Creative Ways to Transfer Assets Without Any Remaining Exemption

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Table of Contents

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Creative Ways to Transfer Assets Without Any Remaining Exemption[1]

I. Introduction

The federal estate tax exemption is at an all-time high, but the need for creative ways to transfer assets for ultra-wealthy clients who have exhausted their exemption remains. In addition, in 2026, the estate tax exemption is scheduled to decline dramatically, leaving even non-ultra-wealthy clients looking for ways to transfer assets with the least amount of taxes. Practitioners and advisors must understand the strategies and techniques available for transferring assets in a tax-efficient manner so that they can properly make recommendations to their clients.

II. Historical and Current Estate Tax Laws and Exemptions

A. The Federal Estate Tax

The modern estate tax was enacted over a century ago under the Revenue Act of 1916. The rate was graduated starting at 1% and maxing out at a top rate of 10% for estates exceeding $5 million. Estates of U.S. residents were allowed an exemption of $50,000. Since that time the estate tax has undergone significant changes. The estate tax rate rose to a maximum rate of 77% on amounts over $10 million between 1941 to 1976. The exemption also rose during this time, jumping to $100,000 in 1926, before dropping back down to a low of $40,000 in 1935, and then steadily growing to its height today in 2022 of $12.06 million per person.[2] Under current law, the exemption will continue to rise due to inflation adjustments over the next three years before reverting to 2017 levels in 2026.[3]

It may be helpful to note the comparison of today's dollars versus dollars in the past. Fifty thousand dollars in 1916 is equivalent to $1,359,000 today.[4] This means that

[1] This paper focuses on federal estate and gift tax. Other taxes, including state transfer taxes are outside the scope of this paper.

[2] Due to an inflationary adjustment, the federal gift and estate tax exemption will increase by $860,000 to $12,920,000 per person. The annual gift tax exclusion will increase to $17,000.

[3] In 2010, for the first time in nearly a century, the federal estate tax disappeared (for some). Under the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 ("EGTRRA"), in addition to other significant changes to federal estate and gift tax laws, the federal estate tax was temporarily repealed for one year beginning on January 1, 2010. This created a unique situation (and perhaps an opportunity for the cunning) in which no estate tax would be owed for those who died in 2010. At the end of 2010, EGTRRA's provisions were scheduled to expire, and the tax laws of 2001 were set to return. Lawmakers quickly enacted the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("TRUIRJCA"), which retroactively reinstated the estate tax for 2010. In addition, TRUIRJCA put executors of estates of decedent's dying in 2010 to an election. Such executors could elect either to apply the newly reinstated estate tax to the estate, or they could elect out of the estate tax and apply to provisions of EGTRRA to the estate. The decision essentially turned on whether the basis adjustment afforded by TRUIRJCA was more advantageous than opting out of the estate tax.

[4] https://www.usinflationcalculator.com.

today's $12.06 million exemption is $10.7 million higher than it was for taxpayers in 1916. Today's tax rate of 40% is much higher, though than the 10% rate applicable to large estates 106 years ago. You might wonder how a single person with a $15 million estate might fare today compared to 1916. Assuming all other things are equal, a person with a $15 million estate would pay $1,176,000 based on today's estate tax regime, and that same person would pay $1,364,100 based on the estate tax regime in 1916. As you can reinstate see, today's estate tax laws are slightly more favorable to the wealthy than when the estate tax was enacted, but not by much.

As noted above, the exemption amount for 2022 is $12.06 million per person. The current estate tax exemption is set by the Tax Cuts and Jobs Act of 2017 ("TCJA"). Under the TCJA, the estate tax exemption was doubled from $5 million per person to $10 million per person beginning January 1, 2018. Due to inflation adjustments already in effect, the effective exemption amount for 2018 was $11.2 million per person. Because the TCJA was passed as a budget reconciliation bill, many of its provisions expire, including the modified exemption amount. On January 1, 2026, the estate tax exemption returns to the exemption amount before the TCJA, which is the 2017 exemption of $5.6 million per person (increased for inflation). Therefore, in 2026, the exemption amount should be a little over $6 million per person.

Another feature of the gift and estate tax rates is that they have always been progressive rates, meaning larger transfers of wealth were taxed at higher rates and smaller transfers of wealth were taxed at lower rates. In 1916, the lowest marginal rate was 1% and the highest marginal rate was 10%. The lowest marginal rate increased to 18% in 1977 and remains there today. Interestingly, since 2006, the gift and estate tax has effectively been a flat tax rate at the highest marginal rate due to the exemption amount exceeding the highest marginal rate bracket. That is, in 2006, the exemption was $2 million per person and the highest amount at which tax was imposed was also $2 million. This equated to there being no tax on amounts below $2 million, and thus, no amounts subject to the lower marginal rates. We will continue to see a "flat tax" for the estate and gift tax unless the exemption falls below the highest marginal rate bracket. Currently, the highest marginal rate bracket is $1 million, so the exemption would need to fall below that amount in order for taxpayers to start seeing true graduated rates.

B. Estate Tax Marital Deduction

A major advantage to married couples and their estate taxes was granted in 1948. In the Revenue Act of 1948, taxpayers were given the ability to deduct from their estate tax amounts transferred to a surviving spouse at death, subject to certain conditions. The deduction was originally limited to one-half of the deceased spouse's adjusted gross estate. Additionally, the deduction was limited to property that constituted terminable interest property, generally meaning property that is taxable in the estate of the surviving spouse. A terminable interest is generally an interest in property that terminates upon the surviving spouse's death, such as a life estate or a term of years.[5]

[5] 26 CFR 20.2056(b)-1.

Section 2056 of the IRC allows a marital deduction in the estate tax for the value of property passing from the decedent to his or her surviving spouse.

In 1981 Congress removed all quantitative limits on the marital deduction, for the estates of decedents dying after that year, giving married taxpayers an unlimited marital deduction under Section 2056.

In allowing a marital deduction for transfers from the decedent to his or her surviving spouse, Section 2056 requires that the transfer be of an interest in property which is included in the gross estate and which passes from the decedent to the surviving spouse. In addition, the transfer must comply with the highly technical requirements of the "terminable interest rule."

This is the basic function of the terminable interest rule and of its several exceptions which allow a marital deduction at the death of the first spouse, even though the surviving spouse receives a terminable interest, um. der conditions that guarantee that the property will eventually be subject to tax in the hands of the surviving spouse. See IRC Section 2056(b).

To illustrate the operation of the marital deduction, consider the situation of a husband and wife who live in a community property state and have combined wealth in the amount of $25 million. Of that amount, assume that $20 million consists of community property in which each spouse has an equal, present, vested interest and the remaining $5 million is the husband's separate property which he inherited from his parents. Assume that the husband dies first and in his will leaves everything to his wife. Therefore, the wife will receive the husband's half of community property plus all the husband's separate property and will own that in addition to her own half of the community property in which she already had a present, vested interest before the husband's death. The husband's gross estate includes his half of the community property (worth $10 million) and all of his separate property (worth $5 million), for a total of $15 million. (The wife's half of the community property is not included in the husband's gross estate because it is not property owned by him at his death, nor is it includable under any other provision.) From the gross estate of $15 million, and a marital deduction is allowed under Section 2056 for $15 millon, the value of the property passing to the wife. As a result, the husband's taxable estate is zero, and no tax is payable at his death. The wife will become the owner of all of the couple's property remaining after payment of expenses and claims, and that property will be subject to gift or estate tax upon a subsequent transfer by the wife during life or at death.

In 1988 Congress added Section 2056(d), which disallows the marital deduction if the decedent's surviving spouse is not a U.S. citizen, unless the property passes to the spouse in a "qualified domestic trust" (QDOT). Section 2056A sets forth the definition of a QDOT, and provides for a deferred estate tax to be imposed on distributions from the QDOT during the spouse's lifetime (other than distributions of income to the spouse) and on the value of the property remaining in the QDOT at the spouse's death. A QDOT must

have at least one trustee who is an individual U.S. citizen or a domestic corporation, with the right to withhold the deferred estate tax from any distribution. A trust will qualify as a QDOT only if the decedent's executor so elects.[6]

The statute now makes five exceptions to the terminable interest rule.

1. The first, set forth in Section 2056(b)(3), applies when the only way in which the surviving spouse's interest can terminate or fail is upon her death within six months after the death of the decedent (or in a common disaster) and when her death does not in fact so occur.

2. The second exception, under Section 2056(b)(5), applies if the surviving spouse is given a life estate in property and a general power of appointment with respect to that property.

3. A third exception is provided by Section 2056(b)(6) for life insurance, endowment or annuity contracts payable in installments where the surviving spouse has rights in the contract similar to those described in the preceding exception, Section 2056(b)(5).[7]

4. The fourth (and exceedingly important) exception to the terminable interest rule appears in Section 2056(b)(7), which was added to the Code in 1981. Under this exception, a life estate in "qualified terminable interest property" (QTIP) will not be treated as a terminable interest, if the decedent's executor so elects on the estate tax return. The entire property subject to such a life estate is treated as passing to the surviving spouse, and hence the full value of the property (not merely the life estate) qualifies for the marital deduction. "Qualified terminable interest property" is defined as property passing from the decedent, in which the surviving spouse has a qualifying income interest for life, and with respect to which a proper election is made. The spouse must be entitled to all the income from the property, payable at least annually, for life, and no person, including the spouse, may have a power to appoint any part of the property to any person other than the spouse during the spouse's life.[8]

5. The fifth and final exception to the terminable interest rule is set forth in Section 2056(b)(8), which allows a marital deduction for the value of an annuity or unitrust interest passing from the decedent to the surviving spouse, if the spouse is the only noncharitable beneficiary of a qualified charitable remainder trust.[9]

The marital deduction provides a way of postponing the federal estate tax that otherwise would have to be paid on a married person's estate, as well as potentially reducing the aggregate tax that ultimately will have to be paid. The marital deduction does

[6] See generally IRC Section 2056A and the regulations thereunder.
[7] See Reg. Section 20.2056(b)-6.
[8] See Reg. Section 20.2056(b)-7.
[9] IRC Section 2056(b)(8).

this by making it possible for the spouse who dies first to leave some or all of his estate in a manner that makes it deductible for federal estate as purposes and thus reduces or eliminates the estate tax that must be paid at the decedent's death. Of course, any property that qualifies for the marital deduction in the estate of one spouse will, if retained by the surviving spouse until death, be taxed in the survivor's estate.

