifies as a trade or business under IRC Sec. 6166. Royalty interests are not considered to be an active trade or business and generally do not qualify. However, when the decedent owned both working interests and royalty interests in oil and gas properties, the royalty interests are included as part of the trade or business for purposes of meeting the 35% test.

Stock in a Holding Company. For purposes of the trade or business requirement, an executor can elect to treat voting stock in a holding company as stock in a corporation carrying on a trade or business to the extent such holding company stock represents direct (or indirect through one or more additional holding companies) ownership in an active company voting stock. To qualify for this provision, neither the holding company's nor the subsidiary's voting stock can be traded on a stock exchange or in an over-the-counter market. If the election is made, the estate's maximum deferral period under IRC Sec. 6166 is reduced from 14 years to nine years, and the first principal payment on the deferred tax is payable when the estate return is due, rather than up to five years later. In addition, an electing estate loses use of the reduced 2% interest rate.

However, the election can also be made when only the stock of a holding company (and not that of its operating subsidiaries) is non-readily tradable. In that case, the maximum deferral period is reduced from 14 years to 4 years and the first principal payment on the deferred tax is payable when the estate tax return is due. Also, the reduced 2% interest rate is not available.

Example 2B-6 Using holding company stock to qualify for an estate tax deferral.

At his death, Bill Waite owned 100% of the outstanding stock of Multi Holdings, Inc. (Multi). The stock represents almost 80% of the value of his adjusted gross estate. Multi's only asset is a wholly owned subsidiary, Flanders, Inc., which operates a manufacturing business.

Although Multi does not qualify as a trade or business, Bill's executor can elect to treat the Multi stock as if it were stock in Flanders. If so elected, the Multi stock would qualify as stock in a corporation carrying on a trade or business, and Bill's estate could defer the estate taxes attributable to the Multi stock. However, the election reduces the maximum deferral period from 14 years to nine years, and the estate loses the benefit of the special 2% interest rate (i.e., interest is calculated based on 45% of the applicable federal underpayment rate).

Qualifying Lending and Finance Business. Stock in a qualifying lending and finance business is treated as stock in an active trade or business company. However, estates holding stock in qualifying lending and finance businesses must make the required payments (including principal and interest) over five years instead of ten years. A qualifying lending and finance business is one for which:

1. There was substantial activity in the lending and finance business, based on all the facts and circumstances immediately before the decedent's death; or

2. During at least three of the five tax years ending before the date of the decedent's death, the business had at least (a) one full-time employee substantially all of whose services were in the active management of the business, (b) 10 full-time, non-owner employees substantially all of whose services were directly related to the business, and (c) $5 million in gross receipts from lending and finance business activities.

Farming Activities. If the decedent was engaged in the business of farming, such activities can satisfy the trade or business requirement. For example, the decedent was engaged in the business of farming where his income was based on farm production rather than a fixed rental, and he participated in important farming decisions (such as what crops to plant and how to use available farm subsidy programs). Conversely, the activities of a 96-year-old farmer who leased his land and gave away his livestock to his children (for their promise to pay all expenses but no rent), and did not participate in managing the farm after signing the lease, were not a trade or business.

Passing the 35% Test

The benefit of the Section 6166 estate tax deferral is available to the estate of a decedent who was either a citizen or a resident of the U.S. at death if more than 35% of the decedent's adjusted gross estate consists of an interest in a closely held business (i.e., the 35% test). A decedent's adjusted gross estate is the gross estate less deductions allowed under IRC Secs. 2053 and 2054 (e.g., funeral and administration expenses, mortgages, claims, and uninsured losses during administration of the estate).

Charitable bequests are not among the deductions allowed in computing the adjusted gross estate. As a result, the estate is more likely to pass the 35% test if the decedent made lifetime charitable pledges rather than charitable bequests at death. (Both reduce the taxable estate, but only pledges reduce the adjusted gross estate.) To be deductible under IRC Sec. 2053 (and in determining the adjusted gross estate), charitable pledges must be legally enforceable and outstanding at the time of death.

Gifts within Three Years of Death. Gifts made by the decedent within three years of death can affect the estate's ability to pass the 35% test. Normally, the estate must satisfy the test both with and without including such gifts in the adjusted gross estate (and, if applicable, in the value of the business interest included in the gross estate). However, gifts for which a gift tax return was not required (e.g., gifts less than the annual exclusion) are ignored for purposes of this rule unless (1) the gift involved was a life insurance policy, or (2) a gift tax return was not required because of the unlimited marital deduction.

The value to be included in the adjusted gross estate, for purposes of determining whether the 35% test is met, is the fair market value upon the date of the decedent's death or the alternate valuation date (which is six months after the date of death). The three-year rule prevents a decedent from making deathbed transfers in an attempt to reduce his adjusted gross estate to satisfy the 35% test.

Example 2B-7 Gifts within three years of death cause estate to fail the 35% test.

At his death, Billy Owen owned $2 million of stock in a closely held business. The value of his adjusted gross estate (excluding gifts made within three years of his death) is $5 million. In the three years prior to his death, Billy made three cash gifts totalling $400,000, $450,000, and $9,000, respectively, to different individuals.

At first, it appears Billy's estate satisfies the 35% test because the value of the closely held business is more than 35% of the actual adjusted gross estate, excluding gifts made within three years of death ($2 million ÷ $5 million = 40%). However, when taxable gifts are included, the estate fails the 35% test ($2 million ÷ $5.85 million = 34.2%). Note the $9,000 gift is ignored because it did not exceed the $13,000 (for 2009) per donee annual exclusion.

Example 2B-8 Estate passes the 35% test.

Assume the same facts as in Example 2B-7 except that the taxable gifts consisted of stock in Billy's closely held business. In that case, the value of the closely held business interest compared to the value of the adjusted gross estate exceeds 35% both with and without gifts made within three years of death ($2 million ÷ $5 million = 40%, and $2.85 million ÷ $5.85 million = 48.7%). Thus, Billy's estate passes the 35% test and is eligible for deferral of the tax attributable to the business.

Amount of Estate Tax Eligible for Section 6166 Installment Payments

Estate Tax Deferral

Section 6166 treatment generally does not allow all of the estate tax to be deferred. A Section 6166 deferral is available only for the portion of the estate tax relating to a closely held business interest. It is also available for any generation-skipping transfer tax that arises because the interest is the subject of a direct skip occurring at the same time as, and as a result of, the decedent's death.

To determine the amount of estate tax that can be deferred and paid in installments under IRC Sec. 6166, the total estate tax (reduced by available credits) is multiplied by a fraction equal to the value of the closely held business interest divided by the value of the adjusted gross estate. The amount of deferral can be calculated using the following formula:

$$\text{Net Estate Tax Due} \times \frac{\text{Value of Closely Held Business Interest}}{\text{Value of Adjusted Gross Estate}}$$

Unlike the 35% test, the value of gifts made by the decedent within three years of death is not included in the value of the adjusted gross estate unless such transfers are includable in the gross estate. Otherwise, however, the definitions of a closely held business interest and the adjusted gross estate are the same as for the 35% test.

Example 2C-1 Maximum estate tax eligible for deferral.

Bob Branch died on March 5, 2009. His estate includes a closely held partnership interest valued at $1.57 million. The value of the adjusted gross estate is $4 million. The estate owes estate tax (net of the applicable credit) of $225,000. Thus, the estate is eligible to defer up to $88,313 of estate tax under IRC Sec. 6166, calculated as follows:

$$\$225{,}000 \times \frac{\$1{,}570{,}000}{\$4{,}000{,}000} = \$88{,}313$$

Bob's executor elects to pay the $88,313 (plus interest) in 10 equal annual installments with the first installment due on December 1, 2014. The election is made by checking the "yes" box on line 3, Part 3 (Elections by the Executor), of the estate tax return. In addition, a notice of election should be attached to the return.

Payment of the remaining $136,687 ($225,000 − $88,313) of estate tax not eligible for deferral will be due on December 7, 2009, the due date of the estate tax return. (December 7, 2009, is the first business day after December 5, a Saturday.)

The phrase, "reduced by the credits against such tax," used in IRC Sec. 6166(a)(2) is not defined for calculating the net estate tax. Presumably, the phrase refers to the credits listed in IRC Secs. 2010 through 2014 (i.e., the applicable credit amount, the pre-1977 gift tax credit, the credit for tax on prior transfers, and the foreign death tax credit). However, the same phrase appeared in former IRC Sec. 6166A(b), and a regulation under this old Code provision defined the phrase to exclude the Section 2010 unified credit, without providing an explanation for the exclusion of the other credits.

Calculating Interest Due on Deferred Tax. The election to defer payment of the estate tax does not extend the payment of interest on the deferred tax. The interest is paid annually during the first five years on the date selected as the due date of the installment payment. After the first five years, the interest is payable annually with the installment payment. (Note, if the executor elects to defer the initial installment payment for a period shorter than five years, then interest only is due for the shorter period elected.)

Determining the Due Date and Amount of Each Payment. The five-year deferral with ten-year installment payment extension is commonly referred to as a "15-year extension." But since the first annual installment is due no later than the end of the fifth year after the regular due date and the remaining installments are due annually on the same date thereafter, the maximum extension period is actually only 14 years after the regular due date for payment. However, if the executor makes the election on behalf of a qualifying lending and finance business, all installment payments (including principal and interest) must be paid within five years.

The five-year deferral is not available when an executor elects to treat stock in a holding company as stock in a corporation carrying on a trade or business. When the stock in the holding company and its operating subsidiaries are non-readily tradable, the 10 annual installments begin when the estate tax return is due (i.e., a nine year deferral period). However, when only the stock in the holding company (and not that of its operating subsidiaries) is non-readily tradable, the tax must be paid in five annual installments that begin when the estate tax return is due (i.e., a four year deferral period).

Example 2C-2 Due dates for interest payments.

Assume the same facts as in Example 2C-1. Bob's executor elects to defer the initial installment payment for the full five-year period and pay the tax in equal installments for 10 years on December 1. The regular due date for payment of the entire estate tax would be December 7, 2009 (i.e., the due date of the estate tax return). However, since the executor selected December 1 of each year as the date of payment, the first annual payment of deferred tax will be due on December 1, 2014, which is the end of the fifth year after the regular due date for payment. This means the executor will make annual payments of interest only from December 1, 2010, through December 1, 2013.

Beginning on December 1, 2014, the executor will pay interest plus the $88,313 of estate tax eligible for deferral in 10 equal annual installments. The last installment will be due on December 1, 2023, which means that Bob's estate has benefited from a 14-year deferral of the estate tax (i.e., from December 2009 to December 2023).

Generally, interest will be charged on the balance of the deferred tax at 45% of the rate in effect for underpayments of tax. However, a special 2% interest rate applies to a portion of the deferred tax. The portion of the tax to which the special 2% rate applies is the lesser of—

1. $598,500 [the tentative tax on $4.83 million] reduced by the applicable credit amount ($1,455,800 for 2009) allowable under IRC Sec. 2010(a); or

2. the portion of the estate tax attributable to the closely held business.

For decedents who die in 2009, the value of the estate (including the closely held business) must exceed $3.5 million (i.e., the value sufficient to generate tax equal to $1,455,800) before the 2% rate can be used. The 2% rate will then be applicable to the tax on the next $1.33 million of taxable closely held business value, at which time the special 45% of the underpayment rate will apply to the tax on the excess. While the 2% interest rate remains constant throughout the payment period, the special 45% rate changes each quarter with the federal short-term rate resulting in varying interest rates throughout the payment period on the excess value. Thus, $1.33 million of taxable closely held business value (or $598,500 in tax) is the maximum amount eligible for the special 2% interest rate.

Example 2C-3 Determining the maximum amount eligible for the 2% interest rate.

Roger Ward died on January 12, 2009. His estate tax liability is $680,000, of which $600,000 is attributable to a closely held business. Roger's executor elects to defer payment of the portion of the estate tax attributable to the closely held business for five years and then pay the balance in equal annual installments for 10 years. [Thus, the $80,000 ($680,000 − $600,000) of the estate tax liability not deferred must be paid by the due date of the estate tax return.] Assuming the estate is entitled to the full applicable credit amount of $1,455,800, the maximum amount of tax eligible for the special 2% interest rate is $598,500, which equals the lesser of the tax attributable to the closely held business ($600,000) or tax on the first $1.33 million in taxable value ($598,500). Interest on the remaining deferred estate tax of $1,500 ($600,000 − $589,000) is calculated using 45% of the rate applicable to tax underpayments.

If the amount of estate tax deferred under IRC Sec. 6166(a) exceeds the amount eligible for the special 2% interest rate, the amount of each installment payment reduces the portion of the outstanding principal eligible for the 2% rate. The amount of this reduction is pro rata, computed by multiplying the 2% portion outstanding by the ratio that the 2% portion bears to the total tax outstanding.

Example 2C-4 Reducing tax eligible for the special rate by pro rata share of installment payment.

Assume the same facts as in Example 2C-3, which means the executor will make 10 equal installment payments of $60,000 plus interest. In determining the amount of outstanding tax eligible for the 2% rate each year, the amount eligible must be reduced by a pro rata share of each installment payment. Since only $598,500 of the tax qualified for the 2% rate, this amount must be reduced by $59,850 each year, the portion of each installment payment deemed attributable to the 2% portion of the tax outstanding [$60,000 × ($598,500 ÷ $600,000)]. Thus, only $538,650 of principal ($598,500 − $59,850) is eligible for the 2% rate after the first principal payment.

Deducting the Interest Paid

For decedents who die after 1997, the interest on deferred estate tax is not deductible for estate or income tax purposes. Interest paid by an estate on commercial loans incurred to pay federal estate taxes is a deductible administration expense when the loan avoids a significant estate asset's forced sale.

How to Make the Section 6166 Election to Pay the Estate Tax in Installments

Generally, if the election to pay the estate tax in installments is made when the estate tax return is filed, it will apply to the tax due on the return and any subsequent deficiency assessed by the IRS. If no election is made when the estate tax return is filed, an election can still be made to pay any deficiencies assessed by the IRS in installments.

Since IRC Sec. 6166 allows the estate to pay taxes attributed to the business over 14 years, the Service is concerned about the unsecured status of the Section 6166 payments once the 10-year general federal tax lien expires. While the IRS has the discretion to require a bond or lien before granting the Section 6166 election, the Tax Court ruled that a bond or lien should not arbitrarily be required in every case. The court held that the IRS abused its discretion by failing to diligently evaluate the facts before applying a bright line requirement for a bond or lien. In IRS Notice 2007-90, the Service provided guidance, until regulations are developed, concerning what factors would be considered when determining whether a bond or lien would be required. The current standard procedure is for an IRS estate tax attorney to use these guidelines when determining on a case-by-case basis whether to require a lien or bond. The IRS will contact the executor regarding specifics of furnishing a bond or electing the special lien.

According to IRS Notice 2007-90, the Service will make its determination concerning whether to require a bond or lien based on information in the estate tax return and attachments, information obtained by audit, information gained by studying the duration and stability of the business, the estate's ability to pay the taxes and interest, and the business's and estate's tax compliance history. These provisions will generally apply to estates that timely elect to pay taxes in installments and timely filed returns after November 13, 2007.

Electing on the Original Return

An estate elects to defer estate tax under IRC Sec. 6166 by checking the "yes" box on line 3, Part 3 (Elections by the Executor), of the estate tax return, and attaching a notice of election to the return. The notice of election should include the following information:

1. The decedent's name and social security number.
2. The amount of tax to be paid in installments.
3. The payment date of the first installment.
4. The number of annual installment payments.
5. The assets on the estate tax return that comprise the closely held business (including the schedule and item number where they are reported on the return).
6. A statement of the facts that demonstrate the estate is entitled to the deferral.

In the event the notice of election does not specify the amount of deferral, the period over which the tax will be paid, or the date of the first payment, the presumption is the maximum amount of tax eligible is deferred over a period of 10 years with the first payment due five years and nine months after the date of death.

The election must be made on a timely filed return, including extensions (or, if later, within six months of the return's original due date excluding extensions). Failure to make the election on a timely filed return, except for a deficiency, will result in a denial of the election. No substantial compliance or reasonable cause exception exists to extend the requirement to make the election on a timely filed return. If an estate tax deficiency is later assessed, the portion of the deficiency attributable to the closely held business interest is automatically prorated to all installments payable under the original election. Any portion of the deficiency allocated to an installment payment for which the due date has already passed is due upon notice and demand from the IRS. The balance of the deficiency prorated to installments not yet due is paid at the same time as, and as a part of, the remaining installments.

Electing after a Deficiency Notice Is Received

If an election is not made on a timely filed estate tax return, a Section 6166 election can still be made for the portion of any estate tax deficiency attributable to closely held business interests. (This assumes the estate otherwise qualifies to make the election based on estate tax values as finally determined or agreed to and the deficiency has not resulted from negligence, intentional disregard of rules, or fraud.) Such an election is made by filing a notice of election with the IRS at the location where the estate tax return was filed. The notice must be filed within 60 days after the IRS issues the deficiency notice and should contain the same information as required for an election made with the original return.

In addition, the notice of election should be accompanied by payment of any tax and interest for which the payment date has already passed, plus any unpaid tax and interest not attributable to the closely held business interest and not eligible for further extension under another provision of the Code.

Example 2D-1 Electing to defer estate tax assessed on a deficiency notice.

Susan Rieman died on March 23, 2007. Although her estate included an interest in a closely held business valued at more than 35% of the adjusted gross estate, Susan's executor did not elect Section 6166 treatment when the estate tax return was filed in December 2007.

After auditing the return, the IRS issued a deficiency notice on April 19, 2009, for $220,000 in additional tax, plus interest. Most of the deficiency (93%) related to an increase in the value of the closely held business, with the balance related to several minor items. The executor agreed with the amount of the assessment, but the funds necessary to pay the additional tax were not readily available.

The executor may elect Section 6166 treatment with respect to $204,600 (93% × $220,000) of the deficiency. To make a valid Section 6166 election, the executor should file a notice of election with the IRS office where the estate tax return was filed by June 18, 2009 (i.e., within 60 days after the deficiency notice is issued).

The notice should be accompanied by payment of the interest due, plus the $15,400 ($220,000 − $204,600) in tax not related to the closely held business interest [unless the estate qualifies for an extension of time to pay this portion of the tax due to reasonable cause under IRC Sec. 6161(b)(2). The executor may elect for the first installment payment to be due as late as five years and nine months after the date of death. Thus, none of the $204,600 of tax related to the closely held business is required to be paid at the time the notice of election is filed with the IRS.

Whether a Section 6166 election is made on the original return or after receiving a deficiency notice, the portion of the deficiency that may be deferred under IRC Sec. 6166 cannot exceed the amount of deficiency attributable to the closely held business interest. This amount is the difference between the tax, if any, that the executor previously elected to defer under IRC Sec. 6166 and the maximum amount the executor could have elected to defer after considering the adjustments that resulted in the deficiency.

Example 2D-2 Portion of deficiency attributable to a closely held business interest.

Willie King died on February 4, 2007. His estate includes an interest in a closely held business, the value of which equals 50% of his adjusted gross estate. Willie's executor filed the estate tax return on November 5, 2007, showing an estate tax due of $500,000. The executor paid $250,000 with the return and elected under IRC Sec. 6166 to pay the remaining $250,000 in 10 installments of $25,000 each, beginning on November 5, 2008.

Upon examining the return, the IRS determined the correct tax to be $1 million and the ratio of the value of the closely held business interest to the value of the adjusted gross estate to be 80% (rather than 50%). Thus, as shown in the following calculation, the entire deficiency relates to the closely held business interest.

Amount of tax Willie's executor could have elected to pay in installments (as determined upon audit): 80% × $1,000,000		(A)	$ 800,000
Less: Amount the executor actually elected to pay in installments		(B)	(250,000)
Difference		(C)	$ 550,000
Portion of deficiency attributable to closely held business interest:			
Lesser of (C)	$ 550,000		
or			
Amount of deficiency	$ 500,000		$ 500,000

A total of $750,000 is payable in installments ($250,000 originally elected plus $500,000 related to the deficiency), at a rate of $75,000 per installment. By the time the executor receives the deficiency notice in mid-2009, $275,000 of the estate tax liability has already been paid ($250,000 that was not deferred, plus one installment payment of $25,000). Based on the audit adjustments, however, $325,000 should have been paid by this point ($250,000 nondeferred tax plus one $75,000 installment). Thus, $50,000 ($325,000 − $275,000) is payable upon receipt of the deficiency notice, and the nine remaining installments are payable in the amount of $75,000 each.

If, after the audit adjustment, the executor has paid more than the amount due to date, the overpayment is applied to future unpaid installments. Only when the overpayment exceeds the balance due on all future installments is the estate allowed a refund.

Protective Election

If, at the time the estate return is filed, it is not clear whether the estate qualifies to make a Section 6166 election, the executor can make a protective Section 6166 election. A protective election becomes valid only if the estate qualifies for Section 6166 treatment at the time the estate tax values are finally determined (or agreed to following examination of the return). The election allows deferral of any estate tax related to a closely held business that remains unpaid at the time the election is activated. However, the election does not defer the original deadline for paying the estate tax (nine months after death); thus, to be useful, the protective election must be combined with a request to defer payment under another Code provision.

A protective election is made by filing a notice of election with a timely filed estate tax return and by checking the "yes" box on Part 3 (Elections by the Executor), line 3, of the return. Within 60 days of the date the estate tax values are finally determined (or agreed to following an examination of the return), a final notice of election must be filed with the IRS Center where the original return was filed.

Avoiding an Acceleration of the Deferred Payments

When an estate has made the election to defer the tax attributable to a closely held business, the IRS can terminate the election and accelerate the due date of unpaid installments in the following situations:

1. *Withdrawing Funds from or Disposing of a Closely Held Business Interest.* If a disposition of the closely held business interest or a withdrawal of money or other property from the business interest occurs and, in the aggregate, such dispositions and withdrawals equal or exceed 50% of the interest's value as shown on the estate tax return, the estate's ability to use Section 6166 treatment is revoked. Any unpaid tax is due upon notice and demand from the IRS. This provision does not apply to transfers by reason of the decedent's will (or applicable laws of descent and distribution) or by reason of a trust created by the decedent. Nor does it apply to a recapitalization under IRC Sec. 368(a)(1)(E), a Section 368(a)(1)(D) or (F) reorganization, certain tax-free spin-offs or split-ups, or, in most cases, a Section 303 redemption.

A Section 303 redemption of a decedent's stock avoids accelerating the deferred payments to the extent the redemption proceeds are used to pay federal estate taxes. The estate may use either of the following methods to determine the extent the redemption proceeds are used to pay federal estate taxes:

a. *Cumulative Method.* Cumulative Section 303 redemption proceeds do not exceed the cumulative federal estate tax (including nondeferred tax and interest related to the deferred tax) paid by the earlier of (1) the first installment due date after the redemption or (2) one year after the redemption.

b. *Redemption-by-redemption Method.* The Section 303 redemption is no more than the amount of federal estate tax (including nondeferred tax and interest) paid during the time period beginning on the date of the redemption and ending on the earlier of the next installment due date or the date one year after the redemption.

2. *Making a Delinquent Payment.* The unpaid portion of the tax payable in installments becomes payable on demand if the estate misses an interest or principal payment due date by more than six months. If a payment is no more than six months late, the Section 6166 installment agreement remains in place, but the estate loses the benefit of the special (i.e., 2%) interest rate for the late payment. In addition, a penalty is assessed against the estate equal to 5% of the late payment amount times the number of months (or fractions thereof) the payment is past due.

3. *Accumulating Income.* To the extent the estate has undistributed net income (UNI) for any tax year ending on or after the date the first Section 6166 principal payment is due, an amount equal to this UNI must be used to reduce the balance of unpaid installments. UNI is the estate's distributable net income for the year, less the following items:

   a. The portion of the estate's income for the year required to be distributed currently, plus any other amount properly paid, credited, or required to be distributed for the year.

   b. The estate's federal income tax liability for the year.

   c. The estate tax (and related interest) paid by the executor during the year (other than any amount paid by reason of this provision).

   The payment of undistributed income should be made by the estate's income tax return filing due date (including extensions).

4. *Failing to Maintain Sufficient Collateral.* To receive the benefits of a Section 6166 deferral, the executor may be required to furnish a bond securing payment of the deferred tax. In lieu of furnishing such a bond (and to avoid remaining personally liable for the tax), the executor can elect under IRC Sec. 6324A to provide the IRS with a lien on property with a value sufficient to secure payment. If the value of the collateral drops below the balance of unpaid Section 6166 installments, the IRS may request that additional property be made subject to the lien. Failure to respond to this request within 90 days causes the estate's Section 6166 deferral to terminate.

Options When Section 6166 Benefits Are Denied

An estate that elects Section 6166 treatment can assume the election has been approved unless notified by the IRS to the contrary. If an examination of the estate tax return later causes the IRS to believe the estate does not qualify, the IRS will offer an appeals conference before it makes its final decision.

The decision of the Appeals Office is considered the IRS's final determination. However, prior to this point, the estate can request that the matter be referred to the IRS National Office for technical advice on the grounds that a lack of uniformity exists as to the disposition of the issue, or that the issue is so unusual or complex as to warrant consideration by the National Office.

When the Appeals Office denies an extension request under IRC Sec. 6166 without determining whether the estate qualifies for the extension, the estate may request a determination of qualification from the Appeals Office. If the

Appeals Office does not respond within 180 days of the request, the estate may file a petition with the Tax Court for a determination of qualification. In addition, within 90 days after notice is mailed from the Appeals Office that the estate does not qualify for the extension, the estate can file a petition with the Tax Court for a determination of qualification.

The IRS issued Rev. Proc. 2005-33 detailing the requirements a fiduciary must meet before requesting a declaratory judgment from the Tax Court concerning a Section 6166 election. Before a fiduciary will be considered to have exhausted all administrative remedies, the fiduciary must—

1. timely file a Form 706 for the estate and attach an election to extend the time to pay pursuant to IRC Sec. 6166(a); and

2. request in writing a conference with the Appeals Office within 30 days after the mailing date of the preliminary determination letter and then fully participate in the conference.

Upon completion of these steps and after a reasonable time (approximately two months) for the Appeals Office to issue a final determination letter, the fiduciary can request a declaratory judgment from the Tax Court. If no election was initially made, the fiduciary can file a notice of election within 60 days after receiving the notice and demand for payment. If the election is denied in whole or in part, a preliminary determination letter will be issued. The fiduciary has 30 days to request the Appeals conference.

When a timely filed notice of election under IRC Sec. 6166 is denied, the estate may request in writing that the notice of election be treated as a timely filed general extension request under IRC Sec. 6161. This request must be made within a reasonable time after the Section 6166 election is rejected and should contain (or be supported by) the same information required for a normal Section 6161 request.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. When a decedent's estate includes an interest in a closely held business (the value of which exceeds 35% of the adjusted gross estate), the estate may elect to pay estate taxes attributable to such an interest by using which of the following methods?

    a. Cumulative method.

    b. Redemption-by-redemption method.

    c. Installment method.

15. Which of the following rules prevents a decedent from making deathbed transfers to reduce their adjusted gross estate?

    a. Attribution rule.

    b. Three-year rule.

16. Which of the following statements regarding interest in a closely held business is most accurate?

    a. An LLC can qualify as a closely held business under the Section 6166 provisions.

    b. An interest in a joint venture operating as a trade or business does not qualify as a closely held business.

    c. Stock in a corporation carrying on a trade if the corporation has 75 or fewer shareholders is considered a closely held business.

17. If no more than the maximum amount of shareholders or partners exists, the size of the decedent's interest in the business is immaterial for determining whether the business is closely held. However, when determining the number of owners, which of the following would be considered held by just one owner other than the decedent?

    a. Interest owned by a husband and wife.

    b. Stock and partnership interest owned by the decedent's brother.

    c. Stock owned indirectly by an estate.

18. In determining whether the activities of the decedent, partnership, LLC, or corporation constitute an active trade or business, the activities of agents and employees of the decedent, the partnership, LLC, or corporation are also taken into consideration. Which of the following scenarios does **not** qualify as a closely held business?

    a. Malcolm died on January 1, 2006. At the time of death, Malcolm owned a ten store strip mall titled in Malcolm's name. Malcolm personally handled the day—to—day operation, management, and maintenance of the strip mall. Malcolm also personally handled most repairs. When Malcolm was unable to personally perform a repair, Malcolm hired a third party independent contractor. Malcolm selected the contractor and reviewed and approved the work performed.

    b. Shasta owned several small apartment complexes at the time of her death. She and several of her employees handled the day-to-day operation, management, and maintenance of the properties. They were responsible for negotiating and executing leases, collecting and crediting rental payments, paying property taxes, in addition to repairing and maintaining the properties. When she or an employee was unable to perform a repair, she personally selected a third-party independent contractor and approved the work performed.

c. At the time of Audrey's death, she owned a small office plaza titled in her name. The plaza consisted of a cluster of buildings, each of which had multiple tenants. Rather than managing the details of the property management herself, Audrey hired Ready in a Crisis Management Company (RIC) to lease, manage, and maintain the buildings. Audrey had no ownership interest in RIC. In addition to providing a monthly accounting statement to Audrey, the employees of RIC were responsible for advertising the property, showing the property, negotiating and administering leases, collecting the monthly rent and arranging for all necessary repair and maintenance services.

d. Natalie died on April 1, 2009. At the time of death, her assets included a one percent general partner interest and a 20% limited partnership interest in a limited partnership. The limited partnership owned three strip malls that, collectively, made up 85% of the value of the limited partnership's assets. The partnership agreement required Natalie, as the general partner, to provide the limited partnership with all services necessary to operate the limited partnership's business. Natalie received an annual salary from the limited partnership for her services. Natalie (either personally or with the assistance of employees or agents) performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing, and approving the work of third-party independent contractors for such work), and making decisions regarding renovations of the three strip malls.

19. Which of the following does **not** qualify as a trade or business under IRC Sec. 6166?

    a. Royalty interests.

    b. Voting stock in a holding company.

    c. Farming activities.

    d. Stock in finance business.

20. When calculating the portion of the estate tax eligible for Section 6166 installment payments, which of the following is most accurate?

    a. IRC Sec. 6166 allows the installment payment of the estate taxes if the value of the closey held business exceeds 25% of the gross estate.

    b. The amount of estate tax that can be paid in installments can be determined by dividing the value of the adjusted gross estate by the value of the business interest and multiplying by the net estate tax due.

    c. The Section 6166 deferral is available for a portion of estate tax that relates to the closely held business.

    d. Payment of interest on the estate tax is also deferred when the estate tax deferred.

21. When determining the due date and amount of each installment payment, which of the following statements is most accurate?

    a. The maximum extension of 14 years is commonly referred to as a 15-year extension.

    b. The estate executor is never liable for deferred taxes.

    c. An executor must use the five-year deferral if treating stock in a holding company as stock in a corporation carrying on a trade.

22. How is a Section 6166 election made for the portion of any estate tax deficiency attributable to closely held business interests after a deficiency notice is received?

    a. Filing a notice of election with the IRS at the location where the estate tax return was filed.

    b. Filing a notice of election with a timely filed estate tax return.

23. What does a protective election allow?

    a. The executor can collect tax from the beneficiary of any life insurance policy included in the gross estate but not payable to the estate.

    b. The executor can collect estate tax from the beneficiary of property included in the decedent's gross estate under a general power of appointment.

    c. Estate tax related to a closely held business that remains unpaid at the time the election is activated can be deferred.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. When a decedent's estate includes a closely held business interest with a value exceeding 35% of the adjusted gross estate, the estate may elect to pay estate taxes attributable to such an interest by using which of the following methods? **(Page 43)**

    a. Cumulative method. [This answer is incorrect. Under IRC Sec. 303, this method can be used by estates to determine the extent the redemption proceeds are used to pay federal taxes.]

    b. Redemption-by-redemption method. [This answer is incorrect. Under IRC Sec. 303, this method can be used by estates to determine the extent the redemption proceeds are used to pay federal taxes.]

    c. Installment method. [This answer is correct. The installment method can be used in the situation described above. The installment payments can be spread over a period of up to 14 years, with interest only due the first four years and interest and principal due for the remainder of the deferral period. Elegibility reqirements for installment payments are in IRC Sec. 6166.]

15. Which of the following rules prevents a decedent from making deathbed transfers to reduce their adjusted gross estate? **(Page 43)**

    a. Attribution rule. [This answer is incorrect. When identifying a closely held business, the IRS has ruled that the attribution rules apply only for purposes of determining whether the 45-or-fewer-partners-or-shareholders rule has been met.]

    b. Three-year rule. [This answer is correct. The value to be included in the adjusted gross estate, for purposes of determining whether the 35% test is met, is the fair market value upon the date of the decedent's death or the alternate valuation date (which is six months after the date of death). The three-year rule prevents a decedent from making deathbed transfers in an attempt to reduce his adjusted gross estate to satisfy the 35% test.]

16. Which of the following statements regarding interest in a closely held business is most accurate? **(Page 43)**

    a. An LLC can qualify as a closely held business under the Section 6166 provisions. [This answer is correct. Although a limited liability company (LLC) is not specifically included within this definition, an interest in such an entity can presumably qualify as a closely held business interest because, for federal income tax purposes, an LLC is treated as a partnership or corporation.]

    b. An interest in a joint venture operating as a trade or business does not qualify as a closely held business. [This answer is incorrect. An interest in a joint venture operating a trade or business should also qualify, since it is treated as a partnership for federal income tax purposes.]

    c. Stock in a corporation carrying on a trade if the corporation has 75 or fewer shareholders is considered a closely held business. [This answer is incorrect. According to the Code, closely held business interest (as determined immediately before the decedent's death) is stock in a corporation carrying on a trade or business if such corporation has 45 or fewer shareholders.]

17. If no more than the maximum amount of shareholders or partners exists, the size of the decedent's interest in the business is immaterial for determining whether the business is closely held. However, when determining the number of owners, which of the following would be considered held by just one owner other than the decedent. **(Page 43)**

    a. Interest owned by a husband and wife. [This answer is correct. According to the attribution rules, an interest owned by a husband and wife is considered held by one owner if the interest is held as community property (or the income from the interest is community property), joint tenants, tenants by the entirety, or tenants in common.]

b. Stock and partnership interest owned by the decedent's brother. [This answer is incorrect. According to the IRS, stock and partnership interests owned by the decedent's brothers, sisters, spouse, ancestors, or lineal descendants are deemed to be owned by the decedent.]

c. Stock owned indirectly by an estate. [This answer is incorrect. According to the IRS, stock or a partnership interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for the entity's shareholders, partners, or present-interest beneficiaries, rather than by the entity itself.]

18. In determining whether the activities of the decedent, partnership, LLC, or corporation constitute an active trade or business, the activities of agents and employees of the decedent, the partnership, LLC, or corporation are also taken into consideration. Which of the following scenarios does **not** qualify as an active trade or business? **(Page 43)**

a. Malcolm died on January 1, 2006. At the time of death, Malcolm owned a ten store strip mall titled in Malcolm's name. Malcolm personally handled the day—to—day operation, management, and maintenance of the strip mall. Malcolm also personally handled most repairs. When Malcolm was unable to personally perform a repair, Malcolm hired a third party independent contractor. Malcolm selected the contractor and reviewed and approved the work performed. [This answer is incorrect. Malcolm's activities went beyond those of a mere investor collecting profits from a passive asset. His use of the contractors does not prevent his activities from qualifying as an active trade or business. Thus, Malcolm's ownership of the properties qualifies as an interest in a closely held business for purposes of IRC Sec. 6166.]

b. Shasta owned several small apartment complexes at the time of her death. She and several of her employees handled the day-to-day operation, management, and maintenance of the properties. They were responsible for negotiating and executing leases, collecting and crediting rental payments, paying property taxes, in addition to repairing and maintaining the properties. When she or an employee was unable to perform a repair, she personally selected a third-party independent contractor and approved the work performed. [This answer is incorrect. Shasta's activities went beyond those of a mere investor collecting profits from a passive asset. Her use of the contractors does not prevent her activities from qualifying as an active trade or business. Thus, under Rev. Rul. 2006-34, Shasta's ownership of the properties qualifies as an interest in a closely held business for purposes of IRC Sec. 6166.]

c. At the time of Audrey's death, she owned a small office plaza titled in her name. The plaza consisted of a cluster of buildings, each of which had multiple tenants. Rather than managing the details of the property management herself, Audrey hired Ready in a Crisis Management Company (RIC) to lease, manage, and maintain the buildings. Audrey had no ownership interest in RIC. In addition to providing a monthly accounting statement to Audrey, the employees of RIC were responsible for advertising the property, showing the property, negotiating and administering leases, collecting the monthly rent and arranging for all necessary repair and maintenance services. [This answer is correct. In determining whether Audrey, as a sole proprietor, carried on an active trade or business with respect to her interest in the office plaza, the activities of RIC and its relationship to Audrey are taken into account. Since Audrey had no ownership of RIC and lacked any significant participation in oversight of the property, and since RIC and its employees provided all necessary services for the property, Audrey was not considered active in a trade or business. Therefore, under Rev. Rul. 2006-34, the interest in the office park does not qualify as an interest in a closely held business for purposes of IRC Sec. 6166.]

d. Natalie died on April 1, 2009. At the time of death, her assets included a one percent general partner interest and a 20% limited partnership interest in a limited partnership. The limited partnership owned three strip malls that, collectively, made up 85% of the value of the limited partnership's assets. The partnership agreement required Natalie, as the general partner, to provide the limited partnership with all services necessary to operate the limited partnership's business. Natalie received an annual salary from the limited partnership for her services. Natalie performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs and making decisions regarding renovations of the three strip malls. [This answer is incorrect. The activities of Natalie, on behalf of the limited partnership, included performing daily maintenance of and repairs to the strip malls collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. Thus, under Rev. Rul. 2006-34, the limited partnership carried on an active trade or business, and Natalie's interest in the limited partnership qualifies as an interest in a closely held business for purposes of IRC Sec. 6166.]

19. Which of the following does **not** qualify as a trade or business under IRC Sec. 6166? **(Page 43)**

    a. **Royalty interests. [This answer is correct. Royalty interests are not considered to be an active trade or business and generally do not qualify. A working interest in an oil and gas property qualifies as a trade or business under IRC Sec. 6166. There is an exception allowing royalty interests to be included as part of the trade of business. To qualify for the exception, the decedent must have owned both working interests and royalty interests in oil and gas properties, the royalty interests are included as part of the trade or business for purposes of meeting the 35% test.]**

    b. Voting stock in a holding company. [This answer is incorrect. To meet the trade or business requirement, an executor can elect to treat voting stock in a holding company as stock in a corporation carrying on a trade or business to the extent such holding company stock represents direct (or indirect through one or more additional holding companies) ownership in an active company voting stock.]

    c. Farming activities. [This answer is incorrect. Farming activities can satisfy the trade or business requirement for a decedent who was engaged in the business of farming.]

    d. Stock in finance business. [This answer is incorrect. Stock in a qualifying lending and finance business is treated as stock in an active trade or business company.]

20. When calculating the portion of the estate tax eligible for Section 6166 installment payments, which of the following is most accurate? **(Page 48)**

    a. IRC Sec. 6166 allows the installment payment of the estate taxes if the value of the closely held business exceeds 25% of the gross estate. [This answer is incorrect. The value must exceed 35% of the adjusted gross estate to qualify under IRC Sec. 6166.]

    b. The amount of estate tax that can be paid in installments can be determined by dividing the value of the adjusted gross estate by the value of the business interest and multiplying by the net estate tax due. [This answer is incorrect. To determine the amount of estate tax that can be deferred and paid in installments under IRC Sec. 6166, the total estate tax is multiplied by a fraction equal to the value of the closely held business interest divided by the value of the adjusted gross estate.]

    c. **The Section 6166 deferral is available for the portion of estate tax that relates to the closely held business. [This answer is correct. Section 6166 treatment generally does not allow all of the estate tax to be deferred. A Section 6166 deferral is available in the situation described above and for certain generation-skipping transfer tax.]**

    d. Payment of interest on the estate tax is also deferred when the estate tax deferred. [This answer is incorrect. The interest is paid annually during the first five years on the date selected as the due date of the installment payment.]

21. When determining the due date and amount of each installment payment, which of the following statements is most accurate? **(Page 48)**

    a. **The maximum extension of 14 years is commonly referred to as a 15-year extension. [This answer is correct. The five-year deferral with ten-year installment payment extension is commonly referred to as a "15-year extension." The maximum extension period is actually only 14 years after the regular due date for payment because the first annual installment is due no later than the end of the fifth year after the regular due date and the remaining installments are due annually on the same date thereafter.]**

    b. An executor must use the five-year deferral if treating stock in a holding company as stock in a corporation carrying on a trade. [This answer is incorrect. If this election is made, the estate's maximum deferral period under IRC Sec. 6166 is reduced from 14 years to nine years, and the first principle payment on the deferred tax is payable when the estate return is due, rather than up to five years later.]

c. Interest of 2% is charged on all deferred taxes. [This answer is incorrect. Generally, interest will be charged on the balance of the deferred tax at 45% of the rate in effect for underpayments of tax. However, a special 2% interest rate applies to a portion of the deferred tax.]

d. All installment payments on deferred tax are applied to outstanding principle. [This answer is incorrect. If the amount of estate tax deferred under IRC Sec. 6166(a) exceeds the amount eligible for the 2% interest rate, the amount of each installment payment reduces the portion of the outstanding principal eligible for the 2% rate.]

22. How is a Section 6166 election made for the portion of any estate tax deficiency attributable to closely held business interests after a deficiency notice is received? **(Page 51)**

a. Filing a notice of election with the IRS at the location where the estate tax return was filed. [This answer is correct. If an election is not made on a timely filed estate tax return, a Section 6166 election can still be made for the portion of any estate tax deficiency attributable to closely held business interests. Such an election is made by filing a notice of election with the IRS at the location where the estate tax return was filed. The notice must be filed within 60 days after the IRS issues the deficiency notice and should contain the same information as required for an election made with the original return.]

b. Filing a notice of election with a timely filed estate tax return. [This answer is incorrect. A protective Section 6166 election is made by filing a notice of election with a timely filed estate tax return and by checking the "yes" box on Part 3, line 3, of the return.]

23. What does a protective election allow? **(Page 51)**

a. The executor can collect tax from the beneficiary of any life insurance policy included in the gross estate but not payable to the estate. [This answer is incorrect. IRC Sec. 2206 allows the executor to collect this type of tax.]

b. The executor can collect estate tax from the beneficiary of property included in the decedent's gross estate under a general power of appointment. [This answer is incorrect. IRC Sec. 2207 allows the executor to collect this type of estate tax.]

c. Estate tax related to a closely held business that remains unpaid at the time the election is activated can be deferred. [This answer is correct. A protective election becomes valid only if the estate qualifies for Section 6166 treatment at the time the estate tax values are finally determined (or agreed to following examination of the return).]

The Extention of a Payment of Estate Tax Attributable to a Remainder Interest

Although a reversionary or remainder interest owned by the decedent at death is included in the gross estate, it is usually difficult to convert such an interest to cash in order to pay the related estate tax liability. To avoid a cash flow problem, the executor can elect to defer payment of estate tax related to a reversionary or remainder interest in property until six months after preceding interests in the property have terminated. The six-month period can be extended for up to three years if reasonable cause is shown. Interest accrues during the extension period at the regular underpayment rate established in IRC Sec. 6621(a)(2). There appears to be no recourse to the courts if the IRS denies the extension because the Tax Court has no jurisdiction when there is no deficiency. To appeal to the claims court or a federal district court, the entire tax must be paid. Various courts have held that once the tax is paid, the election is no longer available.

An election to defer the estate tax related to a reversionary or remainder interest must be made before the estate tax's normal due date (i.e., within nine months of the decedent's death). The election is made by checking the "yes" box on line 4, Part 3 (Elections by the Executor), of the estate tax return and filing a notice of election with the following:

For decedents domiciled in the U.S.:	Cincinnati Submission Processing Center Cincinnati, OH 45999

The notice of election should be accompanied by a certified copy of the will or other instrument under which the reversionary or remainder interest was created. However, if the instrument was never filed of record, a copy of the instrument as verified by the executor is acceptable. If the preceding interest is based on someone's life, the notice should include that person's date of birth.

Tax Attributable to Remainder or Reversionary Interest

The amount of tax attributable to the remainder or reversionary interest (i.e., the amount that may be deferred) is determined by multiplying the total estate tax by the ratio that the value of the remainder interest bears to the value of the gross estate. This calculation can be expressed in a formula as follows:

$$\frac{\text{Value of Remainder or Reversionary Interest}}{\text{Value of Gross Estate}} \times \text{Total Estate Tax}$$

When computing this ratio, the value of the remainder or reversionary interest is reduced by—

1. the amount of any claim, mortgage, or indebtedness that is a lien upon such property;

2. the amount of any unreimbursed losses related to such property that were incurred during the settlement of the estate;

3. the amount of any estate tax charitable deduction available with respect to such property; and

4. the portion of any marital deduction allowed as a result of transferring such property to the decedent's surviving spouse.

Likewise, the value of the gross estate (the denominator) is reduced by similar deductions attributable to property included in the gross estate.

Example 2E-1 Deferring estate tax attributable to a remainder interest.

Donald Greer gave his son, Jerry, the remainder interest in their family residence and retained the life estate. Jerry died unexpectedly in 2009. At the time of his death, Jerry had a gross estate valued at $4.5 million, including $200,000 representing the value of the remainder interest in the residence. Jerry's debts and expenses totaled $350,000, including a $75,000 mortgage against the family residence. Pursuant to Jerry's will, $200,000 was bequeathed to a qualified charity. The residue of his estate was divided equally among his three children. Therefore, Jerry's taxable estate is $3,950,000, and his total estate tax is $202,500 (after the applicable credit).

Since Jerry's estate included a remainder interest in the residence, the estate tax attributable to the residence can be deferred. The amount of tax that may be deferred is determined by multiplying the total estate tax ($427,500) by the ratio that the value of the remainder interest bears to the value of the gross estate. However, when determining the estate tax attributable to the remainder interest, the value of the remainder interest must be reduced by the $75,000 mortgage outstanding on the residence. The value of the gross estate must also be reduced by similar deductions attributable to items included in the gross estate (e.g., debts, expenses, and bequests to charity). The tax attributable to the remainder interest is calculated as follows:

$$\frac{\$200{,}000 - \$75{,}000}{\$4{,}500{,}000 - (\$350{,}000 + \$200{,}000)} \times \$202{,}500 = \$6{,}408$$

Thus, $6,408 of the total estate tax is attributable to the remainder interest and can be deferred up to six months after the death of the life beneficiary (i.e., Donald).