For gift tax purposes, a parallel provision disallows the marital deduction for gifts to a spouse who is not a U.S. citizen, but allows an increased annual exclusion for such gifts. IRC Section 2523(i).

C. The Federal Gift Tax

To avoid the federal and state taxes on transmission or receipt of property at death, some property owners made large lifetime transfers. To counteract this technique and partly for political reasons, the federal gift tax was enacted in 1924. (It was repealed in 1926 but reinstated in 1932.) This gift tax was imposed on lifetime gifts at rates equal to three-quarters of the estate tax rates on equivalent transfers made at death. The gift tax was, and is, progressive and cumulative over a donor's lifetime. The tax on a taxable gift of a given amount is higher if the donor has made many or large taxable gifts previously, even in prior years.

D. Gift Tax Exclusions

Section 2503(a) defines "taxable gifts" as the total amount of gifts made during the calendar year, less the deductions provided in Section 2522-2524. In computing taxable gifts, every person is entitled to an annual, per-donee exclusion of $10,000 (indexed for inflation, $16,000 in 2022). The annual per-donee exclusion is authorized in IRC Section 2503(b), which states that in computing taxable gifts for the calendar year, in the case of all gifts (other than gifts of future interests in property) made to any person by the donor, the first $10,000 of such gifts to such person shall not be included in the total amount of gifts made during that year. Since a gift of a future interest does not qualify for the annual exclusion, the entire value of a future interest in the property must be included in the total amount of gifts for the calendar year in which the gift is made. In other words, the first $10,000 of present-interest gifts made by a donor to a particular donee during a calendar year are automatically excluded in determining the donor's gift tax liability. Thus, a donor who makes gifts of $10,000 to each of six different donees is entitled to six annual exclusions, enabling the donor to make tax-free gifts totaling $60,000 in the current year, and the result will be the same for the following year and every other year in which the donor makes similar gifts. If a gift is made in trust, the beneficiary of the trust (rather than the trust itself is treated as the donee.[10]

The exclusion removes the need to keep records of and report small incidental gifts and most ordinary family or holiday transfers.

[10] Reg. Section 25.2503-2(a).

The annual exclusion not only exempts many gifts from tax but also relieves taxpayers of a heavy burden of reporting those gifts by filing tax returns. In general, a donor is required to file a gift tax return for any calendar year in which he or she makes any gift that is not fully covered by the annual exclusion, the exclusion for tuition and medical care, the marital deduction or the charitable deduction.[11] The return is normally due on April 15th following the close of the calendar year, and the tax is to be paid when the return is filed.[12] The annual exclusion under Section 2503(b) applies automatically to gifts made to each donee during the calendar year, up to the excludable amount; gifts to any donee in excess of that amount may give rise to gift tax liability. A new annual exclusion becomes available each new year; and any unused exclusion expires at year-end and cannot be carried over or accumulated.

The size of the annual exclusion has been changed from time to time. These changes remain relevant in later years by reason of the way the gift tax is calculated. Although the gift tax is payable on an annual basis, each year's gift tax computation builds on the donor's cumulative taxable gifts made in prior years. To determine the tax payable for a given year, the total taxable gifts made since enactment of the gift tax on June 6, 1932 to the end of the current year must be aggregated and a tentative tax on such gifts must be computed at present rates. From that amount must then be deducted a tentative tax, again determined at present rates, on the total taxable gifts made up to the beginning of the current taxable year. The amount so calculated is the gift tax for the current year[13]. The taxpayer may offset the gift tax using any unused portion of the unified credit.[14]

Section 2503(e) expressly excludes amounts paid on behalf of an individual as tuition to an educational organization described in Section 170(b)(1)(A)(ii) for the education or training of such individual, or to any person who provides medical care for such individual as payment for such care. Note that the beneficiary need not be a dependent of the donor, nor need the educational institution be tax exempt. The exclusion does not apply where the donor gives cash to the beneficiary who then himself pays the school or doctor, or to the beneficiary to reimburse him for amounts previously paid to the school or doctor.[15]

E. Annual Exclusion Gifts of Future Interests

As the annual exclusion only applies to gifts of "present interests" in property, no exclusion is allowed for gifts of "future interests" in property. This limitation, contained in IRC Section 2503(b).

In attempting to help describe what does constitute a present interest in property, the regulations say that an unrestricted right to the immediate use, possession or enjoyment of property or the income from property (such as a life estate or term certain)

[11] IRC Section 6019.
[12] IRC Section 6075(b) and 6151.
[13] IRC Section 2501 and 2502.
[14] IRC Section 2505.
[15] Reg. Section 25.2503-6.

is a present interest in property. Therefore, an exclusion is allowable with respect to a gift of such an interest, but not in excess of the value of that interest.[16]

In the case of a transfer in trust, the Supreme Court has held that it is the individual beneficiary, not the trustee, who is the donee for purposes of determining the annual exclusion. Helvering v Hutchings, 312 U.S. 393 (1941). Therefore, even if the donor of a gift in trust completely divests himself of ownership, dominion and control over the property, he will not be entitled to an annual exclusion unless he can show that an ascertainable beneficiary will receive some present enjoyment from the trust property. As the Supreme Court put it in the leading case of Fondren v. Commissioner, 324 U.S. 18 (1945), the term "present interest" connotes the right to substantial present economic benefit. The question is of the time not when title vests but when enjoyment begins. If anything puts a limitation of a substantial period between the wish of the donee or beneficiary to enjoy the gift and actual enjoyment, the gift is one of a future interest.[17]

If the beneficiary of a trust has a power to compel the trustee to pay a fixed sum to him from corpus upon demand, such a power makes the gift one of a present interest, even if the beneficiary has no other immediate right to receive income or corpus.[18]

A gift to another person of shares in a corporation generally will be considered a gift of a present interest, in the absence of extraordinary terms restricting the donee's rights as a shareholder. Problems may arise in connection with gifts of interests in a family owned business entity. In one case, gifts made by parents to their children of shares in a limited liability company were held to be gifts of future interests, even though the donees received all of the legal rights originally possessed by the donors, where the donees could not receive any distributions, sell their shares, or withdraw from the company without the consent of the company's manager. The court concluded that the terms of the company's operating agreement prevented the donee from realizing any substantial present economic benefit from their ownership of the shares. Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003).

F. Annual Exclusion Gifts to Minors

The future interest rule raises special problems when a gift to a minor is involved. Because of legal disabilities imposed by state law, a minor cannot personally exercise all the rights of property ownership in the same way that adult donees can. However, this concern was eliminated by the IRS in Rev. Rul. 54-400, 1954-2 C.B. 319. So, the annual exclusion is generally available for an outright gift to a minor. If the gift is in trust and so limited as to grant a future interest, the exclusion will be unavailable.

Often, however, a donor may find it convenient or prudent to make a gift to or for the benefit of a minor in the form of a custodianship or trust arrangement, rather than as a direct gift. Before the enactment of IRC Section 2503(c), and even thereafter in cases

[16] Reg. Section 25.2503-3(b).
[17] Id.
[18] Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

not covered by that provision, there was some uncertainty about whether a gift of property to a trustee for a minor could be regarded as a gift of a present interest. Some courts held that the gift was a transfer of a present interest if the trustee did not have any discretion to withhold payment or if a guardian could demand payment of the income or property on behalf of the minor. See Crummey v. Commissioner, 397 F. 2d 82 eth Cir 1968); Kieckhefer v. Commissioner, 189 rad 118 (7th Cir. 1951).

The IRS now accepts the Crummey approach. A withdrawal power given to a minor will qualify a transfer in trust as a present interest so long as here is no impediment to the appointment of a guardian who could exercise the withdrawal power on the minor's behalf. Rev.Rul. 73-405, 1973-2 C.B. 321. The beneficiary must be informed of the existence of the withdrawal power and must be given a reasonable opportunity to exercise that power. Frequently the beneficiary is given a limited period of time in which to exercise the withdrawal power, which will automatically lapse if the beneficiary fails to act. The Service has ruled that a power that lapsed after only two days was "illusory," but has allowed an exclusion for a power that lapsed after 46 days. See Rev.Rul. 81-7, 1981-1 C.B. 474; Rev.Rul. 83-108, 1983-2 C.B. 167.

The uncertainty of the case law led to the enactment in 1954 of Section 2503(c). This provision provides a way to obtain an annual exclusion even if the gift is not outright and does not require an immediate payment to or for the benefit of the minor beneficiary.