Redeeming Closely Held Stock for Paying the Estate Tax

If a significant portion of the decedent's estate consists of corporate stock, IRC Sec. 303 offers an opportunity to withdraw funds from the corporation on a tax-favored basis (i.e., usually at little or no estate or income tax cost). If all relevant requirements are met, amounts received from the corporation in redemption of its stock are treated as payment for the stock (i.e., eligible for capital gain treatment) instead of a dividend (with no basis offset). Because the basis of the estate's stock is "stepped up" to fair market value (FMV) at the decedent's death, the recognized capital gain is limited to the stock's appreciation in value after death. Thus, the redemption can be accomplished with little or no income tax effect.

Requirements for a Section 303 Redemption

The benefits of Section 303 are available regardless of the class of stock being redeemed. Thus, whether the decedent's stock was common or preferred, voting or nonvoting, the estate can qualify for redemption treatment if the following requirements are satisfied.

<u>Inclusion in Gross Estate.</u> Stock qualifies for Section 303 redemption treatment only when included in the decedent's gross estate for federal estate tax purposes. However, the actual stock redeemed need not have been owned by the decedent. Exchange treatment also applies to the redemption of stock received after the decedent's death if the basis of the stock is determined with reference to the basis of the stock held on the date of death (i.e., substituted basis).

Section 303 treatment can apply for a distribution in redemption of stock received (1) in connection with any other reorganization provision under IRC Sec. 368, (2) in a distribution or exchange under IRC Sec. 355 (or so much of IRC Sec. 356 as relates to IRC Sec. 355), (3) in a Section 1036 exchange of common stock for common stock or preferred stock for preferred stock (in the same corporation), or (4) in a distribution to which IRC Sec. 305(a) applies (i.e., a stock dividend). In addition, Section 306 stock (i.e., "tainted" preferred stock that normally triggers ordinary income upon disposition) can qualify for Section 303 redemption treatment.

Example 2F-1 Redeeming newly issued nonvoting stock.

Kubik Corporation (Kubik) has outstanding 1,000 shares of voting common stock owned 51% by the estate of Larry Pillar and 49% by Charlie Reed. Larry's wife and two children are the beneficiaries of the estate and are also active in Kubik management. The value of the estate's Kubik stock exceeds the amount required to qualify for Section 303 treatment. The estate wants to redeem a portion of its Kubik stock to pay death taxes. However, the Pillar family is concerned about losing control of the corporation (and about the resulting potential for management turnover) if any of the estate's stock is redeemed.

To maintain the relative voting power of the two shareholders and to preserve continuity of management, Kubik undertakes the following two-part transaction. First, 10 shares of a new class of nonvoting common stock are issued for each share of common stock outstanding. Immediately following this, Kubik redeems 1,860 shares of the nonvoting stock from the estate in return for cash. The redemption price equals the FMV of the newly issued shares, and the total distribution to the estate equals the death taxes due from the estate.

As a result of this two-part transaction, the estate receives the cash it needs, and the Pillar family retains control of Kubik. In addition, the redemption qualifies for Section 303 treatment. Thus, the estate should recognize little or no taxable gain on the transaction because the portion of its stepped-up basis in Kubik's voting stock that is allocated to the nonvoting stock should approximately equal the nonvoting stock's FMV.

A Section 303 redemption applies not only to situations where stock is redeemed directly from the decedent's estate, but also to redemptions of stock included in the estate but held at the time of the redemption by a person who acquired it from the decedent (e.g., as a surviving joint tenant or legatee). Section 303 treatment does not apply, however, to a redemption from a shareholder who acquired the stock by gift or purchase from the person to whom the stock passed from the decedent. Nor is Section 303 treatment applicable to a redemption from a shareholder who received the stock from the decedent's executor in satisfaction of a pecuniary (fixed-dollar) bequest.

Passing the 35% Test. To qualify for Section 303 redemption treatment, the value of the redeeming corporation's stock included in the decedent's estate must exceed 35% of the excess of the decedent's gross estate over amounts allowable (whether claimed or not) as deductions under IRC Secs. 2053 and 2054 (i.e., funeral and administration expenses, debts related to property included in the estate, and uninsured losses incurred during administration of the estate).

If the value of the estate for estate tax purposes is determined by using the IRC Sec. 2032 alternate valuation date, the value of the stock and the gross estate are determined on that date. All classes of a corporation's stock (whether common or preferred) are considered when determining whether an estate includes stock of the corporation of sufficient value to pass the 35% test.

Example 2F-2 Passing the 35% test for a Section 303 redemption.

At the time of his death, Cory's estate consisted of a 2% interest (valued at $1.3 million) in Coburn Enterprises, Inc. and various other assets having a combined FMV of $2.7 million. The estate incurred funeral and administration expenses of $50,000, and debts related to estate property equaled $350,000. Thus, Cory's estate satisfies the 35% test as follows:

Gross estate ($1.3 million + $2.7 million)	$ 4,000,000
Less: Section 2053 and 2054 deductions ($50,000 + $350,000)	(400,000)
Adjusted gross estate	$ 3,600,000

$$\$1,300,000 \div \$3,600,000 = 36\%$$

The focus of the 35% test is on the value of the decedent's corporate stock relative to the value of the decedent's entire estate. Thus, the percentage of the corporation the decedent actually owned is irrelevant.

Stock of two or more corporations can be used to satisfy the 35% test if the decedent's gross estate includes 20% or more of the value of each corporation. Thus, in the case of this special 20% test, the percentage of a corporation's value actually included in the estate is important (i.e., the decedent must own 20% or more of the value of the stock). In addition, for purposes of this special 20% test—but not for purposes of the 35% test—a surviving spouse's interest in stock held by the decedent and surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as included in the decedent's estate.

Example 2F-3 Passing the 35% test through ownership in multiple corporations.

Marcos and Rene Metz acquired a community property interest in three corporations during their marriage. The FMV of their interests in these corporations on the date of Rene's death is as follows:

	Combined Ownership % of Rene and Marcos	Value of Interest
Anderson, Inc.	50%	$ 1,735,000
Vaught Corp.	40%	1,840,000
Sibello, Inc. (an S Corp.)	20%	1,875,000
Total community property interest		$ 5,450,000
Rene's half interest		$ 2,725,000

The remaining value of Rene's gross estate, net of funeral and administration expenses and other deductions allowed under IRC Secs. 2053 and 2054, is $4,050,000. Thus, by combining its interest in the three corporations, Rene's estate qualifies for a Section 303 redemption [$2,725,000 ÷ ($2,725,000 + $4,050,000) = 40.2%].

Rene's 10% community property interest in Sibello, Inc. appears to be less than the 20% threshold needed to allow Rene's estate to count the interest toward satisfying the 35% test. However, the 20% requirement is met by combining Rene's 10% interest with the 10% community property interest of Marcos, her surviving spouse. In addition, for purposes of the 35% test (whether it is met with or without the special 20% provision), it does not matter that one or more of the corporations used to satisfy the test or make the redemption is an S corporation.

Special Three-year Rule. If the decedent owned stock in a corporation but transferred all ownership rights to the stock prior to death, the stock is not included in the decedent's estate. However, if the transfer occurred within three years of the decedent's death, the value (or ownership percentage) of the transferred stock is counted to determine whether the decedent's estate satisfies the 35% test (or the special 20% provision of the 35% test) for other stock owned at death. Thus, by counting the stock disposed of within three years of the decedent's death, an estate can qualify for a Section 303 redemption even though the stock it owns at the decedent's death represents less than 35% of the adjusted gross estate (i.e., the gross estate minus Section 2053 and 2054 deductions).

Determining Amount Eligible for Redemption

The amount of a corporate distribution eligible for Section 303 treatment is limited to the sum of—

1. death taxes (estate, inheritance, legacy, and succession taxes, plus any interest paid in connection with such taxes) imposed as a result of the decedent's death; and

2. funeral and administration expenses allowable (whether claimed or not) as a deduction against the gross estate.

Example 2F-4 Section 303 redemption treatment is limited to taxes and funeral and administration expenses.

The estate of Karen Kraftson owes $500,000 in death taxes and funeral and administration expenses. The bulk of Karen's estate consists of its ownership of 80% of the outstanding shares of Rudd, Inc. The remaining 20% is owned by Karen's daughter and sole beneficiary, Julie.

To provide needed estate liquidity, Rudd redeems $575,000 of its stock from Karen's estate. Of this total distribution, $75,000 ($575,000 – $500,000) will not qualify under IRC Sec. 303 because it exceeds the estate's total death taxes, funeral expenses, and administration expenses. Thus, unless the excess distribution qualifies for exchange treatment under IRC Sec. 302, it will be taxed to the estate as a dividend (to the extent of Rudd's undistributed earnings and profits). In contrast, the $500,000 portion of the distribution will likely produce little or no income tax effect to the estate. The estate's basis in the redeemed stock (which was stepped up to FMV at Karen's death) is allowed to offset the proceeds. The excess, if any, is taxed as capital gains.

Distributions made to a shareholder other than the estate qualify for Section 303 redemption treatment only to the extent the death taxes, funeral expenses, and administration expenses reduce the shareholder's inheritance directly, or the shareholder is otherwise liable for such expenses. In addition, distributions on stock held by the estate will not qualify for Section 303 treatment if, under the will, the stock passes to a beneficiary free of death expenses (e.g., a specific bequest of the stock to the children free and clear of all expenses, or to a marital deduction trust free and clear of all expenses). However, if stock passes as part of the residuary estate and the residuary estate bears the burden of death taxes and expenses, redemption from the estate before distribution to the residuary beneficiaries presumably will qualify for Section 303 treatment. The requirement that the shareholders' interest in the estate must be reduced by the death costs is often the toughest requirement in a Section 303 redemption.

Example 2F-5 Section 303 treatment not allowed.

The bulk of Carrie Craft's estate consists of its ownership of 85% of the outstanding shares of Craft, Inc. The shares of stock are specifically bequeathed to Carrie's only daughter, Kris. The residual beneficiaries are responsible for all death taxes, funeral expenses, and estate administration expenses.

Kris may not redeem the stock and receive Section 303 treatment because the stock passes to her free of death taxes and funeral and administration expenses.

If a generation-skipping transfer occurs as a result of a transfer of corporate stock at the decedent's death, the generation-skipping transfer taxes imposed on the transfer are considered death taxes for this purpose. Apparently, generation-skipping transfer taxes resulting from a direct skip, taxable distribution, or taxable termination occurring at death are treated as death taxes because IRC Sec. 303(d)(2) is not limited to transfers resulting from direct skips occurring at death. Thus, the amount of stock that may be redeemed is actually increased by taxes that are not a liability of the decedent's estate (i.e., taxes imposed on a taxable distribution or a taxable termination occurring at the decedent's death).

Example 2F-6 Benefiting from a Section 303 redemption even if no liquidity problem.

Assume the same facts as in Example 2F-4 except that the estate does not have a liquidity problem (i.e., the death taxes and administration expenses can be paid with other funds). Since control of Rudd, Inc. is not an issue (because Julie will eventually have 100% control regardless of how many shares the corporation redeems), the estate should consider redeeming $500,000 of its stock even though it does not have liquidity problems. This allows $500,000 to be pulled out of the corporation for Julie's benefit with little or no income tax cost, since it allows the estate taxes and expenses to be paid with corporate funds. The authors recommend that executors make every effort to utilize this opportunity to extract cash from a corporation because it may be the only opportunity to take significant money out of the corporation without having to take it as dividends (in which case there would be no basis offset).

Time Limitation

For a corporate distribution to qualify for Section 303 treatment, the distribution from the corporation normally must occur after the decedent's death and within three years and 90 days following the due date of the estate tax return. Thus, for a timely filed return, the redemption must occur within approximately four years of the decedent's death (or four and a half years if a six-month extension to file the estate tax return is obtained). Exceptions to this rule apply in the following situations:

1. If the estate tax return is filed on a delinquent basis, the deadline for making the distribution is three years and 90 days after the return is filed.

2. If a timely petition is filed in Tax Court for redetermination of an estate tax deficiency, the general deadline for making a Section 303 distribution is extended until 60 days after the Tax Court decision becomes final.

3. If a Section 6166 election has been made, a Section 303 distribution can be made as late as the due date of the final estate tax installment.

4. If the Section 303 redemption relates to stock involved in a generation-skipping transfer, the period in which to make Section 303 distributions is measured from the date of the generation-skipping transfer.

Regardless of which deadline applies, distributions made more than four years after the decedent's death only qualify for Section 303 treatment to the extent of the lesser of—

1. the death taxes, funeral expenses, and administration expenses that remain unpaid immediately before the distribution; or

2. the amount of such taxes and expenses actually paid during the one-year period beginning with the date of the distribution.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. When using the formula to calculate the amount of tax attributable to the remainder or reversionary interest, which of the following lists includes only amounts that the value of the remainder or reversionary interest is reduced by when computing the ratio?

    a. i. The amount of unreimbursed losses related to a property that were incurred during the settlement of the estate.

       ii. The amount of death costs.

    b. i. The amount of any estate tax charitable deduciton available with respect to a property.

       ii. The amount of any claim, indebtedness, or mortgage that is a lien upon such property.

    c. i. The portion of the marital deduction allowed if the property is transfered to the decedent's living spouse.

       ii. Any generation-skipping transfer tax.

25. Which of the following IRC Sections offers an opportunity to withdraw funds from the corporation on a tax-favored basis if a significant portion of the decedent's estate consists of corporate stock?

    a. IRC Sec. 303.

    b. IRC Sec. 1036.

    c. IRC Sec. 2204.

    d. IRC Sec. 6323.

26. At the time of her death, Lucy's estate consists of a 2% interest in Whammy! Inc. valued at $1.3 million and various other assets with a combined FMV of $2.7 million. Her estate incurs $50,000 of funeral and administration expenses, and debts related to estate property equal $350,000. Does Lucy's estate pass the 35% test?

    a. Yes.

    b. No.

27. When can a Section 303 distribution be made if a Section 6166 election has already been made?

    a. Three years and 90 days after the return is filed.

    b. Due date of the final estate tax installment.

    c. 60 days after the Tax Court decision becomes final.

    d. It is measured from the date of the generation-skipping transfer.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. When using the formula to calculate the amount of tax attributable to the remainder or reversionary interest, which of the following lists includes only amounts that the value of the remainder or reversionary interest is reduced by when computing the ratio? **(Page 64)**

    a. i. The amount of unreimbursed losses related to a property that were incurred during the settlement of the estate.

    ii. The amount of death costs. [This answer is incorrect. Although the amount of any unreimbursed losses related to such property that was incurred during the settlement of the estate is one amount the value of the remainder or reversionary interest is reduced by, the requirement that the shareholders' interest in the estate must be reduced by the death costs is part of the Section 303 redemption and has nothing to do with calculating the amount of remainder or reversionary interest.]

    b. i. The amount of any estate tax charitable deduciton available with respect to a property.

    ii. The amount of any claim, indebtedness, or mortgage that is a lien upon such property. [This answer is correct. Both i., and ii. are amounts the value of the remainder or reversionary interest are reduced by as part of this ratio.]

    c. i. The portion of the marital deduction allowed if the property is transfered to the decedent's living spouse.

    ii. Any generation-skipping transfer tax. [This answer is incorrect. Although the portion of any marital deduction allowed as a result of transferring such property to the decedent's living spouse is correct, generation-skipping transfer tax is not related to the formula described above (though it can qualify for Section 6166 treatment.)]

25. Which of the following IRC Sections offers an opportunity to withdraw funds from the corporation on a tax-favored basis if a significant portion of the decedent's estate consists of corporate stock? **(Page 65)**

    a. IRC Sec. 303. [This answer is correct. If a significant portion of the decedent's estate consists of corporate stock, IRC Sec. 303 offers an opportunity to withdraw funds from the corporation on a tax-favored basis (i.e., usually at little or no estate or income tax cost). If all relevant requirements are met, amounts received from the corporation in redemption of its stock are treated as payment for the stock (i.e., eligible for capital gain treatment) instead of a dividend (with no basis offset).]

    b. IRC Sec. 1036. [This answer is incorrect. IRC Sec. 1036 covers the exchange of common stock for common stock or preferred stock for preferred stock in the same corporation.]

    c. IRC Sec. 2204. [This answer is incorrect. The executor can request a discharge from personal liability for any additional estate tax by specifically asking for a discharge from personal liability and referring to IRC Sec. 2204.]

    d. IRC Sec. 6323. [This answer is incorrect. IRC Sec. 6323 describes certain lienholders that a general tax lien is not valid against.]

26. At the time of her death, Lucy's estate consists of a 2% interest in Whammy! Inc. valued at $1.3 million and various other assets with a combined FMV of $2.7 million. Her estate incurs $50,000 of funeral and administration expenses, and debts related to estate property equal $350,000. Does Lucy's estate pass the 35% test? **(Page 65)**

    a. Yes. [This answer is correct. The $400,000 of Section 2053 and 2054 deductions ($50,000 + $350,000) are subtracted from the $4 million in the gross estate ($1.3 million + $2.7 million), which equals $3,600,000. The percentage is determined by dividing the amount of the stock ($1,300,000)

by the adjusted gross estate ($3,600,000), which equals 36%. Therefore, the value of the stock exceeds 35%, so this estate passes the 35% test.]

b. No. [This answer is incorrect. The focus of the 35% test is on the value of the decedent's corporate stock relative to the value of the decedent's entire estate. Thus, the percentage of the corporation Lucy actually owned is irrelevant. Because the value of the stock is more than 35%, Lucy's estate passes the 35% test and qualifies for Section 303 redemption treatment.]

27. When can a Section 303 distribution be made if a Section 6166 election has already been made? **(Page 65)**

a. Three years and 90 days after the return is filed. [This answer is incorrect. If the estate tax return is filed on a delinquent basis, the deadline for making the Section 303 distribution is three years and 90 days after the return is filed.]

b. Due date of the final estate tax installment. [This answer is correct. If a Section 6166 election has been made, a Section 303 distribution can be made as late as the due date of the final estate tax installment.]

c. 60 days after the Tax Court decision becomes final. [This answer is incorrect. If a timely petition is filed in Tax Court for redetermination of an estate tax deficiency, the general deadline for making a Section 303 distribution is extended until 60 days after the Tax Court decision becomes final.]

d. It is measured from the date of the generation-skipping transfer. [This answer is incorrect. If the Section 303 redemption relates to stock involved in a generation-skipping transfer, the period in which to make Section 303 distributions is measured from the date of the generation-skipping transfer.]

Personal Liability of the Executor

The executor is responsible for paying the federal estate tax. This duty extends to the entire tax, even though the executor may not have control over all of the property included in the decedent's gross estate (i.e., nonprobate assets). The executor is also responsible for paying the decedent's income and/or gift tax.

If estate assets are insufficient to pay the decedent's estate, gift, or income taxes, the executor may be held personally liable when—

1. estate debts were paid or beneficiary distributions were made prior to paying the tax, and
2. the executor knew (or constructively knew) of the tax when estate assets were sufficient to pay the tax.

In a case where an estate was held liable for gift taxes, and the executrix (as surviving spouse) transferred all of her interest under a joint will with the decedent to a family trust, the court held that the executrix was personally liable for the gift taxes (plus interest) because she knew of the gift tax liability when the estate still had assets to pay the tax. There were insufficient assets to pay the gift tax after estate assets were transferred to the family trust.

The executor's personal liability is limited to the lesser of the value of the beneficiary distribution (or debt payment) or the estate tax liability plus interest.

Example 2G-1 Executor's personal liability for decedent's income tax.

Jim Mant did not pay his federal income taxes for 2005 and 2006. In February 2008, the IRS filed notices of federal tax liens against Jim's real estate property. Jim Mant died in June 2009 without having paid the $50,000 of federal income taxes and interest due for 2005 and 2006.

Jim's will designated Carl Tate as sole beneficiary and executor of the estate that primarily consisted of real estate valued at $500,000. A few months after Jim's death, Carl sold the real estate to a third party. Carl did not pay the federal income tax liability.

As executor, Carl is personally liable for the decedent's federal income tax liability of $15,000. Carl had constructive knowledge of the tax liability before the real estate was sold since the IRS previously filed federal tax liens. In addition, the sale of the real estate left insufficient estate assets to pay the tax liability.

The fact that the executor has personal liability means that the IRS can collect any unpaid taxes from the executor's personal assets, in addition to being able to collect from the assets of the estate. The personal liability exposure makes it imperative that the executor ensures all tax filings are complied with and the proper amount of tax is paid.

Request for Prompt Assessment

Because of the executor's personal liability, it is important to make certain all taxes are paid and the period for assessment has expired before making a final distribution of estate assets. Therefore, it is not unusual for an executor to withhold estate assets from ultimate distribution to protect against a later assessment. This conflicts with the beneficiary's desire to receive a final distribution of his or her interest from the estate. To help alleviate this process, the executor can request a prompt assessment of the decedent's tax liability. This applies not only to the decedent's final income tax return or gift tax return, but also to the fiduciary returns for the decedent's estate.

If this request is made, the government has only 18 months (rather than three years) within which to assess additional taxes or bring an action in court for such liability. In addition to protecting the executor, the shorter statute of limitations applies to the estate and its beneficiaries. The 18-month period begins on the date the IRS receives the request for prompt assessment. Such request is made by the executor by filing Form 4810 [Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)], which must be filed after the return is filed. The shortened limitations period does not apply if (1) no return was filed or (2) a fraudulent return has been filed, or (3) more than 25% of the gross income reported on an income tax return (or 25% of the total gift value reported on a gift tax return) has been omitted. Such request should be sent by registered mail or by certified mail, return receipt requested, to document proof of filing.

Although this request for prompt assessment does not apply to the estate tax, it does apply to any gift tax returns filed by or on behalf of the decedent.

Estate Taxes

The executor can also request a discharge from personal liability for any additional estate tax. The request must specifically ask for a discharge from personal liability and should refer to IRC Sec. 2204. This request may be filed before or after the estate tax return is filed. No specific IRS form exists for requesting a discharge from personal liability for estate tax. It is suggested that you send such requests by registered mail or by certified mail, return receipt requested, to document proof of delivery and to provide certainty as to when the statute of limitations has run.

A successor fiduciary (executor or trustee) may also request a discharge from personal liability for a decedent's estate tax. In addition, the following should be attached to the request: (1) a copy of the instrument providing for a successor fiduciary, (2) a description of the decedent's property transferred to the fiduciary, and (3) any information relevant to determining the fiduciary's tax liability.

Generally, the IRS must notify the executor of the amount of estate tax due within nine months of its receipt of the application. However, if the application is filed before the estate tax return is filed, the IRS has until nine months after receiving the estate tax return to notify the executor of the amount of tax due. Upon payment of the amount of tax specified in the notification from the IRS, the executor will receive notice of discharge from personal liability for payment of the tax. If the IRS fails to notify the executor of its determination of the tax due within nine months, the executor is discharged from personal liability for any future deficiency in the amount of tax due.

Similar to the release from liability under IRC Sec. 6905, the discharge of the executor's personal liability under IRC Sec. 2204 applies only to the executor's personal assets. The estate is not discharged with respect to any of its assets, and additional taxes can be collected from the undistributed assets or from assets that have been distributed to the beneficiaries that are still subject to tax liens.

Example 2G-2 Executor's request for discharge of personal liability.

Ron Wier was the executor for the Estate of Harold Raines. As executor, Ron filed the estate tax return, reflecting a $275,000 estate tax liability, and paid the tax on April 5. On May 12, Ron filed an application for a determination of estate tax payable and a discharge from personal liability for the tax.

On November 8, the IRS notified Ron that it had accepted the return as filed. Thus, Ron was discharged from personal responsibility for payment of the estate tax because the entire balance of the tax had previously been paid. (Note that if the Service had determined that the actual liability was $290,000, Ron's personal liability would have been discharged upon payment of the additional $15,000 in estate tax.)

The executor may also request to be discharged from personal liability for the amount of the tax for which payment has been extended under IRC Sec. 6161, 6163, or 6166. Generally, the IRS will respond within nine months of the receipt of the request (or nine months from the date the return is filed, if later) notifying the executor that he will be discharged from personal liability upon furnishing a bond in an amount not to exceed the amount of tax that has been extended.

The executor is discharged from personal liability upon furnishing the bond, or if no bond is required, upon receipt of the notice informing him that no bond is due. If the IRS does not respond within the requisite nine-month period, the executor's personal liability for the extended tax is discharged. This discharge relates only to the executor's personal assets and not to any estate assets currently in his or her possession or with respect to any assets received as a distribution from the estate.

If the executor wishes to further reduce exposure to fiduciary liability, there are other steps that should be considered. First, the executor should retain a sufficient cash reserve to cover any anticipated tax liability. Second, the executor should obtain an indemnification agreement from all the beneficiaries. Finally, the executor can resign as executor, in accordance with the requirements of state law and provide notice of withdrawal to the IRS. Form 56 may be used for the notification of termination. The exposure to liability is not reduced if notice is not given to the IRS.

Estate Tax Closing Letter

It is common for the IRS to issue closing letters with respect to estate tax returns. While this is a positive indication that no issues will be raised thereafter with respect to the return, the executor should be aware that it has no binding effect and the matter can be reopened by the IRS at any time before the expiration of the statute of limitations period. The general statute of limitations is three years from the filing of the return (or the due date of the return, if later). If there is an understatement of the gross estate that is 25% or more than the amount shown on the return, the statute of limitations does not expire until six years after the filing of the return.

Before completing distribution of the estate, the executor should take into account the ability of the IRS to reopen the matter. Although the executor can request a discharge of personal liability for additional estate taxes that may be assessed, he or she may wish to retain some assets to fund the possibility of a later assessment. In any event, the beneficiaries should be informed of the potential liability if the remaining estate assets are distributed.

The Basics of Estate Tax Liens and Transferee Liability

Estate tax liens and transferee liability exist to ensure that estate taxes are paid. In addition to a general tax lien, an automatic estate tax lien attaches to all property held in a decedent's estate. Special estate tax liens can replace the automatic estate tax lien in certain cases (e.g., when the executor elects to defer estate tax payments or to use special use valuation for certain assets). When the decedent's estate does not pay the estate tax liability, the heirs (transferees) may be liable for any unpaid estate tax, penalties, and interest.

General Tax Lien

When a taxpayer who is liable for estate, gift, or income tax fails to pay such tax, a general tax lien is imposed on the taxpayer's assets. The lien also covers penalties, interest, and other costs.

The general tax lien attaches when the tax is formally assessed and continues for ten years unless the statute of limitations period is suspended or extended.

A general tax lien is not valid against certain lienholders described in IRC Sec. 6323.

Automatic Estate Tax Lien

Although a decedent's estate is liable for any estate taxes due, an estate tax lien automatically attaches to the assets of the gross estate to ensure that estate taxes are paid. Such lien attaches to the estate assets for ten years beginning with the decedent's date of death.

An automatic estate tax lien is not valid against property used to pay estate or administration expenses that were allowed by a court that had jurisdiction over the estate. Also, such lien is not valid against a mechanic's lien or certain other types of liens and interests described in IRC Sec. 6323(c).

Lien for Estate Taxes Deferred under IRC Sec. 6166

When estate taxes are paid in installments under IRC Sec. 6166 and the executor seeks to be discharged from personal liability, the executor may elect to grant the IRS a special lien in lieu of the automatic estate tax lien that applies under IRC Sec. 6324(a)(1). (The special lien would also be in lieu of the bonds required by IRC Secs. 2204 and 6165.) The special lien must meet three statutory requirements: (1) the collateral (or substituted property) must survive the installment period and retain its value; (2) the property must be identified in a written agreement showing that all persons having an interest in the property have agreed to the creation of the special lien, and (3) the value of the property must be sufficient to pay the deferred taxes plus the required interest. The collateral can be real or other property including stock or other interests in a closely held business. If these requirements are met, a special lien arises and the collateral must be accepted by the Service.

Substitute property can include property that was not in the decedent's estate. Also, if the substitute property's value is less than the estate taxes and interest, the executor may post a partial bond for the difference.

The lien is effective on the date the executor is discharged from personal liability under IRC Sec. 2204 or, if earlier, the date the IRS filed notice that the payment of deferred estate taxes was accelerated. The lien continues until the estate taxes are paid or are unenforceable due to lapse of time.

This lien is not valid against certain liens on real property (e.g. real property tax liens, mechanic's liens, and security interests from financing agreements). However, it is valid against certain security interests created after the IRS filed notice that the payment of deferred estate taxes was accelerated.

Lien for Special Use Valuation Property

The automatic estate tax lien under IRC Sec. 6324(a) is replaced by a special estate tax lien on gross estate assets for which the executor elected special use valuation under IRC Sec. 2032A. This special lien also covers replacement property and exchange property.

However, a qualified heir that acquired an interest in special use valuation property can apply for a lien discharge by posting a bond or security in an amount that the Area Director determines will adequately cover the potential recapture tax liability on the heir's property interest.

The lien is created when the special use valuation election is made and continues until recapture tax is paid or is unenforceable due to lapse of time, or the IRS determines that recapture tax is no longer applicable.

This lien is not valid against certain liens on real property (e.g. real property tax liens, mechanic's liens, and security interests from financing agreements). However, it is valid against certain security interests created after the IRS filed notice that the payment of deferred estate taxes was accelerated.

Transferee Liability

The automatic estate tax lien under IRC Sec. 6324 follows the property to the transferees for 10 years after the decedent's death. Thus, the transferees have liability to the extent of the assets received, based upon the value as of the decedent's date of death. If the property subject to the lien was included in the gross estate under one or more of IRC Secs. 2034 through 2042, and such property is transferred to a bona fide purchaser or security interest holder, the lien generally will not attach to the subsequently transferred property but rather attaches to the other property of the transferee. However, if the property is included in the estate under IRC Sec. 2033, the lien will continue to attach to the property in the hands of the transferee. The lien attributable to Section 2033 property will be divested only if such property is used for the payment of charges against the estate and expenses of its administration allowed by a court of competent jurisdiction, or if the fiduciary has applied for a discharge from personal liability pursuant to IRC Sec. 2204 and the full amount of tax has been paid. Any property included in the gross estate for estate tax purposes (including nonprobate property) is subject to the liability, whether or not it is distributed to the executor. This means that life insurance proceeds paid directly to a beneficiary, property passing under joint tenancy with right of survivorship, and retirement plan benefits passing directly to a named beneficiary are subject to the lien.

The IRS can pursue recovery of the lien from a bona fide third-party purchaser, even if there are other persons more closely related to the estate (such as a fiduciary or beneficiary) against whom the IRS can also take enforcement action. The IRS is not required to seek recovery from the person that may have actually received a benefit from the estate, but is free to pursue transferees that receive assets that are subject to the estate tax lien.

Along with the unpaid estate tax, the IRS can collect interest. Interest begins to accrue from the date the tax should have been paid, not when the transferee receives the notice of deficiency or when the transferee received the assets.

Issues Related to Tax Apportionment

Eventually, all estate tax due must be paid. Several issues must be addressed:

1. Where will the estate obtain the cash to make the payments?

    a. Does the estate have sufficient cash to make the payments?

b. If assets need to be sold to raise sufficient cash, which assets should be sold?

c. Would borrowing cash be better than selling assets?

d. Are any of the payment methods discussed earlier in this course available?

2. Which beneficiary will have a bequest reduction to pay the tax?

Generally, state law (or the decedent's will) provides guidance about which portion of the estate (and, therefore, which beneficiary) bears the burden of the estate tax. Careful attention to these tax apportionment directives will help avoid litigation from a disgruntled beneficiary who feels his or her bequest was unfairly reduced by the tax.

Estate Bequests

There are three types of bequests in an estate administration: (1) specific, (2) general, and (3) residuary.

A *specific bequest* is a gift of a particular item of property that can be distinguished and identified from the other property in the estate. Often a decedent wants to leave a particular item of sentimental value to a beneficiary. Most specific bequests consist of jewelry, furniture, and other personal property; however, some specific bequests, such as real property land and stock, generate income. Cash is not a specific bequest. If a particular certificate of deposit (CD) was gifted under the will, then the gift would be a specific bequest since the beneficiary is entitled to that particular CD only. If the decedent had redeemed the CD, the beneficiary would not be entitled to any distribution from the estate.

A *general bequest* is a gift payable out of the general assets of the estate, but it is not a specific item. A pecuniary bequest meets the definition of a general bequest. The executor is able to satisfy a pecuniary bequest from any of the estate's assets, provided the fair market value of the assets distributed equals the amount of the pecuniary bequest. Any cash bequest would meet the definition of a general bequest, since the executor can sell assets to generate the funds needed.

A *residuary bequest* consists of the remainder of the estate once all of the specific and general bequests have been made. Under normal circumstances, the residuary bequest is the largest of the three types of bequests.

Payment of Debts, Expenses, and Taxes

Regardless of the type of bequest, all the assets of the estate are subject to the claims of creditors and administration. Certain debts and expenses are charged against principal while the majority of administration expenses is allocated between income and principal at the executor's discretion, generally based on a "just and equitable" test.

Although accounting income can be used to pay administration expenses, most state probate laws contain a prescribed abatement order when determining which assets are actually used to pay the estate's expenses and debts. Normally, the bequests are reduced in the following order:

1. property not disposed of by will, but passing by intestacy;

2. personal property of the residuary estate;

3. real property of the residuary estate;

4. general bequests of personal property;

5. general devises of real property;

6. specific bequests of personal property; and

7. specific devises of real property.

This results in the residuary beneficiaries losing their gifts first, the general beneficiaries losing their gifts second, and the specific beneficiaries losing their gifts last, if the expenses and debts are greater than the assets of the estate. If the claims against the estate are greater than the assets, the executor will pay the creditors prorata. The beneficiaries are not liable for the debts of the estate unless they are entitled to a specific devise of real property on which the creditor has elected to treat the debt as a preferred debt.

Example 2I-1 Payment of estate debts and expenses.

Bill's estate has assets of $250,000 and debts of $200,000. There are specific bequests of $10,000 (a piece of real estate) and general bequests of $75,000. The residuary beneficiary would not receive any distribution from the estate while the general beneficiaries would receive $40,000 only, with the specific devise of real property being made first.

Many states provide for the following three exceptions to the above-referenced abatement order:

1. The testator can provide for the payment of expenses and debts in the will, which will control over any provision in state law.
2. A secured creditor can elect to have his or her claim attached to the specific property as a preferred debt and lien. If the secured creditor makes this election, the debt follows the property. The executor may pay the debt regardless of the secured creditor's election if the executor determines that it is in the best interest of the estate to pay the debt.
3. The payment of estate tax is handled by a separate state law provision causing the allocation of estate tax to be controlled by that particular section.

Approaches to Tax Apportionment

Tax apportionment can be based on any (or a combination) of three different approaches: (1) apportion tax to the residuary estate; (2) apportion tax proportionate to the probate assets; and (3) apportion tax proportionate to the nonprobate assets. Many states have combined the second and third options requiring all assets, whether probate or nonprobate, to bear their proportionate share of any taxes (i.e., *pro rata apportionment*).

Generally, pro rata apportionment of estate tax divides the tax equally among all heirs. Under equitable apportionment, estate tax is apportioned only to heirs who receive taxable bequests (i.e., charitable and marital bequests would not bear the burden of any estate tax since these bequests represent deductions from the taxable estate).

The equitable apportionment method prevents some of the difficulties encountered when the other approaches are used. For example, when the residuary estate bears the entire burden of the estate tax, the residue is used to pay all expenses first. In many cases, the surviving spouse is the main beneficiary of the residuary estate. Since the spouse's bequest is used to pay all expenses, including taxes, the estate marital deduction is reduced resulting in greater estate tax. If tax is apportioned only proportionately to the probate assets, nonprobate assets may generate a large share of estate taxes; however, the executor only has access to probate assets. This causes the probate estate to shoulder a disproportionate share of the estate taxes.

Under this system, applicable to most states, unless the will specifically states otherwise, the executor pays any estate taxes only from bequests that create estate taxes. Bequests to the surviving spouse or a charity are not reduced to pay any of the taxes due. Beneficiaries are allocated taxes based on their proportionate share of the taxable estate. Further, the executor can collect estate taxes from any beneficiary whose bequest caused the tax, even if the bequest is not included in the probate estate. Thus, in the *Patrick* case, the court upheld a summary judgment that a decedent's will lacked a provision contrary to the general apportionment rule, so the proceeds of IRAs (nonprobate assets) were assessed to pay a proportionate share of estate tax.

Example 2I-2 Allocation of estate taxes.

Susan's estate owes estate tax of $225,000 on a taxable estate of $4 million. Her son, Edwin, received a bequest of $1,500,000. His bequest will be reduced by $84,375 [$225,000 × ($1,500,000/$4,000,000)] to pay his share of the estate tax.

Normally, state law provisions are default laws. The decedent has the power to designate which assets and bequests will be used to pay any debt, expense, or tax. When both a will and revocable trust comprise a single estate plan, the practitioner should read both documents together to determine whether state law or the documents control the payment of death taxes. State law, unless the will clearly negates its application, will be used to define what assets will bear the tax burden and the amount of that burden. If insufficient assets exist, state tax apportionment law will apply.

Internal Revenue Code Tax Apportionment and Recovery Provisions

In addition to state law provisions concerning the apportionment of taxes, the Internal Revenue Code (IRC) contains specific sections allowing the collection of tax from certain nonprobate assets in the gross estate. IRC Secs. 2206, 2207, 2207A, and 2207B give the executor a right to reimbursement for any federal estate tax caused by these nonprobate assets. This is a right of recovery only, which means that the executor must pay the tax bill and then seek recovery from the party referred to in the statute. All four sections allow the decedent to provide for a different payment system by will. For example, if the will specifically allocates the tax burden to nonprobate assets, then the person receiving such property will have a primary obligation to pay his or her share of the tax liability, as opposed to being subject to a right of recovery. Further, none of the IRC sections limit the IRS's ability to collect tax from any person or from any property. Also, the IRS does not have to apportion the tax among the beneficiaries.

IRC Sec. 2206 allows the executor to collect tax from the beneficiary of any life insurance policy included in the gross estate but not payable to the estate. Proceeds payable to surviving spouse, which qualify for the marital deduction, are not subject to collection. The estate tax attributable to the proceeds is the percentage of the estate tax that is the same percentage as the ratio of the proceeds to the total taxable estate.

IRC Sec. 2207 allows the executor to collect estate tax from the beneficiary of property included in the decedent's gross estate under a general power of appointment. If the property passes to surviving spouse, nothing can be collected. The executor may collect from the recipient the same proportion of the estate tax as the value of the property bears to the taxable estate.

IRC Sec. 2207A allows the executor to collect estate tax attributable to the inclusion of qualified terminable interest property (QTIP) in the decedent's estate. If someone received property for which a deduction from the gross estate was allowed and if no tax is attributable to that property, then there is no right of recovery from that person. Unlike life insurance and a general power of appointment, the executor can collect the excess of the actual estate tax paid over the tax that would have been payable if the QTIP had not been included in the gross estate.

IRC Sec. 2207B allows the executor to collect estate tax attributable to the inclusion of property subject to IRC Sec. 2036. No right of recovery is allowed against a charitable remainder trust. The estate tax attributable to the property is the percentage of the estate tax that is same percentage as the ratio of the property to the total taxable estate. If more than one person receives the property, the executor can collect against all parties.

Example 2I-3 Allocation of estate taxes to life insurance.

Howard died in 2009 with a taxable estate of $4 million. The estate includes $500,000 of insurance proceeds payable to Howard's son, Seth. Howard's estate tax is $225,000 (after all applicable credits). Howard's executor can collect $28,125 from Seth for his portion of the estate tax [($500,000/$4,000,000) = 12.5% × $225,000 = $28,125].

Example 2I-4 Allocation of estate taxes to QTIP property.

Andy left his wife, Val, $1 million in a QTIP trust. When Val died in 2009, the trust's value was $1,080,000. Val's taxable estate was $5 million and the estate tax was $675,000 (after all applicable credits). Val's executor can collect from the trust for its portion of the estate tax. This amount is the difference in estate tax calculated with and without the QTIP trust. The estate tax without the QTIP trust is $189,000. Therefore, Val's executor can collect $486,000 ($675,000 − $189,000) from the QTIP trust.

Reimbursement is allowed after all estate tax and administration expenses have been paid. One problem with these sections is the lack of an enforcement mechanism. While the sections give the executor the right to collect, they do not state exactly how the executor is to go about enforcing collection. Most states have apportionment statutes. These laws are similar in that they allow the executor to collect estate tax from nonprobate beneficiaries. Unlike the IRC provisions, these state laws generally give the executor power to sue in state court. Most commentators agree that state law can be used to enforce the IRC sections. If local law conflicts with federal law, at most, state law can relieve the executor of the duty to seek reimbursement, but it cannot prevent the executor from doing so.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Which of the following statements regarding an estate tax closing letter is most accurate?

    a. Once the taxpayer receives an estate closing letter, the taxpayer can consider the matter closed.

    b. The general statute of limitations is usually five years from the filing of the return.

    c. If there is an understatement of the gross estate that is 25% or more than the amount shown on the return, the statute of limitations does not expire until three years after the filing of the return.

    d. Closing letters are commonly issued by the IRS.

29. What happens to the automatic estate tax lien under IRC Sec. 6324 once the property is transferred?

    a. It follows the transferees for three years after the decedent's death.

    b. Based on the value as of the decedent's date of death, the transferees have liability to the extent of the assets received.

    c. The IRS will always pursue recovery of the lien from the persons who are more closely related to the estate.

    d. Interest for any unpaid estate tax begins to accrue when the transferee receives the note of deficiency.

30. Which of the following liens covers exchange property?

    a. Lien for special use valuation property.

    b. Lien for estate taxes deferred under IRC Sec. 6166.

    c. General tax lien.

    d. Automatic estate tax lien.

31. Which of the following statements regarding the lien for estate taxes deferred under IRC Sec. 6166 is most accurate?

    a. Substitute property cannot include property that was not in the decedent's estate.

    b. The executor can file an agreement to exchange a special lien for the automatic estate lien that applies under IRC Sec. 6324(a)(1) when estate taxes are paid in installments under IRC Sec. 6166.

    c. The lien is valid against certain liens on real property.

32. Which of the following bequests is the gift of whatever is left after specific gifts are given?

    a. Specific bequest.

    b. General bequest.

    c. Residuary bequest.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Which of the following statements regarding an estate tax closing letter is most accurate? **(Page 74)**

    a. Once the taxpayer receives an estate closing letter, the taxpayer can consider the matter closed. [This answer is incorrect. Although this is a positive indication that no issues will be raised thereafter with respect to the return, the executor should be aware that a closing letter has no binding effect and the matter can be reopened by the IRS at any time before the expiration of the statute of limitations.]

    b. The general statute of limitations is usually five years from the filing of the return. [This answer is incorrect. The general statute of limitations is three years from the filing of the return.]

    c. If there is an understatement of the gross estate that is 25% or more than the amount shown on the return, the statute of limitations does not expire until three years after the filing of the return. [This answer is incorrect. The understatement of the gross estate cannot be less than 25%; however, the statute of limitations does not expire until six years after the filing of the return.]

    d. Closing letters are commonly issued by the IRS. [This answer is correct. It is common for the IRS to issue closing letters with respect to estate tax returns.]

29. What happens to the automatic estate tax lien under IRC Sec. 6324 once the property is transferred? **(Page 76)**

    a. It follows the transferees for three years after the decedent's death. [This answer is incorrect. The automatic estate tax lien under IRC Sec. 6324 follows the property to the transferee for 10 years after the decedent's death.]

    b. Based on the value as of the decedent's date of death, the transferees have liability to the extent of the assets received. [This answer is correct. The transferees have the liability to the extent of the assets received, based on the value as of the decedent's date of death. If the property subject to the lien was included in the gross estate under one or more of the IRC Secs. 2034 through 2042, and such property is transferred to a bona fide purchaser, the lien generally will not attach to the subsequently transferred property but rather attaches to the other property of the transferee.]

    c. The IRS will always pursue recovery of the lien from the persons who are more closely related to the estate. [This answer is incorrect. The IRS can pursue recovery of the lien from a bona fide purchaser, even if there are other persons more closely related to the estate against whom the IRS can also take enforcement action.]

    d. Interest for any unpaid estate tax begins to accrue when the transferee receives the note of deficiency. [This answer is incorrect. Along with the unpaid estate tax, the IRS can collect interest. Interest begins to accrue from the date the tax should have been paid, not when the transferee receives the notice of deficiency or when the transferee received the assets.]

30. Which of the following liens covers exchange property? **(Page 76)**

    a. Lien for special use valuation property. [This answer is correct. The automatic estate lien under IRC Sec. 6324(a) is replace by a special estate tax lien on gross estates assets for which the executor elected special use valuation under IRC Sec. 2032A. This special lien also covers replacement property and exchange property.]

    b. Lien for estate taxes deferred under IRC Sec. 6166. [This answer is incorrect. When estate taxes are paid in installments under IRC Sec. 6166 and the executor seeks to be discharged from personal liability, the executor may elect to grant the IRS a special lien in lieu of the automatic estate tax lien that applies under IRC Sec. 6324(a)(1).]

c. General tax lien. [This answer is incorrect. When a taxpayer who is liable for estate, gift, or income tax fails to pay such tax, a general lien is imposed on the taxpayer's assets.]

d. Automatic estate tax lien. [This answer is incorrect. An estate tax lien automatically attaches to the assets of the gross estate to ensure that estate taxes are paid. However, exchange property is not covered under this lien.]

31. Which of the following statement regarding the lien for estate taxes deferred under IRC Sec. 6166 is most accurate? **(Page 76)**

a. Substitute property cannot include property that was not in the decedent's estate. [This answer is incorrect. In regards to a lien for estate taxes deferred under IRC Sec. 6166, substitute property can include property that was not in the decedent's estate. Also, if the substitute property's value is less than the estate taxes and interest, the executor may post a partial bond for the difference.]

b. The executor can elect to grant the IRS a special lien in lieu of the automatic estate lien that applies under IRC Sec. 6324(a)(1) when estate taxes are paid in installments under IRC Sec. 6166. [This answer is correct. When estate taxes are paid in installments under IRC Sec. 6166, the executor can elect to grant the IRS a special lien in lieu of the automatic estate tax lien that applies under IRC Sec. 6324(a)(1). The special lien must meet three statutory requirements: (1) the collateral (or substituted property) must survive the installment period and retain its value; (2) the property must be identified in a written agreement showing that all persons having an interest in the property have agreed to the creation of the special lien, and (3) the value of the property must be sufficient to pay the deferred taxes plus the required interest.]

c. The lien is valid against certain liens on real property. [This answer is incorrect. A lien for estate taxes deferred under IRC Sec. 6166 is not valid against certain liens on real property (e.g. real property tax liens, mechanic's liens, and security interests from financing agreements). However, it is valid against certain security interests created after the IRS filed notice that the payment of deferred estate taxes was accelerated.]