Section 2503(c) provides that, for purposes of the future interest rule of Section 2503(b), no part of a gift to an individual who has not reached the age of 21 years on the date of the transfer shall be considered to be a gift of a future interest in property if the property and the income therefrom may be expended by or for the benefit of the donee before he reaches the age of 21 and, to the extent not so expended, will pass to the donee when he reaches age 21 or, if he dies before that age, will be payable to the donee's estate or as he may appoint under a general power of appointment. Thus, for example, a gift in trust for a minor child will be eligible for the annual exclusion, even though the child is not immediately entitled to any distributions of income or corpus, if the trustee has unlimited discretion to expend income and corpus for the benefit of the child and all unexpended income and corpus is required to be paid to the child at age 21 (or to the child's estate if the child dies before reaching age 21). Indeed, the income and corpus need not actually be paid to the child at age 21, if the child has a power to demand payment at that time or to extend the trust.[19]

All of the states have enacted some version of the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), which authorize gifts of stocks, bonds, and other property to be made to a minor donee in custodianship form. The Service has ruled that gifts made pursuant to such statutes will qualify for the annual exclusion.[20]

[19] Reg. Section 25.2503-4.
[20] Rev. Rul. 59-357, 1959-2 C.B. 212.

The terminable interest rule in the gift tax marital deduction is broader than its counterpart in the estate tax, reflecting the possibility that the donor may retain an interest or a power with respect to property transferred during life. In particular, the statute disallows the marital deduction for a transfer if the donee spouse receives a terminable interest and the donor retains an interest or a power that may ripen into possession or enjoyment at the termination of the spouse's interest.[21]

G. Split Gifts

IRC Section 2513 contains a split-gift provision designed to give spouses in a separate property setting much the same gift tax treatment as that afforded by community property laws to a gift made by both spouses to a third person. Since each spouse is deemed to have an equal, present, vested interest in community property, a gift of such property by spouses to their child, for example, would be treated as a gift of half the property by each spouse. Accordingly, two annual exclusions and two unified credits would be available to offset the gift tax. In the absence of Section 2513, a gift by one spouse of his or her separate property would be eligible for only one annual exclusion and one unified credit.

To allow similar tax treatment for gifts of separate property, Section 2513 provides that a gift by either a husband or a wife to a third person shall be considered as made one-half by each spouse if both spouses consent to such gift-splitting treatment for all gifts made during the calendar year by either spouse while married to the other.

A gift-splitting election under Section 2513 does not amount to a joint gift tax return filed by the spouses, nor does it enable either spouse to apply the other spouse's unified credit to offset the tax on his or her own taxable gifts.

H. Unification of the Estate Tax and Gift Tax

In 1976, Congress abolished the separate estate and gift tax rate schedules and replaced them with a unified rate schedule which is set forth in IRC Section 2001(c) for estate tax purposes and is adopted by reference in IRC Section 2502(a) for gift tax purposes. Concurrently, Congress abolished the separate estate and gift tax exemptions and replaced them with a unified credit which is found in IRC Section 2010 and 2505. As its name implies, the unified credit functions as a single, cumulative allowance against both the estate and gift taxes, even though the estate and gift tax components are set forth in separate statutory provisions.

Section 2505 provides a credit against the gift tax imposed by Section 2501 for each calendar year in an amount equal to the applicable credit amount in effect for such calendar year less the sum of the credits previously allowed under Section 2505. The "applicable credit amount" is defined in Section 2010(c) as the amount of tax that would be computed under the unified rate schedule of Section 2001(c) with respect to a transfer

[21] IRC Section 2523(b).

of the applicable exclusion amount. The "applicable exclusion amount" generally is the same as the basic exclusion amount ($10 million in 2018), increased in some cases by a predeceased spouse's unused exclusion amount (DSUE).

The mechanics of the unified credit in the estate tax context are somewhat complicated, due to the cumulation of lifetime gifts into the estate tax base. Section 2010 allows the full unified credit (reduced only by 20% of any exemption allowed under prior law for post-September 8, 1976 gifts) to be applied against the estate tax liability, seemingly regardless of whether any or all of the available credit has already been taken against the gift tax during life. In spite of appearances, however, this does not amount to a double allowance of the credit, since the estate tax is computed under Section 2001(b) as the excess of (1) a tentative tax on the sum of the taxable estate plus taxable gifts made after 1976 other than those already includable in the gross estate), over (2) the gift tax "payable" with respect to gifts made after 1976. The unified credit is then applied against this amount. To the extent that the unified credit was used during life, the gift tax "payable" will have been reduced, resulting in a smaller offset against the tentative tax under Section 2001(b). The net result is that the unified credit will reduce the estate tax liability only to the extent that the credit was not already used against the gift tax during life.

Note the effect on the estate tax computation under Section 2001(b) of any changes in the unified rate schedule occurring between the time of a post-1976 taxable gift and the date of death. In determining the amount of the offset against the tentative estate tax under Section 2001(b)(2), the gift tax "payable" with respect to a post-1976 gift is computed as if the rate schedule in effect at the date of death had been applicable at the time of the gift. This method of computation allows a consistent application of the estate tax rate schedule to a cumulative base including post-1976 taxable gifts, and avoids giving retroactive effect to interim rate changes.

The exemption equivalent or basic exclusion amount of $10 million in 2018 corresponds to a unified credit of $4,769,800. In other words, $4,769,800 is the amount of tax computed under the unified rate schedule with respect to a taxable transfer of $10 million, and that tax is completely offset by the credit. To the extent that the unified credit is used against the gift tax during life, there will be a corresponding reduction in the available exemption equivalent remaining at death. The $10 million basic exclusion amount is indexed for inflation.

I. The Generation-Skipping Transfer (GST) Tax

In 1976, Congress introduced for the first time a tax on generation-skipping transfers, to supplement the estate and gift taxes. Under prior law it was possible for a transferor to avoid estate and gift taxes by creating trusts that spread the beneficial enjoyment of property temporally across several generations. For example, a trust to pay income to the grantor's child for life, with remainder to grandchildren, gave the child the immediate use and enjoyment of the property, but occasioned no additional estate tax on the corpus when the property passed to the grandchildren. Consequently the property,

although taxed in the estate of the original grantor, could be passed through one (or more) succeeding generations with no further estate or gift tax liability. The generation-skipping provisions enacted in 1976 closed this opportunity for tax avoidance by taxing the entire property as though it had passed through the estate of the skipped generation (the grantor's child, in the example above). However, those provisions were flawed by administrative complexity and other shortcomings, and they were eventually replaced in 1986 by an entirely new generation-skip-ping transfer (GST) tax.

To be subject to tax, a transfer must fit within one of the three defined types of generation-skipping transfers: (1) a "direct skip" (a transfer, either outright or in trust, that is subject to estate or gift tax and is made to a skip person); (2) a "taxable distribution" (a distribution of trust income or corpus to a skip person); or (3) a "taxable termination" (a shift to a skip person of the beneficial enjoyment of property held in trust). For example, a gift or bequest from a grandparent to a grandchild is a direct skip. If the grandparent creates a trust to pay income to a child for life with remainder to a grandchild, a distribution of trust income or corpus to the grandchild during the child's life is a taxable distribution; at the child's death, a taxable termination will occur with respect to any property remaining in the trust.[22]

The GST tax is aimed at removing incentives to make gifts and bequests to persons more than one generation removed from the transferor in a manner that avoids estate and gift taxation of the transferred property in the intervening generations.

Though closely linked to the estate and gift taxes, the GST tax operates separately from--and in important respects differently from--those taxes. The GST tax is a flat tax; its rate is fixed for all taxpayers at the highest marginal estate tax rate (40% in 2022).[23] Unlike the estate and gift taxes, the GST tax does not make use of the unified credit. Instead, each transferor is allowed a special exemption which shelters up to $10 million (indexed for inflation to $12.06 million in 2022) of property transferred either in the form of direct skips or in generation-skipping trusts having skip persons as beneficiaries.[24]

Many lifetime transfers that are excluded from gift tax under IRC Section 2503 are also exempt from GST tax. For example, a grandparent can make direct payments for a grandchild's tuition or medical care without incurring any GST tax if the payments come within the gift tax exclusion of Section 2503(e). Finally, transfers to individuals more than two generations removed from the transferor are subject to only one application of the GST tax. In this regard, a transferor pays the same tax on a direct skip to a great-grandchild as on a direct skip to a grandchild.

The revised GST tax enacted in 1986 generally applies to transfers made after October 22, 1986, but this general rule is subject to some rather significant exceptions.[25]

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[22] See IRC Section 2612.
[23] See IRC Section 2641.
[24] See IRC Section 2631.
[25] See Tax Reform Act of 1986, P.L. 99-514, Section 1433(b); Reg. Section 26.2601-1.

J. Portability of Exemption

Portability was introduced in 2011 and allows for the transferring of a decedent's unused exclusion amount to his or her surviving spouse under IRC Sec. 2010(c). Before portability, estate planning typically implemented an estate plan that combined two separate bequests by the first spouse to die -one using the applicable exclusion amount (typically a bypass trust) and the other the unlimited marital deduction (This is considered A-B trust planning). Using this combination of a marital deduction bequest with a bypass trust, the applicable exclusion amount of the first spouse to die could be preserved for the benefit of his or her children (or others), and no federal estate tax was due until the death of the surviving spouse.

With portability the executor of the deceased spouse may elect to transfer the deceased spouse's unused exclusion amount (DSUE) to the surviving spouse. If the election is made, any or all of the basic exclusion amount ($12.06 million for 2022) not used by the decedent's estate can be transferred to his or her surviving spouse. The surviving spouse can use this amount, in addition to his or her own basic exclusion amount, for lifetime gifts or transfers at death.

If a DSUE has been transferred to a surviving spouse, and the surviving spouse remarries, followed by a divorce, the DSUE from the first marriage will be preserved.[26] In other words, the last such deceased spouse does not necessarily mean the last spouse.

The decision of whether to elect portability and/or use a bypass trust depends on many factors, including the anticipated appreciation of the assets owned by the surviving spouse, the type of assets held by the deceased spouse, and the surviving spouse's life expectancy. Ultimately, the planner must compare the benefits of portability, such as simplification, with the advantages of using a bypass trust, such as the certainty of minimizing estate taxes if tax laws change or the couple suddenly has a significant increase in wealth.

Furthermore, the effect on the beneficiary's interest under a decedent's overall estate plan should be considered, such as the ability of the deceased spouse or surviving spouse to qualify for other preferential provisions.[27]

When the Portability Election May Be Beneficial. The portability election is available and may be beneficial, regardless of the size of the estate, to save the basic exclusion amount of the first spouse to die that otherwise would have been wasted. For example, a decedent who died in 2022 with a $10 million estate in 2022, all left to children, has $2.06 million of exclusion that is portable. Similarly, a decedent with a $20 million estate, who leaves $10 million to his or her children and $10 million to his or her spouse and charity,

[26] Reg. 20.2010-3(a)(3).

[27] IRC Sec. 303 (stock redemption to pay death taxes and administration expenses); IRC Sec. 2032 (alternate valuation); IRC Sec. 2032A (special-use valuation to value real property used in a business or farming activity); or IRC Sec. 6166 (deferred payment of estate taxes attributable to a closely held business interest).

also has $2.06 million of exclusion that is portable. There will also be specific situations where the nature of the decedent's assets or other factors make the portability election attractive.

The portability provisions simplify estate planning (i.e., so that more complex planning techniques, such as the creation of a bypass trust or naming a trust as the beneficiary of the decedent's IRA, will not be necessary to preserve the first spouse-to-die's unused exclusion amount). This is a significant benefit for couples with widely disparate levels of wealth--it eliminates the need for retitling of assets to fully use each of their basic exclusion amounts. Even if one spouse has most of the couple's wealth, portability permits both spouses to maximize their basic exclusion amounts, regardless of who is the first to die.

If the wealthier spouse is the first to die, all of his or her assets can pass to a QTIP marital trust for the less wealthy spouse. If the executor elects portability, all of the assets will be included in the estate of the less wealthy surviving spouse and both basic exclusion amounts will be available to the surviving spouse. In addition, by planning to use a QTIP trust, the wealthier spouse will be able to control the ultimate disposition of the assets while qualifying for the marital deduction.

Portability has the advantage of giving the surviving spouse's assets a full step-up in basis at his or her death. The assets owned by the first-to-die spouse will receive a step-up in basis at his or her death. If these assets are left to the surviving spouse, with any DUE also transferred to the surviving spouse, this property will receive a second step-up in basis at the surviving spouse's death with the additional exclusion amount available to shelter the increased value from estate tax. In contrast, a bypass trust would not generally be included in the surviving spouse's estate and therefore would not receive a step-up in basis at his or her death.

Because there is no portability of the generation-skipping transfer (GST) tax exemption, a couple who wants to maximize the amount of property held in long-term trusts for descendants should use QTIP or bypass trust planning so that the GST tax exemption of the first spouse to die can be allocated.

III. Proposed Laws by the Biden Administration

Legislation affecting estate and gift taxes is anything but static. Each year laws are proposed that have the ability to move the pendulum one way or the other in terms of impacting wealthier taxpayers. Estate and gift tax laws are easy targets for legislators looking to weild for such purposes. The following are some of the legislative proposals by the current Administration as issued in its Fiscal Year 2023 Budget which pertain to estate and gift techniques addressed in this paper.

A. Proposal #1 - Treat transfers of appreciated property by gift or on death as realization events

Under this proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer, whether during lifetime or at death. The amount of the gain realized would be the excess of the asset's fair market value on the date of the gift or on decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the decedent on the federal gift or estate tax return or on a separate capital gains return. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate.

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years.

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply. First, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business. Second, transfers of property into, and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee. The deemed owner of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, not including distributions made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

Certain exclusions would apply. Transfers to a U.S. spouse or to charity would carry over the basis of the donor or decedent. Capital gain would not be realized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would be exempt from capital gains tax. The transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

The proposal would exclude from recognition any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on a principal

residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple. Finally, the exclusion under current law for capital gain on certain small business stock would also apply.

In addition to the above exclusions, the proposal would allow a $5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift. In addition, the proposal would allow any remaining portion of the $5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (resulting in a married couple having an aggregate $10 million exclusion) and would be indexed for inflation after 2022. The recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death.

The proposal also includes several deferral elections. Taxpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated. Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made. The IRS would be authorized to require security at any time when IRS perceives a reasonable need for security to continue this deferral. That security could be provided from any person, and in any form, deemed acceptable by the IRS.

B. Proposal #2 – Eliminate Certain Grantor Retained Annuity Trusts

The proposal would require that the remainder interest in a GRAT at the time the interest is created have a minimum value for gift tax purposes equal to the greater of 25 percent of the value of the assets transferred to the GRAT or $500,000 (but not more than the value of the assets transferred). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the trust without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These provisions would impose some downside risk on the use of GRATs so they are less likely to be used purely for tax avoidance purposes.

C. Proposal #3 – Treat Sales to Grantor Trusts as Recognition Events and Payment of Income Taxes as Taxable Gifts

For trusts that are not fully revocable by the deemed owner, the proposal would

treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the basis of the transferred asset in the hands of the buyer being the value of the asset at the time of the transfer. Such regarded transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. However, securitization transactions would not be subject to this new provision.

The proposal also would provide that the payment of the income tax on the income of a grantor trust is a gift. That gift occurs on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid.

D. Proposal #4 – Require Consistency Between Valuation of Promissory Notes

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. In addition, the term of the note would be treated as being short term regardless of the due date, or term loans would be valued as demand loans in which the lender can require immediate payment in full, if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.

E. Proposal #5 – Limit Duration of Generation-Skipping Transfer (GST) Tax Exemption

The proposal would provide that the generation-skipping transfer (GST) tax exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust. However, section 2653 of the IRC would not apply for these purposes. In addition, solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment. The result of these proposals is that the benefit of the GST exemption that shields property from the GST tax would not last as long as the trust. Instead, it would shield the trust assets from GST tax only as long as the life of any trust beneficiary who either is no younger than the transferor's

grandchild or is a member of a younger generation but who was alive at the creation of the trust.

Specifically, this limit on the duration of the GST exemption would be achieved at the appropriate time by increasing the inclusion ratio of the trust to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b) of the IRC, each such separate trust would be subject to the same rule for the duration of the exemption, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust.[16] The other rules of section 2653 would continue to apply and would be relevant in determining when a taxable distribution or taxable termination occurs.

F. Proposal #6 – Repeal Deferral of Gain from Like-Kind Exchanges

The proposal would allow the deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind. Any gains from like-kind exchanges in excess of $500,000 (or $1 million in the case of married individuals filing a joint return) a year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

IV. Anti-Clawback Regulations

Individuals taking advantage of the temporary increase of the gift and estate tax exclusion amounts in effect from 2018 to 2025 will not be adversely impacted after 2025 when the exclusion is scheduled to be reduced to pre-2018 levels. The final anti-clawback regulations affirm that if the larger exclusion ($12.06 million in 2022) is applied to gifts made before 2026, the exclusion will not be clawed back into the estate.[28]

Example: If a client makes a $12 million gift in 2022 but dies in 2026 after the basic exclusion amount has sunsetted to $5 million, the $12 million is added into the estate tax calculation as an adjusted taxable gift, but the estate tax exclusion amount is only $6.8 million. The anti-clawback rule of Reg. 20.2010(c)(1) allows the estate to compute its estate tax credit using the higher of the basic exclusion amount (BEA) applied to gifts made during life or the BEA applicable on the date of death. Therefore, if the donor dies when the BEA is $6.8 million, the $12 million gift would be included in the estate tax calculation as an adjusted taxable gift, but the available exclusion amount would be the larger of the $6.8 million BEA at the date of death or the $12 million of BEA applied to the gifts made during life, or $12 million.

[28] Reg. 20.2010-1(c).

V. Constitutionality of Retroactive Laws

When the estate and gift taxes first appeared, taxpayers questioned the constitutionality of retroactivity presented in the statutes where the tax was levied on a transfer made before the tax was enacted. Such taxpayer objections, based on the due process clause, were successful in a few early cases.[29] More recently, however, the Supreme Court has announced a more lenient standard, requiring only "a legitimate legislative purpose furthered by rational means." [30] Accordingly, some degree of retroactivity, in the form of higher rates or slightly different technical provisions, is constitutionally permissible.[31] Sometimes difficult questions arise about which event is the key one for determining whether a new tax rule is retroactive, when some events preceded its enactment and others occurred later.[32] Many estate and gift tax legislative acts have effective dates that begin on the date the bill was introduced to Congress.

VI. Step-Up in Basis vs. Capital Gain

With an ever-changing estate tax environment, tax planning is much more complicated. All of the potential taxes (federal estate tax, state death and inheritance tax, federal and state income tax, capital gain tax, and 3.8% net investment income tax) to which each asset would be subject should be evaluated before deciding whether to give property during lifetime or hold it until death.