32. Which of the following bequests is the gift of whatever is left after specific gifts are given? **(Page 77)**

a. Specific bequest. [This answer is incorrect. A specific bequest is a gift of a particular item of property that can be distinguished and identified from the other property in the estate. Often a decedent wants to leave a particular item of sentimental value to a beneficiary.]

b. General bequest. [This answer is incorrect. A general bequest is a gift payable out of the general assets of the estate, but it is not a specific item.]

c. Residuary bequest. [This answer is correct. According to commonly used definitions, a residuary bequest consists of the remainder of the estate once all of the specific and general bequests have been made. Under normal circumstances, the residuary bequest is the largest of the three types of bequests.]

Failure to File Penalty

Penalty for Filing Late

When a taxpayer, including a trust or decedent's estate, does not file a required return by the due date (including extensions), IRC Sec. 6651(a)(1) imposes a penalty equal to 5% of the *net tax due* for each month or part thereof that the return is late, up to a maximum penalty of 25%. For income tax returns not filed within 60 days of the due date(including any extensions) the minimum failure to file penalty is the lesser of $135 or 100% of the net amount due.

For computation purposes, a *month* for a return required to be filed on the last day of a month is a calendar month. If the return must be filed on any day within a month, the period terminating on the corresponding day of the following calendar month is considered a month. A Saturday, Sunday, or holiday that would otherwise extend the filing date is disregarded for purposes of figuring the penalty. Thus, if an unextended Form 706 is due on March 15 but is not filed until June 25, the penalty is 5% per month for the three months from March 15 through June 15, plus an additional 5% for the fractional month of June 16 through June 25, for a total penalty of 20%.

The *net tax due* equals the tax required to be shown on the return reduced by (1) tax paid on or before the date prescribed for payment, and (2) any credit against the tax that can be claimed on the return. This means a taxpayer that has prepaid the entire amount of tax due (e.g., through estimated tax payments) can file late and avoid the penalty. On the other hand, a deficiency assessed after the return is filed is subject to the penalty.

The penalty can be avoided by timely filing a return, even if tax shown as due on the return cannot be paid (in which case, the failure to pay penalty applies. A taxpayer that files late and owes tax can be subject to both the failure to file and failure to pay penalties. When both penalties apply, they cannot exceed 5% per month or 47$^{1}/_{2}$% of the net tax shown on the return. The failure to pay penalty equals $^{1}/_{2}$ of 1% (0.5%) per month. For any month in which both penalties apply, the failure to file penalty is reduced by the amount of the failure to pay penalty. However, for income tax returns, the failure to pay penalty does not reduce the minimum failure to file penalty when both apply.

Both the failure to file and accuracy-related penalties can apply to the same return. However, the accuracy-related penalty only applies if the return is actually filed, and late filing will not be considered when determining if the accuracy-related penalty should be imposed.

Example 2J-1 Failure to file and failure to pay penalties apply.

Ted died on June 6, 2007. His estate tax return was due nine months later, on March 6, 2008, but was not filed until March 17, 2009. The tax was paid on March 17, 2009. Thus, the return and payment were thirteen months late (twelve months from March 6, 2007 to March 6, 2009 plus one month for the fractional month from March 6, 2009 to March 17, 2009). The failure to file penalty would be equal to 5 months × 5%, less the failure to pay penalty for the same period (0.5% × 5) = [(5 × 5%) − (0.5% × 5) = 25% − 2.5% = 22.5%]. The failure to pay penalty would be equal to 13 months × 0.5% = 6.5%. The total of the two penalties would be failure to file (22.5%) plus failure to pay (6.5%) = 29%.

If a return is at least five months late and payment of the tax is at least fifty months late, the two penalties will reach the maximum of 47$^{1}/_{2}$% of the tax shown due on the return, illustrated as follows:

Failure to file (5 × 5%)	25.0 %
Less: failure to pay (5 × 0.5%)	(2.5)%
	22.5 %
Add: failure to pay for 50 months (50 × 0.5%)	25.0 %
Maximum failure to file and failure to pay penalties on tax shown due on the return	47.5 %

Reasonable Cause for Waiving the Penalty

The penalty can be waived if reasonable cause (and not willful neglect) for the late filing can be shown. Unfortunately, neither the Code nor the regulations provide a specific definition or example of *reasonable cause*. The Code provides no guidance at all, and Reg. 301.6651-1(c)(1) says only that reasonable cause exists if the taxpayer was unable to file on time even though ordinary business care and prudence was exercised. The former *Estate Tax Examiner's Handbook* lists the following as examples, as modified by the authors for Service structural changes, of reasonable cause:

1. Return mailed in time to reach the IRS Center or Area Director's office in the normal course of the mail within the prescribed period, but through no fault of the tax payer, was not delivered in accordance with normal mail handling.

2. Timely mailed return that was sent to the wrong IRS Center.

3. Reliance on erroneous oral or written IRS advice. Note the taxpayer cannot have contributed to the IRS's error by giving the IRS inadequate or inaccurate information.

4. Death or serious illness of the taxpayer or a member of the taxpayer's family.

5. Unavoidable absence of the taxpayer or inability (for reasons beyond the taxpayer's control) to obtain necessary records.

6. Destruction of the taxpayer's business records or place of business by fire or other casualty.

7. Timely request to the IRS for the proper forms necessary to prepare the return and these were not furnished in sufficient time to permit the filing of the return by its due date.

8. Despite a timely visit to the IRS to obtain information or assistance on the return, the taxpayer, through no fault of his own, was unable to obtain the required assistance.

9. Reliance on the erroneous advice of a competent tax advisor or exercise of ordinary care and prudence in reaching the mistaken conclusion that the return was not required. (The taxpayer cannot use reliance on a tax advisor to prepare returns as reasonable cause—the duty to file is on the taxpayer.)

The Tax Court disagreed that the late filing of an estate tax return and the late payment of estate taxes were due to reasonable cause due to the preparer's disability. In *Landers*, the court noted that the co-administrators lacked ordinary business care and prudence in attempting to pay the tax timely and that an ordinary and reasonable person would have consulted another preparer.

The Tax Court also considered the standards of reasonable cause and willful neglect in defense of the late filing penalty in *Zlotowski*. The court cited the Supreme Court precedence that reliance on an attorney to take care of tax matters was not considered reasonable cause. Furthermore, the excuse of taxpayer's knowledge of a superseding will was not an adequate excuse for late filing. The estate had extended the deadline for filing, and as such, had ample time to file. The Section 6651(a)(1) penalty was upheld.

Use of Registered or Certified Mail or Private Delivery Services

Estates and trusts face two primary risks when mailing forms. The IRS could claim: (1) the form was received late, or (2) the form was never received at all. Fortunately, there is a simple way to reduce exposure to both risks.

IRC Sec. 7502 prescribes the rules for what is timely filing of tax returns and other tax documents (e.g., elections, appeals, protest letters, etc.). A return or other document is deemed to be timely if it is mailed and postmarked on or before the prescribed due date for filing. For this purpose, taxpayers can use either the U.S. Postal Service (USPS) or certain private delivery services (PDSs). Only PDSs designated by the IRS can be used for purposes of

IRC Sec. 7502(f). The IRS identified the following designated PDSs as approved for purposes of the timely-mailing-as-timely-filing rule:

1. DHL Express (DHL): DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Services.

2. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.

3. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

Designation under the IRS notice is effective until further notice, and the Service will only publish a new list of PDSs if there is a change (e.g., an addition or a deletion) in the list of designated PDSs.

When a PDS is used, the postmark date generally is deemed to be for (1) DHL or UPS—the date on which the PDS electronically records the item to its database; or (2) FedEx—the date shown on a package label generated by the PDS employee—or if there is no employee-generated label, the date shown on a label generated and applied by the customer, provided the item is delivered within normal delivery time. If FedEx applies a label to the cover of an item received for delivery through FedEx International Priority or FedEx International First, then the preceding rules apply for determining the postmark date. If FedEx records the date in its electronic database, the date so recorded is treated as the postmark date.

Controversy exists as to how IRC Sec. 7502 applies to returns and other tax documents mailed via the U.S. Postal Service (USPS). IRC Sec. 7502(c) states that registered mail and certified mail are prima facie (i.e., legally sufficient) evidence that the document was delivered. However, the appellate courts are split over how this rule impacts documents sent by regular mail. The 8th and 9th Circuits have ruled that the common-law *mailbox* rule applies to tax filings so that, if it can be proven that a properly addressed document bearing adequate postage was mailed, there is a rebuttable presumption that the IRS received it in due course. On the other hand, the 2nd and 6th Circuits have ruled that the *mailbox* rule does not apply and only documents mailed by either certified or registered mail carry the presumption that the IRS received them. Thus, in the 2nd and 6th Circuits, a return or other document sent regular mail is not deemed timely filed if the IRS has no record of receipt, even if the IRS or USPS loses it.

Fraudulent Failure to File

In the case of fraudulent failure to file, the penalty amount for each month is 15% of the net tax due, and the maximum penalty that can be assessed is 75% of the tax. Generally, the fraudulent failure to file penalty will be assessed against taxpayers who did not file in an attempt to evade tax.

Failure to Pay Penalty

Generally

When a taxpayer, including a trust or estate, does not pay tax shown as due on a return by the due date (including extensions of time for payment), IRC Sec. 6651(a)(2) imposes a penalty equal to 1/2 of 1% (0.5%) of the net tax due for each month or fraction thereof that the tax remains unpaid up to a maximum of 25%. Taxpayers cannot avoid liability for the penalty by extending the time for filing the return. The penalty will be assessed from the return's original due date, without regard to extensions of time to file, if the tax due is not paid with the extension.

For computation purposes, a *month* is defined the same as for failure to file purposes, and tax shown as due on a return is reduced by (1) tax paid on or before the beginning of the month and (2) any credit against the tax that can be claimed on the return, whether or not claimed.

Once an assessed deficiency is not paid within 21 calendar days (10 business days for deficiencies greater than $100,000) of the "notice and demand" for payment, a separate 0.5% failure to pay penalty applies for each month or fraction thereof that the deficiency remains unpaid. For computation purposes, the amount stated in the notice and demand is reduced by payments made before the beginning of the month.

Reasonable Cause for Waiving the Penalty

The failure to pay penalty does not apply if it can be shown that failure to pay the tax is due to reasonable cause and not willful neglect. Failure to pay will be considered due to reasonable cause if the taxpayer can show he was unable to pay the tax when due even though he exercised ordinary business care and prudence, or that undue hardship would have resulted from paying on the due date.

If both the failure to pay and the failure to file penalties apply to a taxpayer, the two penalties together cannot exceed 5% per month or 25% of the net tax shown on the return (unless the minimum failure to file penalty, applicable only to income tax returns, applies). However, the maximum of 25% applies to each penalty for periods that do not overlap (i.e., the two penalties combined can exceed 25% of the tax due when there are months for which only one penalty is assessed).

The Penalty for Taxpayer Accuracy

20% Penalty

IRC Sec. 6662 imposes a 20% taxpayer accuracy-related penalty on the portion of an underpayment that is attributable to one or more of the following:

1. Negligence or disregard of the rules or regulations.
2. Any substantial understatement of income tax.
3. Any substantial valuation misstatement under Chapter 1 (i.e., income taxes).
4. Any substantial overstatement of pension liabilities.
5. Any substantial estate or gift tax valuation understatement.

Only items 1, 3, and 5 will be addressed in this lesson as items 2 and 4 do not apply to estate, gift, or generation-skipping transfer tax returns.

The term *one or more* means that only one 20% penalty applies no matter how many categories of the penalty apply to the taxpayer (i.e., the categories cannot be stacked). Thus, if the taxpayer's gift tax valuation is substantially understated because of a valuation understatement resulting from negligence or disregard of the rules, only one 20% penalty applies. Furthermore, the accuracy-related penalty does not apply to any portion of an underpayment to which the Section 6663 75% civil fraud penalty applies.

Underpayment is defined as the amount by which the tax that should have been shown on the return exceeds (1) the sum of the tax shown on the return plus any tax previously assessed (or collected without assessment), less (2) any rebate made.

The accuracy-related penalty cannot be imposed unless a return is filed. However, the penalty does not apply if the IRS prepares a substitute return under IRC Sec. 6020(b). The penalty can be avoided by (1) employing a valid reasonable cause/good faith defense or (2) filing a "qualified amended return." In addition, penalties attributable to negligence or disregard of the rules or regulations can be avoided based on special rules that are discussed later in this lesson.

Reasonable Cause/Good Faith Defense

The accuracy-related penalty will not be imposed on an underpayment if the taxpayer had reasonable cause for taking the position on the tax return that caused the underpayment, and acted in good faith. The reasonable cause/good faith rule is applied on a case-by-case (i.e., facts and circumstances) basis. The following are examples of situations that may be reasonable cause:

1. An honest misunderstanding of fact or law that is reasonable in light of all facts and circumstances including the experience, knowledge, and education of the taxpayer.

2. An isolated computation or transcription error.

3. Reliance on professional advice (i.e., an attorney, accountant, appraiser, etc.); an information return; or other facts if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

For reliance on professional advice (including a professional tax adviser) to be reasonable cause, the advice must be based on all of the material facts and must not rely unreasonably on the representations of the taxpayer. It must not be based on a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true. Note that advice is any communication provided to the taxpayer setting forth the conclusion of a professional about the application of the accuracy-related penalty to the tax treatment of an item. The taxpayer must have reasonably relied on the professional's advice, with the regulations stating that reliance may be unreasonable when the taxpayer knew or should have known the adviser lacked knowledge in the pertinent area of the tax law.

Filing a Qualified Amended Return

A *qualified amended return* is an amended return filed after the due date of the return and before the taxpayer is first contacted by the IRS regarding an examination of the return. A qualified amended return that shows the proper tax liability or supplies disclosure missing on the original return can eliminate exposure to the 20% accuracy-related penalty.

Negligence or Disregard of the Rules or Regulations

IRC Sec. 6662(b)(1) imposes a two-pronged 20% taxpayer penalty on (1) negligence or (2) disregard of rules or regulations. In other words, the penalty can apply if the taxpayer is negligent, and it can apply if the taxpayer is not negligent but disregards rules or regulations. For practical purposes, the two prongs function as two separate, nonoverlapping penalties.

Negligence is any failure to make a reasonable attempt to comply with the rules. Taxpayers are exposed to the negligence prong of the accuracy-related penalty when they fail to keep adequate books and records, fail to substantiate items properly, or take positions that are "too good to be true."

Disregard is a careless, reckless, or intentional disregard of the rules. For the disregard prong, "rules or regulations" include the Code, temporary and final regulations, and revenue rulings and notices published in the Internal Revenue Bulletin. Proposed regulations do not count as rules or regulations. According to the preamble to the Section 6662 regulations, revenue procedures may or may not be "rules"—depending on facts and circumstances. However, revenue procedures are not listed as "rules" in the regulations.

<u>Negligence.</u> The negligence prong can be avoided if the taxpayer can show a "reasonable basis" for the tax position. Regulations have not yet precisely defined the term "reasonable basis." It is generally recognized as a 15%–20% likelihood of being sustained upon challenge. Presumably, it is a lower standard than "substantial authority" (approximately 40%) or "a realistic possibility of being sustained on its merits" (approximately 33%), but a higher standard than "not frivolous." The negligence penalty can also be avoided by satisfying the reasonable cause/good faith test. However, adequate disclosure is no longer a defense to this penalty.

<u>Disregard of Regulations.</u> If a taxpayer knowingly takes a good faith position contrary to a regulation, the only defense, in most cases, against potential assessment of the disregard penalty is to make adequate disclosure. If a taxpayer unknowingly takes a position contrary to a regulation, he or she may be able to mount a reasonable cause/good faith defense. In addition, in limited circumstances, the reasonable cause/good faith defense could apparently apply to a position known to be contrary to a regulation. For example, if a regulation appears to be inconsistent with the statute itself or has been invalidated by a court decision, a taxpayer could apparently argue that the reasonable cause/good faith defense applies—even though adequate disclosure was not made.

<u>Disregard of IRS Revenue Rulings and Notices.</u> A taxpayer can avoid the disregard penalty for positions contrary to revenue rulings and notices by making adequate disclosure or by showing the position has a "realistic possibility of being sustained on its merits." Basically, the realistic possibility standard is met if there is approximately a 33% or better chance that the tax position will be sustained on its merits. Finally, a taxpayer may be able to mount a reasonable cause/good faith defense.

Adequate Disclosure Defense. If a taxpayer provides a complete, item-specific disclosure of a position that has a reasonable basis on a return (and in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation), the taxpayer will be excepted from the disregard of rules or regulations prong of the accuracy-related penalty for that position. However, disclosure will not prevent imposition of the penalty if the position disclosed does not have a reasonable basis, or proper books and records were not maintained, or items are not substantiated.

To adequately disclose a position taken on an income tax return (for purposes of the penalty for disregarding rules or regulations), a taxpayer must do the following:

1. Disclose the position on a properly completed Form 8275 (Disclosure Statement) for positions other than those contrary to a regulation or Form 8275-R (Regulation Disclosure Statement) if a position is contrary to the regulations, and attach it to the return. A separate statement attached to the return is not sufficient.

2. Identify the statutory provision, ruling, or regulatory provision in question on Form 8275 or 8275-R. (These forms are available on the IRS website: **www.irs.gov**.)

Substantial Estate or Gift Tax Valuation Understatement

Under the accuracy-related penalty provisions, a 20% penalty is imposed on the underpayment of tax attributable to a substantial estate or gift tax valuation understatement. Generally, a substantial valuation understatement exists if the value of any property claimed on an estate, gift, or generation-skipping transfer tax return is 65% or less of the amount ultimately determined to be the correct value. However, no penalty will be imposed unless the amount of the underpayment exceeds $5,000.

Example 2L-1 Gift tax valuation understatement.

Len Yount gave her son, Rob, 5,000 shares of common stock in Yount's Food Stores, Inc. (YFS). At the time of the gift, YFS had 25,000 shares of common stock outstanding, so the block of shares transferred to Rob represented 20% of the outstanding common shares. A qualified appraiser valued the gifted shares at $75 per share and also deducted $35 per share as a minority discount. Accordingly, the shares were valued at $200,000 on Len's gift tax return (5,000 × $40).

Upon examination, the IRS challenged the initial value assigned to the shares ($75) and the minority discount amount ($35). Ultimately, Len and the IRS agreed on a gross value of $105 per share and a minority discount of $20 per share. Thus, the agreed value of the stock was $425,000 (5,000 × $85). Since the value of the stock claimed on Len's gift tax return ($200,000) was less than 65% of the agreed value ($425,000), Len will be subject to the substantial estate or gift tax valuation understatement penalty. However, the penalty will not be imposed if Len can demonstrate she had reasonable cause for claiming the stock value listed on the return (i.e., reliance on a professional appraiser).

Gross Valuation Understatement. The amount of the penalty imposed on the underpayment of tax is increased to 40% if the underpayment is attributable to a gross valuation misstatement. An underpayment of tax is attributable to a gross valuation misstatement if the value of any property claimed on an estate, gift, or generation-skipping transfer tax return is 40% or less of the amount ultimately determined to be correct. The penalty will not be imposed if the amount of the underpayment does not exceed $5,000.

Substantial Valuation Misstatement on Income Tax Returns

The substantial valuation misstatement penalty under IRC 6662(e) applies to income tax returns, but the overstatement of value of property on an estate, gift, or GST tax return would cause a substantial valuation misstatement on an income tax return if the overstated value is used in computing the asset's basis for income tax purposes.

A substantial valuation misstatement exists if the value or adjusted basis of property claimed on an income tax return is 150% or more of the amount determined to be the correct amount. No penalty is imposed if the underpayment resulting from the valuation misstatement is $5,000 or less.

Generally, the penalty is imposed at the rate of 20% of the underpayment. However, in the case of gross valuation misstatements, the rate is 40% rather than 20%. A gross valuation misstatement exists if the value or adjusted basis of the property claimed on a return is 200% or more of the correct amount.

The Penalty for Fraud

Underpayment Penalty

If any part of an underpayment is due to civil fraud, the IRS will assess a penalty of 75% on that part of the underpayment. The penalty can be collected from the taxpayer's estate.

Fraud is not defined in IRC Sec. 6663; however, the Tax Court says there must be actual intentional wrongdoing and an intent to evade tax. In addition, the existence of fraud is determined based on consideration of all the facts and circumstances and includes (1) a knowing falsehood, (2) an underpayment of tax, and (3) an intent to evade tax. In *Trompeter*, the 9th Circuit stated that blind reliance on a professional for valuation or other purposes may not provide an adequate defense against the fraud penalty.

The burden of proving fraud rests initially with the IRS. However, once it has been established that any portion of the underpayment is attributable to fraud, the burden of proof for establishing that the entire underpayment is not due to fraud shifts to the taxpayer.

The 20% accuracy-related penalty will not apply to any portion of an underpayment on which the fraud penalty is imposed. However, the accuracy-related penalty may be applied to any portion of the underpayment not attributable to fraud.

IRC Sec. 7201 provides that a willful attempt to defeat or evade tax is a felony (i.e., criminal fraud). If convicted, a taxpayer can be fined up to $100,000 (in addition to any other penalties imposed by the law) or imprisoned for up to five years, or both.

Penalties for Preparers and Appraisers

Tax Return Preparer Penalties

There is a penalty on a person who provides advice regarding, or prepares for compensation (or who employs one or more persons who prepare for compensation), all or a substantial portion of any tax return or claim for refund for which any part of an understatement of liability is due to an unreasonable position or reckless or willful conduct.

<u>Preparer Definition.</u> The regulations clarify who, as a return preparer, is subject to a penalty. A tax return preparer is anyone who prepares or employs others to prepare any tax return or refund claim for compensation. A preparer is subject to IRC Sec. 6694 if the individual is primarily responsible for the position(s) on the return or claim for refund giving rise to the understatement. A signing preparer is the individual who has the primary responsibility for the overall substantive accuracy of the preparation of the return and can be subject to a preparer penalty. A nonsigning preparer is an individual who prepares all or a substantial portion or the return relating to events that have already occurred. A nonsigning preparer can be subject to the preparer penalty if the individual had overall supervisory responsibility for the position giving rise to the understatement. If either a signing or nonsigning preparer within a firm could be held primarily responsible for a position giving rise to an understatement, the penalty may be assessed against either one of the individuals, but not both with regard to the same position.

<u>Unreasonable Position.</u> A preparer who prepares a return or claim for refund for which any part of an understatement of liability is due to an *unreasonable position* (and the preparer knew, or should have known, of the position) is liable for a penalty in an amount equal to the greater of (1) $1,000 or (2) 50% of the tax return preparation fees. IRC Secs. 6694(a)(2)(A)–(C) define an *unreasonable position* as follows:

1. In general, a position is unreasonable unless there is or was *substantial authority* for the position.

2. For a disclosed position (which *is not* a reportable transaction or tax shelter), the position is unreasonable unless there is a *reasonable basis* for the position. Disclosure should be as provided in the substantial-understatement-of-income-tax-penalty disclosure rules under IRC Sec. 6662(d)(2)(B)(ii)(I).

3. For a tax shelter or reportable transaction as defined in IRC Sec. 6662(d)(2)(C)(ii), a position is unreasonable unless it is reasonable to believe that the position will *more likely than not* be sustained on its merits. However, Notice 2009-5 provided an exception to the more-likely-than-not standard that is not contained in the statute or the final regulations. The exception applies to a tax shelter that is not a listed transaction or a reportable transaction having tax avoidance or evasion as a significant purpose. Until further guidance is issued, solely for purposes of IRC Sec. 6694(a), a preparer may rely on the substantial authority standard if the following information is given to the taxpayer and the preparer contemporaneously documents that the information was provided:

    a. The preparer must explain the penalty standards that will apply if the transaction is found to have a significant purpose of tax avoidance or evasion.

    b. The explanation must include that the accuracy-related penalty under IRC Sec. 6662(d) would apply unless there is at least substantial authority for the position and the taxpayer possesses a reasonable belief that the tax treatment was more likely than not the proper treatment.

    c. The preparer must explain that disclosure will not provide protection from an accuracy-related penalty for tax shelters.

These provisions are generally effective for tax returns prepared after May 25, 2007; however, the provisions related to tax shelters and reportable transactions are effective for tax returns prepared for tax years ending after October 3, 2008.

According to Notice 2009-5, until further guidance is issued, *substantial authority* has the same meaning as in Reg. 1.6662-4(d)(2) of the accuracy-related penalty regulations. Thus, the *substantial authority* standard is an objective standard involving an analysis of the law and application of the law to relevant facts. It is less stringent than the *more likely than not* standard (a greater than 50% likelihood of being upheld), but more stringent than the *reasonable basis* standard [generally, a position reasonably based on one or more of the authorities in Reg. 1.6662-4(d)(3); higher than the *not frivolous disclosure* standard]. *Substantial authority* exists if the weight of authorities supporting the taxpayer's position is substantial in relation to the weight of those that take a contrary position. Notice 2009-5 also indicated that Reg. 1.6662-4(d)(3) will apply for purposes of determining whether *substantial authority* is present and which authorities may be relied upon.

<u>Reckless or Willful Conduct.</u> For conduct that is considered reckless or willful, the preparer penalty is the greater of (1) $5,000 or (2) 50% of the tax return preparation fee.

<u>Reasonable Basis and Disclosure.</u> If a position does not meet the substantial authority standard but the preparer wants to avoid a penalty, the position must have a reasonable basis (with the same minimum threshold applicable under IRC Sec. 6662), and the preparer must adequately disclose the position. In this situation, the signing preparer can:

1. Disclose the position on a properly completed Form 8275 (Disclosure Statement) or Form 8275—R (Regulation Disclosure Statement) filed with the tax return;

2. Provide the taxpayer with a prepared tax return that includes the disclosure in accordance with Reg. 1.6662—4(f) (i.e., the annual revenue procedure related to disclosure); or

3. For returns or claims for refund that are subject to penalties under IRC Sec. 6662 other than the penalty for a substantial understatement of income tax under IRC Sec. 6662(b)(2) and (d), the signing preparer can advise the taxpayer of the penalty standards applicable under IRC Sec. 6662, and contemporaneously document the advice in the files. [This rule addresses situations in which the penalty standard applicable to the taxpayer is based on compliance with requirements other than disclosure on the return; for example, IRC Sec. 6662(e).]

<u>Reliance on Information Furnished by Taxpayer or Others.</u> The final regulations retain the basic rule that a preparer can rely, without further verification, on information provided by clients. But as before, the preparer cannot ignore the implications of information received from clients, and must make further inquiries if the information appears to be incomplete, inconsistent, or inaccurate.

The preparer can also rely on information furnished by other preparers or advisors, subject to the same limitation that the preparer must make inquiries if the information appears to be inconsistent, inaccurate, or incomplete. Likewise, the preparer can rely on a previously filed return, although he or she must confirm that there have been no audit adjustments or amendments to the return.

However, a preparer cannot rely on information in good faith if—

1. The advice or information is unreasonable on its face;

2. The preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or

3. The preparer knew or should have known (given the nature of his or her practice) that at the time the return or refund claim was prepared, the advice or information was no longer reliable due to developments in the law since the advice was given.

Preparer Penalty and Estate Tax Exams

A May 8, 2008, Small Business/Self–employed Division memorandum provided guidance to estate tax examiners on imposing the Section 6694 and 6695 return preparer penalties. According to the memorandum, during every estate and gift tax examination, the examiner should determine if further consideration of preparer penalties is necessary. A decision not to develop a penalty issue must be documented in the workpapers.

Penalty for Aiding and Abetting an Understatement of Tax

IRC Sec. 6701 imposes a $1,000 penalty ($10,000 for corporate taxes) on any person who (1) aids or assists, procures, or advises the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) the return or other document will be used for any material tax matter, and (3) knows that if the return or other document were so used, an understatement of another person's tax liability will result.

The penalty applies regardless of whether the taxpayer (i.e., the other person) had knowledge of or consented to the understatement, and whether the taxpayer actually relied on the subject document. Furthermore, it is not necessary for the subject return or other document to have been filed at all, or for the taxpayer to have actually understated his or her tax liability.

One of the requirements for application of the penalty is that the person knows the return or other document (or a portion thereof) will be used for a material tax matter, and such use will result in the understatement of another person's tax liability. This means the person must have actual knowledge—negligence or intentional disregard is not enough.

While the aiding and abetting penalty can be imposed with any other applicable penalties, it cannot be assessed when the penalties under IRC Sec. 6694(a) and (b) for understatements due to unrealistic positions or willful or reckless conduct are imposed for the same document.

Appraiser Penalty

If a person prepares a property appraisal, and such person knows (or reasonably should have known) that the appraisal would be used in connection with a return or a claim for refund, that person is subject to a penalty if the claimed property value results in a *substantial estate or gift tax valuation misstatement* under IRC Sec. 6662(g) or a *gross estate or gift tax valuation misstatement* under IRC Sec. 6662(h) for the property. The amount of the penalty equals the lesser of:

1. The greater of: (a) 10% of the underpayment or (b) $1,000 or

2. 125% of the gross income received by the appraiser for the appraisal services.

The Penalty for the Failure to Produce Records

A $500 penalty can be imposed on an executor for failing to comply with the duty to file the decedent's estate tax return. In addition, the $500 penalty can be imposed if, upon request, the executor refuses to produce records or property in his or her possession pertaining to the decedent's estate.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. The penalty that is imposed when a taxpayer does not file a required return by the due date is equal to what percent of the net due for each month?

    a. 0.5.

    b. 5.

    c. 10.

    d. 20.

34. Lola died on June 6, 2007. Her estate tax return was due nine months later, on March 6, 2008, but the return was not filed until March 17, 2009. The estate tax was paid on March 17, 2009. What is the total percentage of the failure to file and the failure to pay penalties that would be assessed against Lola's estate?

    a. 22.5%.

    b. 25%.

    c. 29%.

    d. 47.5%.

35. Which of the following statements regarding the use of registered or certified mail or private delivery services is most accurate?

    a. According to the 2nd and 6th Circuits rulings, the mailbox rule applies to all tax filings.

    b. The postmark date for FedEx is deemed to be the date on which the service electronically records the item to its database.

    c. Certified mail and registered mail are considered evidence that a document was delivered.

    d. DHL Express (DHL) is not considered an approved designated private delivery service (PDS) for purposes of the timely-mailing-as-timely-filing rule.

36. Negligence is best described as which of the following?

    a. Actual intentional wrongdoing.

    b. Careless or intentional disregard of the rules.

    c. Failure to make a reasonable attempt to comply with the rules.

37. The penalty imposed on a gross valuation understatement is which of the following?

    a. 20%.

    b. 40%.

    c. 75%.

    d. $1,000.

38. When relying on reasonable cause/good faith defense, reliance on professional advice includes which of the following?

    a. Advice based on all material facts.

    b. Representations of the taxpayer.

    c. Assumption of the taxpayer's knowledge.

39. Which of the following statements regarding fraud is most accurate?

    a. According to IRC Sec. 6663, there must be actual, intentional wrongdoing for fraud to exist.

    b. IRC. Sec. 6662 imposes a 20% accuracy-related penalty on any portion of the underpayment on which the fraud penalty is imposed.

    c. The IRS always has the burden of proving fraud.

    d. A taxpayer can be fined up to $100,000 for a fraud conviction.

40. Which of the following statements regarding the penalty for aiding and abetting an understatement of tax is most accurate?

    a. The taxpayer must have had knowledge of the understatement for the penalty to apply.

    b. The person must know the return will be used for a material tax matter for the penalty to be assessed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. The penalty that is imposed when a taxpayer does not file a required return by the due date is equal to what percent of the net due for each month? **(Page 86)**

    a. 0.5. [This answer is incorrect. Under IRC Sec. 6651, a penalty equal to 0.5% of the net tax shown on the return is due for each month that the tax remains unpaid beyond the prescribed date for payment.]

    b. 5. [This answer is correct. When a taxpayer, including a trust or decedent's estate, does not file a required return by the due date (including extensions), IRC Sec. 6651(a)(1) imposes a penalty equal to 5% of the net tax due for each month or part thereof that the return is late, up to a maximum penalty of 25%.]

    c. 10. [This answer is incorrect. The property appraisal penalty under IRC Sec. 6662 is equal to the lesser of the greater of (1) 10% of the underpayment or (2) $1,000 or 125% of the gross income received by the appraiser for the appraisal services.]

    d. 20. [This answer is incorrect. IRC Sec. 6662 imposes a 20% taxpayer accuracy-related penalty on the portion of an underpayment that is attributable under certain circumstances, such as any substantial understatement of income tax.]

34. Lola died on June 6, 2007. Her estate tax return was due nine months later, on March 6, 2008, but the return was not filed until March 17, 2009. The estate tax was paid on March 17, 2009. What is the total percentage of the failure to file and the failure to pay penalties that would be assessed against Lola's estate? **(Page 86)**

    a. 22.5%. [This answer is incorrect. The is the amount of the failure to file penalty percentage for the scenario above, but the failure to pay penalty for the 13 months has not been included.]

    b. 25%. [This answer is incorrect. This is the full amount of the failure to file penalty percentage for the scenario above; however, when calculating the penalties, the failure to pay for the same period must be subtracted from the 25%.]

    c. 29%. [This answer is correct. Based on the information in the Internal Revenue Code, the penalty percentage for the estate in the scenario above would be calculated as follows: the failure to file penalty would be (5 months – 5%) – (0.5% x 5%) = 22.5%, and the failure to pay penalty would be 13 months x 0.5% = 6.5%. The total percentage is 29%—22.5% + 6.5%.]

    d. 47.5%. [This answer is incorrect. Under the Code, when both the failure to file and the failure to pay penalties apply, they cannot exceed 5% per month or 47.5% of the net tax shown on the return. The maximum penalty is too high a percentage for the scenario above.]

35. Which of the following statements regarding the use of registered or certified mail or private delivery services is most accurate? **(Page 86)**

    a. According to the 2nd and 6th Circuits rulings, the mailbox rule applies to all tax filings. [This answer is incorrect. This ruling was made by the 8th and 9th Circuits. These Circuits ruled that the common-law mailbox rule applies to tax filings so that, if it can be proven that a properly addressed document bearing adequate postage was mailed, there is a presumption that the IRS received it in due course.]

    b. The postmark date for FedEx is deemed to be the date on which the service electronically records the item to its database. [This answer is incorrect. When a private delivery service (PDS) is used, the postmark date generally is deemed to be for (1) DHL or UPS—the date on which the PDS electronically records the item to its database; or (2) FedEx—the date shown on a package label generated by the PDS employee—or if there is no employee-generated label, the date shown on a label generated and applied by the customer, provided the item is delivered within normal delivery time.]

c. **Certified mail and registered mail are considered evidence that a document was delivered. [This answer is correct. IRC Sec. 7502(c) states that registered mail and certified mail are legally sufficient evidence that the document was delivered.]**

d. DHL Express (DHL) is not considered an approved designated private delivery service (PDS) for purposes of the timely-mailing-as-timely-filing rule. [This answer is incorrect. The IRS identified the following designated PDSs as approved for purposes of the timely-mailing-as-timely-filing rule:

- DHL Express (DHL): DHL Same Day Service, DHL Next Day 10:30 am, DHL Next Day 12:00 pm, DHL Next Day 3:00 pm, and DHL 2nd Day Services.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.]

36. Negligence is best described as which of the following? **(Page 89)**

a. Actual intentional wrongdoing. [This answer is incorrect. According to the Tax Court, for fraud to exist, there must be actual intentional wrongdoing and intent to evade tax. Fraud is different from negligence.]

b. Careless or intentional disregard of the rules. [This answer is incorrect. Careless, reckless, or intentional disregard of the rules is the definition of disregard, which is a separate violation from negligence under the Code.]

c. **Failure to make a reasonable attempt to comply with the rules. [This answer is correct. Under IRC Sec. 6662, negligence is any failure to make a reasonable attempt to comply with the rules.]**

37. The penalty imposed on a gross valuation understatement is which of the following? **(Page 89)**

a. 20%. [This answer is incorrect. Under the accuracy-related penalty provisions, a 20% penalty is imposed on the underpayment of tax attributable to a substantial estate or gift tax valuation understatement.]

b. **40%. [This answer is correct. Under IRC Sec. 6662(h)(2)(c), the penalty amount imposed on the underpayment of tax is 40% if the underpayment is attributable to a gross valuation misstatement.]**

c. 75%. [This answer is incorrect. If any part of an underpayment is due to civil fraud, the IRS will assess a penalty of 75% on that part of the underpayment.]

d. $1,000. [This answer is incorrect. IRC Sec. 6701 imposes a $1,000 penalty on any person who (1) aids or assists, procures, or advises the preparation of any portion of a return, affidavit, claim, or other document; (2) knows (or has reason to believe) the return or other document will be used for any material tax matter; and (3) knows that the return or other document were so used, an understatement of another person's tax liability will result.]

38. When relying on reasonable cause/good faith defense, reliance on professional advice includes which of the following? **(Page 89)**

a. **Advice based on all material facts. [This answer is correct. According to IRC Sec. 6664, for reliance on professional advice (including a professional tax adviser) to be reasonable cause, the advice must be based on all of the material facts.]**

b. Representations of the taxpayer. [This answer is incorrect. Under the Code, reliance must not be based on a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true. Note that advice is any communication provided to the taxpayer setting forth the conclusion of a professional about the application of the accuracy-related penalty to the tax treatment of an item.]

c. Assumption of the taxpayer's knowledge. [This answer is incorrect. Under the Code, the taxpayer must have reasonably relied on the professional's advice, with the regulations stating that reliance may be unreasonable when the taxpayer knew or should have known the professional adviser lacked knowledge in the pertinent area of the tax law.]

39. Which of the following statements regarding fraud is most accurate? **(Page 92)**

    a. According to IRC Sec. 6663, there must be actual, intentional wrongdoing for fraud to exist. [This answer is incorrect. Fraud is not defined in IRC. Sec. 6663.]

    b. IRC. Sec. 6662 imposes a 20% accuracy-related penalty on any portion of the underpayment on which the fraud penalty is imposed. [This answer is incorrect. The 20% accuracy-related penalty will not apply to any portion of an underpayment on which the fraud penalty is imposed.]

    c. The IRS always has the burden of proving fraud. [This answer is incorrect. Under the Code, once it has been established that any portion of the underpayment is attributable to fraud, the burden of proof for establishing that the entire underpayment is not due to fraud shifts to the taxpayer.]

    d. A taxpayer can be fined up to $100,000 for a fraud conviction. [This answer is correct. IRC Sec. 7201 provides that a willful attempt to defeat or evade tax is a felony (i.e., criminal fraud). If convicted, a taxpayer can be fined up to $100,000 (in addition to any other penalties imposed by the law) or imprisoned for up to five years, or both.]

40. Which of the following statements regarding the penalty for aiding and abetting an understatement of tax is most accurate? **(Page 92)**

    a. The taxpayer must have had knowledge of the understatement for the penalty to apply. [This answer is incorrect. According to the Code, the penalty applies regardless of whether the taxpayer had knowledge of or consented to the understatement, and whether the taxpayer actually relied on the subject document.]

    b. The person must know the return will be used for a material tax matter for the penalty to be assessed. [This answer is correct. One of the requirements for application of the penalty under the Internal Revenue Code is that the person knows the return or other document will be used for a material tax matter, and such use will result in the understatement of another person's tax liability.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (706TG091)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

12. A discretionary extension of time to pay a deficiency for reasonable cause may be granted for one year at a time, up to a maximum of how many years?

    a. 4.

    b. 5.

    c. 10.

    d. 16.

13. How long does the executor have to appeal a denial once the request for an extension has been denied?

    a. 10 days.

    b. 30 days.

    c. 60 days.

    d. 120 days.

14. If the IRS grants the maximum extension, how long does the taxpayer have to pay an estate tax deficiency?

    a. Two years.

    b. Four years.

    c. Six years.

    d. Eight years.

15. In which of the following scenarios does the decedent or the decedent's closely held business meet one of the qualifications for making the Section 6166 election?

    a. George was a citizen of Canada at the time of his death.

    b. Mary's business was a sole proprietorship.

    c. Leo's business earns income for tasks that are considered passive.

    d. The value of Ivy's business is 30% of her adjusted gross estate.

16. There are certain attribution rules that must apply when determining the number of owners of a closely held business. The IRS has ruled that these attribution rules only apply for purposes of determining which of the following?

i. If the 45-or-fewer-partners-or-shareholders rule has been met.
ii. If the 20% or 35% tests have been met.
iii. The amount of estate tax eligible for installment payments.
iv If the 20% ownership test has been met.

a. i, iv.

b. ii, iii.

c. i, ii.

d. iii. iv.

17. Mark died on July 9, 2009, and his estate includes a closely held business. What interest rate applies to the first $1 million in taxable value of Mark's closely held business?

    a. 1%.

    b. 2%.

    c. 3%.

    d. 5%.

18. Frankie Valet died on March 5, 2009. His estate includes a closely held partnership interest valued at $1.57 million. The value of the adjusted gross estate is $4 million. The estate owes estate tax of $225,000. Thus, the estate is eligible to defer up to how much of estate tax under IRC Sec. 6166?

    a. $87,043.

    b. $87,313.

    c. $88,043.

    d. $88,313.

19. Assume the same facts as in the above example. Frankie's executor elects to defer the initial installment payment for the full five-year period and pay the tax in equal installments for 10 years on December 1. The regular due date for payment of the entire estate tax would be December 7, 2009. However, since the executor selected December 1 of each year as the date of payment, the first annual payment of deferred tax will be due on December 1, 2014, which is the end of the fifth year after the regular due date for payment. This means the executor will make annual payments of interest only from ___________ through ___________.

    a. December 1, 2010, December 1, 2013.

    b. December 5, 2010, December 5, 2013.

    c. December 1, 2010, December 1, 2014.

    d. December 5, 2010, December 5, 2014.

20. How often is deferred tax interest paid?

    a. Annually during the first three years on the date selected as the due date of the installment payment.

    b. Annually during the first four years on the date selected as the due date of the installment payment.

    c. Annually during the first five years on the date selected as the due date of the installment payment.

    d. Annually during the first six years on the date selected as the due date of the installment payment.

21. For decedents who die in 2009, before the 2% interest rate can be applied to a portion of deferred tax, the value of the estate must exceed which of the following?

    a. $1.33 million.

    b. $2 million.

    c. $3.5 million.

    d. $4 million.

22. If the executor fails to include the deferral amount and the number of installment payments by checking the "yes" box on the estate tax return, the IRS automatically presumes to defer the maximum amount over a period of ___________ years with the first payment due ___________ years and ___________ months after the date of the decedent's death.

    a. 5, 3, 6.

    b. 10, 5, 3.

    c. 10, 5, 9.

    d. 15, 6, 3.

23. When extending payment of estate tax attributable to a remainder interest, the executor can elect to defer payment of estate tax related to a reversionary or remainder interest in property until six months after preceding interests in the property have terminated. The six-month period can be extended for up to how many years if reasonable cause is shown?

    a. Three.

    b. Six.

    c. Eight.

    d. Nine.

24. When does stock qualify for Section 303 redemption?

    a. When the shareholder acquired the stock by gift from the person to whom the stock passed from the decedent.

    b. Only when the actual stock that was redeemed was owned by the decedent.

    c. When included in the decedent's gross estate for estate tax purposes.

    d. To a redemption from a shareholder who received the stock from the decedent's executor in satisfaction of a pecuniary bequest.

25. Name one way transferred stock can help an estate meet the 35% test for purposes of the Section 303 redemption.

    a. The transfer occurred within three years of the decedent's death.

    b. The amount transferred must be at least double the sum of death taxes, funeral, and administration expenses.

    c. If the stock was held by the decedent and his or her spouse as community property or joint tenants.

    d. All ownership rights were transferred within five years of the decedent's death.

26. For a corporate distribution to qualify for Section 303 treatment, the distribution from the corporation normally must occur after the decedent's death and within ___________ years and __________ days following the due date of the estate tax return.

    a. One, 30.

    b. Two, 60.

    c. Three, 90.

    d. Five, 120.

27. A request for prompt assessment of a decedent's tax liability allows the executor to do which of the following?

    a. To collect tax from the beneficiary of any life insurance policy in the gross estate.

    b. To collect estate tax from the beneficiary of property included in the decedent's gross estate under a general power of appointment.

    c. To pay off any outstanding mortgage

    d. To make certain all taxes are paid and the period for assessment has expired before making a final distribution of estate assets.

28. Who is responsible for paying the decedent's federal estate tax?

    a. Transferor.

    b. Executor.

    c. Transferee.

    d. Decedent.

29. An estate tax lien automatically attaches to which of the following, even though the decedent's estate is liable for any estate taxes due?

    a. To all real property held in a decedent's estate.

    b. To property that is used to pay administration expenses that were allowed by a court with jurisdiction over the estate.

    c. To the estate assets when the tax is formally assessed and continues for ten years unless the statute of limitations period is suspended or extended.

    d. Do not select this answer choice.

30. Which of the following types of liens would **not** be valid against a security interest from financing agreements?

    a. General tax lien.

    b. Lien for special use valuation property.

    c. Lien for estate taxes deferred under IRC Sec. 6166.

    d. Automatic estate tax lien.

31. Where can guidance be found for determining which beneficiary bears the burden of the estate tax?

    a. State law or the decedent's will.

    b. The Internal Revenue Code.

    c. The executor of the estate.

    d. The instruction of Form 706.

32. If the equitable apportionment approach is used, who pays the estate tax?

    a. Tax is divided equally between all heirs.

    b. Tax is paid by heirs who receive taxable bequests.

    c. Tax is paid by those who receive marital or charitable bequests.

    d. Tax is paid from the residuary estate.

33. Mr. Tibbs failed to timely file his return. His unextended Form 706 was due on March 15. What would the total penalty be if Mr. Tibbs filed Form 706 on June 25?

    a. 5%.

    b. 10%.

    c. 15%.

    d. 20%.

34. What is the maximum penalty amount that can be imposed on a taxpayer for failure to pay tax shown as due on a return by the due date?

    a. 5%.

    b. 15%.

    c. 25%.

    d. 30%.

35. An isolated computation error is considered which of the following?

    a. Disregard of the rules.

    b. Willful neglect.

    c. Negligence.

    d. Reasonable cause.

36. Generally, a substantial valuation understatement exists if the value of any property claimed on an estate, gift, or generation-skipping transfer tax return is _________ or less of the amount ultimately determined to be the correct value.

    a. 35%.

    b. 45%

    c. 55%

    d. 65%.

37. Who is initially responsible for proving fraud?

    a. Taxpayer.

    b. Attorney.

    c. IRS.

    d. Accountant.

38. What is the preparer penalty for conduct that is reckless or willful?

    a. The greater of $1,000 or 50% of the tax return preparation fee.

    b. The greater of $5,000 or 25% of the tax preparer fee

    c. The greater of $1,000 or 25% of the tax preparer fee.

    d. The greater of $5,000 or 50% of the tax preparer fee.

39. What penalty is imposed on an executor for failing to comply with the duty to file the decedent's estate tax return?

    a. $250.

    b. $500.

    c. $750.

    d. $1000.

40. Estate and gift tax return preparers presumably can be found liable under which of the following Code sections for the $1,000 penalty for offering help on a return that generates a tax understatement?

    a. Section 6662.

    b. Section 6663.

    c. Section 6694.

    d. Section 6701.

GLOSSARY

Actual Tax: The transferee's actual tax is determined by subtracting the applicable credit amount, credit for gift taxes paid on pre-1977 gifts, and the credit for foreign death taxes from the gross estate tax. No reduction is allowed for the credit for tax on prior transfers or any credit for foreign death taxes claimed under a treaty provision.

Automatic Estate Tax Lien: Although a decedent's estate is liable for any estate taxes due, an estate tax lien automatically attaches to the assets of the gross estate to ensure that estate taxes are paid. Such lien attaches to the estate assets for ten years beginning with the decedent's date of death. An automatic estate tax lien is not valid against property used to pay estate or administration expenses that were allowed by a court that had jurisdiction over the estate.

Cumulative Method: Cumulative Section 303 redemption proceeds do not exceed the cumulative federal estate tax (including nondeferred tax and interest) paid by the earlier of (1) the first installment due date after the redemption or (2) one year after the redemption.

Disregard: Disregard is a careless, reckless, or intentional disregard of the rules.

Fraud: For fraud to exist, the Tax Court says there must be actual intentional wrongdoing and intent to evade tax. The existence of fraud is determined based on consideration of all the facts and circumstances and includes (1) a knowing falsehood, (2) an underpayment of tax, and (3) intent to evade tax.

General Bequest: general bequest is a gift payable out of the general assets of the estate, but it is not a specific item. A pecuniary bequest meets the definition of a general bequest.

Hypothetical Tax: The transferee's hypothetical tax is the net estate tax payable computed by excluding an amount equal to the value of the transferred property from the gross estate and not claiming the credit for tax on prior transfers or the foreign tax credit computed under a treaty provision.

Form 4768: The extension of time to pay estate tax can be requested on Form 4768 [Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes].

Form 706-CE: Form 706-CE (Certificate of Payment of Foreign Death Tax) must be filed before any credit for foreign death taxes will be allowed.

Form 706-NA: Form 706-NA is used to compute estate and generation-skipping transfer tax liability for nonresident alien decedents.

General Tax Lien: When a taxpayer who is liable for estate, gift, or income tax fails to pay such tax, a general tax lien is imposed on the taxpayer's assets.

Negligence: Negligence is any failure to make a reasonable attempt to comply with the rules.

Protective Election: If, at the time the estate return is filed, it is not clear whether the estate qualifies to make a Section 6166 election, the executor can make a protective Section 6166 election. A protective election becomes valid only if the estate qualifies for Section 6166 treatment at the time the estate tax values are finally determined.

Qualified Amended Return: A qualified amended return is an amended return filed after the due date of the return and before the taxpayer is first contacted by the IRS regarding an examination of the return. A qualified amended return that shows the proper tax liability or supplies disclosure missing on the original return can eliminate exposure to the 20% accuracy-related penalty.

Redemption-by-redemption Method: The Section 303 redemption is no more than the amount of federal estate tax (including nondeferred tax and interest) paid during the time period beginning on the date of the redemption and ending on the earlier of the next installment due date or the date one year after the redemption.

Resident: When determining a decedent's eligibility for the credit, a resident decedent is one who, at the time of his death, was domiciled in the U.S.

Residuary Bequest: A residuary bequest consists of the remainder of the estate once all of the specific and general bequests have been made. Under normal circumstances, the residuary bequest is the largest of the three types of bequests.

Specific Bequest: A specific bequest is a gift of a particular item of property that can be distinguished and identified from the other property in the estate.

Underpayment: Underpayment is defined as the amount by which the tax that should have been shown on the return exceeds (1) the sum of the tax shown on the return plus any tax previously assessed (or collected without assessment), less (2) any rebate made.

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COMPANION TO PPC's 706/709 DESKBOOK

COURSE 2

Form 706/709: Generation-Skipping Transfer (GST) Taxes (706TG092)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses how Form 706 [United States Estate (and Generation-Skipping Transfer) Tax Return] is used to compute and report a decedent's estate tax liability. Lesson 1 discusses how the GST tax is imposed, and Lesson 2 provides detailed information on taxable distributions and taxable terminations.
PUBLICATION/REVISION DATE:	November 2009
RECOMMENDED FOR:	Users of *PPC's 706/709 Deskbook*
PREREQUISITE/ADVANCE PREPARATION:	Experience with filing IRS Forms 706 and 709
CPE CREDIT:	8 QAS Hours, 8 Registry Hours 8 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **November 30, 2010**
KNOWLEDGE LEVEL:	Intermediate

LEARNING OBJECTIVES:

Lesson 1—Generation-Skipping Transfer (GST) Tax and Reporting Direct and Indirect Skip Transfers

Completion of this lesson will enable you to:
- Identify the types of generation-skipping transfers (GSTs) and the unique terms that relate to GSTs.
- Determine variables of the GST tax calculation, such as the taxable amount, applicable rate, and valuation.
- Determine how the timing of the allocation (late or timely) affects the GST tax exemption and qualified severances.
- Determine the allocation of *inter vivos* direct skips and lifetime transfers that are not direct skips, the effect of estate tax inclusion periods (ETIPs), and all the related forms and filing requirements.
- Determine the filing requirements and calculations related to Schedules R and R-1 of Form 706.

Lesson 2—Reporting Taxable Distributions, Taxable Terminations, and Qualified Trust Severances

Completion of this lesson will enable you to:
- Recognize the relationship between taxable distributions from a trust to a skip person and the GST tax.
- Determine the items covered by and the filing requirements for Form 706-GS(D) and (D-1).
- Determine taxable terminations and the filing requirements of Form 706-GS(T).

- Identify items covered on Schedules A, B(1), and B(2) of Form 706-GS(T) (e.g., the alternate valuation date election; the inclusion ratio; and general debts, expenses, and taxes related to trusts), and discuss reporting qualified severances.

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Lesson 1: Generation-skipping Transfer (GST) Tax and Reporting Direct and Indirect Skip Transfers

Introduction

Prior to the enactment of the generation-skipping transfer (GST) tax, an older generation individual (e.g., a grandparent) could transfer property to an individual who was more than one generation younger (e.g., a grandchild), and the transfer would escape one layer of transfer tax that would have applied if the property was transferred first to an individual in the next generation (e.g., a parent) and then to the ultimate transferee. The GST tax is designed to ensure that transfer tax is paid when generations are "skipped."

The GST tax is broad-based and applies to most transfers from grandparents to their grandchildren or others (including nonfamily members) below their children's generation. The regulations limit application of the GST tax to situations in which a gift tax was imposed on the transfer, or the transferred property was included in the transferor's gross estate. This lesson provides an overview of the generation-skipping transfer tax.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the types of generation-skipping transfers (GSTs) and the unique terms that relate to GSTs.
- Determine variables of the GST tax calculation, such as the taxable amount, applicable rate, and valuation.
- Determine how the timing of the allocation (late or timely) affects the GST tax exemption and qualified severances.
- Determine the allocation of *inter vivos* direct skips and lifetime transfers that are not direct skips, the effect of estate tax inclusion periods (ETIPs), and all the related forms and filing requirements.
- Determine the filing requirements and calculations related to Schedules R and R-1 of Form 706.

The Basics of Generation-skipping Transfers (GSTs)

The GST tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor, and on transfers involving trusts having beneficiaries in more than one generation below that of the transferor. The term *trust* includes any arrangement (other than an estate) that has substantially the same effect as a trust, such as life estates and remainders, estates for a term of years, and insurance and annuity contracts. The determination as to whether a transfer of property is a GST is made by reference to the most recent transfer subject to estate or gift tax. The GST tax is assessed in addition to any such gift or estate taxes that apply to the transfer at the highest transfer tax rate (e.g., 45% for 2009).

Direct Skips

A direct skip occurs when property subject to either the estate or gift tax is transferred to a skip person. (Note that only one direct skip occurs even when a single transfer of property skips two or more generations.) A transfer to a trust is a direct skip (occurring at the time of the transfer) if all of the beneficiaries with an interest in the trust are skip persons. Generally, skip persons are individuals who are two or more generations younger than the transferor.

There are three types of direct skips—*inter vivos* direct skips, direct skips at death, and direct skips at death from a trust. As the name implies, *inter vivos* direct skips are direct skip transfers made during the life of the transferor. *Inter vivos* direct skips include direct transfers from the transferor to a skip person, as well as transfers to a trust that qualifies as a skip person.

A direct skip at death occurs when property included in the transferor's estate is transferred to a skip person. As with *inter vivos* direct skips, the skip person may be either an individual or a trust qualifying as a skip person.

A direct skip can also occur when property from a trust included in the transferor's gross estate is transferred to a skip person.

GST Tax Liability. In the case of a direct skip, the transferor or the transferor's estate is liable for the GST tax. If the direct skip is made from a trust, the trustee is treated as the transferor and is liable for the tax. The amount subject to the GST tax is the value of the property received by the transferee. The tax base for computing the GST tax for a direct skip made during life is the amount received and does not include the GST tax.

However, the GST tax paid by the transferor on a taxable gift that is a direct skip increases the amount of the taxable gift for gift tax purposes by the amount of the GST tax. Thus, the amount of the GST tax on a lifetime direct skip is subject to gift tax.

Taxable Distributions

A taxable distribution is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person. The amount of the distribution subject to tax is the value of the property received by the transferee (recipient), reduced by any expense incurred by the recipient in connection with the determination, collection, or refund of the GST tax imposed on the distribution. If the recipient is subject to income tax on the distribution (e.g., a distribution of current income), an income tax deduction is allowed for the GST tax paid by the recipient.

The recipient of a distribution is liable for the GST tax on taxable distributions. Thus, the recipient pays the GST tax out of the amount received. If the trust pays any of the GST tax (including penalties and interest on the tax), such payment is treated as a further taxable distribution. The additional distribution is treated as having been made on December 31 of the year in which the original distribution was made.

Taxable Terminations

A taxable termination is the termination (by reason of death, lapse of time, release of power, or otherwise) of an interest in property held in trust, unless:

1. a transfer subject to the federal estate or gift tax occurs in connection with the property held in trust at the time of the termination,
2. a nonskip person has an interest in such property immediately after such termination, or
3. at no time after such termination may a distribution (including a distribution on termination) be made to a skip person. For this purpose, it is sufficient that the probability of a distribution to a skip person be less than 5%, determined actuarially.

A property interest in a trust is a present right to receive income or corpus from the trust or when a person is a permissible current recipient of trust income or principal.

Certain partial terminations are also treated as taxable terminations. If a property interest in a trust terminates because of the death of a lineal descendant of the transferor and, as a result, a specified portion of the trust's assets are distributed to at least one skip person (or at least one trust for the exclusive benefit of such person), then such partial termination is a taxable termination with respect to the portion distributed to the skip person.

The taxable amount of a taxable termination is the value of the terminated property interest passing to the skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property. The trustee is liable for the GST tax on taxable terminations.

The definition of taxable transfers sometimes overlaps. The Code defines a taxable distribution as transfers that are not taxable terminations or direct skips. The regulations state that a transfer subject to estate or gift tax at the time of the termination (i.e., a direct skip) is not a taxable termination. The rules indicate that direct skips take priority over taxable terminations.

When the GST Tax Does Not Apply

Certain transfers are excluded or exempt from the GST tax. The following exclusions and exemptions are discussed in this lesson:

- Grandfathered and certain other irrevocable trusts.

- Lifetime GST tax exemption.
- Annual exclusion gifts.
- Medical and tuition transfers.
- Previously taxed property.

In addition to the exclusions and exemptions listed, the GST tax does not apply under the predeceased parent rule. Generally, when the parent dies before the grandparent, the descendants "move up" one generation.

Grandfathered and Certain Other Irrevocable Trusts. Grandfathered trusts are trusts that were irrevocable on September 25, 1985. Grandfathered trusts are exempt from the GST tax to the extent there are no additions or modifications to the trust after September 25, 1985. Modifications to these trusts that change the quality, value, or timing of any of the trust powers, beneficial interests, or rights originally provided under the terms of the trust will cause the trust to lose its grandfathered status. Thus, the GST tax will apply to trusts that were irrevocable on September 25, 1985, if additions or modifications are made after that date.

When subsequent additions are made to a trust that was irrevocable on September 25, 1985, a proportionate amount of distributions from, or terminations of interests in property held in, such trust are subject to GST tax. Also, revocable trusts that became irrevocable (because the grantor died) after September 25, 1985, but before October 23, 1986, are not subject to the GST tax. In addition, the GST tax does not apply to trusts created under a will executed before October 22, 1986 by a decedent who died before January 1, 1987. Finally, the GST tax does not apply to testamentary trusts established by a will where the decedent has at all times after October 22, 1986 lacked legal capacity to alter the will.

The following four modifications will not cause a trust to lose its exempt status:

1. The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust if either (a) the existing governing instrument grants the trustee authority to make such distributions without the consent or approval of any beneficiary or court or (b) state law (when the exempt trust became irrevocable) permitted such distributions or retention in a continuing trust *and* the terms of the new trust or continuing trust do not extend the time for vesting of any beneficial interest.

2. A court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of the terms of a trust instrument. This applies only if the settlement is the result of an arm's length negotiation and the settlement is considered reasonable under the governing instrument and state law.

3. A court order in a construction proceeding (i.e., a determination of a settler's intent as of the date the trust instrument became effective) that resolves an ambiguity in the terms of a trust instrument. This applies only if the proceeding involves a bona fide issue and the court's decision is consistent with the applicable state law.

4. Allowing a trust to be modified as long as the modification does not shift a beneficial interest to a lower generation than the person(s) holding the beneficial interest prior to the modification. Also, the modification cannot extend the time for vesting of any beneficial interest in the trust beyond the original period.

In addition, the regulations provide that a modification of an irrevocable trust will shift a beneficial interest if the modification results in either (1) an increase in the amount of a GST or (2) the creation of a new GST. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a lower generation beneficiary, the effect of the instrument on the date of the modification is measured against the effect of the instrument immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a lower generation beneficiary.

If the modification is administrative in nature and only indirectly increases the amount transferred (such as by lower administration costs or income taxes) such modification will not be a shift in a beneficial interest in the trust.

Example 1A-1 Clarifying an ambiguous term in the instrument.

In 1982, Donna Webb established an irrevocable trust for the benefit of her children, Ann and Lance. The trust is to terminate on the death of the last to die of Ann and Lance. At termination, the principal is to be distributed to their issue.

The language in the instrument is unclear as to whether trust principal is to be distributed only to Donna's grandchildren or to other "issue" of Ann and Lance. The trustee requested a court rule to remove the ambiguity.

The court issued a ruling consistent with state law and determined the "issue" is Ann and Lance's children (both natural born and adopted). This ruling does not result in a "modification" of the trust and the trust remains exempt from GST tax.

Lifetime GST Tax Exemption. All individuals are allowed a $3.5 million (for 2009) exemption from the GST tax. This exemption can be allocated to any property transferred by the transferor. If spouses elect to gift-split for gift tax purposes, the gift must also be split for GST tax purposes, allowing each spouse to use their lifetime exemption against a transfer.

Annual Exclusion Gifts. Direct skip transfers that are nontaxable gifts for gift tax purposes because of the annual gift tax exclusion ($13,000 for 2009) have an inclusion ratio of zero, resulting in no GST tax. Thus, grandparents can currently make GST tax-free direct skips to their grandchildren of up to $13,000 per donee per year ($26,000 if gift-splitting between spouses is elected). The $13,000 GST tax annual exclusion applies only to direct skips to individuals and certain qualifying trusts. Direct skip transfers to a trust that qualify as a present interest eligible for the gift tax annual exclusion will qualify for the GST annual exclusion only if—

1. the trust is solely for the benefit of one skip person;

2. during the life of such skip person, no portion of the trust principal or income may be distributed to (or for the benefit of) anyone else; and

3. the trust assets will be included in the skip person's gross estate if he or she dies before the trust terminates.

Medical and Tuition Transfers. Transfers for tuition paid directly to a qualified educational organization or medical expenses paid directly to a medical care provider are not generation-skipping transfers. For example, direct payments by grandparents of their grandchildren's tuition are not taxable gifts and therefore not generation-skipping transfers. In addition, contributions to a qualified tuition program or education savings account are treated as completed gifts of a present interest and are eligible for the gift tax annual exclusion. Therefore, if a donor actually uses the gift tax annual exclusion, the contributions would qualify for the GST annual exclusion.

Previously Taxed Property. Transfers of property that were previously subject to the GST tax are excluded to the extent the transferee in the prior GST was in the same or younger generation as the current transferee and the transfer does not have the effect of avoiding the GST tax.

Double Skip Exclusion. A transfer to a skip person more than two generations below the transferor (e.g., a great-grandchild) is only subject to one level of GST tax. For example, if a donor transfers assets to a trust for the benefit of a great-grandchild, the transfer is a direct skip. GST tax is imposed only once although two generations are skipped.

Example 1A-2 Double skip to great-grandchild.

Sarah directly transfers $50,000 to each of her six great-grandchildren. If Sarah has any remaining GST tax exemption, it will be automatically allocated to these direct skips. Even though she skips two generations (her children and grandchildren), only $222,000 [($50,000 − $13,000) × 6] of her GST tax exemption must be used.

Terms Related to the GST Tax

A generation-skipping transfer (GST) occurs when there is a direct or indirect transfer from a transferor to a skip person. The determination of whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax. To identify transfers subject to the GST tax, the practitioner must have a thorough understanding of the GST terms and their definitions, which are discussed in the following paragraphs.

Transferor

Identification of the transferor is important in a GST because the assignment of generations is determined relative to the transferor. Also, only the transferor or the transferor's executor (in the case of a decedent's estate) may allocate the GST tax exemption to the transferred property.

In the case of *inter vivos* transfers, the donor is the transferor for any transferred property subject to the gift tax. For this purpose, a transfer is subject to the gift tax if it is a completed gift for federal gift tax purposes, regardless of whether the gift tax is actually imposed under IRC Sec. 2501(a). Also, a person is considered to have transferred any property where the individual is treated as the transferor, which means a person can be a transferor even though no transfer has occurred under local law at the time of imposition of the transfer tax. In the case of transfers occurring at death, the decedent is the transferor for any transferred property subject to the estate tax.

<u>Gift Splitting Elected.</u> When a husband and wife elect gift splitting for gift tax purposes under IRC Sec. 2513 each spouse is treated as the transferor of half of the gift for GST tax purposes. Thus, each spouse may allocate his or her GST tax exemption to his or her respective part of the gift.

Example 1B-1 Each spouse is transferor of half of a gift if gift splitting is elected.

Roger Barnes gave $100,000 of stock to his grandson. Roger and his wife, June, elected gift splitting for the year of the transfer so that each was considered the donor of half of the stock for gift tax purposes. The gift tax election to split gifts by married couples also applies to generation-skipping transfers. Thus, Roger and June will each be treated as the transferor of $50,000 of stock to their grandson for GST tax purposes.

<u>QTIP Property.</u> Decedents often provide their surviving spouse an income interest for life in property, but not the right to designate the beneficiaries who will succeed to the property at the surviving spouse's death. Such beneficiary designation is provided by the will of the first spouse to die (i.e., the original property owner). Although a property interest that terminates upon the surviving spouse's death is generally not eligible for the marital deduction, the decedent's executor can elect to treat certain terminable interests, known as qualified terminable interest property (QTIP), as property eligible for the marital deduction.

As a condition of the election, property included in a QTIP trust must be included in the surviving spouse's gross estate. Thus, the property is subject to estate tax and, accordingly, the surviving spouse becomes the transferor of the property for GST purposes. When the surviving spouse is treated as the transferor of QTIP property, results can be harsh from a GST tax standpoint; namely, the GST tax exemption of the first spouse to die may be completely wasted.

Example 1B-2 Surviving spouse is transferor of qualified terminable interest property.

Harold Stockton's will created a $1 million QTIP trust for the benefit of his wife, Mildred. Upon her death, the remainder is to be distributed to their grandchildren. Mildred died several years later when the trust is worth $10 million. The $10 million is included in Mildred's estate and, accordingly, Mildred is treated as the transferor of the $10 million to her grandchildren. The executor of Mildred's estate allocates her GST tax exemption to the transfer; however, since Mildred is the transferor, the distribution of the $10 million to the grandchildren will be treated as a direct skip subject to the GST tax. This means that only $3.5 million (for 2009) of the $10 million will be sheltered from the GST tax.

<u>Reverse QTIP Election.</u> To avoid these harsh consequences, a decedent's estate may elect to treat (for GST tax purposes only) all of the QTIP property as if the QTIP election had not been made. This election is provided by

IRC Sec. 2652(a)(3) and is referred to as the reverse QTIP election. If the reverse QTIP election is made, the decedent or donor spouse will continue to be treated as the transferor of the property for GST purposes only.

Example 1B-3 Using a reverse QTIP election to use spouse's GST tax exemption.

Assume the same facts as in Example 1B-2 except that the executor of Harold's estate makes the reverse QTIP election and allocates $1 million of Harold's GST tax exemption to the trust. Because of this election, Harold is treated as the transferor of the QTIP property for GST purposes after Mildred's death. Thus, at Mildred's death, a taxable termination occurs with respect to the QTIP trust. However, Harold is considered the transferor of the trust property. Thus, Harold's exemption shelters all $10 million of trust assets from the GST tax.

<u>Noncitizen Surviving Spouse Is Transferor.</u> A surviving spouse is the transferor of a qualified domestic trust (QDOT) that is used to obtain a marital deduction in the decedent's estate unless the trust is subject to the reverse QTIP election.

<u>Property Passing by Disclaimer.</u> If a person disclaims an interest in property using a qualified disclaimer, the transferor is the original transferor of the property. Since the disclaimant is treated as predeceasing the transferor (in the case of a transfer at death), the property subject to a qualified disclaimer is considered to have passed directly from the original transferor to the person receiving the property as a result of the disclaimer. Thus, the original transferor is the transferor of the disclaimed property for GST purposes.

Example 1B-4 Decedent is transferor of disclaimed property.

At the time of his death, Ron owned a $200,000 life insurance policy on his life. The beneficiary designation on the policy named Ron's son, Don, as primary beneficiary. Ron's grandson, Mike, was named secondary beneficiary of the policy. Don executed a qualified disclaimer disclaiming his interest in the property. As a result of the disclaimer, the proceeds of the policy passed to Mike. Ron will be treated as the transferor of the insurance policy to Mike; therefore, a GST occurs.

Skip Person

For a generation-skipping transfer to occur, property must be transferred to a skip person. A skip person is a natural person assigned to a generation that is two or more generations below the transferor. The classic examples are grandchildren of the transferor. However, only one direct skip occurs when a single transfer of property skips two or more generations (e.g., a transfer to a great-grandchild).

There are two instances where a trust can be a skip person. First, a trust can be a skip person if all interests in the trust are held by skip persons.

Example 1B-5 Trust is skip person if all interests in the trust are held by skip persons.

Joe Green sets up a trust to make annual distributions to his grandchild, Bart Green, for life. At Bart's death, trust assets are to be distributed to Bart's children. The trust is a skip person since all interests in the trust are held by skip persons.

A trust can also be a skip person if (1) no person holds an interest in the trust, and (2) at no time after the transfer may a distribution (including distributions on termination) be made to a nonskip person.

<u>Interest in Trust.</u> A person has an interest in a trust if the person—

1. has a present right to receive trust principal or income,
2. is a permissible current recipient of trust principal or income and is not a charitable organization, or
3. is a charitable organization that has a present right to receive trust principal or income from the trust or is a remainder beneficiary of a charitable remainder annuity trust or unitrust, or a pooled income fund.

Example 1B-6 Interest in a trust.

Bob establishes an irrevocable trust in which the income is payable to his daughter Nicole, for her life. Upon Nicole's death, the trust principal is paid to Bob's grandchild (Nicole's son), Matthew. Because Nicole has a present right to receive income, she has an interest in the trust. Because Matthew cannot currently receive distributions from the trust, he does not have an interest in the trust. (Thus, the trust is not a skip person.)

Example 1B-7 Interest disregarding if purpose is to postpone GST tax.

Karen forms a trust to pay her child, Julie, $50 a year for 30 years and to pay her grandchild the remainder. Karen is hoping that by paying the nominal annual amount to Julie, she will postpone the imposition of the GST tax for 30 years (when the trust corpus will be paid to her grandchild). The IRS could maintain that Julie's interest was created with the significant purpose of postponing GST tax and disregard the interest.

Example 1B-8 Section 2503(c) trust qualifies as a skip person.

Jim Brown sets up a trust for the benefit of his grandson, Bobby. Pursuant to the trust instrument, the trustee is required to accumulate income until Bobby turns 21. All accumulated income and principal must be distributed to Bobby at age 21, or to Bobby's estate if Bobby dies before age 21. The trust, known as a Section 2503(c) trust, is a skip person because no person has an interest in the trust (i.e., a present right to receive principal or income) and no distribution may be made to a nonskip person.

Example 1B-9 GST occurs when trust is established and funded.

Assume the same facts as in Example 1B-8. The transfer is subject to GST tax when the trust is established. When Bobby turns 21 and gets the trust distribution, there is not a taxable distribution or termination and therefore, no GST tax is payable when assets are distributed to Bobby. The transfer is eligible for the GST tax annual exclusion.

Nonskip Person

A nonskip person is any person who is not a skip person. Thus, a skip person and a nonskip person are mutually exclusive. An example of a nonskip person is a person assigned to a generation one level below the transferor's level or to the same or higher level of the transferor. This means a transferor's ancestors, children, and spouse are nonskip persons. In addition, a charity is a nonskip person.

A trust is a nonskip person if a nonskip person holds an interest in the trust (as defined above), even if other interests in the trust are held by skip persons. Also, a trust is a nonskip person if a distribution can be made to a nonskip person.

Example 1B-10 Trust is nonskip person if trust interest held by nonskip person.

Betty Walls established a trust that will make discretionary annual distributions to her daughter, Sally. The trustee also has the power to make discretionary distributions of income or principal to Sally's children (i.e., Betty's grandchildren). The trust is a nonskip person because a nonskip person holds an interest in the trust.

Generation Assignments

A beneficiary's status as a skip or a nonskip person is determined by his or her generation relative to the transferor.

<u>Lineal Descendants.</u> In most cases involving GSTs, generation assignments are based on family relationships. Thus, a lineal descendant of a transferor's grandparent is assigned to a generation by comparing (1) the number of generations between the descendant and the grandparent to (2) the number of generations between the transferor and the grandparent. For transfers between family members, the generation assignment is relatively obvious. A husband, wife, and their brothers and sisters are one generation. Their children, nieces, and nephews are the first younger generation. The grandchildren and great nieces and nephews are the next generation, and so on.

Example 1B-11 Generation assignments for lineal descendants.

Red Wyatt transferred $50,000 to his nephew's son, Mark. Since Mark is the second generation, below his great uncle Red, Mark is a skip person.

If Red had given the money to his nephew, his nephew would not be a skip person because his nephew is only one generation below Red.

A descendant of a grandparent of a spouse (or former spouse) of the transferor is assigned to a generation by comparing the number of generations between the spouse and the grandparent to the number of generations between the descendant and the grandparent.

A spouse (or former spouse) of the transferor is assigned to the same generation as the transferor. A spouse (or former spouse) of the transferor's parent is assigned to the same generation as the parent. Parents are assigned to the same generation as their siblings (aunts and uncles of the transferor).

Adopted Individuals. When assigning generations to beneficiaries, a relationship by legal adoption is generally treated as a relationship by blood, and a relationship by half-blood is treated as a relationship by whole blood.

However, regulations clarify that an adopted individual is deemed to belong to one generation below the adoptive parents if he or she is—

1. legally adopted by an adoptive parent,
2. a descendent of a parent of the adoptive parent (or the spouse or former spouse of the adoptive parent),
3. under the age of 18 at the time of the adoption, and
4. not adopted primarily for the purpose of avoiding the GST tax.

Example 1B-12 Generation assignment of an adopted child.

Mike and Sandy have one child, David. David has a 20-year old son, Tyler. Mike and Sandy legally adopt Tyler and Mike transfers $100,000 to him. Under state law, Tyler is considered Mike and Sandy's child. However, for GST tax purposes, Tyler is assigned to the generation that is two generations below Mike and is therefore a skip person. Thus, the $100,000 transfer to Tyler is a direct skip.

Persons Who Are Not Lineal Descendants. Individuals not assigned to generations based on family relationships are assigned to generations based on their age relative to the age of the transferor.

An individual not more than 12½ years younger than the transferor is treated as a member of the transferor's generation. An individual more than 12½ years, but not more than 37½ years, younger is assigned to the first generation below the transferor. Thereafter, every 25 years represents a new generation. A good example of generation assignments can be found in Ltr. Rul. 200150003.

Example 1B-13 Generation assignments for unrelated parties.

Tim (age 72) created an irrevocable trust to pay income to his butler, Geoffrey (age 56), for life, with the remainder on Geoffrey's death going to Geoffrey's son, Herbert, age 32. The transfer to Geoffrey is not a GST because Geoffrey is assigned to the first generation below Tim (i.e., Geoffrey is 16 years younger than Tim, which places him in the next generation because 16 is greater than 12½ and not more than 37½ years younger than Tim).

However, the death of Geoffrey will result in a taxable termination, since his son is a skip person. Herbert is a skip person because he is more than 37½ years younger than Tim and is thus assigned to the second generation below Tim.

Special Rule for Predeceased Parents and Other Collateral Relatives. In most cases involving GSTs, generation assignments are based on family relationships. For transfers between family members, the generation assignment is relatively obvious. A husband, wife, and their brothers and sisters represent one generation. Their children, nieces, and nephews represent the first younger generation. The grandchildren, great nieces and great nephews represent the next generation, and so on. However, there is an exception to the direct skip rule for the children of deceased parents (commonly referred to as the *predeceased parent exception*) permitting a direct skip transfer to a transferor's grandchild without any GST tax if the grandchild's parent is deceased at the time of the transfer. In addition, transfers to collateral heirs are permitted when the transferor has no living lineal heirs at the time of the transfer. The exception also applies to taxable distributions and taxable terminations in favor of a grandchild or other lineal descendant when the original transfer in trust is made after the death of the grandchild's or other lineal descendant's parent.

Regulations clarify that to the extent of a QTIP election, the remainder beneficiary's interest would be deemed established at the death of the income beneficiary (otherwise, a remainder beneficiary of a QTIP trust would not benefit from the predeceased parent rule if the remainder beneficiary's parent is alive when the QTIP is established, but is deceased when the income beneficiary's interest terminates).

Example 1B-14 Predeceased parent rule.

Bob Cann made a taxable gift to his grandson, Charley. Charley's father, who is Bob's son, was deceased at the time of the gift. Charley "moves up" and is treated as though he were Bob's son for GST tax purposes. Thus, no direct skip occurs because Charley is not a skip person.

Example 1B-15 Predeceased parent and QTIP election.

Tom died in 2005, survived by his spouse Cheryl, their children, Kory and Katie, and several grandchildren. Under the terms of Tom's will, a trust was established for the benefit of Cheryl and their children and grandchildren. All income is distributed to Cheryl during her lifetime and the trustee may distribute principal to Cheryl for health, support, and maintenance. At Cheryl's death, the principal is distributed to their children. If either child predeceases Cheryl, that child's share goes to that child's descendents, per stirpes.

The executor of Tom's estate makes the QTIP election (but not the reverse QTIP election). In 2007, Kory died and is survived by Cheryl, Katie, and all grandchildren. In 2009, Cheryl dies and the trust terminates. The fair market value of the trust is included in Cheryl's estate and she is the transferor for GST tax purposes. As a result, Kory's children are not considered skip persons because Kory is deceased at the time the interest is established (i.e., at Cheryl's death).

Example 1B-16 Predeceased parent and the reverse QTIP election.

Assume the same facts as in Example 1B-15 except that the executor of Tom's estate makes the reverse QTIP election for the entire trust. Tom is considered the transferor for GST tax purposes. Therefore, the children's interest is considered established in 2005 (when Tom died), the predeceased parent rule does not apply because Kory is alive at that time. When the trust terminates at Cheryl's death, there is a taxable termination for the portion of the trust distributed to Kory's children. There would be GST tax to the extent the inclusion ratio is greater than zero.

Example 1B-17 GST exception for transfers to collateral heirs.

Diane is a successful business owner who never married or had any children. Diane's sister, Nancy, had one child, Monica. Monica had two children, Jane and June. In 2001, Monica was killed in an automobile accident. In 2009, Diane gave 20% of her business to Jane (Diane's grandniece).

The exception for transfers to collateral heirs applies because Jane's mother, Monica, was not alive at the time of the transfer *and* Diane had no living lineal descendants. As a result, Jane is not considered a skip person.

Charitable and Governmental Entities. Charitable trusts, charitable organizations, and governmental entities are assigned to the transferor's generation. Therefore, such charitable and governmental entities are nonskip persons.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. In the case of a(n) ___________, the transfers are during the lifetime of the transferor.

   a. *Inter vivos* direct skip.

   b. Direct skip at death.

   c. Direct skip at death from a trust.

   d. Taxable distribution.

2. The GST tax applies to which of the following examples?

   a. Granny paid $30,000 to The University of Texas at Arlington for her granddaughter's college tuition.

   b. Papa paid $50,000 to Heritage Hospital for his grandson's surgery.

   c. Grandma transfers a gift of $13,000 to her granddaughter Harriet, who uses the money to buy a car.

   d. Pappy decided to give his granddaughter, Robin, $70,000 to help buy a house after she graduates from college.

3. Which of the following modifications will shift the beneficial interest in an irrevocable trust?

   a. Lower income taxes.

   b. A modification in an irrevocable trust that results in an increase in the amount of the GST.

   c. A court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of the terms of a trust instrument.

4. A generation-skipping transfer (GST) occurs when—

   a. A transferor makes a direct transfer to a skip person.

   b. When property subject to either the gift or estate tax is transferred to a person one generation below the transferor.

   c. When the transferor's lineal descendant predeceases the transferor.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. In the case of a(n) ___________, the transfers are during the lifetime of the transferor. **(Page 115)**

   a. *Inter vivos* direct skip. [This answer is correct. According to the Internal Revenue Code, *inter vivos* skips are direct skip transfers made during the life of the transferor. *Inter vivos* direct skips include direct transfers from the transferor to a skip person, as well as transfers to a trust that qualifies as a skip person.]

   b. Direct skip at death. [This answer is incorrect. A direct skip at death occurs when property included in the transferor's estate is transferred to a skip person.The skip person may be either an individual or a trust qualifying as a skip person.]

   c. Direct skip at death from a trust. [This answer is incorrect. A direct skip at death from a trust occurs when property from a trust included in the transferor's gross estate is transferred to a skip person.]

   d. Taxable distribution. [This answer is incorrect. A taxable distribution is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person.]

2. The GST tax applies to which of the following examples? **(Page 115)**

   a. Granny paid $30,000 to The University of Texas at Arlington for her granddaughter's college tuition. [This answer is incorrect. If a student is approaching college age, the grandparent might want to write a check for tuition payments to the school. If such payments are made directly to a qualified educational organization, no gift or generation-skipping taxes should be incurred.]

   b. Papa paid $50,000 to Heritage Hospital for his grandson's surgery. [This answer is incorrect. Grandparents can pay as much as they like toward a grandchild's medical costs, if they pay the hospital or doctor directly. Such payments are not seen as taxable gifts.]

   c. Grandma transfers a gift of $13,000 to her granddaughter Harriet, who uses the money to buy a car. [This answer is incorrect. Direct skip transfers that are nontaxable gifts for gift tax purposes because of the annual gift tax exclusion ($13,000 for 2009) have an inclusion ration of zero, resulting in no GST tax. Thus, grandparents can currently make GST tax-free direct skips to their grandchildren of up to $13,000 per donee per year.]

   d. Pappy decided to give his granddaughter, Robin, $70,000 to help buy a house after she graduates from college. [This answer is correct. Under the Code, the GST tax applies in this situation because the GST tax is imposed on direct transfers to beneficiaries more than one generation below that of the transferor.]

3. Which of the following modifications will shift the beneficial interest in an irrevocable trust? **(Page 115)**

   a. Lower income taxes. [This answer is incorrect. If the modification is administrative in nature and only indirectly increases the amount transferred (such as by lower administration costs or income taxes) a shift in a beneficial interest in the trust will not occur due to such modification.]

   b. A modification in an irrevocable trust that results in an increase in the amount of the GST. [This answer is correct. The regulations provide that a modification of an irrevocable trust will shift a beneficial interest if the modification results in either (1) an increase in the amount of a GST or (2) the creation of a new GST.]

   c. A court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of the terms of a trust instrument. [This answer is incorrect. A court-approved settlement of a bona fide controversy relating to the administration of a trust or the construction of the terms of a trust instrument will not cause a trust to lose its exempt status.]

4. A generation-skipping transfer (GST) occurs when—**(Page 119)**

   a. **A transferor makes a direct transfer to a skip person. [This answer is correct. According to Code, GST occurs when there is a direct or indirect transfer from a transferor to a skip person. The determination of whether an event is a GST is made by reference to the most recent transfer subject to the estate or gift tax.]**

   b. When property subject to either the gift or estate tax is transferred to a person one generation below the transferor. [This answer is incorrect. A direct skip, which is a GST, occurs when property subject to either the estate or gift tax is transferred to a skip person who would generally be two or more generations younger than the transferor.]

   c. When the transferor's lineal descendant predeceases the transferor. [This answer is incorrect. For deaths of nonskip persons, the GST tax exemption can be allocated retroactively when there is an unnatural order of death, which occurs when a lineal descendant of the transferor predeceases the transferor.]

Calculating the GST Tax

Conceptually, the calculation of the generation-skipping transfer (GST) tax is not difficult. Like most other taxes, the GST tax is the product of the taxable amount and the applicable rate. In reality, the calculation of the tax is a multistep process that is dependent on the type of GST involved (i.e., direct skip, taxable termination, or taxable distribution).

Taxable Amount

The taxable amount of a GST depends on whether the transfer was a direct skip, a taxable distribution, or a taxable termination.

Direct Skips. The taxable amount of a direct skip is the value of the property received by the transferee. Thus, in the case of *inter vivos* gifts made by the transferor, the value of the property received is its value on the date of the gift and does not include the amount of any gift tax paid on the transfer.

Example 1C-1 Taxable amount of *inter vivos* direct skip is value of property received.

Lucy Rand transferred 200 shares of B&R stock to her grandson. At the time of the transfer, the stock was valued at $60,000. The taxable amount of the direct skip transfer to her grandson is $60,000.

In the case of a direct skip at death, the taxable amount is the value of the property received by the transferee. Thus, the value of the property is its FMV on the decedent's date of death or alternate valuation date, if elected. In addition, the value of the transfer must generally be reduced by the amount of state and federal death and GST taxes imposed on the transfer. Note that if the decedent's will directs that such taxes be paid from other estate property, the value of the transfer is not reduced by these taxes since they do not reduce the amount of property transferred to the beneficiary.

Example 1C-2 Value of a direct skip at death is reduced by taxes charged to property.

Frank Nunn bequeathed 300 shares of Plane Inc. stock to his granddaughter, Mary. The stock was valued at $150,000 on Frank's death and $130,000 on the alternate valuation date. Frank's executor elected to value estate property at the alternate valuation date. Assume $65,000 of state and federal taxes were allocable to the stock. In addition, Frank had previously used his lifetime GST tax exemption. The amount of GST tax on the transfer can be determined using the following formula:

$$\frac{\text{Amount received exclusive of GST taxes}}{1 + (1 \div \text{highest estate tax rate})}$$

Assuming the estate tax rate is 45%, the amount of GST tax is computed as follows:

$$\frac{\$130,000 - \$65,000}{1 + (1 \div .45)} = \frac{\$65,000}{3.22222} = \$20,172$$

The calculation can be proved as follows:

Property transferred	$ 130,000
Less:	
State and federal taxes	(65,000)
GST tax	(20,172)
Amount received before GST tax	44,828
Times: GST rate	× .45
GST tax	$ 20,172

Taxable Termination. In the case of a taxable termination, the taxable amount is the value of the terminated property interest passing to the skip person(s) reduced by the type of deductions allowed under IRC Sec. 2053(a), i.e., funeral expenses, administration expenses, claims, etc.

Example 1C-3 Value of taxable termination is reduced by trust expenses.

Wade Santos created a trust that pays all of its net income annually to his son, Carl, for life. At Carl's death, the balance of the trust will be distributed to Carl's son, Ray. Carl died in 2009 creating a taxable termination subject to the GST tax. At Carl's death, the trust held real estate and stocks valued at $400,000. The trust also had accrued real property taxes of $4,500 and termination expenses of $6,000. For purposes of computing the GST tax on the taxable termination, the taxable amount will be $389,500 ($400,000 − $10,500).

Taxable Distributions. The taxable amount of a taxable distribution is the value of the property received reduced by any expenses incurred by the transferee in connection with the determination, collection, or refund of the GST tax on the distribution. If the trust pays the GST tax, the payment will be treated as a taxable distribution made on the last day of the calendar year in which the original taxable distribution is made.

Example 1C-4 Value of taxable distribution is reduced by tax preparation fee.

Mona Hart received a $60,000 taxable distribution from a trust. Mona's CPA charged $550 to prepare Form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions). Assuming the inclusion ratio (discussed below) for the trust is 1.0, the taxable amount of Mona's distribution is $59,450 ($60,000 − $550). The fee is deductible even if it has not been paid at the time the return is filed.

Applicable Rate

Once the taxable amount has been determined, the second component necessary for the calculation of GST tax is the applicable rate. The applicable rate is the maximum federal estate tax rate (45% for 2009) multiplied by the inclusion ratio, which equals one minus the "applicable fraction."

Inclusion Ratio. The inclusion ratio is used to give effect to the portion of the transferor's $3.5 million (for 2009) lifetime exemption allocated to a given transfer. It is multiplied by the maximum GST tax rate of 45% (for 2009) to determine the effective (applicable) GST tax rate to be applied to the taxable amount. Thus, the allocation of the GST tax exemption with regard to a particular transfer reduces the effective GST tax rate on a prorata basis via the inclusion ratio. The inclusion ratio equals one minus the applicable fraction.

Applicable Fraction. The Code defines the inclusion ratio as 1 minus the applicable fraction. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust or transferred property. The denominator of the applicable fraction is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax attributable to the property, and (2) the gift or estate tax charitable deduction allowed for the property, if any. When computing the inclusion ratio, the applicable fraction must be rounded to the nearest one-thousandth (.001) before subtracting it from one. Expressed algebraically, the applicable fraction is—

$$\frac{\text{Amount of GST tax exemption allocated to trust or property}}{[\text{Value of property transferred}] - [(\text{State and federal estate taxes} + \text{charitable deductions allowed})]}$$

Example 1C-5 Determining the inclusion ratio.

In 2009, Harold White transferred property worth $5 million to a newly created irrevocable trust for the benefit of his grandson, Hal. Harold allocates his full $3.5 million (for 2009) GST tax exemption to the trust. The applicable fraction is $3.5 million/$5 million, or .70. The inclusion ratio is .30 (1 − .70). Thus, any taxable transfer with respect to the trust will be taxed at .135% (45% maximum estate tax rate × .30 inclusion ratio).

The applicable fraction, and thus the inclusion ratio, is required to be recomputed when additional property is transferred (or an additional exemption is allocated) to an existing trust. The numerator of the recomputed applicable fraction is the sum of the amount of the GST tax exemption allocated to the additional property transferred to the trust and the "nontax portion" of the trust immediately before the additional transfer. The nontax portion is the product of the value of all of the property in the trust (before the additional transfer) and the applicable fraction (before the additional transfer).

The denominator of the recomputed applicable fraction is the sum of (1) the value of the property involved in such transfer reduced by the sum of any federal estate tax or state death tax attributable to such property and recoverable from the trust and any charitable deduction allowed with respect to such property, and (2) the value of all property in the trust immediately before the transfer.

Example 1C-6 Recomputing the inclusion ratio because of additional transferred property.

In 1998, Nan Buck created a trust with property worth $1,200,000 and allocated $900,000 of her GST tax exemption to the trust. This resulted in an applicable fraction of .750 ($900,000 ÷ $1,200,000) and an inclusion ratio of .250 (1 − .750).

In 2009, Nan contributed an additional $1 million to the trust when the trust property had appreciated to $1,800,000 (before the additional transfer). The nontax portion of the trust before the additional contribution is $1,350,000 ($1,800,000 × .750).

If Nan does not allocate any of her remaining GST tax exemption to the trust, the recomputed applicable fraction is .4821 [$1,350,000 ÷ ($1 million + $1.8 million)] and the inclusion ratio is .5179 (1 − .4821).

If she allocates an additional $1.2 million of her GST tax exemption in 2009, the recomputed applicable fraction is .9107 [($1,200,000 + $1,350,000) ÷ ($1,000,000 + $1,800,000)] and the inclusion ratio is .0893 (1 − .9107).

The applicable fraction and inclusion ratio must also be recomputed if additional GST tax exemption is allocated to the value of property held in trust created by the transferor and included in the transferor's estate. The numerator of the recomputed applicable fraction is equal to the value of the nontax portion of the property immediately after the death of the transferor, increased by the amount of the exemption allocated by the executor. The denominator is the value of the trust property at the date of death.

Example 1C-7 Allocating an additional GST tax exemption to a trust included in the transferor's estate.

In 1999, Henry Winker transferred $200,000 to an irrevocable trust with income payable to his son, Ralph, for life. At Ralph's death, the trust terminates, and the remainder is payable to Henry's grandchild. At the time when there was no ETIP with respect to the trust property, Henry initially allocated $100,000 of his GST tax exemption to the trust. The applicable fraction is .500 ($100,000 ÷ $200,000). The inclusion ratio is .500 (1 − .500).

At Henry's death in 2009, the trust property is valued at $500,000 and is included in Henry's estate because of certain retained powers. The executor of the estate allocates an additional $100,000 of Henry's unused GST tax exemption to the trust. This additional allocation means the applicable fraction and inclusion ratio must be recomputed.

The nontax portion of the trust at the date of death is $250,000 ($500,000 × .500). The numerator of the recomputed applicable fraction is $350,000 ($250,000 + $100,000), which is the nontax portion plus the allocation of the additional exemption. The denominator of the recomputed applicable fraction is $500,000, the value of the trust property at the date of death. Thus, the recomputed applicable fraction is .700 ($350,000 ÷ $500,000) and the recomputed inclusion ratio is .300 (1 − .700).

<u>Inclusion Ratio for Nontaxable Gifts.</u> The inclusion ratio for an outright transfer to a skip person is zero to the extent the transfer is a nontaxable gift, i.e., a gift up to the annual exclusion amount or a gift excluded for medical and education expenses. Thus, gifts excluded under these provisions are not subject to the GST tax.