Holding assets until death is not the ideal strategy in every case. If the client resides in a state that has some form of estate or inheritance tax, that tax may be greater than the income tax that would be owed if the client transferred the asset in his or her lifetime. Therefore, it is important to compare the potential state death or inheritance tax with the potential income tax to both the client and beneficiary.

If the client will be subject to estate tax, the transfer tax rate (i.e., adjusted gifts are included in the donor's estate at death) is higher than the combined federal and state capital gains rate (in states that impose income taxes). If the client will not be subject to estate tax, the appreciated assets will lose their eligibility for the step-up in basis. However, taxable gifts (i.e., those that use a portion of the applicable exclusion amount) may make sense for clients who reside in states with a high death tax rate and a lower applicable exclusion amount than the federal amount (e.g., Washington, New York, and Pennsylvania). In these situations, the client may consider gifting the excess value over the state estate exclusion amount (sometimes referred to as the gap share) to avoid or minimize state death taxes.

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[29] See Nichols v. Coolidge, 274 U.S. 531 (1927) (estate tax); Untermyer v. Anderson, 276 U.S. 440 (1928) (gift tax).
[30] United States v. Carlton, 512 U.S. 26 (1994).
[31] See Milliken v. United States, 283 U.S. 15 (1931); NationsBank of Texas, N.A. v. United States, 269 F.3d 1332 (Fed.Cir 2001), cert. den., 537 U.S. 813 (2002).
[32] See United States v. Jacobs, 306 U.S. 363 (1939); United States v. Irvine, 511 U.S. 224 (1994).

Because they benefit from the potential step-up in basis when the client dies and can minimize future income and capital gains taxes, the ideal assets to be included in the client's estate are appreciated investments (or those that are likely to appreciate and his or her personal residence). Assets that are subject to a 28% maximum capital gains tax, such as appreciated art and collectibles, are likely to save taxes by being held in the client's estate. Any patents, trademarks, and copyrights created by the client are also likely to be better held in the estate because the tax basis of these assets is typically zero. A beneficiary who inherits these assets may be able to receive a stepped-up basis.

The ideal assets to transfer during the client's lifetime are those that do not benefit from a step-up in basis, even if the value has increased. Cash, variable annuities, and qualified retirement plans (including IRAs and 401(k) plans) do not receive an increased basis after the owner's death. For annuities and retirement plans, the client may save future federal estate and state death taxes by receiving distributions during life and paying the income taxes currently. Legacy assets (those that are likely to be held by heirs long after a client's death may also be ideal for lifetime transfers because the potential capital gains tax would not be recognized for many years. However, if the legacy assets have appreciated significantly since the client acquired them, it may be preferable for the client to hold them until death so they can be eligible for the future step-up in basis.

VII. Tax Inclusivity vs. Tax Exclusivity

For transfer tax purposes, it may be desirable for wealthy taxpayers who can afford it to make substantial lifetime gifts, even if those gifts will be taxable when made.

One advantage of making lifetime gifts is that the "tax-exclusive" gift tax base includes only the value of the transferred property (net of tax on the transfer), while the "tax-inclusive" estate tax base includes the entire value of property transferred at death (including any funds used to pay the tax). In addition, if a donor makes a gift more than three years before death, the amount of the resulting gift tax will never be subject to transfer tax. If the gift is made within three years of death, the amount of the gift tax will be subject to the gross-up provision of Section 2035(b). Otherwise, the gift tax will not be subject to estate tax, because it either will already have been paid or will be deductible as a claim against the estate. This difference may seem inconsequential in small estates, but it becomes significant in very large estates. For example, assuming a flat 40% tax rate, a person starting with $28 million can make a $20 million gift and pay the resulting gift tax of $8 million. In contrast, a transfer of $28 million at death will incur an estate tax of $11.2 million, leaving only $16.8 million for the recipients after tax. Thus, the transferor can save $3.2 million simply by making the transfer during life instead of at death.

VIII. Techniques for Transferring Assets Without Any Remaining Exemption

A. The Not-So-Old Ways are Still In (For Now)

As the saying goes, there's nothing new under the sun.[33] So it is with estate and gift tax planning (mostly). Techniques are packaged and repackaged by attorneys and advisors, but in many regards such planning is the same as used before, or with refinements based on changes in the law. The following are techniques are no different. These techniques have been used for decades but they have been refined through the years and consolidated in this paper.

B. A Word About Other Laws, Rules, and Regulations

It is worth mentioning that attorneys and advisors considering the planning techniques outlined in this paper should also me mindful of laws, rules, and regulations that may apply to the design, execution, and implementation of any or all of these techniques, including, but not limited to: the reciprocal trust doctrine, the step-transaction doctrine, audit risk and uncertainty, the fraudulent transfer rule, informed consent of the client and proper explanation of risks, and applicable ethical standards. Such topics are beyond the scope of this paper, but should be weighed and possibly analyzed as part of any client's planning.

C. Sale in exchange for a Promissory Note to Trusts for Descendants

Intrafamily sales of property on the installment basis offer a number of advantages for estate planning, but also contain some dangerous traps. This discussion focuses on the estate and gift planning aspects of these transactions. Income tax considerations can be significant and are addressed in this discussion; however, complete coverage of the income tax aspects of installment sales is beyond the scope of this paper.

In a low interest rate environment, intrafamily installment sales could be particularly attractive for clients who are not concerned about the cash flow received from the sale, but would like to sell property on a note at favorable interest rates to the younger generation.

Intrafamily installment sales of property offer a variety of practical as well as tax benefits. When the parties to the sale are related, greater flexibility can be achieved with regard to the amount and timing of payments, prepayment options, and other terms, taking into account the seller's cash flow requirements and the buyer's ability to service the debt.

Before considering an installment sale, the income tax treatment of the sale should be considered. Previously, planners have been more concerned with lowering the taxable estate. However, with the increased estate and gift tax basic exclusion amount ($12.06

[33] Ecclesiastes 1:9.

million for 2022), there is now a greater emphasis on reducing the individual's income tax consequences and the 3.8% net investment income tax.

A wealth transfer planning technique that has evolved over the years is an installment sale to an irrevocable grantor trust.

Losses on direct or indirect sales or exchanges of property between related parties are disallowed for income tax purposes.[34] This is to prevent taxpayers from manipulating loss recognition for tax purposes when an economic loss has not actually been realized. The disallowance rules apply to any related-party sale or exchange, including involuntary sales, even if the sale is bona fide and the terms are determined on a fair market basis. Nonrecognition on related party sales does not extend to gains.

In addition to having potential capital gains converted into ordinary income, sales of depreciable property between certain related persons are not eligible for the installment method.[35] The entire amount of the installment note is deemed received in the year of the sale (unless part or all of the payments are contingent as to amount, and their FMV cannot be reasonably ascertained). Further, the purchaser cannot increase the basis of the property until the income has been reported by the seller.

An exception to the gain recognition requirement allows installment reporting if the taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes.[36] Lack of a significant tax deferral is useful in establishing that tax avoidance was not the principal purpose of the transaction.

Because they are not conducted at arm's length, transactions between related parties often come under IRS scrutiny. If the amounts involved in the transaction do not represent fair market values, the IRS can recharacterize a transaction to reflect its actual substance, regardless of its form (Rev. Rul. 68-430). IRC Sec. 482 empowers the IRS to allocate gross income, deductions, credits, or allowances between organizations, trades, or businesses that are directly or indirectly controlled by the same interests.

If property is sold at fair market value, and the terms reflect current market factors, an installment sale of property to a family member should not result in a taxable gift. However, a gift will occur when the sales price is less than fair market value. The amount by which the value of the property sold exceeded the value of the consideration received by the seller is a gift for gift tax purposes.[37]

If the installment note has a low rate of interest or no interest at all, the Section 7872 imputed interest rules may apply, resulting in a taxable gift. It is uncertain whether an interest rate based on the IRS's applicable federal rate (AFR) will avoid this problem.

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[34] IRC Sec. 267(a).
[35] IRC Sec. 453(g).
[36] IRC Sec. 453(g)(2).
[37] IRC Sec. 2512(b).

While doubt remains as to what happens if the market rate exceeds the Section 7872 rate, commentators believe that the latter rate may be used. Most planners use the higher of the Section 7520 rate or the AFR for the actual term of the note.

Because the rates under IRC Sec. 7872 are published monthly, the note could be structured where the rate and term can be renegotiated to take advantage of changing interest rates. Additionally, the long term rate in recent years has been low, making an installment sale an attractive transaction. Because the long term rate is currently low but is expected to rise, a short-term note can be used and renegotiated later when rates increase.

If the seller is a trust and the buyer is a beneficiary of the trust, any bargain element may be deemed to be a disguised distribution. Such a recharacterization may cause current or accumulated trust income to be taxable to the beneficiary.

If the trust purchases property from a beneficiary for less than fair market value, the beneficiary is deemed to have made a gift to other beneficiaries of the trust. This would make the donor/beneficiary a transferor to the trust and for federal estate tax purposes could cause gross estate inclusion of the property under IRC Sec. 2036, 2037, or 2038 on the death of the beneficiary. If the property was included in the beneficiary's estate because of one of these sections, only the excess of the date-of-death fair market value of the property over the consideration received by the beneficiary would be includable.[38] The transfer is not deemed full and adequate consideration under IRC Sec. 2043(a).

The seller may forgive part or all of the installment payments as they come due. For gift tax, a forgiveness should be eligible for the annual gift tax exclusion under IRC Sec. 2503(b). However, the gain on forgiven installments is still taxed (for income tax purposes) to the seller under IRC Sec. 453.