Example 1C-8 Inclusion ratio is zero for certain annual exclusion gifts.

Martha Jones transferred $26,000 to her grandson during 2009. Martha and her husband, Jim, elected gift splitting on the transfer so that each was considered the transferor of $13,000. Although Martha and Jim would each be considered the transferor of a direct skip transfer with a taxable amount of $13,000, the inclusion ratio on each transfer is zero because of the GST tax annual exclusion ($13,000 for 2009, indexed for inflation). Thus, no part of the transfer is subject to GST tax.

Direct skip transfers to a trust that qualify as a present interest eligible for the $13,000 (for 2009) gift tax annual exclusion will qualify for the GST tax annual exclusion only if—

1. the trust is solely for the benefit of one skip person, and
2. the trust assets will be included in the skip person's gross estate if he or she dies during the term of the trust.

Example 1C-9 Transfers to a Section 2503(c) minor's trust eligible for the annual GST tax exclusion.

Don Nots transferred $13,000 to a trust for the benefit of his grandson, Ron. Pursuant to the trust instrument, the trustee has the discretion to distribute or accumulate trust income or corpus until Ron turns 21. At age 21, the balance in the trust will be distributed to Ron. Ron has a testamentary general power of appointment over trust assets should he die before age 21. This type of trust arrangement, known as a Section 2503(c) minor's trust, meets the requirements of IRC Sec. 2642(c). Thus, the transfer qualifies for the GST tax annual exclusion ($13,000 for 2009) and the trust has an inclusion ratio of zero.

Example 1C-10 Transfers to a *Crummey* trust not eligible for annual GST exclusion.

Gabe Waite transferred $30,000 to an irrevocable life insurance trust for the benefit of his three grandchildren. Pursuant to the trust instrument, each grandchild has the right to withdraw up to $10,000 of amounts contributed to the trust within thirty days of the contribution. The withdrawal power lapses in 30 days if not exercised. The trustee may "sprinkle" income and corpus among the beneficiaries during Gabe's life. At his death, the trust will divide into separate trusts for each grandchild. Although this type of trust arrangement, known as a *Crummey* trust, qualifies for the gift tax annual exclusion, it does not meet the requirements of IRC Sec. 2642(c) for the GST tax annual exclusion. Thus, the $30,000 transferred to the trust is a direct skip subject to GST taxes. However, Gabe may have sufficient GST tax exemption to offset the taxable transfer.

<u>Special Rule for Charitable Lead Annuity Trusts.</u> Charitable lead annuity trusts are treated differently than other trusts for allocating the GST tax exemption. For determining the inclusion ratio for charitable lead annuity trusts, the applicable fraction is recalculated based on the value of assets when the charitable interest ends. The applicable fraction has a numerator equal to the adjusted GST tax exemption and a denominator equal to the value of all property in such trust immediately after the termination of the charitable lead annuity. The adjusted GST tax exemption is the amount equal to the GST tax exemption allocated to the trust, increased by the Section 7520 rate used in determining the amount of the deduction under IRC Sec. 2055 or 2522 for the actual period of the charitable lead annuity. The amount of the GST tax exemption allocated to a CLAT is not reduced even if it is ultimately determined that the allocation of a lesser amount of the GST tax exemption would have resulted in a zero inclusion ratio. Charitable lead annuity means any interest in a form of a guaranteed annuity with respect to which a deduction was allowed under IRC Sec. 2055 or 2522.

Example 1C-11: Inclusion ratio for a CLAT.

Ken creates a CLAT for a 10-year term with the remainder payable to his grandchild. Ken timely allocates some of his GST tax exemption to the trust, which he expects will ultimately result in a zero inclusion ratio. However, at the end of the charitable lead interest, because the property has not appreciated to the extent Ken anticipated, the numerator of the applicable fraction is greater than the denominator. The inclusion ratio for the trust is zero. No portion of the excess GST tax exemption allocated to the trust is restored to Ken or to Ken's estate.

Valuation

Valuation is a key concept in determining the denominator of the applicable fraction. The regulations address the valuation concept for lifetime transfers and for transfers at death.

<u>Lifetime Transfers.</u> When determining the denominator of the applicable fraction, the value of property transferred during life is its FMV (as finally determined for gift tax purposes) on the effective date of the allocation of the GST tax exemption to the transfer. This effective date is the date of the transfer (the date of the gift) if a timely allocation of the exemption is made.

The allocation of the exemption will be timely if the allocation is made on a timely filed gift tax return (including extensions). Typically, a transferor making a gift in trust will choose property with the expectation that the property value will appreciate between the date of the gift and the date of death so that the appreciation is excluded from the transferor's estate. Thus, it is important to make a timely allocation of the GST tax exemption, since an allocation at a later date will shelter a smaller amount of the transfer.

If the allocation of the exemption is made on a gift tax return that is not timely filed, the value of the property is the value on the date the gift tax return is filed.

Transfers at Death. Generally, when determining the denominator of the applicable fraction, the value of property transferred at death is its value, as finally determined, for estate tax purposes. Thus, property is valued at the date of death or alternate valuation date.

However, special rules apply if property other than cash is used to satisfy a pecuniary (fixed-dollar) bequest. The denominator of the applicable fraction is the pecuniary amount only if such payment must be made with property on the basis of the property's date of distribution values or a value based on a date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly represents net appreciation and depreciation from the date of death in all assets available to satisfy the payment. These rules prohibit the executor from using the most highly appreciated assets to fund a pecuniary gift to which the GST tax exemption will be allocated.

Example 1C-12 Allocating the GST tax exemption to a pecuniary bequest funded with assets other than cash.

Under the provisions of Ethyl's will, $200,000 is to be paid to her grandchild. The executor of Ethyl's estate funds the pecuniary bequest with assets that have a date-of-death value of $200,000 and a date-of-distribution value of $250,000. The executor allocates $200,000 of the GST tax exemption to the transfer.

If the assets used to fund the transfer are fairly representative of the appreciation and depreciation of all of the estate's assets from which the distribution could have been made, then the applicable fraction is one ($200,000 ÷ $200,000) and the inclusion ratio is zero.

However, if the assets used to fund the transfer are not representative of the appreciation and depreciation of all of the estate's assets from which the distribution could have been made, the date-of-distribution value must be used for the denominator, resulting in an applicable fraction of .800 ($200,000 ÷ $250,000) and an inclusion ratio of .200 (1.0 − .80). Thus, in this situation, if the executor desires an inclusion ratio of zero, he or she must allocate $250,000 of the GST tax exemption to the transfer.

If the exemption is to be allocated to a residual trust after a pecuniary payment, the denominator of the applicable fraction is generally the date of death values reduced by the pecuniary amount if the pecuniary payment carries "appropriate interest." Appropriate interest means either interest required under state law on such a distribution or 80% of the Section 7520 rate at the decedent's death. Appropriate interest can be deemed to be satisfied if the pecuniary payment is made by cash payment or property irrevocably set aside within 15 months of death or a prorata share of income allocation is made to the pecuniary payment as required by the governing instrument or local law. If the pecuniary share does not carry appropriate interest, the denominator is the date of death values reduced by the present value of the pecuniary payment. In other words, the pecuniary amount is discounted to present value using applicable interest rates, and this reduced pecuniary amount is then subtracted from the estate tax value of the residue.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. What is the maximum federal estate tax rate for 2009?

   a. 5%.

   b. 25%.

   c. 45%.

   d. 80%.

6. How does the Code define the inclusion ratio?

   a. Nontax portion of the property immediately after the death of the transferor plus the allocation of the exemption allocated by the executors.

   b. One minus the applicable fraction.

7. In 2009, Walter transfers $5 million worth of property into a newly created trust that benefits his granddaughter, Summer. Walter allocates his full $3.5 million GST tax exemption to this trust. Calculate the inclusion ratio for this scenario.

   a. .30.

   b. .70.

   c. .135.

8. What is the value of property transferred at death when determining the denominator of the applicable fraction?

   a. The property's value, as finally determined, for estate tax purposes.

   b. The value of the terminated property interest that passes to a skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property.

   c. The value of the property received by the transferee.

   d. Zero, to the extent the property transferred is a taxable gift.

9. When calculating the GST tax inclusion ratio, both the numerator and denominator must be determined. Which of the following terms best describes a key concept in determining the denominator of the applicable fraction?

   a. Inclusion ratio.

   b. Valuation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. What is the maximum federal estate tax rate for 2009? **(Page 128)**

   a. 5%. [This answer is incorrect. One of the qualifications for determining if a taxable termination has occurred, is that at no time after such termination may a distribution (including a distribution on termination) be made to a skip person. For this purpose, it is sufficient that the probability of a distribution to a skip person be less than 5%, determined actuarially.]

   b. 25%. [This answer is incorrect. A GST trust could have a generation-skipping transfer with respect to the transferor, unless certain circumstances exist. One such situation is if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are nonskip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals.]

   c. 45%. [This answer is correct. According to the Internal Revenue Code, the maximum federal estate tax rate for 2009 is 45%.]

   d. 80%. [This answer is incorrect. When dealing with transfers at death, if the exemption is to be allocated to a residual trust after a pecuniary payment, the denominator of the applicable fraction is generally the date of death values reduced by the pecuniary amount if the pecuniary payment carries "appropriate interest." Appropriate interest means either interest required under state law on such a distribution or 80% of the Section 7520 rate at the decedent's death.]

6. How does the Code define the inclusion ratio? **(Page 128)**

   a. Nontax portion of the property immediately after the death of the transferor plus the allocation of the exemption allocated by the executors. [This answer is incorrect. This is the numerator of the recomputed applicable fraction.]

   b. One minus the applicable fraction. [This answer is correct. According to the Internal Revenue Code, the inclusion ratio equals one minus the applicable fraction. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to trust or transferred property.]

7. In 2009, Walter transfers $5 million worth of property into a newly created trust that benefits his granddaughter, Summer. Walter allocates his full $3.5 million GST tax exemption to this trust. Calculate the inclusion ratio for this scenario. **(Page 128)**

   a. .30. [This answer is correct. The inclusion ratio is 1 * .70, which equals .30.]

   b. .70. [This answer is incorrect. This is the applicable fraction, and it is calculated as $3.5 million/$5 million.]

   c. .135. [This answer is incorrect. This is the tax rate for any taxable transfer with respect to the trust, which is calculated as the 45% maximum estate tax rate × .30.]

8. What is the value of property transferred at death when determining the denominator of the applicable fraction? **(Page 128)**

   a. The property's value, as finally determined, for estate tax purposes. [This answer is correct. Under the IRS regulations, generally, when determining the denominator of the applicable fraction, the value of property transferred at death is its value, as finally determined, for estate tax purposes. Thus, property is valued at the date of death or alternate valuation date.]

   b. The value of the terminated property interest that passes to a skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property. [This answer is incorrect. This is the taxable amount of a taxable termination. The Code defines a taxable distribution as transfers that are not taxable terminations or direct skips.]

c. The value of the property received by the transferee. [This answer is incorrect. In the case of a direct skip, the transferor or the transferor's estate is liable for the GST tax. If the direct skip is made from a trust, the trustee is treated as the transferor and is liable for the tax. The amount subject to the GST tax is the value of the property received by the transferee. The tax base for computing the GST tax for a direct skip made during life is the amount received and does not include the GST tax.]

d. Zero, to the extent the property transferred is a taxable gift. [This answer is incorrect. The inclusion ratio for an outright transfer to a skip person is zero to the extent the transfer is a nontaxable gift, i.e., a gift up to the annual exclusion amount or a gift excluded for medical and education expenses.]

9. When calculating the GST tax inclusion ratio, both the numerator and denominator must be determined. Which of the following terms best describes a key concept in determining the denominator of the applicable fraction? **(Page 128)**

a. Inclusion ratio. [This answer is incorrect. The inclusion ratio is used to give effect to the portion of the transferor's $3.5 million (for 2009) lifetime exemption allocated to a given transfer.]

b. Valuation. [This answer is correct. Valuation is a key concept in determining the denominator of the applicable fraction. The regulations address the valuation concept for lifetime transfers and for transfers at death.]

Making Timely Allocation of the GST Tax Exemption

Each transferor is allowed a lifetime GST tax exemption. For 2009, the exemption is $3.5 million. This means that each individual may transfer $3.5 million (during life or at death) of property without such transfers being subject to the GST tax. Only the transferor or the transferor's executor (in the case of an estate) may allocate the GST tax exemption to the transferred property. Once made, the allocation is irrevocable.

GST planning revolves primarily around allocation of the exemption to transferred property. The exemption is allocated to property or trusts and not to transferees. This means that once the exemption is allocated, any further generation-skipping transfers (e.g., taxable distributions from or terminations of trust) with respect to the exempted property remain exempt from the GST tax. Thus, proper allocation of the exemption helps ensure that future appreciation in the value of transferred property escapes further GST taxation.

Example 1D-1 Exempted property's appreciation escapes future GST tax.

Jake Brown transferred property worth $1 million to a trust and allocated $1 million of his GST tax exemption to the trust. Ten years later, the value of the trust property had increased to $4 million, at which time, a taxable termination occurred. Even though the trust property had increased in value, the entire $4 million of property is exempt from the GST tax on the taxable termination.

If Jake had not made the $1 million allocation when he transferred the property, a late allocation could be made in 2009. At the taxable termination, a GST tax of $225,000 would result [($4 million − $3.5 million GST tax exemption) × .45].

Lifetime Allocations

The GST tax exemption can be allocated to lifetime direct skips or to transfers in trust that may result in future taxable distributions or terminations. Assuming a timely allocation of the exemption, the exemption is allocated based on the transferred property's value on the date of the gift (for lifetime transfers) or on the date of death (for testamentary transfers).

The allocation of the exemption will be timely if the allocation is made on a timely filed gift tax return including extensions. Typically, a transferor making a gift in trust will choose property that will appreciate in value between the date of the gift and the date of death to exclude the appreciation from the transferor's estate. Thus, it is important to make a timely allocation of the GST tax exemption, since an allocation at a later date may shelter a smaller amount of the transfer. However, see a discussion later in this lesson of the automatic allocation of the GST tax exemption.

The allocation of the exemption to lifetime direct skips is made on Form 709, Schedule C.

The allocation of the exemption to lifetime transfers other than a direct skip is also made on Form 709, Schedule C. Additionally, there may be transfers to trust that are not indirect skip transfers subject to the deemed allocation rules. If the donor desires to allocate the GST tax exemption to such a transfer, an affirmative allocation of the GST tax exemption should be made.

Automatic Allocation of Exemption to Direct Skips

The law provides a set of rules governing the allocation of the GST tax exemption if the transferor or executor fails to allocate the exemption to a particular transfer.

Direct skips made during life use up the GST tax exemption first. If an individual makes a lifetime direct skip, any unused portion of the GST tax exemption is automatically allocated to the transferred property to the extent necessary to make the inclusion ratio zero. The unused portion of the GST tax exemption is determined by subtracting from $3.5 million (for 2009) the sum of the amounts previously allocated by the transferor, including prior deemed allocations to direct skips and indirect skips to a GST trust. If the amount of the direct skip exceeds the unused portion of the exemption, the entire unused portion of the exemption is allocated to the transferred property.

Example 1D-2 Failure to recognize a GST causes automatic allocation of exemption.

Bob Wood transferred $1 million cash to a trust for the benefit of his grandson, Mike. Pursuant to the trust instrument, the trustee may, at his discretion, distribute or accumulate income or corpus until Mike turns 21. The balance in the trust will be distributed to Mike when he turns 21. Mike has a testamentary general power of appointment over trust property.

Bob's preparer filed a gift tax return reporting the transfer to the trust. However, no GST tax was paid nor was any of Bob's GST tax exemption allocated to the transfer. Under the automatic allocation rule, $1 million of Bob's lifetime GST tax exemption is allocated to the direct skip transfer.

If the GST tax exemption is not allocated by the due date of Form 706, the remaining exemption is automatically allocated—

1. first to direct skips occurring at death, and
2. next to all transfers to GST trusts for which the decedent is the most recent transferor, even if the trust is not included in the gross estate, but which have the possibility of having a taxable distribution or taxable termination.

Electing Out of the Deemed Allocation Rule for Lifetime Direct Skips. The transferor can irrevocably elect out of the automatic exemption allocation rule for direct skips.

Example 1D-3 Electing out of the automatic allocation rules.

Assume the same facts as in Example 1D-2. Assume further that in 2009 (five years later), Bob wants to establish another trust that will pay all of its income to his son, Craig, for life. At Craig's death, the remainder in the trust will pass to Mike (the grandson). Bob wants to fund the trust with $3.5 million of highly appreciating closely held stock. He would like to shelter the entire transfer with $3.5 million of his GST tax exemption so that when the trust terminates, no part of the appreciated value will be subject to GST tax.

Because Bob's exemption was previously allocated to the trust for Mike under the automatic allocation rules, only $2.5 million (i.e., $3.5 million − $1 million previously allocated) can be allocated to the trust created in 2009. Thus, a taxable termination of the new trust funded with the stock will cause 28.57% [1 − ($2.5 million ÷ $3.5 million)] of the trust's value at the date of its termination to be subject to GST tax.

Assume Craig (Mike's dad) died when Mike turned 21. Thus, Mike will receive the balance of *both* trusts at that time. Assume the first trust (funded with cash) is valued at $1.5 million and the trust funded with stock is valued at $5 million. Thus, 28.57% of the value (i.e., $1,428,500 million) of the $5 million trust will be subject to GST tax (because the automatic allocation rules allocated the exemption to the first trust).

Alternatively, had Bob elected to not have the automatic allocation rules apply to the first transfer, he would have paid the GST tax on the $1 million (i.e., value at time of transfer to the trust) direct skip to the trust for his grandson. However, he would have had all of the GST tax exemption to allocate to the $3.5 million of stock transferred to the second trust. That allocation would have resulted in no GST tax on the taxable termination of the second trust because the exemption would have sheltered the appreciation of the trust property.

If the transferor died and the executor failed to allocate the GST tax exemption, the unused exemption is automatically allocated first to direct skips occurring at death (e.g., specific bequests) on a prorata basis. Any remaining exemption is allocated prorata to trusts from which a taxable distribution or taxable termination may occur after the transferor's death. Thus, the executor must take care to make an allocation of the exemption amount in a manner that causes the desired result; otherwise, the automatic allocation provisions will determine the manner of allocation.

Automatic Allocation of Exemption to Indirect Skips

For transfers after 2000, any unused portion of the individual's generation-skipping transfer tax exemption is automatically allocated (i.e., a deemed allocation is made) to *indirect skips* (defined below) made during life to the extent necessary to produce the lowest possible inclusion ratio for such property.

Indirect Skip. An *indirect skip* is any transfer of property (other than a direct skip subject to the gift tax) made to a *GST trust*.

GST Trust. A *GST trust* is a trust that could have a generation-skipping transfer with respect to the transferor unless—

1. the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are nonskip persons:

    a. before they reach age 46;

    b. on or before one or more dates specified in the trust instrument that will occur before they reach age 46; or

    c. upon the occurrence of an event that, in accordance with regulations to be issued, may reasonably be expected to occur before they reach age 46;

2. the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are nonskip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;

3. the trust instrument provides that, if one or more individuals who are nonskip persons die on or before a date or event described in clause (1) or (2), more than 25% of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals;

4. any portion of the trust would be included in the gross estate of a nonskip person (other than the transferor) if such person died immediately after the transfer;

5. the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable remainder unitrust; or

6. the trust was allowed a deduction under IRC Sec. 2522 (presumably a charitable lead unitrust) for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a nonskip person if such person is alive when the payments terminate.

Exception to the Six Exceptions Listed Previously. With regard to indirect skips, the value of property transferred to a GST trust will not be includable in the gross estate of a nonskip person or subject to a right of withdrawal by a nonskip person to the extent such right is restricted to the gift tax annual exclusion amount. It is further presumed for indirect skips that powers of appointment held by nonskip persons will not be exercised.

Example 1D-4 Identifying a GST trust.

Ricky transfers $250,000 to a trust for the benefit of his heirs. The trust's instrument provides that income distributions are to be made to Danielle, Ricky's daughter, during her life and upon her death to Danielle's then living heirs (i.e., Ricky's grandchildren). Danielle's interest in the trust is limited to the trust income. The trust is a GST trust because it is a trust that could have a taxable termination or distribution and it does not fall under any exceptions. The transfer by Ricky to the trust is an indirect skip subject to automatic allocation of the GST tax exemption.

Example 1D-5 Direct skip to a GST trust.

Monica transfers $250,000 to a trust for the benefit of her grandchild. The trust's instrument provides that income distributions are to be made to Monica's grandchild during the grandchild's lifetime and upon her grandchild's death, the trust is to be distributed to the grandchild's heirs. Although the trust satisfies the qualifications of a GST trust, the transfer to the trust is not an indirect skip because the trust is a skip person. This transfer is a direct skip (subject to automatic allocation of the GST tax exemption).

The deemed allocation rules relating to indirect skips apply to the unused portion of an individual's GST tax exemption. Generally effective for transfers after 2000, the unused portion of an individual's GST tax exemption is that portion of the exemption that has not previously been—

1. allocated by the individual;

2. treated as allocated because of a direct skip under IRC Sec. 2632(b); or

3. treated as allocated because of a previous indirect skip under IRC Sec. 2632(c)(1).

Several elections are available related to the automatic allocation of the GST exemption to indirect skips.

Allocations at Death

The allocation of a deceased transferor's unused exemption to property included in the transferor's gross estate is made on a Form 706 and is effective as of the date of death. Property is valued at its estate tax values. The executor also may allocate unused exemption to lifetime transfers not included in the gross estate. If the executor fails to allocate the GST tax exemption, the unused exemption is automatically allocated first to direct skips occurring at death and then to the nonexempt portion of trust property with respect to which a taxable termination may occur or from which a taxable distribution may be made.

Estate Tax Inclusion Period (ETIP)

Certain transfers that are completed gifts when made may subsequently be included in the transferor's gross estate (e.g., if the transferor retains the power to alter beneficial enjoyment of the property causing it to be included in his gross estate under IRC Sec. 2038). Such property is subject to an estate tax inclusion period (ETIP) and an allocation of the GST tax exemption is not effective until the termination of the ETIP.

An ETIP is any period during which (should death occur) the value of the transferred property would be included in the gross estate of either the transferor or the transferor's spouse.

Transferred property that would be included in the transferor's estate under IRC Sec. 2035 (adjustments for transfers made within three years of death) is not subject to an ETIP. In addition, the ETIP rules do not apply when the possibility that the property will be included in the gross estate of the transferor (or the transferor's spouse) is so remote as to be negligible. Also, certain property transferred to a spouse will not be subject to an ETIP.

<u>Deemed Allocation of GST Tax Exemption to Indirect Skips Subject to an ETIP.</u> An indirect skip to a trust that is subject to an ETIP is subject to the deemed allocation rules. In the case of an ETIP, the GST tax exemption is automatically allocated at the end of the ETIP based on the value of the property at the termination of the ETIP. An individual can elect not to have the automatic allocation rules apply to an indirect skip.

<u>Termination of an ETIP.</u> An ETIP terminates on the first of the following to occur:

1. the transferor's death;

2. the time when the property would no longer be included in the transferor's gross estate, determined without regard to IRC Sec. 2035 (or where a spouse is treated as transferor because of gift splitting, when the property would no longer be included in the donor spouse's estate);

3. the time of a GST with respect to the property involved in the GST; or

4. in the case of an ETIP arising by reason of an interest held by the transferor's spouse, at the death of the spouse, or the time at which no portion of the property would be included in the spouse's gross estate (excluding IRC Sec. 2035), whichever occurs first.

Example 1D-6 Taxable distribution results in automatic GST tax exemption allocation.

In 2003, Tracy transferred $100,000 to a trust. The trust instrument provides that trust income is paid to Tracy for 10 years or until she dies. The trust principal is paid to Tracy's grandchildren when the income interest terminates. In addition, the trustee can invade trust principal on behalf of Tracy's grandchildren during the term Tracy has an income interest. In 2009, when the value of the trust is $150,000, the trustee distributes $10,000 to Tracy's grandchild. The distribution is a taxable distribution. With respect to the $10,000, the ETIP terminates at the time of distribution. With respect to the $10,000, the ETIP terminates at the time of distribution. The automatic allocation rules will apply to allocate $10,000 of Tracy's GST tax exemption to the distribution effective immediately prior to the taxable distribution.

Example 1D-7 Automatic allocation of the GST tax exemption at termination of the ETIP.

Byron Mann transferred $300,000 to an irrevocable trust that will pay him $15,000 annually for 10 years. When the trust terminates, the balance in the trust will be distributed to Byron's grandson, Rob. [Thus, the trust is a GST trust under IRC Sec. 2632(c)(3)(B).] At the time of the termination, the deemed allocation rules will apply to allocate his GST tax exemption. Assuming the value of the trust increases to $500,000 in the year of termination, $500,000 of his GST tax exemption will be allocated to the trust, resulting in a zero inclusion ratio.

Retroactive GST Tax Exemption Allocation for Unnatural Order of Death

Normally, a transferor will not allocate any of the GST tax exemption to a trust that the transferor expects will benefit only nonskip persons because transfers to nonskip persons are not subject to the GST tax. Unexpected circumstances, however, may cause the GST tax to apply. This could happen, for example, when the transferor's child suddenly dies and the trust terminates in favor of the transferor's grandchild. If no GST tax exemption had been allocated to the trust, the GST tax would be due even if the transferor had an unused portion of the GST tax exemption.

For deaths of nonskip persons, the GST tax exemption can be allocated retroactively when there is an *unnatural order of death*, which occurs when a lineal descendant of the transferor predeceases the transferor (e.g., the son or daughter predeceases his or her parent). In that event, the transferor can allocate any unused generation-skipping transfer tax exemption to any previous transfer(s) to the trust on a chronological basis.

A transferor can retroactively allocate the GST tax exemption to a trust where a beneficiary:

1. is a nonskip person;
2. is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse;
3. is a generation younger than the generation of the transferor; and
4. dies before the transferor.

The GST tax exemption will be retroactively allocated under this rule, and the applicable fraction and inclusion ratio will be determined based on the property's value on the date it was transferred to the trust. The allocation will be deemed to be effective immediately before the nonskip person's death.

Example 1D-8 Retroactive allocation of the GST tax exemption.

Terry Stephens established a trust in 1995 for the benefit of her daughter, Anna. The trust terminates when Anna reaches 45. If Anna dies before age 45, the trust terminates upon Anna's death and is distributed to Anna's children. Terry did not allocate any of her GST tax exemption to the trust. Anna died in a car accident in 2009. In 2009, Terry can retroactively allocate her GST tax exemption, using the value of the assets (i.e., in 1995) when they were transferred to the trust.The election should be made by the due date of Form 709 for the year of the nonskip person's death.

How a Late Allocation Affects the GST Tax Exemption

Inadvertent Late Allocation of GST Tax Exemption

If an election to allocate the GST tax exemption is made on a gift tax return filed timely with respect to the transfer to trust, the value on the date of transfer to the trust is used for determining the allocation. However, if the allocation relating to a specific transfer is not made timely, the value on the date of allocation must be used. Historically, many practitioners have failed to recognize the need to allocate GST tax exemption for indirect skip transfers to trusts, which has often resulted in a future taxable distribution or taxable termination. As a result, their clients have been required to use additional GST tax exemption to shelter the transfer from GST tax if the value of the trust property appreciated in value.

Congress felt these results were too harsh when the taxpayer intended to allocate the GST tax exemption and the failure to do so timely was inadvertent. Thus, for certain late GST tax exemption allocation relief requests pending on or filed after 2000, the IRS is directed to grant time extensions without regard to any limitation period. Generally, for transfers subject to estate or gift tax made after 2000, the IRS is directed to grant extensions of time to make the election to allocate the GST tax exemption or to elect out of the automatic allocation rules and to grant exceptions to the time requirement without regard to whether any limitation period has expired. If relief is granted, the gift tax or estate tax value of the transfer to trust will be used for making the exemption allocation.

The IRS is directed to consider all relevant circumstances including evidence of intent contained in the trust instrument or instrument of transfer and other such factors as the IRS deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute. Therefore, taxpayers may seek an extension of time to make an allocation under Reg. 301.9100-3.

Proposed regulations provide specific guidance for seeking an extension of time (through the private letter ruling program) to:

1. allocate GST tax exemption to a transfer;
2. elect out of the deemed allocation of GST tax exemption to a direct skip transfer;
3. elect out of the deemed allocation of GST tax exemption to an indirect skip transfer (or transfer made to a trust); and
4. elect to treat any trust as a GST trust under IRC Sec. 2632(c).

If relief is granted, the allocation or election will be considered effective as of the date of the transfer (or first transfer, in the case of the election for treatment as a GST trust). In addition, any allocation made as a result of granted relief will be limited to the amount of the transferor's remaining GST tax exemption as of the date of the transfer. Requests for relief under the regulations will be granted when the taxpayer establishes that the transferor acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. (Both requirements are explained in nonexclusive lists of examples. Circumstances in which relief will *not* be granted are also identified.) The regulations, which will become effective when published as final, will replace relief provisions under Reg. 301.9100-3 and render IRS Notice 2001-50 obsolete.

<u>Simplified Method for Relief.</u> Rev. Proc. 2004-46 allows taxpayers an alternative to the private letter ruling process to obtain an extension of time to timely allocate the generation-skipping transfer tax exemption. The alternative method can be used if the taxpayer meets the following requirements:

1. on or before December 31, 2000, the taxpayer made or was deemed to have made a transfer by gift to a trust from which a GST may be made;
2. no taxable distributions have been made and no taxable terminations have occurred;
3. the transfer qualified for the annual exclusion under IRC Sec. 2503(b) and the transfer, when added to the value of the other gifts to that donee in the same year, did not exceed the annual exclusion for the year;

4. no GST tax exemption was allocated to the transfer; and

5. the taxpayer has an unused GST tax exemption available to allocate to the transfer.

In order to obtain the extension under these simplified procedures, the taxpayer must:

1. file a Form 709 for the year of the transfer (regardless of whether they have previously filed for that year) indicating at the top of the form that it is "FILED PURSUANT TO REV. PROC. 2004-46";

2. report on the Form 709 the value of the transferred property as of the date of transfer;

3. allocate the GST tax exemption to the trust by attaching a statement to the Form 709 entitled "Notice of Allocation."

The Notice of Allocation must contain:

1. a clear identification of the trust, including name and the tax identification number;

2. the value of the property transferred as of the date of transfer;

3. the amount of the taxpayer's unused GST tax exemption at the time the Notice of Allocation is filed;

4. the amount of the GST tax exemption allocated to the transfer;

5. the inclusion ratio of the trust after the allocation; and

6. a statement that all of the requirements of section 3.01 of Rev. Proc. 2004-46 have been met.

Substantial Compliance with the GST Tax Exemption Allocation Requirements

For transfers subject to estate and gift tax made after 2000, substantial compliance with the statutory and regulatory requirements for allocating the GST tax exemption will suffice to establish that the exemption was allocated to a particular transfer or a particular trust.

In one private letter ruling, Schedule R was attached to Form 706 but there were no entries on the schedule. However, copies of three trust instruments were attached to the return. The trust instruments contained specific language directing the trustee to divide assets between a generation skipping transfer trust and a non-exempt trust. The Service concluded that the trust instruments attached to the Form 706 contained sufficient information to be substantial compliance. In another private letter ruling, the taxpayers attached a trust agreement to Form 709, but failed to complete Schedule C of Form 709. The IRS ruled that there was sufficient information included with the return for determining the taxpayer's intent to make the allocation of the GST tax exemption. The IRS has also found substantial compliance (for effective and timely allocation of GST tax exemption) when the notices of allocation attached to the taxpayers' gift tax returns reported that the amount allocated was zero, but that a formula allocation was being made of the smallest amount necessary to produce an inclusion ratio of zero.

If a taxpayer demonstrates substantial compliance, the transferor's unused GST tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust or transfer instruments and other such factors as the IRS deems appropriate.

Intentional Late Allocation of the GST Tax Exemption

If the allocation of the exemption is made on a gift tax return that is not timely filed, the value of the property is the value on the date the gift tax return is filed. In such situation, the filing date is the postmark date from the mailing of the return. Fortunately, the regulations provide some relief to the practical impossibility of both knowing the value of the transfer and preparing the notice of allocation of the exemption (which is attached to the gift tax return) on the same day the gift tax return is filed. If a transferor makes a late allocation of the GST tax exemption to a trust, the transferor may elect to value the transferred property as of the first day of the month in which the allocation occurs. However, such an election is not available with respect to life insurance or a life insurance trust if the insured individual has died.

Example 1E-1 Value of transferred property declines.

During 2000, Rachel made a gift of 100 shares of ABC stock to a trust for her daughter, Leslie, and her granddaughter (Leslie's daughter), Catherine. On the date of the gift, the shares were worth $100,000. Rachel has not filed a gift tax return. On May 1, 2009, the value of the shares is $50,000. If Rachel had filed her gift tax return on time, she would have had to allocate $100,000 of her GST tax exemption to have a zero inclusion ratio for the trust. If Rachel filed her gift tax return and made the GST tax exemption allocation for the trust on May 15, 2009, she would need to allocate only $50,000 of her exemption to have a zero inclusion ratio.

Example 1E-2 Late allocation of the GST exemption.

In 1997, Jan Tucker created an irrevocable trust for the benefit of her grandchildren. Jan's children are permissible income beneficiaries; therefore, transfers to the trust are not direct skips because the trust is not a skip person. The trust holds a life insurance policy payable upon Jan's death. Since 1997, Jan has transferred $10,000 to the trust each year to pay the annual premium. The annual transfers did not qualify for the GST tax annual exclusion.

Jan made her annual transfer to the trust in May 2009. Although she had not previously allocated any of her GST tax exemption to this GST trust, unless she elected out of the automatic allocation rules, $90,000 of Jan's GST tax exemption ($10,000 each year in 2001–2009) was allocated to the trust under the automatic exemption allocation rules of IRC Sec. 2632(c).

Her estate planner advises her of the consequences of not allocating enough of her GST tax exemption *before death* to make the trust have a zero inclusion ratio. Jan has two possible options. If Jan can prove that she intended to make the GST tax exemption allocation every year as transfers were made to the trust, she can request an extension of time to make the allocation. If such extension is granted, she can allocate her GST tax exemption as of the date of each transfer (i.e., $10,000 per year for 1997–2000). This would use another $40,000 of her GST tax exemption.

Her other option is to make a late allocation of her GST tax exemption. Because a portion of her exemption was automatically allocated to the transfers after 2000, the current inclusion ratio of the trust must be determined at each of the previous transfer dates. To determine the inclusion ratio, the policy's value immediately before each of the transfers and the value of the policy at the time of the late allocation must be obtained. Generally, this information can be obtained from the life insurance company that carries the policy. The trust's inclusion ratio must be calculated each time an allocation of the GST tax exemption is made.

Below is a summary of the information needed to calculate the applicable fractions and inclusion ratios.

Date of transfer	Policy value before transfer (obtained from life insurance co.)	GST Tax Exemption Allocated	Applicable fraction (after transfer)	Inclusion ratio (after transfer)
5/15/2001	$ 30,000	$ 10,000	.25	.75
5/15/2002	$ 35,000	$ 10,000	.417	.583
5/15/2003	$ 40,000	$ 10,000	.534	.466
5/15/2004	$ 45,000	$ 10,000	.619	.381
5/15/2005	$ 50,000	$ 10,000	.682	.318
5/15/2006	$ 55,000	$ 10,000	.731	.269
5/15/2007	$ 60,000	$ 10,000	.769	.231
5/15/2008	$ 65,000	$ 10,000	.800	.200
5/15/2009	$ 70,000	$ 10,000	.825	.175

Jan's Form 709 (i.e., her gift tax return) will be filed on April 15, 2010. The policy has a value on April 1, 2010 of $75,000. Because the inclusion ratio is .175, Jan must make a late allocation of $13,125.

Date of transfer	Policy value before transfer (obtained from life insurance co.)	GST Tax Exemption Allocated	Applicable fraction (after transfer)	Inclusion ratio (after transfer)
4/1/2010	$75,000	$ 13,125	1.0	-0-

Jan must attach an election to Form 709 to use the first day of the month value of the policy instead of the value on the date Form 709 is filed.

Severing a Trust into an Exempt and Nonexempt Trust

An effective GST planning strategy is to segregate property protected by the GST tax exemption (exempt property) from property not so protected (nonexempt property). This typically is done through the use of trusts. One trust will benefit the transferor's children, and the other trust will benefit the transferor's grandchildren. The transferor's GST tax exemption is allocated to the grandchildren's trust (i.e., the exempt trust) so that this trust has an inclusion ratio of zero. Thus, distributions from this trust will not be subject to GST tax. No GST tax exemption is allocated to the children's trust since all the beneficiaries are nonskip persons.

Requirements for a Qualified Severance

Many trusts are not structured to take advantage of this GST strategy. Prior to 2000, *inter vivos* trusts could not be severed into multiple trusts to accommodate a GST tax exemption allocation unless they met the separate share rule or had multiple grantors. Effective for trust severances occurring after 2000, a trust can be severed in a *qualified severance*.

A *qualified severance* is the division of a single trust into two or more trusts if—

1. The single trust was divided on a fractional basis. Each new trust must be funded with assets equal to a fraction or percentage of the total value of the trust assets. The separate trusts can be funded on a nonprorata basis as long as the funding is based on an asset's total FMV on the date of severance. Note that the trust severance cannot be based on a pecuniary amount.

   Regulations define "date of severance" as the date selected by (a) the trustee or (b) the court for determining the value of the trust assets, provided that funding is commenced immediately and occurs within a reasonable time (no more than 90 days) after the selected valuation date.

Regulations also clarify that discounts and other reductions arising from the severance are not allowed for funding purposes for interests in closely held corporations, partnership interests, or other "single assets."

2. The terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. The separate trusts will be deemed to have the same succession of interests of beneficiaries if:

    a. the terms of the separate trusts are the same as the terms of the original trust,

    b. each beneficiary's interest in the resulting trusts equals the beneficiary's interest in the original trust,

    c. the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation than the person or persons who held the beneficial interest in the original trust, and

    d. the severance does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

3. The single trust is severed pursuant to local law or the governing instrument.

4. The severance is effective under local law.

Effective August 2, 2007, qualifying severances allow more than two resulting trusts when the original trust has an inclusion ratio between zero and one. The resulting trusts in the aggregate would have to receive a pro rata share of the total value of the original trust (as of the date of severance) equal to the fraction used to determine the inclusion ratio of the original trust immediately before the severance. The trust(s) receiving the pro rata share has an inclusion ratio of zero, and each of the other resulting trusts would have an inclusion ratio of one. In addition, the trustee may designate the beneficiary of each resulting trust, as long as it preserves the original interest in the trust.

Prior to August 2, 2007, a trust had an inclusion ratio greater than zero and less than one, a severance was considered to be a qualified severance only if the single trust was divided into two trusts, one of which received a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving the fractional share received an inclusion ratio of zero and the other trust received an inclusion ratio of one.

Making a Qualified Severance

A qualified severance of a trust may occur any time prior to the trust's termination. If the separate trusts continue in existence after the severance, a qualified severance can occur either before or after:

1. the GST tax exemption has been allocated to the trust,

2. a taxable event has occurred with respect to the trust, or

3. an addition has been made to the trust.

A qualified severance has no effect on taxable distributions or taxable terminations that occurred before the date of severance. A qualified severance is deemed to occur before a taxable distribution or a taxable termination that occurs by reason of the severance.

Example 1F-1 Qualified severance deemed to occur immediately prior to taxable termination.

In 2004, Trammell establishes an *inter vivos* irrevocable trust (Trust) for a term of 10 years providing that Trust income is to be paid annually in equal shares to his daughter, Cathy and his grandson, Travis (the child of his son, Tyler). If either Cathy or Travis dies prior to the expiration of the 10-year term, the deceased beneficiary's share of Trust's income is to be paid to that beneficiary's then-living descendants for the remaining trust term. At the end of the 10-year trust term, the principal is to be distributed equally to Cathy and Travis; if either Cathy or Travis is not then living, then such decedent's share is to be distributed instead to such decedent's then-living descendants.

Trammell allocates his GST tax exemption to Trust such that Trust's applicable fraction is .50 and Trust's inclusion ratio is .50 (1-.50). In 2006, the trustee severs the trust into two equal trusts, Trust 1 and Trust 2 with each receiving 50% of Trust's assets. Both resulting trusts are identical to Trust, except that each has different beneficiaries: Cathy and her descendants are the beneficiaries of Trust 1, and Travis and his descendants are the beneficiaries of Trust 2. The severance is a qualified severance. Because the applicable fraction with respect to Trust is .50 and Trust was severed into two equal trusts, the trustee may designate which resulting trust has an inclusion ratio of one and which has an inclusion ratio of zero. The trustee designates Trust 1 as having an inclusion ratio of one and Trust 2 as having an inclusion ratio of zero.

Because Trust 2 is a skip person, the severance of Trust resulting in the distribution of 50% of Trust's corpus to Trust 2 would be a taxable distribution or termination of that 50% of Trust for GST tax purposes, but for the rule that a qualified severance is deemed to precede a taxable termination that is caused by the qualified severance. Thus, no GST tax will be due with regard to the creation and funding of Trust 2 because the inclusion ratio of Trust 2 is zero.

Election to Sever a Trust

A trustee may elect to sever a trust in a qualified severance at any time. The severance is reported by filing Form 706-GS(T) (or by any such form that may be published by the IRS that is specifically designated to be used to report qualified severances).

The Filing Requirements for GSTs

The filing requirements for generation-skipping transfers (GSTs) are dependent on the particular type of GST. The following is a summary of the reporting requirements for each type of GST.

Generation-skipping Transfer	Return or Schedule	Person Required to File	Due Date
Inter vivos direct skip	709 (Sch. C)	Transferor	Due date for the gift tax return
Direct skip at death	706 (Sch. R)	Executor	Due date for the estate tax return
Direct skip at death from a trust	706 (Sch. R-1)	Trustee	Due date for the estate tax return
Taxable distribution	706-GS(D) and (D-1)	Transferee Trustee	15th day of the fourth month following the calendar year in which the distribution occurs
Taxable termination	706-GS(T)	Trustee	15th day of the fourth month following the calendar year in which the termination occurs

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. Which of the following statements regarding electing out of the deemed allocation rule for lifetime direct skips is most accurate?

    a. A transferor can irrevocably elect out of the automatic exemption allocation rule for direct skips.

    b. If an allocation of the GST tax exemption is not timely made, the amount of the transfer generally is not affected.

    c. The allocation of the exemption of direct skip lifetime transfers is made on Form 706, Schedule C.

    d. If a transferor dies and the executor fails to allocate the GST tax exemption, the unused exemption is automatically allocated to indirect skips.

11. The GST tax exemption is allocated to a lifetime transfer based on which of the following?

    a. Family relationships.

    b. Age relative to the age of the transferor.

    c. Transferred property's value on the date of the gift.

    d. The property's value on the date it was transferred to the trust.

12. What is the definition of a GST trust?

    a. A trust that could have a generation-skipping transfer.

    b. Any trust created in a will.

    c. Any trust that was irrevocable on September 25, 1985.

13. When does an estate tax inclusion period (ETIP) occur?

    a. Nine months after the date of death.

    b. Period in which a severance has occurred.

    c. When the value of transferred property is included in the gross estate of the transferor.

    d. When transferred property is included in the transferor's estate under IRC Sec. 2035.

14. Rev. Proc 2004-46 provides an alternate method that allows taxpayers to obtain an extension of time to timely allocate the generation-skipping transfer tax exemption without filing for a private letter ruling. This method can be used if the taxpayer meets several requirements. Which of the following is one of those requirements?

    a. The taxpayer made a transfer by gift to a trust from which a GST may be made on or before January 1, 2002.

    b. No taxable distributions have been made, but taxable terminations may have occurred.

    c. GST tax exemption has been allocated to the transfer.

    d. An unused GST exemption is available for the taxpayer to allocate to the transfer.

15. Which of the following statements regarding severing a trust is most accurate?

    a. A qualified severance is when one trust is divided into two or more trusts, if the single trust is divided on a fractional basis.

    b. The severance of a trust is reported using Form 706-GS(D).

    c. Most trusts are structured to take advantage of the GST strategy of severing trusts.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. Which of the following statements regarding electing out of the deemed allocation rule for lifetime direct skips is most accurate? **(Page 136)**

    a. A transferor can irrevocably elect out of the automatic exemption allocation rule for direct skips. [This answer is correct. According to the Code, the transferor can irrevocably elect out of the automatic exemption allocation rule for direct skips.]

    b. If an allocation of the GST tax exemption is not timely made, the amount of the transfer generally is not affected. [This answer is incorrect. The allocation of the exemption will be timely if the allocation is made on a timely filed gift tax return (including extensions). Typically, a transferor making a gift in trust will choose property that will appreciate in value between the date of the gift and the date of death to exclude the appreciation from the transferor's estate. Thus, it is important to make a timely allocation of the GST tax exemption, since an allocation at a later date may shelter a smaller amount of the transfer.]

    c. The allocation of the exemption of direct skip lifetime transfers is made on Form 706, Schedule C. [This answer is incorrect. The allocation of the exemption to lifetime direct skips is made on Form 709, Schedule C.]

    d. If a transferor dies and the executor fails to allocate the GST tax exemption, the unused exemption is automatically allocated to indirect skips. [This answer is incorrect. If the transferor died and the executor failed to allocate the GST tax exemption, the unused exemption is automatically allocated first to direct skips occurring at death on a prorata basis. Any remaining exemption is allocated prorata to trusts from which a taxable distribution or taxable termination may occur after the transferor's death.]

11. The GST tax exemption is allocated to a lifetime transfer based on which of the following? **(Page 136)**

    a. Family relationships. [This answer is incorrect. In most cases involving GSTs, family relationships are used to make generation assignments rather than the GST tax exemption allocation.]

    b. Age relative to the age of the transferor. [This answer is incorrect. The transferee's age relative to the age of the transferor is important when individuals not assigned to generations based on family relationships are assigned to generations based on their age relative to the age of the transferor.]

    c. Transferred property's value on the date of the gift. [This answer is correct. According to the Code, the GST tax exemption can be allocated to lifetime direct skips or to transfers in trust that may result in future taxable distributions or terminations. Assuming a timely allocation of the exemption, the exemption is allocated based on the transferred property's value on the date of the gift (for lifetime transfers) or on the date of death (for testamentary transfers).]

    d. The property's value on the date it was transferred to the trust. [This answer is incorrect. The GST tax exemption for unnatural order of death will be retroactively allocated. The applicable fraction and inclusion ratio will be determined based on the property's value on the date it was transferred to the trust.]

12. What is the definition of a GST trust? **(Page 136)**

    a. A trust that could have a generation-skipping transfer. [This answer is correct. According to the Code, a GST trust is a trust that could have a generation-skipping transfer with respect to the transferor, unless one of six specific exceptions applies.]

    b. Any trust created in a will. [This answer is incorrect. Any trust created in a will is called a testamentary trust.]

    c. Any trust that was irrevocable on September 25, 1985. [This answer is incorrect. Grandfathered trusts are trusts that were irrevocable on September 25, 1985.]

13. When does an estate tax inclusion period (ETIP) occur? **(Page 136)**

    a. Nine months after the date of death. [This answer is incorrect. The GST tax is due nine months after the date of death.]

    b. Period in which a severance has occurred. [This answer is incorrect. The return and attached notice must be filed by April 15th of the year immediately following the year during which the severance occurred.]

    c. When the value of transferred property is included in the gross estate of the transferor. [This answer is correct. According to the regulations, an ETIP is any period during which (should death occur) the value of the transferred property would be included in the gross estate of either the transferor or the transferor's spouse.]

    d. When transferred property is included in the transferor's estate under IRC Sec. 2035. [This answer is incorrect. Transferred property that would be included in the transferor's estate under IRC Sec. 2035 (adjustments for transfers made within three years of death) is not subject to an ETIP. In addition, the ETIP rules do not apply when the possibility that the property will be included in the gross estate of the transferor (or the transferor's spouse) is so remote as to be negligible.]

14. Rev. Proc 2004-46 provides an alternate method that allows taxpayers to obtain an extension of time to timely allocate the generation-skipping transfer tax exemption without filing for a private letter ruling. This method can be used if the taxpayer meets several requirements. Which of the following is one of those requirements? **(Page 141)**

    a. The taxpayer made a transfer by gift to a trust from which a GST may be made on or before January 1, 2002. [This answer is incorrect. This method may be used if the taxpayer made a transfer by gift to a trust from which a GST may be made on or before December 31, 2000.]

    b. No taxable distributions have been made, but taxable terminations may have occurred. [This answer is incorrect. This method can be used if no taxable distributions and no taxable terminations have occurred.]

    c. GST tax exemption has been allocated to the transfer. [This answer is incorrect. The alternate method can only be used if the taxpayer has not allocated any GST tax exemption to the transfer.]

    d. An unused GST exemption is available for the taxpayer to allocate to the transfer. [This answer is correct. Under Rev. Proc. 2004-46, for the taxpayer to qualify to use the alternate method, the taxpayer must have an unused GST tax exemption available to allocate to the transfer.]

15. Which of the following statements regarding severing a trust is most accurate? **(Page 144)**

    a. A qualified severance is when one trust is divided into two or more trusts, if the single trust is divided on a fractional basis. [This answer is correct. A *qualified severance* is the division of a single trust into two or more trusts if certain conditions are met. One of those conditions is that the single trust is divided on a fractional basis. Each new trust must be funded with assets equal to a fraction or percentage of the total value of the trust assets. The separate trusts can be funded on a nonprorata basis as long as the funding is based on an asset's total FMV on the date of severance.]

    b. The severance of a trust is reported using Form 706-GS(D). [This answer is incorrect. The severance is reported by filing Form 706-GS(T) (or by any such form that may be published by the IRS that is specifically designated to be used to report qualified severances). The Form 706-GS(D) is for taxable distributions.]

    c. Most trusts are structured to take advantage of the GST strategy of severing trusts. [This answer is incorrect. Many trusts are not structured to take advantage of this GST strategy. Prior to 2000, *inter vivos* trusts could not be severed into multiple trusts to accommodate a GST tax exemption allocation unless they met the separate share rule or had multiple grantors. Effective for trust severances occurring after 2000, a trust can be severed in a *qualified severance*.

Inter Vivos Direct Skips (Form 709, Schedule C)

Defined

Inter vivos direct skips are direct skip transfers made during the life of the transferor. *Inter vivos* direct skips include direct transfers from the transferor to a skip person as well as transfers to a trust that qualifies as a skip person. An *inter vivos* direct skip is a transfer subject to the gift tax. Thus, transfers to charitable organizations, transfers that qualify for the medical and educational exclusions, and outright transfers (i.e., not in trust) fully offset by the gift tax annual exclusion need not be reported.

Example 1H-1 *Inter vivos* direct skip on transfer to a trust.

Ben Coates established and funded a trust for the benefit of his grandson, Tommy. Pursuant to the trust instrument, the trustee has the discretionary right to accumulate or distribute income for Tommy's health, education, or support. The balance of the trust will be distributed to Tommy when he turns 35. Since the trust is a skip person, the transfer of property to the trust is an *inter vivos* direct skip subject to the GST tax.

The amount of GST tax imposed on *inter vivos* direct skips is computed on Form 709, Schedule C. However, since *inter vivos* direct skips are also subject to gift tax, these transfers are first reported on Form 709, Schedule A, Part 2, in the chronological order in which they were made. Transfers are then entered on Schedule C, Part 1, in the same order and using the same value as reported on Schedule A.

Example 1H-2 *Inter vivos* direct skip reported on Form 709, Schedule C.

On March 2, Byron Evans, a widower, transferred $45,000 of Hallmart stock to his grandson, Mark. On March 3, he gave $30,000 cash to his grandson, Jay.

Both transfers Byron made during the year are *inter vivos* direct skips. They are listed on Form 709, Schedule A, Part 2, as transfers subject to both the gift tax and the GST tax. The transfers are entered on Schedule C in the same order as they were listed on Schedule A. Note that the item number listed on Schedule C, Part 1, column A, should correspond to the item number listed on Schedule A. The value from Schedule A, Part 2, column H, should be entered on Schedule C, Part 1, column B.

Double Taxation on *Inter Vivos* Direct Skips

The use of direct skips during lifetime to transfer property can be an expensive proposition if the client's GST tax exemption has already been used. This is because the GST tax paid by the transferor on a taxable gift that is a direct skip increases the amount of the taxable gift by the amount of the GST tax. Thus, the amount of the GST tax paid on a lifetime direct skip is subject to gift tax.

Example 1H-3 Double taxation of lifetime direct skips.

Janice made a $1 million gift to her grandchild, Molly. Janice previously used all of her GST tax exemption. The GST tax rate is 45% (for 2007–2009) and the GST tax on the direct skip is $450,000. The gift tax on the transfer is imposed on the $1 million gift plus the $450,000 GST tax, for a total taxable gift of $1,450,000. Thus (assuming a 45% gift tax rate), the gift tax is $652,500. This means that the total transfer tax for a $1 million gift is $1,102,500 ($450,000 + $652,500).

Split Gifts

When a husband and wife elect gift splitting for gift tax purposes, each spouse must be treated as the transferor of half of the gift for GST tax purposes as well.

Example 1H-4 Gift splitting elected for *inter vivos* direct skips.

On January 4, Ben Rogers gave $60,000 of JMart stock to his grandson, Bob. On February 6, Ben's wife, Jo, gave her granddaughter, Mae, a racehorse valued at $28,000. Ben and Jo elected gift splitting on the transfers so that each was considered the donor of half the gifts for gift tax purposes.

The gift tax election to split gifts by married couples also applies to generation-skipping transfers. Thus, Ben and Jo will each be the transferor of half the value of the stock ($30,000) and the racehorse ($14,000).

Annual Exclusion

For gift tax purposes, a donee must have a present interest in the gifted property for the transfer to qualify for the $13,000 (for 2009) annual exclusion. A gift is considered a present interest if the donee has the immediate right to use, possess, and enjoy the property, including the current right to the property's income. Thus, for an outright transfer of property, up to $13,000 (for 2009) of the amount transferred is excluded for gift tax purposes. A similar exclusion is allowed for GSTs.

Outright Transfers. For GST purposes, the inclusion ratio for an outright transfer to a skip person is zero to the extent the transfer qualifies for the GST tax annual exclusion. In essence, assigning a zero inclusion ratio to qualifying transfers produces the same result as the exclusion. In fact, the annual exclusion is claimed for GSTs by subtracting the amount of exclusion available from the value of the transferred property.

Example 1H-5 Claiming the annual exclusion on GSTs.

On January 23, Mark Johnson transferred $30,000 cash to his grandson, Mike, and $12,000 cash to his grandson, Mel. On February 8, Mark's wife, Sally, transferred $40,000 cash to her grandson, Roy. Mark and Sally elected gift splitting on the transfers so that each was considered the transferor of half the amounts.

Because Mark and Sally elected gift splitting, each is considered to have given $15,000 to Mike, $6,000 to Mel, and $20,000 to Roy. Since all the amounts transferred were present interests in property, they would be eligible for the annual gift tax exclusion. For GST tax purposes, Mark and Sally can exclude up to $13,000 (for 2009 of the amounts they were each deemed to have transferred. Thus, Mark and Sally can each exclude $13,000 of the amount given to Mike, the entire $6,000 given to Mel, and $13,000 of the amount given to Roy. (Note the amount eligible for exclusion is the lesser of $13,000 or the amount transferred. Thus, the exclusion on the amount given to Mel is limited to $6,000.)

Direct Skip Transfers in Trust. Transfers to a trust that qualify for the gift tax annual exclusion do not automatically qualify for the GST tax annual exclusion. Direct skip transfers to a trust that qualify as present interests eligible for the gift tax annual exclusion will not qualify for the GST tax annual exclusion unless:

1. the trust is solely for the benefit of a skip person, and

2. the trust assets will be included in the skip person's gross estate if he or she dies before the trust terminates.

Transfers to Section 2503(c) minor's trusts will qualify for the annual exclusion for GST tax purposes (such a trust is considered a skip person). However, most other transfers to trusts (after March 31, 1988) will not be eligible for the annual exclusion. Most notably, transfers to trusts that qualify for the annual gift tax exclusion by providing the beneficiary a withdrawal power over trust contributions (e.g., a *Crummey* trust) are not always eligible for the GST tax annual exclusion due to IRC Sec. 2642(c)(2).

Example 1H-6 Transfers to a *Crummey* trust not eligible for the GST tax annual exclusion.

Dennis Waite transferred $40,000 to an irrevocable life insurance trust for the benefit of his daughter and three grandchildren. Pursuant to the trust instrument, each beneficiary has the right to withdraw up to $10,000 of amounts contributed to the trust within thirty days of the contribution. The withdrawal power lapses in 30 days if not exercised. Although this type of trust arrangement, known as a *Crummey* trust, qualifies for the gift tax annual exclusion, it does not meet the requirements of IRC Sec. 2642(c) for the GST tax exclusion. Therefore, a portion of the transferor's GST tax exemption should be allocated to the trust to avoid a GST tax on a future taxable distribution or termination.

Allocating the GST Tax Exemption to Direct Skips during Lifetime

Each transferor is allowed a GST tax exemption of $3.5 million for 2009. This means that each individual may transfer a cumulative $3.5 million (for 2009) of property (during life or at death) without such transfers being subject to the GST tax. Only the transferor or the transferor's executor (for an estate) may allocate the GST tax exemption to the transferred property. Once made, the allocation is irrevocable. The law provides a set of rules governing the allocation of the GST tax exemption if the transferor or executor fails to allocate the exemption to a particular transfer.

The GST tax exemption may be allocated to lifetime direct skips or to transfers in trust that may result in future taxable distributions or terminations. Assuming a timely allocation, the exemption is allocated based on the transferred property's value on the date of the gift. The allocation of the exemption will be timely if the allocation is made on a timely filed gift tax return (including extensions actually granted). If the allocation of the exemption is made on a gift tax return that is not timely filed, the value of the property is the value on the date the gift tax return is filed. The gift tax return is deemed filed on the date it is postmarked to the IRS Center.

Lifetime Direct Skips. A portion of the transferor's unused GST tax exemption will automatically be allocated to lifetime direct skips. The allocation of the exemption to lifetime direct skips can be made on Form 709, Schedule C. Specifically, the GST tax exemption is allocated on an item by item basis on Part 3 (Tax Computation), column C.

Example 1H-7 Allocating GST exemption to lifetime direct skips.

On January 10, Fran Hughes transferred $35,000 of real estate to his grandson, John, $40,000 of Rayco Inc. stock to his granddaughter, Jane, and $15,000 of T-Bills to his grandson, Dick. Fran would like to use his GST tax exemption to offset the transfers. He has previously used $225,000 of his GST tax exemption.

Fran has sufficient GST tax exemption to offset his current-year transfers; thus, GST tax exemption is automatically allocated to these transfers. He will not owe any GST tax in the current year.

If the transferor does not want to allocate a portion of his lifetime exemption to a lifetime direct skip, he can elect out of the automatic allocation rules on a timely filed gift tax return simply by checking column C on Form 709, Schedule A, Part 2 and attaching a statement to Form 709 describing the transaction and the extent to which the automatic allocation is not to apply. Reporting the direct skip and paying the GST tax on the transfer will qualify as such statement.

The automatic allocation of GST tax exemption or the election out of the automatic allocation rules is irrevocable after the Form 709 due date (including extensions to file that are granted).

Example 1H-8 Paying the GST tax avoids the automatic allocation of the GST tax exemption.

On February 8, Beth Roth transferred $200,000 to a Section 2503(c) minor's trust for the benefit of her granddaughter, Sara (the trust is a skip person). On February 19, Beth transferred $120,000 worth of mutual funds to her grandson, Jordy. Beth has previously used $450,000 of her GST tax exemption and wants to preserve some of her remaining exemption to offset a future transfer to a trust for the benefit of her son and his two daughters. Thus, she does not want to allocate any of her GST tax exemption to the current-year transfer to Judy.

To avoid having a portion of her GST tax exemption automatically allocated to the gift of the mutual funds, Beth should file a gift tax return and pay the GST tax on the transfer of the mutual funds on or before April 15 of the following year.

GST Exemption Reconciliation. Schedule C, Part 2, is a reconciliation of the use of the transferor's GST tax exemption. The exemption allocated to current-year direct skip transfers (previously discussed) is entered on line 4, while the exemption automatically allocated to current-year indirect skips is reported on line 5. The exemption allocated to other lifetime transfers is entered on line 6. The total amount allocated during the current year cannot exceed the amount of exemption available at the beginning of the year (i.e., the amount on line 3).

Reverse QTIP Election

Generally, the donee spouse of a QTIP trust is treated as the transferor of the trust for GST purposes. Thus, the donor spouse's GST tax exemption may be wasted inadvertently when the remainder beneficiary of the trust is a skip person (i.e., grandchildren). The reverse QTIP election allows the donor spouse to be treated as the transferor of the trust property for GST purposes. Thus, the donor spouse's GST tax exemption can be allocated to the transfer.

Lifetime Transfers That Are Not Direct Skips and the GST Tax Exemption

Allocating Exemption to Lifetime Transfers in Trust Other Than Direct Skips

Schedule C of Form 709 is generally used to allocate the GST tax exemption and compute the tax only on lifetime transfers that are direct skips. The GST tax exemption may also be allocated to lifetime transfers in trust (other than direct skips) that may result in future taxable distributions or terminations.

Generally, for transfers after 2000, any unused portion of the individual's GST tax exemption is automatically allocated (i.e., a deemed allocation is made) to indirect skips to GST trusts made during life to the extent necessary to produce the lowest possible inclusion ratio for such trust.

Typically, indirect skips to GST trusts are transfers to trusts that may produce a taxable distribution or a taxable termination.

Example 1I-1 Allocating the GST exemption to trusts subject to future GST.

During the year, Kyle Easton transferred $300,000 to a trust that will pay all of its net income annually to his son, Cord, for life. At Cord's death, the remainder interest in the trust will be distributed in equal shares to Cord's three daughters. Since Cord has an interest in the trust, the trust is not a skip person, and the transfer to the trust itself is not subject to GST tax. However, a taxable termination will occur on Cord's death when the trust property is distributed to his daughters. Kyle wants to allocate a portion of his lifetime GST tax exemption to the trust so future trust distributions will be exempt from the GST tax. He has not previously used any of his lifetime GST tax exemption.

The automatic allocation of the GST tax exemption rules apply [i.e., the trust is a GST trust as defined by IRC Sec. 2632(c)(3)(B)]. Therefore, Kyle's GST tax exemption will be automatically allocated to the trust. If Kyle does not want his GST tax exemption to be allocated to the trust, he must elect out of the automatic allocation.

Kyle must file a gift tax return to report the transfer. The transfer is an indirect skip to a GST trust and is reported on Schedule A, Part 3. In addition to reporting on Schedule A, Part 3, the GST tax exemption is reported on Schedule C, Part 2, line 5.

If the automatic allocation rules do not apply (e.g., a late allocation or where the taxpayer elected out of the automatic allocation rules), the allocation of the GST tax exemption to lifetime transfers other than direct skips can be made on a Notice of Allocation attached to Form 709.

According to Reg. 26.2632-1(b)(4)(i) and the Form 709 instructions, the Notice of Allocation should identify:

1. The trust to which the allocation is made, including the trust's EIN if known.
2. If applicable, the item number(s) from column A, Schedule A, Part 3 of the transfers.
3. If the allocation is late, the year the transfer was reported on Form 709.
4. The amount of GST tax exemption allocated to it (or a statement that the exemption is being allocated by means of a formula).
5. The value (as shown in column H of Schedule A, Part 3) of the gift or, if the allocation is late, the value of the assets at the time of allocation.
6. The inclusion ratio of the trust after the allocation.

Electing Out of the Automatic Allocation of the GST Tax Exemption to Indirect Skips

As discussed above, an individual's GST tax exemption is automatically allocated to indirect skips to GST trusts made during life to the extent necessary to produce the lowest possible exclusion ratio for such trust. There are several elections available, as discussed in the following paragraphs.

Election to Treat Trust as a GST Trust. The automatic allocation of GST tax exemption to indirect skips applies to transfers made to a GST trust. An individual may elect to treat any trust as a GST trust relating to any or all transfers made by the individual to the trust. The election is made by attaching a statement to a timely filed (including extensions actually granted) gift tax return (Form 709) for the calendar year in which the transfer is made. The statement must identify the trust, describe or clearly identify the transfer(s) covered by the election, and specifically provide that, pursuant to IRC Sec. 2632 (c)(5)(A)(ii), the transferor is electing to have the trust treated as a GST trust. This election will remain in effect unless and until terminated.

Indirect skips for which an election has been made to treat the trust as a GST trust are reported on Form 709, Schedule A, Part 3. (If the practitioner prefers to make an express allocation of the GST tax exemption to provide a record of the use of the transferor's GST tax exemption, the allocation is reported on Schedule C of Form 709.)

The election to be treated as a GST trust can be terminated by the transferor by attaching a statement to a timely filed gift tax return for the calendar year of the first transfer to which the election is not to apply or the first calendar year for which the GST trust election is not to apply (even if no transfer is made to the trust during the year). The termination statement must identify the trust, describe the current-year transfer (if any), and state that the prior election to treat the trust as a GST trust is terminated. If the trust otherwise does not satisfy the definition of a GST trust, the automatic allocation rules will no longer apply to the described current transfer or to any future transfers made by the transferor to the trust (unless another election to treat the trust as a GST trust is made).

Electing Out of the Deemed Allocation Rules for Lifetime Indirect Skips. An individual can elect not to have the automatic allocation rules apply to an indirect skip. The election will be considered to be timely if filed on a timely-filed (including extensions actually granted) gift tax return for the calendar year in which—

1. the first transfer to be covered by the election out was made, or
2. the ETIP closes (for transfers subject to an ETIP).

The following are five separate elections out that a transferor can make:

1. *Election not to have the automatic allocation rules apply to prior-year transfers subject to an ETIP.* Prior-year transfers that are subject to an ETIP must be specifically described or identified in the election out statement. This election will not cover future transfers to such trust. However, see item 5. Since the GST tax exemption cannot be allocated until the ETIP closes, the election out can free the GST tax exemption to be allocated to other transfers. When the ETIP closes, the GST tax exemption can be affirmatively allocated at that time.

2. *Election to not have the automatic allocation rules apply to one or more (or all) current-year transfers.* This election by itself will only cover current-year transfers. However, see item 5. Donors typically make this election to preserve their GST tax exemption for future years.

3. *Election not to have the automatic allocation rules apply to one or more (or all) future-year transfers.* This election by itself will only cover future transfers and not current transfers. However, see item 5. This election can be terminated.

4. *Election not to have the automatic allocation rules apply to all future-year transfers to all trusts.* All future transfers made by the transferor to all trusts (whether or not the trust is in existence at the time of the election). This election by itself will only cover future transfers to all trusts unless this election is terminated. This election can be terminated.

5. *Any combination of the previously discussed four elections.* If a transferor is certain that he or she does not want to allocate his or her GST tax exemption to a particular trust, he or she should combine the elections

out for current-year transfers and all future transfers (this will prevent a filing requirement if future transfers are made to the trust and a gift tax return is not otherwise required).

Schedule A, Part 3 was added to Form 709 to help track the use of the GST tax exemption that is automatically allocated to indirect skip transfers and to provide a mechanism for electing out of these deemed allocation rules. The election is made by indicating (on Form 709, Schedule A, Part 3, Column C) each transfer the donor wants to exclude from the deemed allocation rules. In addition, a statement must be attached to a timely filed Form 709 for the year in which the election is desired. The statement must identify the trust, describe the transfer, and specifically state that the transferor is electing out of the automatic allocation rules with respect to the described transfer(s) under IRC Sec. 2632(c)(5)(A).

Termination of Election Out. The election out can be terminated in a subsequent year by attaching a statement to a timely filed gift tax return for the year for which the first transfer was made to which the election out is lifted (even if a gift tax return would not otherwise be required). The statement must identify the trust (if applicable), describe the prior election out that is being terminated, and specifically provide that the prior election out is being terminated, and describe the extent to which the prior election out is being terminated or describe any current-year transfers to which the election out will no longer apply. This results in the automatic allocation rules applying to the described current transfer as well as all future transfers made by the transferor to the trust (unless and to the extent another election out of the automatic allocation rules is made in the future).

Recalculating the Trust's Inclusion Ratio

The trust's inclusion ratio will need to be recalculated when additional GST tax exemption is allocated to the trust or when additional property is contributed to the trust.

Relief for Late Allocations of the GST Tax Exemption

Generally, for transfers before 2001, there was no provision for an automatic allocation of GST tax exemption to transfers that could result in a future taxable distribution or taxable termination. As a result, no exemption was allocated to the transfer unless it was expressly allocated at the time the gift tax return was filed. Absent an express allocation, any GST tax (or allocation of the transferor's exemption) would be based on the value of the property at the time of a future taxable distribution or taxable termination. This may be costly if the value of the property increases prior to the taxable termination, taxable distribution, late allocation of exemption, or a future late allocation of exemption. Relief is available for inadvertent missed GST tax exemption allocations. If a transfer falls under these relief provisions, the exemption is allocated based on the date of transfer values.

GST Not Eligible for Annual Exclusion

The Notice of Allocation is also used to allocate the GST tax exemption to gifts that qualify for the gift tax annual exclusion but not the GST tax annual exclusion. Generally, the gifts are *Crummey* type trusts where beneficiaries have withdrawal powers that make transfers to the trust eligible for the gift tax annual exclusion but not the GST tax annual exclusion because of the requirements of IRC Sec. 2642(c)(2).

Example 1I-2 Gift to ILIT with *Crummey* Powers and Indirect Skip

On January 15, 2009, Sid Tenor established an irrevocable life insurance trust (ILIT). He funded it with $60,000 to pay the first annual premium on a $1,600,000 policy on his life. The Sid Tenor Irrevocable Life Insurance Trust (Tenor ILIT) gives each of his two sons *Crummey*-type withdrawal powers over the trust, shared equally. Sid and his wife, Nancy, elect gift splitting for these gifts, which are the only gifts they made during the year. Since the trust instrument designates ultimate distribution to skip persons (i.e., their grandchildren or more remote generations), they will allocate some of their previously unused GST tax exemption to the gift. Sid's tax preparer recommends to elect out of the automatic allocation rules to eliminate uncertainty regarding whether the automatic allocation rules apply. In addition, as a general rule, he employs formula language in the Notice of Allocation.

Allocating Exemption to Multiple Nonskip Trusts

When there are transfers to multiple nonskip trusts during the year, or when there are transfers subject to the GST tax but not the gift tax (i.e., transfers not eligible for the annual GST tax exclusion), one Notice of Allocation can be filed for all transfers (each of which is specifically identified) for which the exemption is being allocated. The total GST tax exemption allocated to transfers on the notice should be entered on Schedule C, Part 2, line 6.

Property Subject to an Estate Tax Inclusion Period (ETIP)

Certain transfers that are completed gifts when made may subsequently be included in the transferor's gross estate (e.g., the transferor retains the power to alter beneficial enjoyment of the property causing it to be included in his gross estate under IRC Sec. 2038). Such property is subject to an estate tax inclusion period (ETIP) and an allocation of the GST tax exemption is not effective until the termination of the ETIP.

An ETIP is any period during which (should death occur) the value of the transferred property would be included in the gross estate of either (1) the transferor, or (2) the spouse of the transferor.

Transferred property that would be included in the transferor's gross estate under IRC Sec. 2035 (i.e., adjustments for transfers made within three years of death) is not subject to an ETIP. In addition, the ETIP rules do not apply when the possibility that the property will be included in the estate of the transferor or the transferor's spouse is so remote as to be negligible. This would occur if there is less than a 5% probability of the property being included in the gross estate. Also, property transferred to a spouse will not be subject to an ETIP where the only power possessed by the spouse is a right to withdraw no more than the greater of 5% or $5,000, and such withdrawal right terminates within 60 days of the transfer.

Example 1J-1 Transferor's retained interest creates an ETIP.

Steve Roe transferred $250,000 to an irrevocable trust that will pay him a $5,000 annuity for five years. At the end of the five-year period, the balance in the trust will be distributed to his grandson, Rob. If Steve dies during the five-year period, the value of the trust will be included in his gross estate under IRC Sec. 2036(a). Thus, the transfer is subject to an ETIP, and an allocation of the GST tax exemption to the transfer will not be effective until the termination of the ETIP.

Example 1J-2 Transferor's power to alter enjoyment creates an ETIP.

Kay Davis transferred $200,000 to an irrevocable trust and retained the discretionary right to sprinkle trust income and principal among her three grandchildren. Since Kay's retained powers to alter beneficial enjoyment of the trust will cause the trust to be included in her estate under IRC Sec. 2036 or 2038, the transfer is subject to an ETIP. Any allocation of her GST tax exemption will not be effective until the ETIP terminates.

Termination of an ETIP

An ETIP terminates on the first to occur of—

1. the transferor's death;
2. the time at which the property would no longer be included in the transferor's gross estate, determined without regard to IRC Sec. 2035 (or where a spouse is treated as transferor because of gift splitting, when the property would no longer be included in the donor spouse's estate);
3. the time of a GST with respect to the property involved in the GST; or
4. in the case of an ETIP arising by reason of an interest held by the transferor's spouse, at the death of the spouse or the time at which no portion of the property would be included in the spouse's gross estate (excluding IRC Sec. 2035), whichever occurs first.

Example 1J-3 Termination of an ETIP.

Assume the same facts as in Example 1J-1, Steve's ETIP will terminate on the earlier of the expiration of the five-year term, or his death. In addition, the ETIP would terminate if Steve gave his interest in the trust to someone other than his spouse.

Assume the same facts as in Example 1J-2, Kay's ETIP will terminate on the earlier of her relinquishment of the power to sprinkle trust income and corpus, or her death.

In both situations, the GST tax exemption will be automatically allocated to the trust at the end of the ETIP, unless an election is made to not have the automatic allocation rules apply.

Allocating Exemption to Transfers Subject to an ETIP

An allocation of the GST tax exemption to property subject to an ETIP takes effect upon the termination of the ETIP if the allocation is made by the due date for filing Form 709 for a gift occurring at the time of the ETIP termination. The GST tax exemption is allocated to property subject to an ETIP based on the value of the property at the close of the ETIP. The allocation is deemed effective on and after the close of the ETIP.

Direct Skip Subject to ETIP. If a direct skip transfer is subject to an ETIP, the direct skip is treated as occurring at the termination of the ETIP. Thus, the exemption is allocated equal to the value of the property at the close of the ETIP or the GST tax will be imposed on the transfer when the ETIP terminates. The gift tax portion of such a transfer is reported on Form 709, Schedule A, Part 1, in the year of the actual transfer. The GST portion of the transfer is reported at the time the ETIP terminates.

If the ETIP terminated as a result of something other than the donor's death, the GST portion of the transfer is reported on Form 709, Schedule A, Part 2, for the year in which the termination occurred. (Note, if the ETIP terminated as a result of the donor's death, the transfer is reported on Form 706.

If the donor made other gifts during the year for which Form 709 is required to be filed, the GST transfer is reported on Schedule A, Part 2, as follows:

1. Complete column B in the usual manner. In addition, describe the interest that closed, what caused it to terminate, and the year (and item number) the gift portion of the transfer was originally reported.

2. Enter in column E the date the ETIP terminated, not the date of the initial gift.

3. Since the transfer is not subject to gift tax in the current year, enter "N/A" for its value in column F, G, and H.

Schedule C is then completed in the usual manner except the value of the property at the termination of the ETIP is entered in Part 1, column B, provided the exemption is being allocated on a timely filed gift tax return. Otherwise, enter the value of the property as of the date the exemption is being allocated.

Example 1J-4 Allocating the GST exemption to a direct skip subject to an ETIP.

In 2002, Perry Robb transferred $300,000 to an irrevocable trust for the benefit of his three grandchildren. Perry retained the discretionary right to sprinkle trust income and principal among the grandchildren. Since Perry's power to alter beneficial enjoyment of the trust would cause the trust to be included in his estate under IRC Sec. 2036 or 2038, the transfer was subject to an ETIP. On January 10, 2009, when the trust was valued at $500,000, Perry relinquished his discretionary power to distribute trust income and principal. As a result of his relinquishment of these powers, the property would no longer be included in his estate if he died (excluding IRC Sec. 2035) and, thus, the ETIP is terminated. Since the initial transfer to the trust was a direct skip subject to an ETIP, the GST is deemed to occur on January 10, 2009, when the ETIP terminated.

Since this is a direct skip at the termination of the ETIP, the automatic allocation rules relating to a direct skip should apply. As a result, $500,000 would be automatically allocated against Perry's GST tax exemption.

Other Transfers Subject to an ETIP. Lifetime transfers in trust (other than direct skips) may result in future GST distributions or terminations. To the extent the transfer to the trust is subject to an ETIP, the allocation of the GST tax exemption cannot be effective until the close of the ETIP, which is the time for the deemed GST.

An indirect skip to a trust that is subject to an ETIP is subject to the deemed allocation rules. In the case of an ETIP, the GST tax exemption is deemed allocated at the end of the ETIP based on the value of the property at the termination of the ETIP. An individual can elect not to have the automatic allocation rules apply to an indirect skip. The election must be made any time before the due date of Form 709 for the calendar year in which the ETIP terminates.

Example 1J-5 Other lifetime transfer subject to an ETIP.

Linda Roberts transferred $150,000 to an irrevocable trust for the benefit of her son, Len. Linda retained the discretionary right to allocate income or principal to Len. At Len's death, the balance in the trust will be distributed to Len's two sons (Linda's grandsons).

Since someone other than a skip person has an interest in the trust, the transfer to the trust is not a direct skip subject to the GST tax. However, the transfer will result in a future GST termination or distribution because the trust assets will be distributed to Linda's grandchildren at her son's death. Thus, Linda may want to allocate a portion of her unused GST tax exemption to the trust so that a future distribution of trust assets to her grandchildren would not be taxable. Unfortunately, Linda's discretionary power to distribute income or corpus to her son will cause the value of the trust to be included in her estate under IRC Sec. 2036 or 2038. Thus, the transfer is subject to an ETIP and the allocation of her lifetime exemption cannot be effective until the ETIP terminates.

Example 1J-6 Deemed allocation of GST tax exemption to trust subject to an ETIP.

In 2005, Tracy transferred $100,000 to a trust. The trust instrument provides that trust income is paid to Tracy for 10 years or until she dies. The trust principal is paid to Tracy's grandchildren when the income interest terminates. Tracy made no other gifts in 2005. The GST tax exemption is automatically allocated to this trust but will not be effective until the income interest terminates.

Example 1J-7 Election out of automatic allocation of the GST tax exemption for a trust subject to an ETIP.

Assume the same facts as Example 1J-6. Tracy files Form 709 on April 15, 2010, and elects out of the automatic allocation of the GST tax exemption for this trust. She specifically refers to the prior year transfers. She has made a timely election out.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Which of the following statements regarding allocation of the GST tax exemption is most accurate?

    a. For 2009, a transferor may transfer a cumulative $5 million of property without the transfer being subject to the GST tax.

    b. If timely, the GST exemption is allocated based on the value of transferred property on the date of the gift.

    c. Transfers in trust are not eligible for the GST tax exemption.

    d. Any allocation of the GST tax exemption is completely retractable.

17. Which of the following allows the donor spouse to be treated as the transferor of a trust property for GST?

    a. QDOT.

    b. Reverse QTIP.

18. Which of the following statements regarding direct skip transfers in trust is most accurate?

    a. Transfers to a trust that qualify for the gift tax annual exclusion do not automatically qualify for the GST tax annual exclusion.

    b. Transfers to Section 2503(c) minor's trust do not automatically qualify for the GST tax annual exclusion.

19. What is Schedule C of Form 709 used for?

    a. To allocate the GST tax exemption.

    b. To report direct skips that occurs at death.

    c. To report a qualified severance.

20. An individual can elect not to have the automatic allocation rules apply to an indirect skip. All of the following are separate elections out that a transferor can make **except**:

    a. Election to allocate the GST tax exemption made on a gift tax return.

    b. Election to not have the automatic allocation rules apply to one or more current-year transfers.

    c. Election not to have the automatic allocation rules apply to all future-year transfers to all trusts.

    d. Election not to have the automatic allocation rules apply to prior-year transfers subject to an ETIP.

21. What is one thing the Notice of Allocation is used for?

    a. To reconcile the use of the transferor's GST tax exemption.

    b. To give effect to the portion of the transferor's lifetime exemption allocated to a given transfer.

    c. To allocate the GST tax exemption to gifts qualifying for the gift tax annual exclusion but not the GST tax annual exclusion.

    d. To terminate an election out.

22. Sam transferred $200,000 to an irrevocable trust and retained the discretionary right to sprinkle trust income and principal among his three grandchildren. Since Sam's retained powers to alter beneficial enjoyment of the trust will cause the trust to be included in his estate under IRC Secs. 2036 or 2038, the transfer is subject to an ETIP. Sam relinquished his discretionary power to distribute the trust income and principal in 2009. Sam died in 2010. Which of the following forms is used to report the GST portion of the transfer?

    a. Form 709, Schedule A, Part 2.

    b. Form 706.

    c. Form 709, Schedule A, Part 1.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Which of the following statements regarding allocation of the GST tax exemption is most accurate? **(Page 151)**

    a. For 2009, a transferor may transfer a cumulative $5 million of property without the transfer being subject to the GST tax. [This answer is incorrect. For 2009, the GST tax exemption is $3.5 million. Therefore, each individual may transfer a cumulative $3.5 million, not $5 million, of property without the transfer being subject to GST tax.]

    b. If timely, the GST exemption is allocated based on the value of transferred property on the date of the gift. [This answer is correct. Under the Internal Revenue Code, assuming a timely allocation, the exemption is allocated based on the transferred property's value on the date of the gift. The allocation of the exemption will be timely if the allocation is made on a timely filed gift tax return (including extensions actually granted).]

    c. Transfers in trust are not eligible for the GST tax exemption. [This answer is incorrect. The GST tax exemption may be allocated to lifetime direct skips or to transfers in trust that may result in future taxable distributions or terminations.]

    d. Any allocation of the GST tax exemption is completely revocable. [This answer is incorrect. Once made, the allocation is irrevocable. The law provides a set of rules governing the allocation of the GST tax exemption if the transferor or executor fails to allocate the exemption to a particular transfer.]

17. Which of the following allows the donor spouse to be treated as the transferor of a trust property for GST? **(Page 151)**

    a. QDOT. [This answer is incorrect. A surviving spouse is the transferor of a qualified domestic trust (QDOT) that is used to obtain a marital deduction in the decedent's estate unless the trust is subject to the reverse QTIP election.]

    b. Reverse QTIP. [This answer is correct. Under the Code, the reverse QTIP election allows the donor spouse to be treated as the transferor of the trust property for GST purposes. Thus, the donor spouse's GST tax exemption can be allocated to the transfer.]

18. Which of the following statements regarding direct skip transfers in trust is most accurate? **(Page 151)**

    a. Transfers to a trust that qualify for the gift tax annual exclusion do not automatically qualify for the GST tax annual exclusion. [This answer is correct. This is accurate according to the Internal Revenue Code. Direct skip transfers to a trust that qualify as present interests eligible for the gift tax annual exclusion will not qualify for the GST tax annual exclusion unless the trust is solely for the benefit of a skip person, and the trust assets will be included in the skip person's gross estate if he or she dies before the trust terminates.]

    b. Transfers to Section 2503(c) minor's trust do not automatically qualify for the GST tax annual exclusion. [This answer is incorrect. Transfers to Section 2503(c) minor's trusts will qualify for the annual exclusion for GST tax purposes (such a trust is considered a skip person). However, most other transfers to trusts (after March 31, 1988) will not be eligible for the annual exclusion.]

19. What is Schedule C of Form 709 used for? **(Page 154)**

    a. To allocate the GST tax exemption. [This answer is correct. Schedule C of Form 709 is generally used to allocate the GST tax exemption and compute the tax only on lifetime transfers that are direct skips. The GST tax exemption may also be allocated to lifetime transfers in trust (other than direct skips) that may result in future taxable distributions or terminations.]

    b. To report direct skips that occurs at death. [This answer is incorrect. Schedule R is used to report direct skips that occur at death and to compute the amount of GST tax payable on the transfer.]

    c. To report a qualified severance. [This answer is incorrect. Form 706-GS(T) is used to report a taxable termination.]

20. An individual can elect **not** to have the automatic allocation rules apply to an indirect skip. All of the following are separate elections out that a transferor can make **except**: **(Page 154)**

    a. Election to allocate the GST tax exemption made on a gift tax return. [This answer is correct. This election is not one of the five elections for the automatic allocation rules listed in the IRS regulations. The timing of this election determines what date the value of the transfer must be calculated from.]

    b. Election to not have the automatic allocation rules apply to one or more current-year transfers. [This answer is incorrect. The election to not have the automatic allocation rules apply to one or more (or all) current-year transfers is available. This election by itself will only cover current-year transfers and preserve the GST tax exemption for future years.]

    c. Election not to have the automatic allocation rules apply to all future-year transfers to all trusts. [This answer is incorrect. The election not to have the automatic allocation rules apply to all future-year transfers to all trusts will cover only future-year transfers will only cover future transfers to all trusts unless this election is terminated. This election can be terminated.]

    d. Election not to have the automatic allocation rules apply to prior-year transfers subject to an ETIP. [This answer is incorrect. The election not to have the automatic allocation rules apply to prior-year transfers subject to an ETIP can free the GST tax exemption for other transfers. Prior-year transfers that are subject to an ETIP must be specifically described or identified in the election out statement.]

21. What is one thing the Notice of Allocation is used for? **(Page 154)**

    a. To reconcile the use of the transferor's GST tax exemption. [This answer is incorrect. Schedule C, Part 2, is a reconciliation of the use of the transferor's GST tax exemption.]

    b. To give effect to the portion of the transferor's lifetime exemption allocated to a given transfer. [This answer is incorrect. The inclusion ratio is used to give effect to the portion of the transferor's $3.5 million (for 2009) lifetime exemption allocated to a given transfer.]

    c. To allocate the GST tax exemption to gifts qualifying for the gift tax annual exclusion but not the GST tax annual exclusion. [This answer is correct. The Notice of Allocation is used to allocate the GST tax exemption to gifts that qualify for the gift tax annual exclusion but not the GST tax annual exclusion. Generally, these are *Crummey* type trusts where beneficiaries have withdrawal powers that make transfers to the trust eligible for the gift tax annual exclusion but not the GST tax annual exclusion because of the requirements of IRC Sec. 2642(c)(2).]

    d. To terminate an election out. [This answer is incorrect. The election out can be terminated in a subsequent year by attaching a statement to a timely filed gift tax return for the year for which the first transfer was made to which the election out is lifted (even if a gift tax return would not otherwise be required).]

22. Sam transferred $200,000 to an irrevocable trust and retained the discretionary right to sprinkle trust income and principal among his three grandchildren. Since Sam's retained powers to alter beneficial enjoyment of the trust will cause the trust to be included in his estate under IRC Secs. 2036 or 2038, the transfer is subject to an ETIP. Sam relinquished all power to the trust in 2009. Sam died in 2010. Which of the following forms is used to report the GST portion of the transfer? **(Page 157)**

    a. Form 709, Schedule A, Part 2. [This answer is correct. If the ETIP terminated as a result of something other than the donor's death, the GST portion is reported on Form 709, Schedule A, Part 2, for the year the termination occurred. Sam's ETIP terminated as a result of his relinquishment of power, not because of death.]

    b. Form 706. [This answer is incorrect. Form 706 should be used if the ETIP terminates as a result of the donor's death, but that is not the case in this scenario.]

    c. Form 709, Schedule A, Part 1. [This answer is incorrect. If a direct skip transfer is subject to an ETIP, the direct skip is treated as occurring at the termination of the ETIP. Thus, the exemption is allocated equal to the value of the property at the close of the ETIP or the GST tax will be imposed on the transfer when the ETIP terminates. The gift tax portion of such a transfer is reported on Form 709, Schedule A, Part 1, in the year of the actual transfer.]

Form 706, Schedule R: Direct Skips at Death

A direct skip at death occurs when property included in the transferor's estate is transferred to a skip person. As with *inter vivos* direct skips, the skip person may be either an individual or a trust qualifying as a skip person.

Example 1K-1 Direct skip occurring at death.

Pursuant to Jodie Bray's will, 200 shares of IBN stock were transferred to her grandson, Ralph. Since Ralph is a skip person, the bequest of the stock is a direct skip at death subject to the GST tax.

Schedule R is used to report direct skips that occur at death and to compute the amount of GST tax payable on the transfer. Schedule R is also used to report direct skips at death from certain trusts. Direct skips from an explicit trust (a trust created by will or lifetime declaration) in which any of the decedent's executors serve as trustee are reported on Schedule R. In addition, direct skips from a nonexplicit trust (a trust for GST purposes only) are reported on Schedule R if the value of the trust property, less taxes and other charges borne by the trust property, is less than $250,000.

Schedule R is filed with Form 706 on or before the due date of the estate tax return.

Taxable Value of a Direct Skip at Death

The taxable amount of a direct skip at death is the value of the property received by the transferee. Generally, the value of direct skip property is its fair market value at the decedent's date of death or alternate valuation date (if elected). If property was valued using special use valuation (i.e., under IRC Sec. 2032A), that value must be used in the GST tax computation.

Taxes Charged to Direct Skip Property (Schedule R, Part 2). Since the taxable amount of a direct skip at death is the value of the property received by the transferee, the value of the transfer must generally be reduced by the amount of state, federal, and GST taxes imposed on the transfer. For direct skip transfers, the GST tax is imposed on the transferred property unless the decedent's will directs otherwise.

A special formula is needed to compute the GST tax on a direct skip transfer that bears the burden of the GST tax imposed because such tax reduces the taxable transfer (which in turn reduces the GST tax imposed). The GST tax is computed by dividing the amount received by the skip person (after reduction for federal and state death taxes and other charges against the property and allocation of the GST tax exemption) by 3.222222 (for 2009 based on 45% GST tax; see Part 2, line 8 of 2009 Schedule R). Schedule R, Part 2, is used to compute the GST tax due on a direct skip transfer at death that bears the burden of the GST tax imposed.

Example 1K-2 GST tax on a direct skip at death reduced by taxes charged to property.

Fred Barnes bequeathed 1,000 shares of Texico Inc. stock to his grandson, Mark. The stock was included in Fred's gross estate at its date of death value of $250,000. Assume that pursuant to Fred's will $112,500 of state and federal taxes were charged against the stock. In addition, GST taxes are chargeable against the property transferred. Frank had previously used all of his GST tax exemption.

Since GST taxes are charged against the transfer of the stock, the amount of GST tax imposed is computed on Schedule R, Part 2. Assuming this was Fred's only direct skip transfer at death, the skip person (Mark), the interest transferred (Texico stock), and its estate tax value ($250,000) are entered in the appropriate columns. The amount of federal and state death taxes ($112,500) and any other charges against the property are entered on line 2. In addition, if any GST taxes imposed on other transfers are charged against the stock, this amount is entered on line 3. Since Fred had previously used all of his GST tax exemption, no amount is allocated on line 6, and the amount of GST tax on the transfer can be determined by dividing the net value of the property received ($137,500) by 3.222222 (for 2009). Thus, $42,672 of GST tax is imposed on the transfer. This amount is entered on Form 706, Part 2 (Tax Computation), line 17.

Taxes Not Charged against Direct Skip Property (Schedule R, Part 3). If the decedent's will directs GST taxes to be paid from other estate property, the value of the transfer is not reduced by these taxes since they do not reduce the amount of property transferred to the beneficiary. Since taxes are not charged against the direct skip property, the amount of GST tax imposed on the transfer is computed by multiplying the amount received by the skip person (after reduction for federal and state death taxes and other charges against the property and allocation of GST tax exemption) by the maximum estate tax rate (which is 45% for 2007–2009). Schedule R, Part 3, is used to compute the GST tax imposed on direct skip transfers that do not bear the GST tax. The amount of GST tax computed on Part 3 is entered on Part 2, line 9.

Allocating GST Tax Exemption to Transfers at Death

Schedule R is used to allocate the decedent's unused GST tax exemption to direct skips to individuals or trusts that occur at death. (Schedule R is also used to allocate the decedent's unused exemption to nonskip trusts that may have a future taxable termination or taxable distribution.) The allocation of the exemption is effective as of the decedent's date of death and is allocated on the basis of the property's value for estate tax purposes (i.e., date of death or alternate value date). Once made, the election is irrevocable. If the executor fails to allocate the GST tax exemption, the unused exemption is automatically allocated first to direct skip transfers occurring at death and then to trusts in which a taxable termination.

Direct Skips at Death. The GST tax exemption is allocated to transfers occurring at death on Schedule R, Part 2 or 3, depending on whether the GST taxes are charged against the property.

Example 1K-3 Allocating the GST tax exemption to a direct skip at death.

Laura Welch bequeathed 500 shares of Jensen & Jensen stock to her grandson, Jay. At the time of her death, the stock was valued at $100,000. The executor did not elect to value estate property on the alternate valuation date. Assume $30,000 of state and federal death taxes were charged against the property, and any GST taxes would be charged against the property. Laura's executor elects to allocate $70,000 of her GST tax exemption to the transfer. Since the property bears the burden of any GST taxes imposed on the transfer, it is reported on Schedule R, Part 2. The $70,000 exemption allocated to the transfer is entered on Part 2, line 6, and again on Part 1, line 4.