When a decedent sold property on the installment method during his or her lifetime, the estate or the person entitled to receive the installment sale income by bequest or inheritance from him or her recognizes income as it is collected, using the same gross profit percentage as the decedent would have if he or she had lived and received the payments [Reg. 1.691 (a)-5]. Transferring a predeath installment note at death usually is not an installment obligation disposition that would accelerate gain recognition.[39]

1. Income In Respect of a Decedent (IRD)

The unrecognized gain (the excess of the face amount of the note over its basis) is considered income in respect of a decedent (IRD). IRD classification causes the unrecognized gain to be subject to both income and estate tax. The double taxation is partially mitigated by the Section 691 (c) income tax deduction of estate tax attributable to IRD. The gain is subject to income tax as the proceeds are collected by the person entitled to receive them. Estate tax results from inclusion of the fair market value of the

[38] IRC Sec. 2043(a).
[39] IRC Sec. 453B(c).

note in the gross estate. The fair market value includes the amount of unpaid principal plus interest accrued to the date-of-death unless the executor can establish the note is worth less because of a below-market interest rate, inadequacy of security, extended payout term, or collectability problems.[40]

Cancellation of the note due to death triggers the recognition of the IRD.[41] (Cancellation includes any situation where the note becomes unenforceable.) Furthermore, if the buyer and seller are related, the face amount of the note is deemed to be its fair market value.

Certain transactions will accelerate the recognition of the unrecognized gain. When an item of IRD is transferred for reasons other than the decedent's death, the IRD is recognized at the time of the transfer. Transfers for this purpose include sales, exchanges, gifts, or other dispositions. If the right to receive IRD is distributed to a beneficiary in satisfaction of a pecuniary bequest, accelerated gain recognition is triggered.

D. Self-Cancelling Installment Notes (SCINs)

One estate planning strategy to remove an asset, and its potential appreciation, from an estate using intrafamily installment sales calls for the note to be canceled when the seller dies. A variation of this strategy calls for a sale of closely held corporate stock back to the closely held corporation (i.e., redemption) for an installment note that is cancelled at the former shareholder's death. Such arrangements are often referred to as self-canceling installment notes, or SCINs. Assuming the sale has been made for adequate consideration, the value of the note is not included in the seller's gross estate for estate tax purposes because no asset is transferred to another person as a result of the seller's death.

The primary objective of a SCIN is to convert property subject to estate tax at full value to property that is only partially taxable (the deferred gain portion) at potentially lower income tax rates (preferably at capital gain rates). If the seller desires to transfer the asset prior to death and needs to receive some consideration in return, the SCIN is an attractive technique to meet these objectives. In addition, a transfer of property in exchange for a SCIN will not be subject to gift taxes. Therefore, individuals can use it as a vehicle for making lifetime transfers in excess of the basic exclusion amount ($12.06 million in 2022) for gift tax purposes. However, with SCINs, the federal and state income tax rates should also be considered because the estate must recognize any unrecognized gain on cancellation of the installment obligation at the seller's death.[42]

Properly structuring the SCIN is imperative if the desired estate tax results are to be achieved. Transfers between family members are presumed to be gifts; therefore, if the transaction is to be a sale, all the required formalities must be followed. For a sale to

[40] Reg. 20.2031-4.
[41] IRC Sec. 691(a)(5).
[42] IRC Sec. 691 (a)(5).

exist, the fair market value (FMV) of the consideration received by the seller must equal the FMV of the property being sold; therefore, the present value of the SCIN must equal the value of the property being sold. Several key items must be addressed when structuring a sale with a SCIN to establish there is a bona fide debt: (a) documenting the seller's health status and the reasonableness of the seller surviving the term of the note, (b) the reasonableness of the interest rate used and the valuation of the property being sold, (c) the purchaser's ability to repay the debt, and (d) complying with all the payment terms and enforcing the seller's rights in the event of noncompliance. When setting the term, the note should not extend beyond what the actuarial tables show as the life expectancy of the seller. Failure to follow these rules can result in either the value of the property being included in the gross estate as a retained interest transfer or an increase in adjusted taxable gifts to reflect the bargain sale element of the transaction.

The IRS is likely to scrutinize SCIN transactions if the decedent had health issues or dies soon after the SCIN transaction.[43] Additionally, the settlement in 2015 between the IRS and the Davidson Estate was largely in favor of the taxpayer but lacked the long-awaited guidance on valuing SCINs, making it difficult to rely on past approaches when planning for current or future SCINs. The IRS had argued in the Davidson case that the SCIN should not be valued using the Section 7520 rate when death is imminent and that the risk premium associated with SCINs must be based on a willing buyer/seller test that accounts for the medical history and health of the seller on the date of the sale rather than simply relying on the IRS published mortality tables and rates.

1. Risk Premium Feature

To meet the adequate consideration of the sale requirement, the cancellation feature must be a part of the note rather than a provision in the seller's will, and the sale must be structured to include a risk premium to compensate the seller for assuming the risk that he or she might die before the note is paid in full. Such a risk premium usually takes the form of a higher-than-normal interest rate or a higher sales price (or both), and, in any event, should be reasonable and supportable in the event of IRS challenge. The authors suggest that an enrolled actuary be retained to determine the reasonableness of the risk premium. It should be the result of arm's-length bargaining, and the trade-off between a higher purchase price or a higher interest rate will impact the parties' income tax positions (ordinary income versus capital gain).

Some experts recommend paying the entire risk premium with the first installment payment to minimize the amount of risk (which theoretically would increase over time as the seller ages) and therefore the amount of the premium. However, this strategy reduces the effectiveness of the technique by transferring assets (cash) to the seller. In addition, the seller's actuarial life expectancy must exceed the term of the note at the time the sale is consummated or the transaction will be a private annuity.[44] SCINs may be a useful tool when the seller's actual life expectancy is less than the actuarial life expectancy, causing value to effectively disappear although this strategy may not work if death is clearly

[43] CCA 201330033.
[44] GCM 39503.

imminent). The risk to using a SCIN is that the seller may outlive the term of the note, and because of the risk premium, the seller's estate could be larger than it otherwise would have been.

To help combat an IRS challenge, it may help to obtain a written medical opinion that the client is in good health when making the SCIN transaction.

If the note is canceled at the decedent's death under the terms of a SCIN, a taxable event occurs for income tax purposes.[45] The IRS has taken the position that the cancellation or transfer results in immediate recognition of gain by the estate in the amount of the previously unrecognized installment sale income.[46] In addition, the 8th Circuit held that the gain is reported on the estate's income tax return rather than the decedent's final individual income tax return.

Example: Self-canceling installment obligations.

> Clyde Smith sold the stock in his closely held business to his son Billy several years ago, accepting a cash downpayment and a 15-year installment note. The sales agreement and the installment note provided that all sums due on the note were automatically canceled when Clyde dies. Clyde's life expectancy at the time of the sale was longer than 15 years, and the terms included a risk premium to compensate him for the cancellation feature. He reported the gain on the sale using the installment method. At the time of Clyde's death, the unrecognized installment sale income was $100,000. Clyde's death canceled the installment obligation with six years of payments outstanding.

If the seller has sufficient capital loss carryovers, he or she can elect out of the installment sale in the year of the sale and trigger all the gain in that year, thereby avoiding future income tax issues.

The buyer's basis in the property is the purchase price (i.e., fair market value), even though there is a possibility that all payments may not be made. It is uncertain how the buyer's basis in the property purchased will be affected if the seller dies before the end of the SCIN's term. Some commentators believe the buyer's basis must be adjusted downward to reflect a cancellation of purchase money indebtedness under IRC Sec. 108(e), while others believe there is no adjustment to the buyer's basis. The installment sale rules do not address the buyer's basis in property received in exchange for a SCIN.[47] The IRS has informally ruled in a general counsel memorandum (GCM) that the buyer can include the full face value of the note as the basis of the property acquired in the transaction. No cases or revenue rulings have been issued on this issue. Because the seller's estate must report the unrecognized installment sale income, it is believed that the buyer's basis is not reduced if the seller dies prematurely.

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[45] IRC Sec. 691(a)(5).
[46] Rev. Rul. 86-72.
[47] Reg. 15a.453-1(c).

If the sale involves an interest in a pass-through entity (e.g., S corporation stock), the purchaser will be able to deduct (for income tax purposes) the interest portion of the installment payments.[48] This may be classified as business or investment interest, depending on the activities of the S corporation.[49] A similar rule should apply for the sale of a partnership interest.[50]

E. Sale in Exchange for a Private Annuity

An alternative to an installment sale is a sale of property in exchange for a private annuity. An annuity might be appropriate in cases where the property sold does not qualify for installment sale treatment, such as marketable securities. Generally, the value of annuity payments received by a decedent at the date-of-death is included in his or her gross estate.[51] However, if all rights to receive payments terminate when the annuitant dies, no "transfer at death" occurs, and nothing is included in the gross estate. If the decedent had transferred property to a trust during his or her life and retained the right to use trust property or to receive an annuity, unitrust, or other income payment from the trust, IRC Sec. 2036, rather than IRC Sec. 2039, will generally apply to cause gross estate inclusion.[52]

A private annuity involves a transfer of property in exchange for an unsecured promise to receive a stream of fixed payments for life. It is distinguished from a commercial annuity involving a contract between an individual and an insurance company. A private annuity is a valuable estate planning tool in many family transfer situations. Typically, an older-generation family member transfers an appreciating asset (e.g., closely held business) to a younger-generation family member or to a trust in exchange for the transferee's promise to make fixed, periodic payments for the remainder of the transferor's life.

F. Loans to Trusts and Descendants (and Forgiveness of Loans)

Another technique to transfer assets to family members is to make loans to descendants or to trusts for their benefits.

After standing on the sidelines of the interest-free loan controversy for a decade, Congress resolved most of the interest-free loan questions when it enacted IRC Section 7872 in 1984.

In the event of any below-market-rate (or interest-free) loan, the foregone interest is treated as a gift from the lender to the borrower. In order to eliminate income-shifting opportunities, the fore. gone interest is considered also to be interest income to the lender. IRC Section 7872(a)(1). In other words, Section 7872 creates an imaginary world in which

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[48] Temp. Reg. 1.163-8T.
[49] Ltr. Rul. 9215013.
[50] Ltr. Rule. 9037027 and 9040066; IRS Notices 88-20 and 89-35.
[51] IRC Sec. 2039.
[52] Regs. 20.2036-1(c)(1) and (2) and 20.2039-1(e).

the recipient of an interest-free loan pays "interest" to the lender and the lender transfers this "interest" back to the recipient as a gift.

Section 7872 applies to both term and demand loans. Interest is imputed at an "applicable federal rate" determined under Section 1274(d).[53] Section 7872 provides a general de minimis exception, from both its gift and income tax provisions, for gift loans between individuals not exceeding $10,000 outstanding at any one time. However, this exception does not apply if the borrower invests the loan proceeds in income-producing assets.[54]

G. Sale to an Intentionally Defective Grantor Trust (IDGT)

In order to maximize the tax transfer of a sale to a trust for a descendant, the trust can be structured as an intentionally defective grantor trust (IDGT). An IDGT is an irrevocable trust drafted to cause one or more of the grantor trust rules of IRC Secs. 671-678 to apply so that the trust income is taxed to the grantor rather than the trust. Although the trust is defective (an incomplete transfer) for income tax purposes income is taxed to the grantor), it can be effective (a complete transfer) for estate tax purposes so that the property is not included in the grantor's gross estate. If the trust is irrevocable and the grantor does not retain ownership powers that would cause the trust principal to be included in his or her estate, the value of the trust assets should not be subject to estate inclusion by the grantor. For example, if the grantor has the power to substitute assets of equivalent value or can borrow from the trust without adequate interest or security, he or she is considered the owner of the trust for income tax purposes [IRC Sec. 675(4) or 675(2)], but the trust property will generally not be included in the grantor's gross estate.

1. Restore Grantor Trust Status

If a grantor has previously turned off grantor trust status by releasing his or her powers that created the grantor trust status initially, it may be optimal for the grantor trust status to be restored. Grantor trust status can only be restored if there is a mechanism for restoring the powers previously released. One mechanism is for a trust protector named in the trust to restore such the previously released power, provided the trust agreement names a trust protector and such agreement grants the trust protector the power to restore powers to the grantor. Another mechanism for restoring grantor trust status may to modify the trust by decanting to a new trust instrument which restores the power or to modify the trust through either a non-judicial or judicial modification.[55]

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[53] IRC Section 7872(f)(2).
[54] IRC Section 7872(c)(2).
[55] What are the tax consequences of releasing or restoring grantor trust powers? Zaritsky has provided a detailed discussion of the tax consequences of releasing and restoring grantor trust powers in Tax Planning for Family Wealth Transfers: Analysis with Forms (WG&L) at 3.02[3][i][vii]. Zaritsky also surmises that the elimination of a specific power or powers would instantly terminate grantor tax status of the trust, relying on Madorin v. Commissioner, 84 T.C. 667 (1985). See Zaritsky at 3.02[3][i][ii]. Therefore, he suggests that “[i]f one wants to release a power effective for the next taxable year, one should release it effective at midnight on December 31 of the current taxable year.” Id.

H. Health and Educational Gifts

Unlimited amounts can be paid for tuition and medical expenses with no transfer tax implications (including generation-skipping transfer tax). [56] These exclusions represent excellent opportunities to transfer significant amounts to children or grandchildren.

Section 2503(e) excludes amounts paid on behalf of an individual as tuition to an educational organization described in Section 170(b)(1)(A)(ii) for the education or training of such individual, or to any person who provides medical care for such individual as payment for such care. The beneficiary need not be a dependent of the donor, nor need the educational institution be tax exempt. The exclusion does not apply where the donor gives cash to the beneficiary who then himself pays the school or doctor, or to the beneficiary to reimburse him for amounts previously paid to the school or doctor.[57]

2. Health and Education Exclusion Trust (HEET)

A health and education exclusion trust (HEET) is a type of irrevocable trust funded to pay medical and tuition expenses of skip persons (e.g., grandchildren) but to avoid a taxable distribution or termination for GST tax purposes. Such trusts do not avoid gift taxes.

For these types of trusts to work as intended, the trust cannot be a skip person (i.e., there must be at least one non-skip beneficiary included among the eligible beneficiaries at all times), otherwise, transfers to the trusts would be subject to GST tax (or the GST tax exemption would need to be allocated). Because of this requirement, a charity is often named a beneficiary.

Transfers for educational and medical expenses that qualify for the gift tax exclusion also qualify for the generation-skipping transfer (GST) tax exclusion [IRC Sec. 2611(b)]. However, unlike the gift tax exclusion for tuition and medical expenses, the GST tax exclusion also applies to transfers from trustees. A clause should be included in the trust instrument authorizing the trustee to make direct payments of tuition and medical expenses.

[56] The tuition exclusion is allowed for both full-time and part-time students, but payments must be made directly to the educational institution. However, no exclusion is allowed for books, supplies, dormitory fees, board, or similar expenses that are not direct tuition costs [Reg. 25.2503-6(b)]. The exclusion for medical expenses applies only to payments made directly to the medical care provider. Medical expenses that qualify for this exclusion are the same expenses that qualify as itemized deductions under IRC Sec. 213(d), including medical insurance.

[57] Reg. Section 25.2503-6.

I. Charitable Giving (During Lifetime and at Death) and Remainder Trusts

The Tax Reform Act of 1969 imposed significant restrictions on the availability of charitable deductions for contributions of partial interests in property. The estate and gift tax provisions are found in IRC Section 2055(e)(2) and 2522(c)(2), respectively.

These provisions were added to prevent taxpayers from obtaining deductions for the present value of interests given to charity which were calculated according to general valuation principles but often turned out to be much larger than the amount eventually received by the charity. For example, under prior law a transferor could create a trust to pay income to a private beneficiary for life, with a power in the trustee to invade corpus for the support of the income beneficiary; at the death of the beneficiary, the remaining trust property would go to charity. Under the general rules, a reduction would be allowed for the present value of the charitable remainder if that interest was presently ascertainable and substantially certain to take effect. However, the amount actually received by the charity might turn out to be much less than initially estimated, if the trust corpus were depleted through invasions for the income beneficiary or through investment policies skewed in favor of the income beneficiary.

The split-interest rules of Section 2055(e)(2) and 2522(c)(2) are highly technical. In general, these provisions deny a charitable deduction where an interest in property is transferred to charity and another interest in the same property passes to a non-charitable beneficiary (or is retained by the transferor, in the case of an inter vivos transfer).The statute then carves out exceptions for certain types of interests that can be valued relatively easily and accurately: a charitable remainder interest in trust following an annuity or a unitrust interest; a charitable remainder interest in a pooled income fund; or a charitable lead interest in the form of an annuity or a unitrust interest. (Conceptually, these provisions are quite similar to the safe harbor provisions of Section 2702 which permit certain retained interests to be valued under general valuation principles) A deduction is still allowed for the present value of a charitable interest that falls within one of the statutory exceptions, but no deduction is allowed for other interests, whether passing to charity or to private beneficiaries.

Thus, Section 2055(e)(2) disallows a deduction for a bequest of a remainder interest to charity unless it is in the form of a charitable remainder annuity trust (CRAT) or unitrust (CRUT)((described in IRC Section 664) or a pooled income fund (described in IRC Section 642(0)(5). Section 2522(c) does the same in the gift tax context. A charitable remainder trust is one which provides for payments, at least annually, to one or more non-charitable beneficiaries for life or for a term of not more than 20 years, followed by a remainder to charity. The trust must be irrevocable and must not be subject to invasion for any non-charitable beneficiary (other than the required annual payments). The value of the charitable remainder interest must be at least 10% of the net fair market value of the trust property at inception. In a charitable remainder annuity trust, the annual payments must be in the form of a fixed dollar annuity which is not less than 5% nor more than 50% of the net fair market value of the trust property at inception. In a charitable remainder unitrust, the annual payments must be in the form of a fixed percent-age--not

less than 5% nor more than 50% of the net fair market value of the trust property, valued annually. A pooled income fund is a trust fund maintained by the charitable recipient, which receives funds from a number of contributors and pays income to the contributors or their nominees or life with the remainder payable at death to the charity.

The restrictions of Section 2055(e)(2) and 2522(c)(2) in split-interest transfers do not apply to a contribution of a remainder interest in a personal residence or farm, a contribution of an undivided portion of the transferor's entire interest in property, or a qualified conservation contribution. Thus, the present value of such contributions remains eligible for the charitable deduction.

Under a special rule enacted in 1981, a work of art and the copyright thereon are treated as two separate properties. The charitable deduction is allowed for a transfer of either the work or the copyright to a Section 501(c)(3) organization (other than a private non-operating foundation), if the organization’s use of the property is related to its exempt purpose. IRC Section 2055(e)(4) and 2522(c)(3).