Protective Allocation to Special Use Valuation Property. The executor may elect to value farms and certain business realty at its present use instead of its highest and best use. If the recipient of the special use property disposes of the property or converts it to other than a qualified use within 10 years of the decedent's death, the estate tax benefits of the lower valuation are recaptured. Thus, to the extent the transferred property was subject to the GST tax, the increase in the property's value generates additional GST tax. To minimize the risk that additional GST tax will be due if the special use benefits are recaptured, a portion of the decedent's exemption can be allocated to these transfers to cover the increase in the property's value. The additional exemption is allocated to these transfers on Schedule R, Part 1, line 10.

Example 1K-4 Allocating an additional GST tax exemption to special use property.

John West died and included in his estate was a farm that qualified for special use valuation. The farm's value in its present use (i.e., special use value) was $200,000. However, if the farm was valued at its highest and best use, its value would be $300,000. John left the farm to his grandson, Moe. Thus, the transfer of the farm to the grandson is a direct skip at death.

John's executor could allocate $200,000 of GST tax exemption to the transfer and eliminate any GST tax. However, if Moe discontinues the qualified use of the farm so that the estate tax benefits are recaptured, the $100,000 increase in the property's value will be subject to the GST tax. To eliminate the risk that recapture of the estate tax benefits will generate a GST liability, an additional $100,000 of John's exemption can be allocated to the transfer to cover the contingency. The allocation of the additional $100,000 of exemption is made on Schedule R, Part 1, line 10.

If estate tax benefits are recaptured under IRC Sec. 2032A(c) and the special use election was effective for GST tax purposes, the applicable fraction is redetermined as of the date of death. Thus, any GST transfer either before or after the recapture event would be based on the redetermined applicable fraction.

Allocation to Cover Post Death Events. If post death events cause the decedent to be treated as a transferor for GST purposes, a portion of the decedent's exemption may be set aside to cover such contingencies. The exemption can be allocated to such contingent events by entering the appropriate amount of exemption on Schedule R, Part 1, line 10, and attaching a schedule listing each event and the amount of exemption allocated to that event.

Reverse QTIP Election

Generally, the donee spouse (surviving spouse) of a QTIP trust is treated as the transferor of the trust for GST purposes. Thus, the donor spouse's (decedent's) GST tax exemption may be wasted when the remainder beneficiary of the trust is a skip person (i.e., grandchildren). The irrevocable reverse QTIP election allows the donor spouse to be treated as the transferor of the trust property for GST purposes. Thus, the donor spouse's GST tax exemption can be allocated to the transfer.

The reverse QTIP election is made by listing the qualifying property on Schedule R, Part 1, line 9.

> **Example 1K-5 Making the reverse QTIP election.**
>
> Roger Smith died and in accordance with his will, $400,000 was transferred to a trust that will pay his wife all of its net income annually for her life. At her death, the trust principal will be distributed to Roger's grandson, Robert. Roger's executor makes the QTIP election for the value of the trust. Roger had $500,000 of unused GST tax exemption available at his death. Absent a reverse QTIP election, Roger's wife will be treated as the transferor of the property at her death and will have to use her GST tax exemption to offset the direct skip that occurs at her death. In effect, Roger's $500,000 of unused GST tax exemption would be wasted.
>
> Roger's executor should make the reverse QTIP election (so that Roger is treated as the transferor for GST purposes) and allocate $400,000 of Roger's exemption to the transfer. This will give the trust a zero inclusion ratio and no part of the trust will be subject to the GST tax at his wife's death. In addition, it preserves $400,000 (or more if the QTIP trust appreciates in value) of her exemption that can be used for other transfers.
>
> The exemption is allocated to the QTIP trust since the transfer is to a nonskip trust that may result in a future taxable distribution or taxable termination.

Making a Late Reverse QTIP Election. The IRS has granted estates an extension of time to make the reverse QTIP election. In some, the executor or accountant failed to make the reverse QTIP election on Form 706 but subsequently filed Schedule R and made the election. In another, Schedule R was filed showing the allocation of the exemption but the box (as it appeared on prior-years' Form 706 indicating a reverse QTIP election was being made) was not marked. The IRS subsequently issued a revenue procedure that simplifies the process for requesting a late reverse QTIP election.

In lieu of the private letter ruling process, which requires a fee, Rev. Proc. 2004-47 provides an alternative procedure for certain executors and trustees to make a reverse QTIP election. This would allow the decedent to remain as the transferor of the QTIP trust or property for GST (generation-skipping transfer) tax purposes and allow use of the decedent's GST tax exemption for the QTIP trust or property. This revenue procedure does not automatically extend the time to make an allocation or retroactively allocate the decedent's remaining GST tax exemption to the QTIP trust or property.

The simplified procedure may be used if the following requirements are met:

1. a valid QTIP election was made;
2. the reverse QTIP election was not made on the estate tax return as filed because the taxpayer relied on the advice of a qualified tax professional who failed to advise the taxpayer of the need, advisability, or proper method to make a reverse QTIP election;
3. the decedent has a sufficient amount of unused GST tax exemption to result in a zero-inclusion ratio for the reverse QTIP trust or property;

4. the estate is not eligible for an automatic six-month extension;

5. the surviving spouse has not made a lifetime disposition of any of the qualifying income interest for life in the QTIP trust or property;

6. the surviving spouse is alive or no more than six months have passed since the death of the surviving spouse; and

7. relief is requested by the executor in accordance with Rev. Proc. 2004-47.

The procedures to obtain relief under this procedure are as follows. The estate must:

1. file a request for an extension of time to make a reverse QTIP election;

2. include a cover sheet for the request that states "REQUEST FOR EXTENSION FILED PURSUANT TO REV. PROC. 2004-47"; and

3. attach specified documents including copies of parts 1 through 5 and Schedule M of the originally filed estate tax return; a properly completed Schedule R as required to make the reverse QTIP election; a statement describing why the reverse QTIP election was not made on the original estate tax return; an affirming statement that all the requirements of this revenue procedure have been met; and disclosures from both the executor and the qualified tax professional.

The request should be sent to the Internal Revenue Service Center, Cincinnati, OH 45999 if mailed via the U.S. Postal Service. (The Service no longer publishes the street address needed for private delivery services.)

Example 1K-6 Making a late reverse QTIP election.

In Morgan Fuller's will, a QTIP trust was established for his spouse, Marie. The QTIP paid income to Marie during her life. At her death, the trust is distributed equally to all grandchildren. The QTIP election was made on Morgan's Form 706, but the reverse QTIP election was not made. Marie will be considered the transferor (for GST purposes) if she dies and no reverse QTIP election is made. Marie's attorney advises her (as executor of Morgan's estate) to request relief under Rev. Proc. 2004-47 to make a late reverse QTIP election. All requirements of the revenue procedure have been met.

The request should include copies of the following from Morgan's Form 706: Parts 1 through 5 and Schedule M. A completed Schedule R making the reverse QTIP election should also be enclosed. Additionally, the executor and qualified tax professional must sign and date disclosures.

Form 706, Schedule R-1: Direct Skips at Death from a Trust

A direct skip can occur when property from a trust included in the transferor's gross estate is transferred to a skip person.

The GST tax on a direct skip at death from a trust is imposed on trust assets and paid by the trustee. Schedule R-1 of Form 706 serves as a notification from the decedent's executor to the trustee that a GST tax is due. See the heading "Filing and Payment Procedures" that follows for information on filing the form and paying the tax.

Example 1L-1 Direct skips at death from a trust.

At the time of her death, Mary Watts was the income beneficiary of a marital deduction trust in which she held a general power of appointment over trust assets. In accordance with her will, Mary appointed the remainder interest in the trust to her grandson, Bill. Since Bill is a skip person, the transfer will be deemed a direct skip at death from a trust.

Except as noted, Schedule R-1 is used to report a direct skip at death from an explicit trust (one created by a will or lifetime declaration) and certain other trusts, referred to as nonexplicit trusts, treated as trusts for GST tax purposes only. However, a direct skip totaling $250,000 or less from a nonexplicit trust is reported on Schedule R. Likewise, a direct skip at death from an explicit trust in which the decedent's executor serves as trustee is also reported on Schedule R.

Direct Skips from Explicit Trusts

A direct skip transfer at death from a trust occurs when, as a result of the transferor's death, property is transferred to a skip person from—

1. a trust that is included in the transferor's gross estate under IRC Sec. 2035, 2036, 2037, 2038, 2039, 2041, or 2042;

2. a marital deduction trust included in the transferor's gross estate as a result of the transferor possessing a life estate with a general power of appointment over trust assets; or

3. a qualified terminable interest property (QTIP) trust included in the transferor's gross estate as a result of a qualifying income interest under IRC Sec. 2044.

A direct skip from an explicit trust occurring at the transferor's death is reported on Schedule R-1. [However, Schedule R is used (not Schedule R-1) to report a direct skip from a trust when the decedent's executor is also a trustee of the trust.] An explicit trust is an express trust created by an *inter vivos* declaration or the decedent's will.

Example 1L-2 Direct skip at death from a GRAT.

Barb Wills transferred $250,000 to an irrevocable trust in 2002. Under the trust agreement, the trust will pay her a $12,500 annual annuity for 10 years or until her death if she dies before the expiration of the term. At the expiration of Barb's interest, the balance in the trust will be distributed to her grandson, Rob. Barb died during 2009, and the trust was included in her estate under IRC Sec. 2036(a). The value of the trust was $310,000 on the date of her death, and federal and state death taxes charged against the property were $124,000.

A direct skip at death from a trust occurs at Barb's death because property is transferred to a skip person from a trust included in her estate under IRC Sec. 2036(a). The direct skip transfer would be reported on Schedule R-1, Part 1. Since the initial transfer was subject to an estate tax inclusion period (ETIP), her GST tax exemption could not be allocated to the trust at the time of the initial transfer. Since the ETIP terminates at her death, Barb's GST tax exemption may be allocated to the transfer. The exemption is allocated to direct skips at death from a trust on Schedule R-1, line 4.

Example 1L-3 Direct skip from a marital power of appointment trust.

At her death, Mary Evans was the life beneficiary of a marital trust established at the death of her husband. Pursuant to the trust agreement, all trust income was distributed to Mary for life. Mary was also granted a testamentary general power of appointment to dispose of trust property at her death. Mary's will designated her granddaughter, April, as the remainder beneficiary of the trust. Since the trust was included in Mary's gross estate and she designated a skip person as the remainder beneficiary, a direct skip from a trust occurs at her death. The direct skip is reported on Schedule R-1.

See Example 1L-2 for a sample completed Schedule R-1.

Example 1L-4 Direct skip from a QTIP trust.

At his death, Dan Dunn was the life beneficiary of a QTIP trust established at the death of his wife. Pursuant to the trust document, his grandson, Don, was named remainder beneficiary of trust property. No reverse QTIP election was made at his wife's death. Under IRC Sec. 2044, the value of the trust is included in Dan's gross estate.

Since the value of the trust is included in Dan's gross estate, he is considered the transferor of the trust property. Thus, a direct skip from a trust occurs at his death because his grandson was named remainder beneficiary. (Note that a direct skip occurs at Dan's death even though Dan's wife designated the remainder beneficiary.) The transfer from the trust is reported on Schedule R-1. In addition, all or part of Dan's exemption could be allocated to the date of death value of the trust.

Nonexplicit Trusts

A nonexplicit trust is a "trust arrangement" treated as a trust for GST purposes only. Examples of nonexplicit trusts include life estates and remainders, estates for years, and insurance and annuity contracts. The trustee of such a trust arrangement is the person in actual or constructive possession of the property.

Under the regulations, direct skips from a nonexplicit trust totaling more than $250,000 are reported on Schedule R-1. To determine whether direct skips from a nonexplicit trust exceed the $250,000 threshold, use the amount that would be entered on Schedule R-1, line 3 (i.e., tentative maximum direct skips), if that schedule were being filed.

Filing and Payment Procedures

Form 706, Schedule R-1, serves as a notification from the executor to the trustee that a GST tax is due. As such, the executor is responsible for the preparation and filing of the form. The trustee uses Schedule R-1 as a payment voucher to remit the GST tax to the IRS.

Filing Requirements. The executor should prepare three copies of Schedule R-1 on or before the due date of the estate tax return. One copy should be attached to the estate tax return. The remaining two copies should be sent to the trustee on or before the due date of the estate tax return. (The trustee has an additional two months to file Schedule R-1. See the discussion below under payment of tax.) The trustee uses one copy to remit the GST tax due. This copy, along with a check or money order (payable to United States Treasury with a notation of the trust's EIN and "GST tax") for the GST tax, should be sent to the IRS Center where Form 706 was filed. This information is reported on the top of Schedule R-1 and will generally be the Cincinnati, Ohio IRS Center. The other copy is for the trustee's records.

Payment of Tax. The GST tax is due nine months after the date of death. (This date is entered on Schedule R-1.) However, the trustee has an automatic two-month extension to file Schedule R-1 and pay the GST tax. (No form is required to be filed for this extension.) Although interest will be charged on the outstanding GST tax during this two-month period, no penalties will be assessed.

Transfers That Are Not Direct Skips and Allocating the GST Tax Exemption at Death

If the GST tax exemption is not allocated by the due date of Form 706, the remaining exemption is automatically allocated:

1. first to direct skips occurring at death, and
2. then to all transfers to GST trusts for which the decedent is the most recent transferor, even if the trust is not included in the gross estate, but which have the possibility of having a taxable distribution or taxable termination.

To avoid the above deemed allocation rules, Form 706 and Schedule R can be filed to allocate any remaining GST tax exemption to trusts that may later have taxable distributions or terminations even if Form 706 is not required to be filed to report estate or GST tax.

Report on Schedule R, Part 1, line 9, column C the amount of the GST tax exemption (included in lines 2 through 6) that is allocated to the trust. In Column D, allocate any of the decedent's remaining GST tax exemption available. The amount may be allocated to trusts that are not reported on Form 706. To make the allocation, provide the following information on line 9:

1. Name of trust—column A.
2. Identification number of trust—column B.

3. Allocated exemption amount in column D.

4. Value of trust as of the date of death (even if not included on Form 706).

If additional GST tax exemption is allocated to a trust included in the transferor's gross estate, the applicable fraction (and thus the trust's inclusion ratio) must be redetermined. The numerator of the redetermined applicable fraction is the nontax portion of the trust immediately before the transferor's death (i.e., the value of the trust multiplied by the trust's applicable fraction) plus the amount of additional GST tax exemption allocated to the trust by the executor. The denominator of the redetermined applicable fraction is the value of the trust at the decedent's date of death, reduced by any federal or state estate or inheritance taxes paid by the trust.

Example 1M-1 Allocating the decedent's GST tax exemption to nonskip trusts.

Troy Young transferred $400,000 to an irrevocable trust in 1992. Pursuant to the trust instrument, net income will be paid annually to his son, Bill, for life. At Bill's death, the balance in the trust will be distributed to Bill's daughter, Jan. Troy allocated $200,000 of his GST tax exemption to the trust at the time of the transfer. Thus, the trust would have a 50% inclusion ratio for any future taxable terminations or distributions. Troy died in 2009 when the value of the trust was $2 million. Troy had $800,000 of unused GST tax exemption at his death.

If the remainder of Troy's GST tax exemption is allocated to the trust, the trust's inclusion ratio is reduced to 10% [1 − ($1,800,000 ÷ $2,000,000)]. Thus, only 10% of future taxable distributions or taxable terminations are subject to the GST tax. The additional GST tax exemption is allocated to the trust on Schedule R, Part 1, line 9.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. What is the taxable amount of a direct skip at death?

    a. The value of the terminated property interest that passes to the skip person(s) reduced by the Section 2053(a) deductions.

    b. The value of the property received by the transferee.

    c. The value of the terminated property interest passing to the skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property.

24. Judy bequeathed 500 shares of MegaCo stock to Lucy, her granddaughter. Upon Judy's death, the stock was worth $100,000. The executor did not elect to value estate property on the alternate valuation date. State and federal death taxes of $30,000 were charged against the property, and any GST taxes would be charged against the property, as well. Judy's executor elects to allocate $70,000 of her GST tax exemption to the transfer. Where would the GST tax be reported in this scenario?

    a. Schedule R, Part 2.

    b. Schedule R, Part 3.

    c. Schedule R-1.

    d. Form 706.

25. Which of the following forms serves as a notification from the decedent's executor to the trustee that GST tax is due?

    a. Schedule R of Form 706.

    b. Schedule R-1 of Form 706.

    c. Schedule A of Form 706.

26. Life estates and remainders are examples of which of the following trusts?

    a. Nonexplicit trust.

    b. Explicit trust.

27. Kendra transfers $400,000 to an irrevocable trust in 1992. Pursuant to the trust instrument, net income is paid annually to her son, Max, for life. At Max's death, the trust balance will be distributed to Max's son, Lloyd. Kendra allocates $200,000 of her GST tax exemption to the trust at the time of transfer. Kendra dies in 2009, when the trust's value is $2 million. She had $800,000 of unused GST tax exemption at her death. All of Kendra's remaining GST tax exemption is allocated to the trust. What percentage of future taxable distributions or taxable terminations are subject to the GST tax?

    a. 10%.

    b. 25%.

    c. 50%.

    d. 111%.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. What is the taxable amount of a direct skip at death? **(Page 166)**

   a. The value of the terminated property interest that passes to the skip person(s) reduced by the Section 2053(a) deductions. [This answer is incorrect. In the case of a taxable termination, the taxable amount is the value of the terminated property interest passing to the skip person(s) reduced by the type of deductions allowed under IRC Sec. 2053(a), i.e., funeral expenses, administration expenses, claims, etc.]

   b. The value of the property received by the transferee. [This answer is correct. This is how the taxable amount of the direct skip is determined under the Code. Generally, the value of direct skip property is its fair market value at the decedent's date of death or alternate valuation date (if elected). If property was valued using special use valuation (i.e., under IRC Sec. 2032A), that value must be used in the GST tax computation.]

   c. The value of the terminated property interest passing to the skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property. [This answer is incorrect. The taxable amount of a taxable termination is the value of the terminated property interest passing to the skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property.]

24. Judy bequeathed 500 shares of MegaCo stock to Lucy, her granddaughter. Upon Judy's death, the stock was worth $100,000. The executor did not elect to value estate property on the alternate valuation date. State and federal death taxes of $30,000 were charged against the property, and any GST taxes would be charged against the property, as well. Judy's executor elects to allocate $70,000 of her GST tax exemption to the transfer. Where would the GST tax be reported in this scenario? **(Page 166)**

   a. Schedule R, Part 2. [This answer is correct. Since the property bears the burden of any GST taxes imposed on the transfer, it is reported on Schedule R, Part 2. The $70,000 exemption allocated to the transfer is entered on Part 2, line 6, and again on Part 1, line 4.]

   b. Schedule R, Part 3. [This answer is incorrect. The GST taxes would only be reported on Schedule R, Part 3, if they were not charged against the property. That is not the case in this scenario.]

   c. Schedule R-1. [This answer is incorrect. One example of something that is reported on Schedule R-1 is direct skips from a nonexplicit trust totaling more than $250,000. That is not the case in the scenario above.]

   d. Form 706. [This answer is incorrect. This answer is not specific enough. In the scenario above, the GST tax is reported on a particular schedule that is filed with Form 706.]

25. Which of the following forms serves as a notification from the decedent's executor to the trustee that GST tax is due? **(Page 169)**

   a. Schedule R of Form 706. [This answer is incorrect. If the executor of the decedent's estate is a trustee of the trust, then all direct skips with respect to that trust must be shown on Schedule R and not on Schedule R-1.]

   b. Schedule R-1 of Form 706. [This answer is correct. Under the Code, the GST tax on a direct skip at death from a trust is imposed on trust assets and paid by the trustee. Schedule R-1 of Form 706 is used as described above as the notification of this tax.]

   c. Schedule A of Form 706. [This answer is incorrect. Schedule A can be used to report multiple terminations with the same inclusion ratio from the same trust.]

26. Life estates and remainders are examples of which of the following trusts? **(Page 169)**

    a. **Nonexplicit trust. [This answer is correct. According to the Code, a nonexplicit trust is a "trust arrangement" treated as a trust for GST purposes only. Other examples of nonexplicit trusts include estates for years, and insurance and annuity contracts.]**

    b. Explicit trust. [This answer is incorrect. An explicit trust is an express trust created by an *inter vivos* declaration or the decedent's will.]

27. Kendra transfers $400,000 to an irrevocable trust in 1992. Pursuant to the trust instrument, net income is paid annually to her son, Max, for life. At Max's death, the trust balance will be distributed to Max's son, Lloyd. Kendra allocates $200,000 of her GST tax exemption to the trust at the time of transfer. Kendra dies in 2009, when the trust's value is $2 million. She had $800,000 of unused GST tax exemption at her death. All of Kendra's remaining GST tax exemption is allocated to the trust. What percentage of future taxable distributions or taxable terminations are subject to the GST tax? **(Page 171)**

    a. **10%. [This answer is correct. To calculate the inclusion ratio in the circumstances above, $1,800,000 is divided by $2,000,000, and the result is subtracted from 1. The result is 10%. Thus, only 10% of future taxable distributions or taxable terminations are subject to the GST tax. The additional GST tax is allocated to the trust on Schedule R, Part 1, line 9.]**

    b. 25% [This answer is incorrect. To arrive at this percentage, the incorrect numbers ($200,000 and $800,000) were used in the calculation of the inclusion ratio.]

    c. 50%. [This answer is incorrect. This is the trust's inclusion ratio after Kendra allocates $200,000 of her GST tax exemption to the $400,000 transfer in 1992.]

    d. 111% [This answer is incorrect. To arrive at this percentage, the inclusion ratio was calculated incorrectly by dividing $2,000,000 by $1,800,000.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (706TG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. The following scenario is best described as which of the following?

   Lola sets up a trust with a life estate to her son, Calvin, and the remainder of the trust to her great-grandson, Vernon, on the death of Calvin. Calvin dies.

   a. Direct skip.

   b. Taxable termination.

   c. Taxable distribution.

   d. *Inter vivos* direct skip.

2. Grandfathered trusts were irrevocable on which of the following dates?

   a. April 15, 1985.

   b. July 1, 1986.

   c. September 25, 1985.

   d. December 31, 1986.

3. What is the inclusion ratio for direct skip transfers that are nontaxable gifts for gift tax purposes because of the annual gift tax exclusion?

   a. Zero.

   b. One.

   c. Three.

   d. Five.

4. Which of the following is considered a skip person?

   a. Your aunt's daughter.

   b. Your wife.

   c. Your grandchildren.

   d. Your niece.

5. Tom Hankin's will created a $1 million QTIP trust for the benefit of his wife, Kelly. Upon her death, the remainder is to be distributed to their grandchildren. Kelly died several years later when the trust was worth $10 million. The $10 million is included in Kelly's estate and, accordingly, Kelly is treated as the transferor of the $10 million to her grandchildren. The executor of Kelly's estate allocates her GST tax exemption to the transfer; however, since Kelly is the transferor, the distribution of the $10 million to the grandchildren will be treated as a direct skip subject to the GST tax. How much of the $10 million will be sheltered from the GST tax?

   a. $1 million.

   b. $2 million.

   c. $3.5 million.

   d. $5 million.

6. Which of the following is the taxable amount of a direct skip?

   a. The value of the property received by the transferee.

   b. The value of the taxable distribution.

   c. The value of the nontax portion of the property.

   d. The value of the pecuniary payment.

7. Which of the following is the taxable amount of a taxable distribution?

   a. The value of the property received by the transferee.

   b. The value of the property received reduced by expenses the transferee incurred in connection with the determination, collection, or refund of the GST tax.

   c. The value of the nontax portion of the property.

   d. The value of the pecuniary payment.

8. When computing the inclusion ratio, the applicable fraction must be rounded to the nearest _____ before subtracting it from one.

   a. One-fifth.

   b. One-tenth.

   c. One-hundredth.

   d. One-thousandth.

9. If the pecuniary share of a death transfer does not carry appropriate interest, which of the following should be the denominator?

   a. The date of death values reduced by the present value of the pecuniary payment.

   b. The value, for estate tax purposes, of the property transferred at death.

   c. The value of the trust at the decedent's date of death, reduced by any federal or state estate or inheritance taxes paid by the trust.

   d. The gift or estate tax charitable deduction allowed for the property.

10. The unused portion of the GST tax exemption is determined by subtracting which of the following from $3.5 million?

    a. The value of the residual estate.

    b. The sum of the amounts previously allocated by the transferor.

    c. The $13,000 annual GST tax exclusion.

    d. The amount of charitable or marital transfers.

11. If the GST tax exemption has not been allocated by the Form 706 due date, the remaining exemption is automatically allocated first to which of the following?

    a. All transfers to GST trusts in which the decedent is the most recent transferor.

    b. Direct skips occurring at death.

    c. Any property transferred by the transferor.

    d. The value of property held in trust created by the transferor and included in the transferor's estate.

12. For transfers after 2000, allocation of the unused portion of the GST to which assets or transactions will produce the lowest inclusion ratio for transferred property when any unused portion of the individual's generation-skipping transfer tax exemption is automatically allocated?

    a. Indirect skip made during life.

    b. Value of the property held in trust created by the transferor and included in the transferor's estate.

    c. Any property transferred by the transferor.

    d. Direct skips occurring at death.

13. Which of the following would be subject to the estate tax inclusion period (ETIP)?

    a. Property transferred to a spouse.

    b. Transfers that are completed gifts when they were made that are later included in the gross estate of the transferor.

    c. Transfers includible in the transferor's estate under IRC Sec. 2035.

    d. Transfers where the possibility of inclusion in the transferor's estate is so remote as to be negligible.

14. Which of the following statements regarding the severing of a trust is most accurate?

    a. Most trusts are structured to take advantage of severing a trust into an exempt and nonexempt trust.

    b. The severance of a trust is reported by filing Form 706 and attaching a Schedule C.

    c. A trust can be severed into a qualified severance for all trust severance occurring after 2001.

    d. A trustee may sever a trust in a qualified severance at any time.

15. Since *inter vivos* direct skips are subject to the gift tax, these transfers should first be reported on which of the following schedules?

    a. Schedule C.

    b. Schedule B.

    c. Schedule A.

    d. Schedule D.

16. What is the total annual exclusion for 2009?

    a. $10,000.

    b. $11,000.

    c. $12,000.

    d. $13,000.

17. On February 8, Jamie transferred $200,000 to a Section 2503(c) minor's trust for the benefit of her granddaughter, Rosie (the trust is a skip person). On February 19, Jamie transferred $120,000 worth of mutual funds to her grandson, Lewis. Jamie has previously used $450,000 of her GST tax exemption and wants to preserve some of her remaining exemption to offset a future transfer to a trust for the benefit of her son and his two daughters. Thus, she does not want to allocate any of her GST tax exemption to the current-year transfer to Lewis. To avoid having a portion of her GST tax exemption automatically allocated to the gift of the mutual funds, Jamie should file a gift tax return and pay the GST tax on the transfer of the mutual funds on or before which of the following dates?

    a. April 15, 2009.

    b. January 1, 2010.

    c. April 15, 2010.

    d. January 1, 2011.

18. For GST purposes, the inclusion ratio for which of the following transfers to a skip person is zero to the extent the transfer qualifies for the GST tax annual inclusion?

    a. Lifetime.

    b. Outright.

    c. Direct skip.

    d. *Inter vivos*.

19. If a GST tax exemption allocation is timely allocated, the exemption is allocated based on the transferred property's value on which of the following?

    a. Date the gift tax return is filed.

    b. Date of the gift.

    c. Date the exemption is being allocated.

    d. Date the gift tax return is due.

20. List all of the following items that should be identified on a Notice of Allocation.

    i. The termination of any elections out.

    ii. The value of the gift as shown in column H of Schedule A, Part 3, or, for a late allocation, the value of the assets at the time of allocation.

    iii. Relief that was requested for late allocations.

    iv. The trust's inclusion ratio after the allocation.

    v. The year the transfer was reported on Form 709, if this is a late allocation.

    vi. The item number (or numbers) from column A, Schedule A, Part 3 of the transfers.

    vii. The trust to which an allocation is made, including the trust's EIN.

    viii. The amount of GST tax exemption that is allocated.

    a. i. and v.

    b. iii., vi., and vii.

    c. ii., iv., v., vi., vii., and viii.

    d. i., ii., iii., iv., v., vi., vii., and viii.

21. Property is subject to the estate tax inclusion period (ETIP) when which of the following occurs?

    a. When a transfer is a completed gift when it is made, but later included in the transferor's gross estate.

    b. When transferred property is included in the transferor's gross estate under IRC Sec. 2035.

    c. When the property included in the transferor's gross estate is so remote as to be negligible

    d. When the only power possessed by the spouse is a right to withdraw no more than the greater of 5%, and the withdrawal right terminates within 60 days of the transfer.

22. When is a direct skip treated as occurring if it is subject to an ETIP?

    a. At the termination of the ETIP.

    b. At the beginning of the ETIP.

    c. At the time of the split gift.

    d. At the date of the initial gift.

23. In 2009, James transferred $250,000 to an irrevocable trust that will pay him $5,000 annually for five years. At the expiration of the five-year period, the balance in the trust will be distributed to his grandson, Bryson. James died in 2016 of natural causes. When does the ETIP expire?

    a. 2009.

    b. 2011.

    c. 2014.

    d. 2017.

24. If the value of trust property, less taxes and other charges borne by the trust property, is less than _______, direct skips from a nonexplicit trust are reported on Schedule R.

    a. $100,000.

    b. $150,000.

    c. $200,000.

    d. $250,000.

25. Vernon James bequeathed 1,000 shares of Cowboy Inc. stock to his grandson, Kenneth. The stock was included in Vernon's gross estate at its date of death value of $350,000. Assume that pursuant to Vernon's will $130,000 of state and federal taxes were charged against the stock. In addition, GST taxes are chargeable against the property transferred. Vernon had previously used all of his GST tax exemption. Since GST taxes are charged against the transfer of the stock, the amount of GST tax imposed is computed on Schedule R, Part 2. Assuming this was Vernon's only direct skip transfer at death, the skip person (Kenneth), the interest transferred (Cowboy stock), and its estate tax value ($350,000) are entered in the appropriate columns. The amount of federal and state death taxes ($130,000) and any other charges against the property are entered on line 2. In addition, if any GST taxes imposed on other transfers are charged against the stock, this amount is entered on line 3. How much of the GST tax is imposed on the transfer?

    a. $32,518.

    b. $42,672.

    c. $56,890.

    d. $68,275.

26. Which of the following is used to allocate the decedent's unused GST tax exemption to direct skips to individuals or trusts that occur at death?

    a. Schedule A.

    b. Schedule R-1.

    c. Schedule B(1).

    d. Schedule R.

27. Which of the following is the value of the denominator of the redetermined applicable fraction for direct skips at death?

    a. The value of the trust at the decedent's date of death, minus any federal or state estate inheritance taxes the trust paid.

    b. The nontax portion of the trust immediately before the transferor's death plus any additional GST tax exempt that the executor allocates to the trust.

    c. The value of the terminated property interest passed to a skip person(s) and reduced by any expenses, indebtedness, and taxes attributable to the property.

    d. The value of the property transferred, reduced by the sum of the allowed gift or estate tax charitable deduction.

Lesson 2: Reporting Taxable Distributions, Taxable Terminations, and Qualified Trust Severances

Introduction

A taxable distribution from a trust to a skip person is subject to the generation-skipping transfer (GST) tax. Two separate parties have filing responsibilities on a taxable distribution. The trustee that makes the distribution is required to file Form 706-GS(D-1) to report the distribution to the IRS and the distributee. The distributee is required to file Form 706-GS(D) to report the taxable amount of the distribution and to pay the GST tax due.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the relationship between taxable distributions from a trust to a skip person and the GST tax.
- Determine the items covered by and the filing requirements for Form 706-GS(D) and (D-1).
- Determine taxable terminations and the filing requirements of Form 706-GS(T).
- Identify items covered on Schedules A, B(1), and B(2) of Form 706-GS(T) (e.g., the alternate valuation date election; the inclusion ratio; and general debts, expenses, and taxes related to trusts), and discuss reporting qualified severances.

Taxable Distributions from a Trust to a Skip Person

A taxable distribution is any distribution (other than a taxable termination or a direct skip) from a trust to a skip person. It is sometimes hard to differentiate a taxable distribution from a taxable termination (e.g., where a distribution to a skip person also terminates a nonskip person's interest). If the distribution completely terminates the nonskip person's interest, the transfer is considered a taxable termination. The amount of the distribution subject to GST tax is the value of the property received by the transferee (recipient), reduced by any expense incurred by the recipient in connection with the determination, collection, or refund of the GST tax imposed on the distribution.

Example 2A-1 Discretionary distribution to a skip person is a taxable distribution.

Telly Moss created an irrevocable trust for the benefit of his son, Greg, in 1993. Pursuant to the trust agreement, the trustee is required to pay all of the trust's income annually to Greg for life. The trustee also has the power to invade corpus for the benefit of Greg's son, Mike (Telly's grandson) for his health, maintenance, or support. At Greg's death, the balance in the trust will be distributed to Mike. During 2009, the trustee made a $10,000 principal distribution to Mike.

Since the trust is not a skip person, the funding of the trust was not a direct skip transfer subject to the GST tax. However, any distributions the trust makes to Mike (other than at the termination of the trust) will be taxable distributions subject to the GST tax. Thus, the current distribution to Mike will be a taxable distribution subject to the GST tax. The amount of tax imposed on the distribution is dependent on the trust's inclusion ratio.

The recipient of the distribution is liable for the GST tax on taxable distributions. Thus, the recipient pays the GST tax out of the amount received. If the trust pays any of the GST tax (including any penalties and interest on the tax), such payment is treated as an additional taxable distribution because the recipient is liable for the tax. The additional distribution is treated as having been made on December 31 of the year in which the original distribution was made. Thus, if the trust pays all or a portion of the GST tax on a distribution made in a prior calendar year, the amount of tax paid is treated as a distribution as of December 31 of the prior year.

Example 2A-2 Trust's payment of the GST tax is a taxable distribution.

Jerry Jeans created a trust that allows the trustee to distribute income and principal to his daughter, Sue, and to his granddaughter, Jane. The trustee distributes $20,000 to Jane in 2009. Assuming the trust's inclusion ratio is 1.00 (i.e., none of Jerry's GST tax exemption was allocated to the trust), Jane must pay GST tax of $9,000 on the $20,000 distribution (based on the 45% GST tax rate). If the trustee pays the tax on the taxable distribution to Jane, the amount paid will be treated as a taxable distribution on December 31, 2009.

Example 2A-3 Grossing up the amount of the distribution to compensate for the GST tax.

Assume the same facts as in Example 2A-2, except the trustee wants Jane to receive $20,000 net of the GST tax. To accomplish the trustee's objective, the distribution amount must be determined by multiplying the net amount to be received by [1 ÷ (1 − tax rate)]. In this fact pattern [1 ÷ (1 − .45)] × $20,000 = $36,364. Thus, the trust must distribute $36,364 to Jane, on which she will pay $16,364 of GST tax. This will provide her with the required net distribution of $20,000 ($36,364 − $16,364).

Excluded Transfers

Certain transfers (including transfers made at taxable distributions) are excluded or exempt from the GST tax. The following exclusions and exemptions apply to taxable distributions and were discussed in detail in Lesson 1.

1. Grandfathered and certain other irrevocable trusts (generally, those trusts that were irrevocable on September 25, 1985, and have not had additions or modifications after September 25, 1985).

2. Transfers to which the transferor allocated all or a portion of the GST tax exemption ($3.5 million for 2009).

3. Annual GST tax exclusion gifts ($13,000 for 2009). These are direct skip transfers and certain transfers in trust.

4. Medical and tuition transfers (generally, transfers paid directly to a qualified educational organization or medical provider).

5. Previously taxed property.

Taxable Amount of Distribution

The amount of tax payable on a taxable distribution depends on the amount of the transferor's GST tax exemption allocated to the trust since the amount of exemption allocated to the trust determines the trust's inclusion ratio. The inclusion ratio determines the portion of the distribution that is subject to GST tax. Note that the transferor's exemption is not allocated directly to (and therefore does not offset) a taxable distribution.

Special Rule for Predeceased Parent and Collateral Relatives

As discussed in Lesson 1, in most cases involving GSTs, generation assignments are based on family relationships. However, an exception applies to taxable distributions in favor of a grandchild or other lineal descendent when the original transfer in trust is made after the death of the grandchild's or other lineal descendent's parent.

Example 2A-4 Predeceased parent exception for taxable distributions.

In 1998, Jill established a $1 million trust for her son, David, and her two grandchildren, Shawna and Hannah, whose mother (Jill's daughter) died in a plane crash. Jill had previously used all of her GST tax exemption. The trustee can make current income or principal distributions to David. When Shawna and Hannah graduate from college, the trustee has discretionary power to make income or principal distributions to them. The trust will terminate when Shawna and Hannah both reach age 45, at which time they will share the trust's corpus equally.

For distributions (including the distribution upon termination), the GST tax will not apply because Shawna and Hannah's mother (Jill's daughter) was deceased when the trust was originally established.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Jamie creates an irrevocable trust for the benefit of her daughter, Sonya, in 1993. Under the trust agreement, the trustee is required to pay all of the trust's income annually to Sonya for life. The trustee also has the power to invade corpus for the benefit of Sonya's son, Nick (Jamie's grandson) for his maintenance, support, or health. At Sonya's death, the trust's balance will be distributed to Nick. In 2009, Nick has surgery, and the trustee makes a $10,000 principal distribution to Nick to pay for his medical bills. Is this transfer subject to the GST tax?

    a. Yes.

    b. No.

29. In 1998, Greg establishes a $1 million trust for his daughter-in-law, May, and his two grandsons, John and Stan (whose father, Greg's son, died in a car accident before the trust was established). All of Greg's GST tax exemption was used previously. The trustee can make current income or principal distributions to May. When John and Stan graduate from college, the trustee has discretionary power to make income or principal distributions to both of them, as well. The trust terminates when John and Stan both reach 45 years of age. At that time, they will share the trust's corpus equally. Do distributions from this trust incur the GST tax?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Jamie creates an irrevocable trust for the benefit of her daughter, Sonya, in 1993. Under the trust agreement, the trustee is required to pay all of the trust's income annually to Sonya for life. The trustee also has the power to invade corpus for the benefit of Sonya's son, Nick (Jamie's grandson) for his maintenance, support, or health. At Sonya's death, the trust's balance will be distributed to Nick. In 2009, Nick has surgery, and the trustee makes a $10,000 principal distribution to Nick to pay for his medical bills. Is this transfer subject to the GST tax? **(Page 185)**

    a. **Yes. [This answer is correct. According to the Code, any distributions the trust makes to Nick (other than at the termination of the trust) will be taxable distributions subject to the GST tax. Thus, the $10,000 distribution described above is a taxable distribution subject to the GST tax.]**

    b. No. [This answer is incorrect. Since the trust is not a skip person, Jamie's funding of the trust was not a direct skip transfer subject to the GST tax. However, that is not the case for the distribution made to Nick.]

29. In 1998, Greg establishes a $1 million trust for his daughter-in-law, May, and his two grandsons, John and Stan (whose father, Greg's son, died in a car accident before the trust was established). All of Greg's GST tax exemption was used previously. The trustee can make current income or principal distributions to May. When John and Stan graduate from college, the trustee has discretionary power to make income or principal distributions to both of them, as well. The trust terminates when John and Stan both reach 45 years of age. At that time, they will share the trust's corpus equally. Do distributions from this trust incur the GST tax? **(Page 185)**

    a. Yes. [This answer is incorrect. In most cases involving GSTs, generation assignments are based on family relationships. However, an exception applies to taxable distributions in favor of a grandchild or other lineal descendent when the original transfer in trust is made after the death of the grandchild's or other lineal descendant's parent.]

    b. **No. [This answer is correct. Under the Internal Revenue Code, for distributions (including the distribution upon termination), the GST tax will not apply because John and Stan's father (Greg's son) was deceased when the trust was originally established.]**

Form 706-GS(D-1): Notification of a Distribution from a Generation-skipping Trust

The trustee of any trust (including "nonexplicit trusts" defined in the following paragraph) that makes a GST taxable distribution is required to file Form 706-GS(D-1) to report the distribution to the distributee and the IRS. Form 706-GS(D-1) is an information return that provides the distributee with the amount of the taxable distribution and the inclusion ratio of the trust. The distributee, who is liable for the tax, uses the information to compute the GST tax due on the distribution.

Nonexplicit Trusts

The trustee is required to report taxable distributions from nonexplicit trusts. A nonexplicit trust is a "trust arrangement" treated as a trust for GST purposes only. In general, a transfer of property in which the identity of the transferee is conditioned on the occurrence of an event is a transfer in trust (although there may not be an official trust instrument that calls such an arrangement a trust). Examples of nonexplicit trusts include life estates and remainders, estates for years, and insurance and annuity contracts. The trustee (i.e., the person responsible for filing Form 706-GS(D-1)] of such a trust arrangement is the person in actual or constructive possession of the property.

If the trust is not an explicit trust, the box on Part III, line 4, must be checked. In addition, a statement describing the trust arrangement must be attached to the return.

Filing Requirements

The trustee is required to file Form 706-GS(D-1) for each skip person that received a taxable distribution during the year. The instructions to Form 706-GS(D-1) indicate that the trustee must file a return for each skip person even if the inclusion ratio applicable to the distribution is zero.

Due Date. The trustee must file Form 706-GS(D-1), Copy A, with the IRS and send Copy B to the distributee by April 15 of the year following the calendar year in which the distribution was made. If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due the next business day. There is no provision for obtaining an extension of time to file Form 706-GS(D-1).

Filing Location. If Form 706-GS(D-1) is sent via U.S. Postal Service, it should be filed with the IRS Center, Cincinnati, OH 45999. The Service no longer publishes the street address for private delivery services (PDSs).

Part I—General Information

Form 706-GS(D-1) consists of three separate parts. General information regarding the trust and the distributee is reported in Part I. If the distributee is an individual, the individual's social security number should be reported on line 1a. If the social security number is unknown or the individual has no number, indicate "unknown" or "none." If the distributee is a trust, the trust's employer identification number (EIN) should be reported on line 1a. Enter the EIN of the trust from which the distribution was made on line 2a. Provide the trust's name and address on line 2b.

Part II—Trust Distributions

The information necessary for the distributee to compute and report the amount of GST tax imposed on the distribution is provided in Part II. If more space is needed than is provided in Part II, attach an additional sheet of the same size and using the same format that is used in Part II. Also, make sure the total on the continuation sheet is included on line 3 of Part II. The following discussion concerns information to be reported on Part II.

Item Number. Generally, each distribution made during the year should be listed separately and assigned an item number in column (a). However, distributions from the same trust with the same inclusion ratio may be combined. Portions of a trust attributable to transfers from different transferors and substantially separate shares of different beneficiaries are treated as separate trusts. Separate trusts must be reported under different item numbers in column (a) of line 3, even if they have the same inclusion ratio.

Description of the Property. When the trust distributes property other than cash, a full description of the property should be entered in column (b). The description of the property required is the same as for listing property on Form 706.

Inclusion Ratio. Enter the inclusion ratio applicable to each taxable distribution made during the year in column (d). The inclusion ratio equals one minus the applicable fraction. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust or transferred property. The denominator of the applicable fraction is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax attributable to the property, and (2) the gift or estate tax charitable deduction allowed for the property, if any.

Distributions with different inclusion ratios should be entered as separate items. For example, a trust may have different inclusion ratios if there was more than one grantor to the trust and the amount of exemption allocated to each transfer was different, or there were additional contributions to a grandfathered trust (i.e., a trust that was irrevocable on September 25, 1985). The inclusion ratio applicable to each distribution may also differ if additional contributions were made to the trust during the year of distribution.

Special Rule for Charitable Lead Annuity Trust. Special rules exist for calculating the applicable fraction and the inclusion ratio when there are distributions from a charitable lead annuity trust. For the applicable fraction, the numerator is the adjusted GST tax exemption and the denominator is the value of the trust immediately after the termination of the charitable lead annuity. The adjusted GST tax exemption is the sum of (1) the GST tax exemption allocated to the trust and (2) interest on the GST tax exemption determined at the interest rate used to figure the estate and gift tax deduction for the charitable lead annuity and for the actual period of the charitable lead annuity. It is possible for the numerator to be larger than the denominator, in which case the applicable fraction is one and the exclusion ratio is zero.

Value. The property's value on the date of its distribution should be entered in column (e).

Example 2B-1 Reporting taxable distributions to the distributee.

Ted Dancer transferred $300,000 to an irrevocable trust for the benefit of his son, Bob. Pursuant to the trust agreement, the trustee is required to pay all of the trust's income annually to Bob for life. The trustee has the power to invade corpus for the benefit of Bob's son, Ken (Ted's grandson) for his health, education, maintenance, or support. At Bob's death, the balance in the trust will be distributed to Ken. At the time of the transfer to the trust, Ted allocated $200,000 of his GST tax exemption to the trust. Thus, the trust's inclusion ratio is .333 [1 − ($200,000 ÷ $300,000)]. On January 14, 2009, the trustee paid $10,000 of trust principal to State University to cover Ken's tuition. On May 8, the trustee distributed $7,500 to Ken for living expenses, then an additional $1,200 on December 15 to cover the GST tax on the May 8 transfer. The taxable distribution to Ken will be reported on Form 706-GS(D-1). The distribution for tuition would not be reported because it qualifies for the educational exclusion.

Part III—Trust Information

Part III of Form 706-GS(D-1) addresses the allocation of the transferor's GST tax exemption to the trust and the calculation of the trust's inclusion ratio. Each question should be answered by checking the appropriate box and attaching the requested information. The following is an explanation of the questions and the required responses.

Line 4. If the trust is not an explicit trust (see the previous discussion of nonexplicit trusts), the box on Part III, line 4, must be checked. In addition, a statement describing the trust arrangement must be attached to the return.

Line 5. A trust's inclusion ratio must be recalculated when additional property is contributed to the trust. If additional contributions of property have been made to the trust since the last taxable termination or taxable distribution, attach a schedule showing the recomputation of the inclusion ratio.

Line 6. A trust's inclusion ratio should be recomputed upon the receipt of additional contributions. If the ratio is not recomputed, a statement detailing the reason should be attached to the return.

Line 7. Generally, a transferor's GST tax exemption ($3.5 million for 2009) is allocated to a trust by the transferor (on Form 709) or his executor (on Form 706). However, in certain instances, the transferor's exemption is automatically allocated to certain transfers. If the transferor's exemption has been allocated to the trust under the automatic allocation rules, a statement detailing the calculation of the trust's inclusion ratio should be attached to the return.

Form 706-GS(D): Distributee's Tax Return for Taxable Distributions

The recipient of a taxable distribution from a trust is required to file Form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions) to report the distribution and compute the GST tax payable. The information necessary to determine the tax consequences of the distribution should be provided by the trustee on Form 706-GS(D-1) (Notification of Distribution From a Generation-Skipping Trust) on or before April 15 of the year following the calendar year in which the distribution was received. Form 706-GS(D) does not have to be filed if the inclusion ratio for all of the distributions is zero. In addition, distributions with an inclusion ratio of zero do not have to be reported on Form 706-GS(D).

Example 2C-1 Reporting distributions with a zero inclusion ratio.

Drew Berry received taxable distributions from three separate trusts during the year. Form 706-GS(D-1) filed by the trustee of Trust A indicated Drew received a $10,000 taxable distribution with a 45% inclusion ratio. Form 706-GS(D-1) filed by the trustee of Trust B indicated Drew received a $15,000 taxable distribution with a 25% inclusion ratio. Form 706-GS(D-1) filed by the trustee of Trust C indicated Drew received a $20,000 taxable distribution with a zero inclusion ratio. Since all of the taxable distributions Drew received during the year did not have a zero inclusion ratio, he must file Form 706-GS(D) to report the taxable distributions. However, the $20,000 distribution from Trust C would not have to be reported because it had a zero inclusion ratio.

Filing Requirements

Due Date. Form 706-GS(D) should be filed and the GST tax paid on or after January 1 but no later than April 15 of the year following the calendar year in which the distributions were made. If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due on the next business day. Note that late filing and late payment penalties may be imposed if the return is not timely filed and/or the tax reported thereon is not timely paid.

Extension of Time to File. An extension of time to file Form 706-GS(D) can be requested on Form 7004 (Application for Automatic Extension of Time To File Certain Business, Income Tax, Information, and Other Returns) by entering code "01" on line 1. This is an automatic 6-month extension and no explanation is needed. The estimated GST tax should accompany the extension request.

Filing Location. File Form 706-GS(D) with the IRS Center, Cincinnati, OH 45999.

Part I—General Information

Line 1a. Enter the name of the skip person on line 1a. A skip person can be an individual or a trust.

Lines 1b and 1c. If the skip person distributee is an individual, enter the individual's social security number on line 1b and do not complete line 1c. If the skip person distributee is a trust, enter the trust's employer identification number (EIN) on line 1c and do not complete line 1b. Do not enter a number on both line 1b and line 1c.

Line 2a. If the skip person distributee is a trust, enter the trustee's name here. If the skip person distributee is a minor or under a disability, enter the name and title or relationship of the person who is legally responsible for acting on behalf of the distributee (e.g., parent or guardian).

Line 2b. Enter the address to which the IRS should send correspondence related to this return. If there is an entry on line 2a, the address of the individual listed will normally be used (rather than the trust or individual listed on line 1a).

Part II—Reporting Distributions

All distributions with inclusion ratios greater than zero received by the distributee should be reported on Part II. The information necessary to complete Part II (Distributions) will be provided by the trustee on Form 706-GS(D-1). A copy of each Form 706-GS(D-1) received during the year should be attached to Form 706-GS(D).

If more space is needed than is provided in Part II, attach an additional sheet of the same size and using the same format that is used in Part II. Also, make sure the total on the continuation sheet is included on line 3 of Part II.

Part III—Tax Computation

The taxable amount of a taxable distribution is the value of the property received (i.e., total transfers entered on Part II, line 3) reduced by any expenses incurred by the transferee for the determination, collection, or refund of the GST tax on the distribution. These expenses must be adjusted so that only the portion attributable to the distribution subject to tax is deducted. The adjusted expense is computed by multiplying the total expense by the inclusion ratio.

Example 2C-2 Computing adjusted allowable expenses (Part III, line 4).

Harry Bond received a taxable distribution from two separate trusts during 2009. Form 706-GS(D-1) filed by the trustee of Trust A indicated Harry received a $10,000 taxable distribution with a 35% inclusion ratio. Form 706-GS(D-1) filed by the trustee of Trust B indicated Harry received a $15,000 taxable distribution with a 20% inclusion ratio. Harry's CPA charged $750 to prepare Form 706-GS(D) and compute the tax on Harry's distributions. To determine the amount of the tax preparation fee that is deductible against the taxable distributions, the total allowable expense must be adjusted to reflect the inclusion ratios of the distributions as follows:

Step 1 Allocate fee to distributions.

Trust A:	($10,000/$25,000) × $750	=	$300
Trust B:	($15,000/$25,000) × $750	=	$450

Step 2 Multiply fee by inclusion ratio.

Trust A:	$300 × .35	=	$ 105
Trust B:	$450 × .20	=	90
	Adjusted allowable expense		$ 195

Thus, $195 of the tax preparation fee would be deductible against Harry's distributions. Note the fee is deductible even if it has not been paid at the time the return is filed as long as the amount is clearly ascertainable. The deductible portion of the fee is entered on Part III (Tax Computation), line 4.

Tax on Taxable Distribution. The GST tax on a taxable distribution is computed by multiplying the taxable amount by the maximum federal estate tax rate (i.e., 45% for 2009).

Example 2C-3 Reporting taxable distributions on Form 706-GS(D).

Assuming the same facts as in Example 2C-2, Harry's GST tax on the taxable distributions would be computed as follows:

Trust A:	$10,000 × .35	=	$ 3,500
Trust B:	$15,000 × .20	=	3,000
Total tentative transfer			$ 6,500
Less: adjusted allowable fees			(195)
Taxable amount			$ 6,305
Maximum estate tax rate			.45
GST tax			$ 2,837

Tax Payment. The amount of tax due is entered on Part III, line 9. The check should be made payable to the United States Treasury and included with (but not attached to) the form. In addition, the distributee's social security number (or trust EIN), the year, and Form 706-GS(D) should be written on the check to ensure the payment is credited to the proper account.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. Form 706-GS(D-1), Copy A must be filed by which of the following dates?

    a. December 31 of the year when the original distribution was made.

    b. On or after January 1 but no later than April 15 of the year following the calendar year in which the distributions were made.

    c. April 15 of the year following the calendar year in which the distribution was made.

31. What line of Form 706-GS(D-1), Part III, should be filled in if a trust's inclusion ratio is recomputed when additional contributions are received?

    a. Line 4.

    b. Line 5.

    c. Line 6.

    d. Line 7.

32. If a distribution received by the distributee has an inclusion ratio that is greater than zero, where should it be reported on Form 706-GS(D)?

    a. Part I, line 1a.

    b. Part 1, line 2b.

    c. Part II.

    d. Part III.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

30. Form 706-GS(D-1), Copy A must be filed by which of the following dates? **(Page 189)**

    a. December 31 of the year when the original distribution was made. [This answer is incorrect. When taxable distributions from a trust are made to a skip person, the recipient of the distribution is liable for the GST tax on taxable distributions. Thus, the recipient pays the GST tax out of the amount received. If the trust pays any of the GST tax (including any penalties and interest on the tax), such payment is treated as an additional taxable distribution because the recipient is liable for the tax. The additional distribution is treated as having been made on December 31 of the year in which the original distribution was made.]

    b. On or after January 1 but no later than April 15 of the year following the calendar year in which the distributions were made. [This answer is incorrect. Form 706-GS(D) should be filed and taxes paid on this date.]

    c. April 15 of the year following the calendar year in which the distribution was made. [This answer is correct. The trustee must file Form 706-GS(D-1), Copy A, with the IRS and send Copy B to the distributee by April 15 of the year following the calendar year in which the distribution was made. If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due the next business day. There is no provision for obtaining an extension of time to file Form 706-GS(D-1).]

31. What line of Form 706-GS(D-1), Part III, should be filled in if a trust's inclusion ratio is recomputed when additional contributions are received? **(Page 189)**

    a. Line 4. [This answer is incorrect. Part III, line 4, must be checked if the trust is not an explicit trust.]

    b. Line 5. [This answer is incorrect. Line 5 is checked when a trust's inclusion's ratio must be recalculated when additional property is contributed to the trust.]

    c. Line 6. [This answer is correct. Part III of Form 706-GS(D-1) addresses the allocation of the transferor's GST tax exemption to the trust and the calculation of the trust's inclusion ratio. A trust's inclusion ratio should be recomputed upon the receipt of additional contributions. If the ratio is not recomputed, a statement detailing the reason should be attached to the return.]

    d. Line 7. [This answer is incorrect. Generally, a transferor's GST tax exemption ($3.5 million for 2009) is allocated to a trust by the transferor (on Form 709) or his executor (on Form 706). However, in certain instances, the transferor's exemption is automatically allocated to certain transfers. If the transferor's exemption has been allocated to the trust under the automatic allocation rules, a statement detailing the calculation of the trust's inclusion ratio should be attached to the return.]

32. If a distribution received by the distributee has an inclusion ratio that is greater than zero, where should it be reported on Form 706-GS(D)? **(Page 191)**

    a. Part I, line 1a. [This answer is incorrect. Line 1a of Part I is used to enter the name of the skip person.]

    b. Part 1, line 2b. [This answer is incorrect. Line 2b of Part I is used to enter the address to which the IRS should send correspondence related to this return.]

    c. Part II. [This answer is correct. All distributions with inclusion ratios as described above should be reported on Part II of Form 706-GS(D). The information necessary to complete Part II (Distributions) will be provided by the trustee on Form 706-GS(D-1). A copy of each Form 706-GS(D-1) received during the year should be attached to Form 706-GS(D).]

    d. Part III. [This answer is incorrect. Part II of Form 706-GS(D) is used for the tax calculation.]

Form 706-GS(T): Taxable Terminations

The trustee of a trust is responsible for reporting and paying the tax imposed on the taxable termination of an interest in the trust. Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations) is used to calculate and report the tax imposed on a taxable termination. Form 706-GS(T) is also used to report the qualified severance of a trust. Qualified severances were explained previously. See Lesson 1 for an overview of the generation-skipping transfer tax.

Defined

A taxable termination is a termination (by reason of death, lapse of time, release of power, or otherwise) of an interest in property held in trust, unless—

1. a transfer subject to the federal estate or gift tax occurs in connection with the property held in trust at the time of the termination,

2. a nonskip person has an interest in such property immediately after termination, or

3. at no time after the termination may a distribution (including a distribution on termination) be made to a skip person. For this purpose, it is sufficient that the probability of a distribution to a skip person be less than 5%, determined actuarially.

It is sometimes hard to differentiate a taxable distribution from a taxable termination (e.g., where a distribution to a skip person also terminates a nonskip person's interest). If the distribution completely terminates the nonskip person's interest, the transfer is considered a taxable termination.

A property interest in trust is a present right to receive income or principal from the trust or when a person is a permissible current recipient of trust income or principal. Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations) is used to calculate and report the tax imposed on a taxable termination. It must be filed even if the trust's inclusion ratio is zero.

Example 2D-1 Taxable termination of a trust.

Keith creates a trust that will pay all of its income to his daughter, Ann, for her life. At her death, the balance in the trust will be distributed in equal shares to Ann's two sons. Since Ann has an interest in the trust, the trust is not a skip person, and the transfer to the trust would not be a direct skip subject to the GST tax. However, a taxable termination will occur on Ann's death when the trust property is distributed to her sons because only skip persons have an interest in the property after her death.

Partial Terminations

Certain partial terminations are also treated as taxable terminations. If a property interest in a trust terminates because of the death of a lineal descendant of the transferor, and if a specified portion of the trust's assets are distributed to at least one skip person (or at least one trust for the exclusive benefit of such person), then such partial termination is a taxable termination with respect to the portion distributed to the skip person.

Example 2D-2 Partial termination of a trust.

Ray Barnes created an irrevocable trust for which the trust instrument provides that the trustee, at his discretion, will distribute trust income to Ray's two sons, Robert and Dan, for their joint lives. On the death of the first to die, half of the trust will be distributed to that child's children (i.e., Ray's grandchildren). The balance in the trust will be distributed to the survivor's children at his death. A partial termination will occur at the death of the first to die because a specified portion of the trust will be distributed to a skip person (i.e., Ray's grandchildren) at the death of Ray's son.

Retroactive Allocation of the GST Tax Exemption

A transferor normally will not allocate any of the GST tax exemption to a trust that the transferor expects will benefit only nonskip persons because transfers to nonskip persons are not subject to the GST tax. Unexpected circumstances, however, may cause the GST tax to apply. For example, if a transferor's child suddenly died, the trust might terminate in favor of the transferor's grandchild. If no GST tax exemption had been allocated to the trust, the GST tax would be due even if the transferor had an unused portion of the GST tax exemption.

As discussed in Lesson 1, the GST tax exemption can be allocated retroactively when there is an *unnatural order of death*. The allocation will be deemed to be effective immediately before the nonskip person's death. The election is made on Form 709 for the year of the nonskip person's death.

Special Rule for Predeceased Parent and Other Collateral Relatives

As discussed in Lesson 1, in most cases involving GSTs, generation assignments are based on family relationships. However, an exception applies to taxable terminations in favor of a grandchild or other lineal descendent when the original transfer in trust is made after the death of the grandchild's or other lineal descendent's parent. These exceptions allow someone normally considered to be a skip person to be "moved up" a generation and not be considered a skip person to which the GST tax may apply.

Example 2D-3 Predeceased parent exception for taxable terminations.

Jill established a trust for the benefit of her son, Jordan, for life with the remainder to be split equally among all grandchildren. Jill previously used all of her GST tax exemption. Jordan has two children, and Jill's predeceased daughter, Jade, had two children.

Jordan died ten years later. A taxable termination occurred at his death. However, because the trust was funded after Jade's death, her two children are moved up a generation. Thus, only half of the trust is subject to GST tax.

<u>Predeceased Parent Exception and QTIPs.</u> The remainder beneficiary's interest of a trust for which a QTIP election is made is deemed established on the date the trust principal is first subject to transfer tax (i.e., typically at the surviving spouse's death). However, when a reverse QTIP election is made, the transferor is the spouse who established the trust and the remainder beneficiary's interest is established at the first-to-die's death.

Excluded Transfers

Certain transfers (including transfers made at a taxable termination) are excluded or exempt from the GST tax. The following exclusions and exemptions apply to taxable terminations and are discussed in detail in Lesson 1.

1. Grandfathered and certain other irrevocable trusts (generally, those trusts that were irrevocable on September 25, 1985, and have not had additions or modifications after September 25, 1985).

2. Transfers to which the transferor allocated all or a portion of his or her GST tax exemption ($3.5 million for 2009).

3. Annual GST tax exclusion gifts ($13,000 for 2009). These are direct skip transfers and certain transfers in trust.

4. Medical and tuition transfers (generally, transfers paid directly to a qualified educational organization or medical provider).

5. Previously taxed property.

Taxable Amount of Termination

The taxable amount of a taxable termination is the value of the terminated property interest that passes to a skip person(s), reduced by any expenses, indebtedness, and taxes attributable to the property.

Example 2D-4 Computing the GST tax on a taxable termination.

Steve created an irrevocable trust requiring the trustee to distribute income to his son, Michael, for life. On Michael's death, the trust will terminate with the remainder going to Michael's daughter, Samantha (Steve's granddaughter). Steve has previously used all of his GST tax exemption.

Michael died in 2009 when the trust property has a value of $1 million. On Michael's death, a taxable termination occurs, and the trustee is liable for GST tax of $450,000 ($1 million × 45% assumed GST tax rate). Samantha receives $550,000 on the termination.

Filing Requirements

The trustee of any trust (including "nonexplicit trusts") that has a taxable termination is required to file Form 706-GS(T) to calculate and transmit the tax due on the termination. The trustee is liable for the GST tax on taxable terminations.

Nonexplicit Trusts. A *nonexplicit trust* is an arrangement that has substantially the same effect as a trust even though it is not an *explicit trust*. In general, a transfer of property in which the identity of the transferee is conditioned on the occurrence of an event is a transfer in trust (although there may not be an official trust instrument that calls such an arrangement a trust). Examples of such arrangements include life estates and remainders, estates for years, and insurance and annuity contracts. The trustee of such a trust arrangement is the person in actual or constructive possession of the property.

If the trust is not an explicit trust, check the box on Part II, line 8, and attach a statement describing the trust arrangement.

Due Date. The trustee must file Form 706-GS(T) with the IRS on or before April 15 of the year following the calendar year in which the termination occurs. If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due on the next business day. Note that late filing and late payment penalties will be imposed if the return is not timely filed and the tax paid. However, if a taxpayer can show "reasonable cause" for filing a return late, the late filing penalty will not be imposed.

Extension of Time to File. An extension of time to file Form 706-GS(T) can be requested on Form 7004 (Application for Automatic Extension of Time To File Certain Business, Income Tax, Information, and Other Returns) by entering the appropriate code on line 1. This is an automatic 6-month extension and taxpayers do not need to provide an explanation for the request. An estimate of the tax due should accompany the extension request.

Filing Location. Generally, Form 706-GS(T) should be filed with the IRS Center, Cincinnati, OH 45999, if delivered by the U.S. Postal Service. The Service no longer publishes the street address needed for private delivery services (PDSs).

Tax Payment. The amount of tax due is entered on Part III, line 12. The check or money order should be made payable to the United States Treasury and enclosed with (but not attached to) the form. In addition, the trust's EIN, the year, and "Form 706-GS(T)" should be written on the check to ensure the payment is credited to the proper account.

Trust Information (Part II)

Part II of Form 706-GS(T) contains a number of questions dealing with the allocation of the transferor's GST tax exemption to the trust and the calculation of the trust's inclusion ratio. Each of these questions should be answered by checking the appropriate box and attaching the requested information. The following discussion is an explanation of the questions and the required responses.

Line 3. Generally, the transferor's GST tax exemption ($3.5 million for 2009) is allocated to trusts by the transferor (on Form 709) or the executor (on Form 706). However, in certain instances, the transferor's exemption is automatically allocated to certain transfers. If the transferor's exemption has been allocated under the automatic allocation rules, a statement detailing the calculation of the trust's inclusion ratio should be attached to the return.

Line 4. A trust's inclusion ratio is recalculated when additional property is contributed to the trust. If additional contributions of property have been made to the trust since the last taxable termination or taxable distribution, attach a schedule showing the recomputation of the inclusion ratio.

Line 5. If there was a termination and excluded transfers, a statement describing the termination should be attached to the return.

Line 6. A trust's inclusion ratio should be recomputed upon the receipt of additional contributions. If the ratio is not recomputed, a statement detailing the reason should be attached to the return.

Line 7. If this is a QTIP trust and the transferor (or the executor) made the reverse QTIP election such that the transferor, and not the surviving spouse, is the transferor of the trust for GST purposes, check the "Yes" box on line 7.

Line 8. If the trust is not an explicit trust (see the discussion of nonexplicit trusts earlier in this lesson), check the box on Part II, line 8. In addition, attach a statement describing the trust arrangement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

33. In which of the following ways is a taxable termination most like a taxable distribution?

    a. The taxable distribution occurs as a result of lapse of time.

    b. Form 706-GS(T) is used to calculate tax due.

    c. The taxable distribution to a skip person terminates a nonskip person's interest.

34. Generally, when can the GST tax exemption retroactively be allocated?

    a. When a taxable termination is made in favor of a grandchild.

    b. When property included in the transferor's estate is transferred to a skip person.

    c. When there is an unnatural order of death.

35. Zoey created a trust that will pay the total amount of its income to her son, Milo. At Milo's death, the trust will be distributed in equal shares to his two daughters. Which of these transfers is taxable?

    a. Zoey's transfer to the trust.

    b. The distribution to Milo's daughters after his death.

36. What is the taxable amount of a taxable termination?

    a. The value of the property received by the transferee.

    b. The value of the property at the close of the ETIP.

    c. The value of a terminated property interest that passes to a skip person reduced by certain deductions.

    d. The value of the property received reduced by any expenses incurred by the transferee in connection with the determination, collection, or refund of the GST tax on the distribution.

37. Which of the following statements best describes the filing requirements for Form 706-GS(T)?

    a. The check or money order for tax payment attached to the form should be payable to the Internal Revenue Service.

    b. A penalty will always be assessed if the form is filed late.

    c. In the case of a taxable termination, the trustee is liable for the GST tax.

    d. Form 706-GS(T) can be submitted as an extension of time to file.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

33. In which of the following ways is a taxable termination most like a taxable distribution? **(Page 197)**

    a. The taxable distribution occurs as a result of lapse of time. [This answer is incorrect. A taxable distribution is not a distribution by lapse of time. The taxable termination is a termination by reason of death, lapse of time, or release of power of an interest in property held in trust unless certain conditions are met.]

    b. Form 706-GS(T) is used to calculate tax due. [This answer is incorrect. Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations) is used to calculate and report the tax imposed on a taxable termination.]

    c. The taxable distribution to a skip person terminates a nonskip person's interest. [This answer is correct. It is sometimes difficult to differentiate a taxable distribution from a taxable termination. According to the regulations, the difference is if the distribution completely terminates the nonskip person's interest, the transfer is considered a taxable termination.]

34. Generally, when can the GST tax exemption retroactively be allocated? **(Page 197)**

    a. When a taxable termination is made in favor of a grandchild. [This answer is incorrect. This is a special rule for predeceased parent and other collateral relatives, which is separate from the retroactive allocation of the GST tax exemption.]

    b. When property included in the transferor's estate is transferred to a skip person. [This answer is incorrect. A direct skip at death occurs when property included in the transferor's estate is transferred to a skip person. However, this is not a circumstance under which the retroactive allocation of the GST tax exemption applies.]

    c. When there is an unnatural order of death. [This answer is correct. The GST tax exemption can be retroactively terminated under these circumstances according to the Code. The allocation will be deemed to be effective immediately before the nonskip person's death.]

35. Zoey created a trust that will pay the total amount of its income to her son, Milo. At Milo's death, the trust will be distributed in equal shares to his two daughters. Which of these transfers is taxable? **(Page 197)**

    a. Zoey's transfer to the trust. [This is incorrect. Since Milo has an interest in the trust, the trust is not a skip person, and the transfer to the trust would not be a direct skip subject to the GST tax.]

    b. The distribution to Milo's daughters after his death. [This answer is correct. A taxable termination will occur on Milo's death when the trust property is distributed to his daughters because only skip persons have an interest in the property after Milo's death.]

36. What is the taxable amount of a taxable termination? **(Page 197)**

    a. The value of the property received by the transferee. [This answer is incorrect. This is the taxable amount of a direct skip.]

    b. The value of the property at the close of the ETIP. [This answer is incorrect. This is how the GST tax exemption is allocated to property subject to an ETIP.]

    c. The value of a terminated property interest that passes to a skip person reduced by certain deductions. [This answer is correct. Under the Code, the taxable amount of a taxable termination is the value of the terminated property interest that passes to a skip person(s), reduced by any expenses, indebtedness, and taxes attributable to the property.]

d. The value of the property received reduced by any expenses incurred by the transferee in connection with the determination, collection, or refund of the GST tax on the distribution. [This answer is incorrect. This is the taxable amount of a taxable distribution.]

37. Which of the following statements best describes the filing requirements for Form 706-GS(T)? **(Page 197)**

a. The check or money order for tax payment attached to the form should be payable to the Internal Revenue Service. [This answer is incorrect. It should be made payable to the United States Treasury.]

b. A penalty will always be assessed if the form is filed late. [This answer is incorrect. Late filing and late payment penalties will be imposed if the return is not timely filed and the tax paid. However, if a taxpayer can show "reasonable cause" for filing a return late, the late filing penalty will not be imposed.]

c. In the case of a taxable termination, the trustee is liable for the GST tax. [This answer is correct. The trustee of any trust that has a taxable termination is required to file Form 706-GS(T) to calculate and transmit the tax due on the termination. The trustee is liable for the GST tax on taxable terminations under the Internal Revenue Code.]

d. Form 706-GS(T) can be submitted as an extension of time to file. [This answer is incorrect. An extension of time to file Form 706-GS(T) can be requested on Form 7004 (Application for Automatic Extension of Time To File Certain Business, Income Tax, Information, and Other Returns) by entering the appropriate code on line 1.]

Schedule A: Computing the Tax on a Taxable Termination

The GST tax on a taxable termination is computed on Form 706-GS(T), Schedule A. One Schedule A can be used to report multiple terminations with the same inclusion ratio from the same trust. However, a separate Schedule A must be prepared for each terminating interest with a different inclusion ratio. Each Schedule A should be numbered separately in the space provided at the top of the form. If additional space is needed to provide all of the required information, attach a separate sheet to the schedule.

Terminating Interest (Line 2)

A taxable termination is the termination (by reason of death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, after the termination, a nonskip person has an interest in such property, or no distributions can be made to a skip person. The power or interest terminated is described on line 2.

Example 2E-1 Terminating an interest in a trust.

Steve Blair is the life income beneficiary of an irrevocable trust established by his mother. At Steve's death, the trust principal will be paid to his daughter. Steve's income interest in the trust terminates at his death. A description of his terminated interest will be entered on Schedule A, line 2 (e.i., life estate in the Blair Family Trust terminated at life beneficiary's death).

Separate Trusts. Schedule A, line 2, is also used to provide an explanation when parts of the same trust are being treated as separate trusts. Generally, portions of a trust attributable to transfers from different grantors, and substantially separate and independent shares of different beneficiaries in a trust are required to be treated as separate trusts. A separate Schedule A is used to report each interest in a trust that is treated as a separate trust.

Alternate Valuation Date Election (Line 3)

A trustee may elect to value trust property as of the alternate valuation date for all taxable terminations that occur at the same time and as a result of the death of an individual. All property included in the termination must be valued at the alternate valuation date if the election is made, and the election cannot be revoked. The alternate valuation election may not be made unless it decreases both the total value of the property interests subject to the termination and the GST tax due on the termination.

The alternate valuation election is made by checking the box on Schedule A, line 3. If alternate valuation is elected, the property interest that has been terminated is valued as follows:

1. Any property distributed or otherwise disposed of or separated from the trust within six months after the termination is valued on the date of distribution or other disposition. Value the property on the date it ceases to form a part of the trust (that is, on the date the title passes as a result of its distribution or other disposition).

2. Any property not distributed or otherwise disposed of within six months following the termination is valued on the date six months after the termination.

3. Any property or interest that is affected by the mere lapse of time is valued as of the time of termination. However, this date of termination value can be changed to the date of distribution or other disposition to account for any change that is not due to mere lapse of time.

Example 2E-2 Valuing trust property at the alternate valuation date.

Mary Watt is the life beneficiary of an irrevocable trust created by her father. At Mary's death, the balance of the trust will be distributed to her daughter. Mary died on April 1. The value of the trust property was $300,000. On October 1, the alternate valuation date, the trust property had decreased in value to $275,000. Assuming the trust's inclusion ratio was one, the trustee could elect to value trust property as of the alternate valuation date, since the value of the trust property and GST tax would both be reduced. For 2009, the alternate valuation reduces the amount of GST tax by $11,250 [($300,000 − $275,000) × 45%].

Computation of Taxable Amount (Lines 4 through 6)

The taxable amount of a taxable termination is the value of all property with respect to which the termination has occurred, reduced by any expenses, indebtedness, and taxes attributable to the property. Generally, the value of property subject to a termination is determined as of the date of the termination. (However, see the discussion above for electing to value property at the alternate valuation date.) Enter the termination date, valuation date, and the property value in the appropriate column on Schedule A, line 4.

Inclusion Ratio (Line 7)

The trustee must calculate the trust's inclusion ratio for every termination. The inclusion ratio is used to give effect to the portion of the transferor's $3.5 million (for 2009) lifetime exemption allocated to a given transfer. The inclusion ratio equals one minus the applicable fraction. The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the trust or transferred property. The denominator of the applicable fraction is the value of the property transferred, reduced by the sum of (1) any federal estate tax or state death tax attributable to the property, and (2) the gift or estate tax charitable deduction allowed for the property, if any. All terminations, or any parts of a single termination that have different inclusion ratios, must be shown on separate Schedules A.

Example 2E-3 Reporting GST tax on a taxable termination.

In 1996, Jane Mann transferred $200,000 of publicly traded securities to an irrevocable trust that will pay her son, Fred, all of its net income annually for his life. At Fred's death, the balance in the trust will be distributed to Fred's daughter, Beth (Jane's granddaughter). At the time the trust was created, Jane allocated $150,000 of her lifetime exemption to the trust. Thus, the trust's inclusion ratio is .25 [1 − ($150,000 ÷ $200,000)]. Fred died on February 8, 2009 when the value of the trust was $400,000. Assume deductions allocable to the termination were $2,500. The amount of GST tax on the termination is computed as follows:

Value of property subject to termination	$ 400,000
Less: allocable deductions	(2,500)
Taxable amount	397,500
Applicable rate (.45 × .25)	× .1125
GST tax on termination	$ 44,719

Schedules B(1) and B(2): Determining Debts, Expenses, and Taxes Attributable to Trust Property

The taxable amount of a taxable termination is the value of all property for which the termination has occurred, reduced by any expenses, indebtedness, and taxes attributable to the property. The allowable expenses are of the type allowed under IRC Sec. 2053(a).

Schedule B(1)—General Trust Debts, Expenses, and Taxes

Schedule B(1) is used to determine the amount of expenses related to the entire trust that are allocable to the terminated interest. Examples of expenses that relate to the entire trust include trustee's fees, administrative expenses, financial adviser's fees, and accounting fees.

Allocating Expenses to Terminated Interest. Because the expenses reported on Schedule B(1) are of the general type that were incurred with respect to the entire trust property, they must be allocated between the terminated interest and the remaining trust property. The amount of expense allocated to the terminated interest is determined by the following formula:

$$\frac{\text{Value of terminated interest}}{\text{Value of entire trust property}} \times \frac{\text{Number of days through date of termination}}{\text{Number of days in the entire year (or days trust was in existence)}} \times \text{Total Amount of Expense}$$

Example 2F-1 Computing expenses allocable to a terminated interest.

John Childs created an irrevocable trust whose governing instrument provided that the trustee, at his discretion, would distribute trust income to John's children, Mark and Dan, for their joint lives. On the death of the first to die, half of the trust will be distributed to that child's children (i.e., John's grandchildren). The balance in the trust will be distributed to the survivor's children at his death. Mark died on June 1 when the trust assets were valued at $400,000. Thus, the value of the terminated interest is $200,000 ($^1/_2 \times$ $400,000). In addition, the trust incurred the following expenses during the year:

Trustee fees	$ 2,500
Accounting fees	1,100
Investment fees	1,600
Total expenses	$ 5,200

The portion of the expenses allocable to the terminated interest is determined by multiplying total expenses ($5,200) by the following percentage:

$$(\$200{,}000 \div \$400{,}000) \times (151 \div 365) = 20.68\%$$

Thus, $1,075 ($5,200 × 20.68%) of the expenses are allocable to the terminated interest. The allocable percentage is entered on Schedule B(1), line 2.

Schedule B(2)—Termination Related Debts, Expenses, and Taxes

Schedule B(2) is used to report those expenses related solely to the terminated interest. Examples of these expenses include taxes on real estate, the cost of selling property, or attorney fees incurred to defend title to property. Presumably, the cost of valuing the terminated interest or preparing Form 706-GS(T) should also qualify.

If the expense is allocable to more than the terminated interest but less than the entire trust property, only the amount attributable to the terminated interest is deductible on Schedule B(2). The portion allocable to the terminated interest is determined by multiplying the amount of the expense by the ratio of the value of the terminated interest to the value of the entire property to which the expense relates.

Example 2F-2 Determining the allocable share of termination expenses.

The Wade Family Trust incurred $2,000 of legal fees clearing title to a parcel of real estate. The fees were necessary to clear title so an undivided 50% interest in the property could be distributed to Joe Wade. The distribution of the real estate to Joe is a taxable termination. Although the $2,000 in legal fees was incurred to facilitate the distribution of the terminated interest, the fees benefitted, and thus were allocable to, 100% of the real estate held by the trust. Thus, only $1,000 (50%) of the legal fees is deductible on Schedule B(2).

Column C. If the expense relates to more property than that involved in the termination but less than the entire trust, enter in column C only the amount attributable to the property involved in the termination. This is determined using the following calculation:

$$\frac{\text{Value of property involved in the termination to which the expense relates}}{\text{Total value of property to which the expense relates}} \times \text{Total Expense}$$

How to Report a Qualified Severance

Form 706-GS(T) (or any other form that may be provided by the IRS for this purpose) is used to report a qualified severance. Write "Qualified Severance" at the top of the form and attach a notice of qualified severance to the return. The notice should contain the following information:

1. Information related to *original trust*—
   a. the transferor's name,
   b. the name and date of creation,
   c. tax identification number, and
   d. inclusion ratio before the severance,
2. Information related to *each new trust*—
   a. name and tax identification number of each new trust,
   b. date of severance,
   c. fraction of the total trust assets of the original trust received by each new trust,
   d. other details explaining the basis for funding each new trust (a fraction of the total fair market value of the assets on the funding date or a fraction of each asset), and
   e. inclusion ratio of each new trust.

The return and attached notice must be filed by April 15th (or the extended due date, if an extension of time is granted) of the year immediately following the year during which the severance occurred.

Example 2G-1 Severing a trust with one income beneficiary.

Eddie died in 2009 and his will established a trust providing income to Pam (his sister) for her life. Upon Pam's death, half of the principal is paid to Eddie's child, Sean (or Sean's estate if Sean predeceases Eddie). The other half is paid to Eddie's grandchild, Kaitlyn (or Kaitlyn's estate if she predeceases Eddie).

Pursuant to state law, Eddie's executor divided the trusts into two separate trusts. Each trust received half of the assets of the original trust. Trust 1 pays income to Pam for her life with the remainder to Sean (or Sean's estate). Trust 2 pays income to Pam for life with the remainder to Kaitlyn (or her estate). Because the trusts provide for the same succession in interest as provided in the original trust, this will be a qualified severance. On Form 706, Eddie's executor can allocate any of Eddie's remaining GST tax exemption to Trust 2.

Eddie's executor should file Form 706-GS(T) by April 15, 2010 (or the extended due date, if an extension of time is granted) to elect to sever the trust. Write "Qualified Severance" at the top of the form and attach a notice of severance.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

38. Harvey is the life beneficiary of an irrevocable trust created by his father. At Harvey's death, the balance of the trust will be distributed to his son, Leon. Harvey dies on April 1, and the trust is valued $300,000. October 1 is elected as the alternate valuation date. As of that date, the trust had decreased in value to $275,000. The trust's inclusion ratio is 1, and the GST tax rate is 45%. Calculate the amount saved by using the alternate valuation date.

    a. $135,000.

    b. $123,750.

    c. $25,000.

    d. $11,250.

39. Which of the following schedules is used to determine the amount of expenses related to the entire trust that are allocable to the terminated interest?

    a. Schedule B(1).

    b. Schedule B(2).

40. Which of the following should be included on Form 706-GS(T) related to the original trust in a qualified severance?

    a. Date of severance.

    b. Fraction of the total trust assets.

    c. Details explaining the basis for funding.

    d. Name and date of creation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

38. Harvey is the life beneficiary of an irrevocable trust created by his father. At Harvey's death, the balance of the trust will be distributed to his son, Leon. Harvey dies on April 1, and the trust is valued $300,000. October 1 is elected as the alternate valuation date. As of that date, the trust had decreased in value to $275,000. The trust's inclusion ratio is 1, and the GST tax rate is 45%. Calculate the amount saved by using the alternate valuation date. **(Page 204)**

    a. $135,000. [This answer is incorrect. The GST tax if calculated on April 1 would be $135,000 (45% of $300,000). The alternate valuation date has not been taken into account.]

    b. $123,750. [This answer is incorrect. This is the total amount of GST tax that must be paid when the alternate valuation date is used in the scenario above. However, this is not the amount that was saved when compared with the value on April 1.]

    c. $25,000. [This answer is incorrect. This is the amount that the trust value decreased between April 1 and October 1. However, there is more that must be done to calculate the amount saved. This is only the first step.]

    d. $11,250. [This answer is correct. For 2009, the alternate valuation date reduces the amount of GST tax for this scenario by $11,250 {($300,000 - $275,000) x 45%}.]

39. Which of the following schedules is used to determine the amount of expenses related to the entire trust that are allocable to the terminated interest? **(Page 205)**

    a. Schedule B(1). [This answer is correct. Schedule B(1) is used to determine the amount described above. Examples of expenses that relate to the entire trust include trustee's fees, administrative expenses, financial adviser's fees, and accounting fees.]

    b. Schedule B(2). [This answer is incorrect. Schedule B(2) is used to report those expenses related solely to the terminated interest. Examples of these expenses include taxes on real estate, the cost of selling property, or attorney fees incurred to defend title to property.]

40. Which of the following should be included on Form 706-GS(T) related to the original trust in a qualified severance? **(Page 207)**

    a. Date of severance. [This answer is incorrect. This would be included for each new trust.]

    b. Fraction of the total trust assets. [This answer is incorrect. The fraction of the total trust assets of the original trust received by each new trust would be included for each new trust.]

    c. Details explaining the basis for funding. [This answer is incorrect. For each new trust, other details would be included explaining the basis for funding each new trust (a fraction of total fair market value of the assets on the funding date or a fraction of each asset).]

    d. Name and date of creation. [This answer is correct. According to IRS regulations, the following information should be provided regarding the original trust: (1) the transferor's name, (2) the name and date of creation, (3) tax identification number, and (4) inclusion ratio before the severance.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (706TG092)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

28. A direct skip from a nonexplicit trust totaling what amount or less is reported on Schedule R?

    a. $125,000.

    b. $150,000.

    c. $200,000.

    d. $250,000.

29. The GST tax is due how long after the date of death?

    a. One month.

    b. Three months.

    c. Six months.

    d. Nine months.

30. Who is responsible for payment of the GST tax on taxable distributions?

    a. Transferor.

    b. Recipient.

    c. Trustee.

    d. Guardian.

31. Jerry Jones created a trust that allows the trustee to distribute income and principal to his son Julius, and to his grandson, Jason. The trustee distributes $30,000 to Jason in 2009. Assuming the trust's inclusion ratio is 1.00 (i.e., none of Jerry's GST tax exemption was allocated to the trust), how much GST tax must Jason pay on the $30,000 distribution if the GST tax rate is 45%?

    a. $9,000.

    b. $11,500.

    c. $13,500.

    d. $15,000.

32. If, in the question above, the trustee paid the GST on the taxable distribution to Jason, the additional distribution would be treated as having been made on which of the following dates?

    a. December 31, 2009.

    b. January 1, 2010.

    c. December 31, 2010.

    d. January 1, 2011.

33. Who is required to report taxable distributions from nonexplicit trusts?

    a. Transferor.

    b. Recipient.

    c. Trustee.

    d. Distributee.

34. The inclusion ratio must be entered on Part II of Form 706-GS(D-1). The inclusion ratio equals one minus the applicable fraction. The numerator of the applicable fraction consists of which of the following?

    a. The total distribution.

    b. The amount of the GST tax exemption allocated to the transferred property or trust.

    c. The value of the trust property at the date of death.

    d. The date of death values reduced by the present value of the pecuniary payment.

35. Who is responsible for filing Form 706-GS(D-1)?

    a. Transferor.

    b. Skip person.

    c. Nonskip person.

    d. Trustee.

36. List all of the circumstances under which the termination of an interest in property held in trust would not be considered a taxable termination.

    i. At the time of termination, a transfer that is subject to the federal estate or gift tax occurs in connection with the property.

    ii. A partial termination occurs in connection with the property.

    iii. Form 706-GS(T) is filed in connection with the termination.

    iv. At no time after the termination can a distribution be made to a skip person (the probability of such must be less than 5% determined actuarially).

    v. Immediately after the termination, a nonskip person has an interest in the property.

    a. i. and iii.

    b. i., iv., and v.

    c. i., ii., iv., and v.

    d. i., ii., iii., iv., and v.

37. Betty establishes a nonexplicit trust to benefit her daughter, Anne, and her grandson Charles. How should the status of this trust be indicated on Form 706-GS(T)?

    a. By entering the appropriate code on line 1 of Form 7004.

    b. By entering the trust's value on Part III, line 12.

    c. By checking the box on Part II, line 8, and attaching an appropriate statement.

    d. By submitting a statement that details the calculation of the trust's inclusion ratio.

38. In 1996, Stephen Kane transferred $300,000 of publicly traded securities to an irrevocable trust that will pay his son, Tommy, all of its net income annually for his life. At Tommy's death, the balance in the trust will be distributed to Tommy's daughter, Sue (Stephen's granddaughter). At the time the trust was created, Stephen allocated $100,000 of his lifetime exemption to the trust. Thus, the trust's inclusion ratio is .66 [1 – ($100,000 ÷ $300,000)]. Tommy died on February 9, 2009, when the value of the trust was $500,000. Assume deductions allocable to the termination were $2,500. What is the total GST tax on the termination?

    a. $44,719.

    b. $55,969.

    c. $147,758.

    d. $151,041.

39. Which of the following amounts is deductible on Schedule B(2) if the expense is allocated to more than the terminated interest but less than the entire trust property?

    a. Only the amount attributable to the terminated interest.

    b. Only the portion attributable to the distribution subject to tax is deducted.

    c. Only the amount of a trust attributable to transfers from different transferors.

    d. Only expenses of the general type that are incurred with respect to the entire trust property.

40. The Thomson Family Trust incurred $2,000 of legal fees clearing title to a parcel of real estate. The fees were necessary to clear title so an undivided 50% interest in the property could be distributed to Ashleigh Thomson. The distribution of the real estate to Ashleigh is a taxable termination. Although the $2,000 in legal fees was incurred to facilitate the distribution of the terminated interest, the fees benefitted, and thus were allocable to, 100% of the real estate held by the trust. How much of the legal fees is deductible on Schedule B(2)?

    a. $250.

    b. $500.

    c. $750.

    d. $1,000.

GLOSSARY

DIrect Skip: A direct skip occurs when property included in the transferor's estate is transferred to a skip person.

DIrect Skip at Death: Occurs when property included in the transferor's estate is transferred to a skip person.

DIrect Skip Exclusion: A transfer to a skip person more than two generations below the transferor (e.g., a great-grandchild) is only subject to one level of GST tax. For example, if a donor transfers assets to a trust for the benefit of a great−grandchild, the transfer is a direct skip. GST tax is imposed only once although two generations are skipped.

Estate Tax Inclusion Period (ETIP): Any period during which (should death occur) the value of the transferred property would be included in the gross estate of either (1) the transferor, or (2) the spouse of the transferor.

Form 706-GS(D): The recipient of a taxable distribution from a trust is required to file Form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions) to report the distribution and compute the GST tax payable.

Form 706-GS(D-1): Form 706-GS(D-1) is an information return that provides the distributee with the amount of the taxable distribution and the inclusion ratio of the trust. The distributee, who is liable for the tax, uses the information to compute the GST tax due on the distribution.

Form 706-GS(T): Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations) is used to calculate and report the tax imposed on a taxable termination. Form 706-GS(T) is also used to report the qualified severance of a trust.

Generation-Skipping Transfer (GST): occurs when there is a direct or indirect transfer from a transferor to a skip person.

Generation-Skipping Transfer Trust: A GST trust is a trust that could have a generation-skipping transfer with respect to the transferor unless.

Grandfathered Trust: Trusts that were irrevocable on September 25, 1985.

Inclusion Ratio: The inclusion ratio is used to give effect to the portion of the transferor's $3.5 million (for 2009) lifetime exemption allocated to a given transfer. The Code defines the inclusion ratio as 1 minus the applicable fraction.

Income in Respect of a Decedent (IRD): Gross income a decedent was entitled to at the time of death but was not included in his or her final income tax return (or any prior return) under his or her regular method of accounting.

Indirect Skip: Any transfer of property (other than a direct skip subject to the gift tax) made to a GST trust.

***Inter Vivos* Direct Skip:** A direct skip transfer made during the life of the transferor.

Nonexplicit Trust: A "trust arrangement" treated as a trust for GST purposes only. Examples of nonexplicit trusts include life estates and remainders, estates for years, and insurance and annuity contracts.

Nonskip Person: Any person who is not a skip person.

Notice of Allocation: Is used to allocate the GST tax exemption to gifts that qualify for the gift tax annual exclusion but not the GST tax annual exclusion.

Property Interest in a Trust: A present right to receive income or corpus from the trust or when a person is a permissible current recipient of trust income or principal.

Qualified Severance: The division of a single trust into two or more trusts.

Reverse QTIP Election: A decedent's estate may elect to treat (for GST tax purposes only) all of the QTIP property as if the QTIP election had not been made. This election is provided by IRC Sec. 2652(a)(3) and is referred to as the reverse QTIP election.

Schedule B(1): Schedule B(1) is used to determine the amount of expenses related to the entire trust that are allocable to the terminated interest. Examples of expenses that relate to the entire trust include trustee's fees, administrative expenses, financial adviser's fees, and accounting fees.

Schedule B(2): Schedule B(2) is used to report those expenses related solely to the terminated interest. Examples of these expenses include taxes on real estate, the cost of selling property, or attorney fees incurred to defend title to property.

Schedule R: Schedule R is used to report direct skips that occur at death and compute the amount of GST tax payable on the transfer. Schedule R is also used to report direct skips at death from certain trusts.

Skip Person: A natural person assigned to a generation that is two or more generations below the transferor.

Taxable Amount of a Taxable Termination: The value of the terminated property interest passing to the skip person(s) reduced by any expenses, indebtedness, and taxes attributable to the property.

Taxable Distribution: Any distribution (other than a taxable termination or a direct skip) from a trust to a skip person.

Taxable Termination: The termination (by reason of death, lapse of time, release of power, or otherwise) of an interest in property held in trust.

INDEX

G

GENERATION-SKIPPING TRANSFER (GST) TAX

GENERATION-SKIPPING TRANSFER TAX RETURNS

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 706/709 Deskbook—Course 1—Form 706/709: Credits, Payments, and Other Taxes (706TG091)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

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2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

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4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2010**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

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EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 706/709 Deskbook—Course 1—Form 706/709: Credits, Payments, and Other Taxes (706TG091)

CTEC Course No. 3039-CE-0231
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2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
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Self-study Course Evaluation

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Course Title: Companion to PPC's 706/709 Deskbook—Course 1—Form 706/709: Credits, Payments, and Other Taxes

Course Acronym: 706TG091

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(Low (1) . . . to . . . High (10))

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 706/709 Deskbook—Course 2—Form 706/709: Generation-skipping Transfer (GST) Taxes (706TG092)

CTEC Course No. 3039-CE-0232
Price $79

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Expiration Date: November 30, 2010

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Course Title: Companion to PPC's 706/709 Deskbook—Course 2—Form 706/709: Generation-skipping Transfer (GST) Taxes

Course Acronym: 706TG092

Your Name (optional): ____________________ Date: ____________

Email: ____________________

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