A CRUT will not be disqualified if an independent trustee is allowed to allocate unitrust payments among charitable and noncharitable beneficiaries. The noncharitable beneficiaries must be paid a portion of the unitrust payment each year. Additionally, the distribution to noncharitable beneficiaries must be more than a deminimis amount of the total required trust distribution (Ltr. Rul. 200813006).

A charitable rematiner trust (CRT) can provide that the noncharitable beneficiary's payments end because of a qualified contingency [IRC Sec. 664(f)]. A qualified contingency is any event or occurrence that causes the payments to end earlier than otherwise provided by the trust. For example, a grantor can provide that payments end at the noncharitable beneficiary's remarriage. However, the deduction for the charitable remainder is valued without considering the contingency [IRC Sec. 664(1)(2)].

A trust can qualify as a charitable remainder unitrust under IRC Sec. 664 if the unitrust amounts will be paid for the life of a financially disabled person [as defined at IRC Sec. 6511 (h) (2)(A)] to a separate recipient trust (i.e., the noncharitable beneficiary) that will administer these payments for the person (Rev. Rul. 2002-20. After the individual's death, the separate recipient trust must distribute any remaining assets to the decedent's estate or (after reimbursing the state for any Medicaid benefits provided to the person) as directed by the person's general power of appointment. The individual is considered to have received the unitrust amounts directly from the CRUT for purposes of IRC Sec. 664(d) (2)(A).

The grantor of a CRT can also serve as its trustee (Rev. Rul. 80-83; Ltr.Ruls. 7730015 and 9712031). This helps ensure that investments made are consistent with the grantor's goals and objectives, although the grantor (trustee) must balance this goal with the fiduciary duty owed to the charitable remainder beneficiary. However, a trust cannot qualify as a CRT if the grantor is the trustee and the trustee is allowed to allocate, or "sprinkle," income among beneficiaries. A grantor is treated as owner of the trust assets

if he or she can allocate the beneficial enjoyment of those assets [IRC Sec. 674(a)]. Therefore, if the grantor serves as trustee and has the power to sprinkle income, the trust is a grantor trust, which cannot qualify as a CRT [Regs. 1.664-2(a)(3) (il) and 1.664-3(a) (3) (i)].

If the grantor (or any related or subordinate party) is a CRUT's trustee, a qualified appraisal of the CRUT assets must be obtained annually [Reg. 1.664-1(a)(7)]. However, an independent trustee would not be required to obtain a qualified appraisal to value the assets. Therefore, it may be costly for the grantor to serve as trustee of a CRUT with difficult-to-value assets.

A CRAT makes fixed periodic payments to the noncharitable beneficiary. No additional contributions may be made to the trust after the initial contribution. Therefore, unless the principal is depleted, the beneficiary receives a known payment for the annuity's duration.

A CRUT is similar to a CRAT except the noncharitable beneficiary's periodic payment equals a fixed percentage of the FMV of trust assets, redetermined annually. A CRUT may accept additional contributions if its trust instrument defines how the additional assets affect the valuation and calculation of its unitrust payments.

Because the income interest of a charitable income trust is not a qualified annuity or unitrust amount, the grantor is not entitled to a charitable deduction for income, gift, or estate tax purposes at the time the trust is funded. It does, however, provide several benefits. The trust is structured so that the grantor is not treated as owner of the trust. Although the grantor will not be entitled to an income tax charitable deduction for the value of the income interest, he or she will not be taxed on the income of the trust under the grantor trust provisions. Instead, the trust will be entitled to a charitable deduction under IRC Sec. 642(c) for the amount of income paid to charity. This allows an individual donor to effectively avoid the percentage of AGI limitation on deducting charitable contributions (because the limitation does not apply to contributions made by nongrantor trusts). In addition, the charitable income trust is often used instead of the nongrantor type CLT because its payment to charity is limited to the trust's income. The nongrantor type CLAT and CLUT may require principal to be distributed to satisfy the guaranteed annuity payment.

Because funding this type of trust does not result in a gift tax charitable deduction to the donor for amounts transferred to the trust, it is usually set up so that the transfer is not a completed gift, and is not subject to gift tax. Typically, the donor retains certain powers, such as the power to designate a beneficiary. However, if the donor dies during the term of the trust, such retained powers may cause the full value of the property to be included in the gross estate. Therefore, the term of a charitable income trust should be set at a period not to exceed the donor's life expectancy.

An income interest in the form of a guaranteed annuity interest or a unitrust interest can be given to charity without the benefit of a trust. However, for the annuity or unitrust

interest to be deductible for estate tax purposes, such an interest must be paid by an insurance company or by an organization regularly engaged in issuing interests that quality as annuity or unitrust interests [Regs. 20.2055-2(e) (2)(vi)(c) and (vil)(c)].

A CRT provides an annual income stream to one or more noncharitable beneficiaries for a term of years or for life. At the expiration of the income interest, the remainder interest in the trust passes to charity. The grantor of an inter vivos (i.e., lifetime) charitable remainder trust receives an income and gift tax deduction in the year the property is contributed to the trust. The deduction equals the actuarial present value of the remainder interest that ultimately will pass to charity (subject to the percentage of AGI limitations). If the income interest is transferred to someone other than the donor, a taxable gift results.

3. Alternative CRUTs

The following are other acceptable periodic payment methods, referred to as "income exception methods," which will not prevent a trust from qualifying as a CRUT:

> Lesser of trust accounting income or fixed percentage without make-up (NI CRUT).
>
> Lesser of trust accounting income or fixed percentage with make-up (NIM-CRUT).
>
> Conversion from income exception method (item a or b) to STAN-CRUT (FLIP-CRUT).

Trust accounting income is determined by state law and the trust's governing instrument, which may specifically allocate certain items to trust income or to principal. However, if the trust instrument differs fundamentally from state law, it is ignored in favor of the state law.[58] For example, a trust instrument allocating ordinary dividends to trust principal generally would be superseded by state law.

Lesser of Income or Fixed Percentage without Make-up (NI-CRUT). This method limits the noncharitable beneficiary's payment to the amount of the trust's income when this amount is less than the required distribution [IRC Secs. 664(d) (2) and (d)(3)(A)].

Lesser of Income or Fixed Percentage with Make-up (NIM-CRUT). The noncharitable beneficiary receives the lesser of the trust's net income or the fixed percentage of the trust's FMV for that year. In a year when the trust's net income exceeds the fixed percentage, the excess is used to make up for past deficiencies in years when the net income was less than the fixed percentage [IRC Sec. 664(d)(2) and (d)(3)(B)].

[58] Reg. 1.643(b)-1.

Example: CRUT with a make-up provision (NIM-CRUT).

Larry transferred property worth $100,000 to a CRUT on December 31, 2020. Annual trust payments equal to the lesser of trust income or 8% of the trust's FMV, redetermined annually, are to be made to Larry's sister for life. Payment is to be made six months after the trust's annual valuation date, and the trust includes a make-up provision. The trust's remainder passes to a qualified charity.

During 2021 and 2022, trust income is $7,500 and $8,750, respectively.

The trust's assets did not change in value through the end of 2022. Because distributions were limited to trust income each year, only $7,500 was distributed for 2021. However, under the make-up provision, the trust distributes $8,500 for 2022 [$8,000 normal distribution ($100,000 FMV of assets × 8%) plus $500 to make up for the shortfall in 2021]. The undistributed $350 ($8,750 - $8,500) at the end of 2022 is added to the trust's undistributed income.

4. Donor Advised Funds (DAFs)

Donor-advised funds (DAF), also known as charitable gift funds or philanthropic funds, allow a donor to make a charitable contribution to a specific public charity or community foundation that uses the assets to establish a separate fund. The public charity or community foundation typically receives grant requests from those charities seeking distributions from the advised fund, and the donor suggests which grant requests should be honored. The donor retains the right, generally during his or her lifetime, to make recommendations for using the separate fund's income and principal. However, the donor can only make recommendations; he or she cannot make a binding directive. The fund is advised rather than directed by the donor. Also, the fund is limited to supporting the public charity's exempt purpose.

A donor-advised fund is defined as a fund or account [IRC Sec. 4966(d) (2)(A)]:

- that is separately identified by reference to contributions of a donor or donors;
- that is owned and controlled by a sponsoring organization; and
- for which a donor (or any person appointed or designated by the donor) has, or reasonably expects to have, advisory privileges as to the distribution or investment of amounts held in the fund or account by reason of the donor's status as a donor.

A sponsoring organization of a donor-advised fund is an organization that [IRC Sec. 4966(d) (1)]:

- is described in IRC Sec. 170(c) [i.e., an organization to which deductible charitable contributions may be made other than a governmental entity, and without regard to the requirement under IRC Sec. 170(c)(2)(A) that the organization be organized in the U.S.],
- is not a private foundation, and

- maintains one or more donor-advised funds.

5. Private Foundations

An individual may wish to create a private foundation during lifetime, through an irrevocable trust, nonprofit corporation, or revocable trust (i.e., a will-substitute). Alternatively, an individual can create a private foundation upon death through a provision in the will. For example, the residuary estate may benefit the surviving spouse for life, with the remainder to pass to a family foundation upon the spouse's death. Or the will may divide the residuary estate into two separate shares--one for the benefit of the testator's family and the other to fund a new foundation to be created by the estate's executor. In these situations, the estate planner should give careful consideration to the private foundation tax issues (e.g., the potential for self-dealing problems) in the administration of the estate. Alternatively, an individual may prefer the simplicity and ease of contributing to a donor-advised fund, in addition to the lower start-up and administrative costs. The advantages and disadvantages of each are discussed in this section.

A private foundation is a Section 501(c)(3) domestic or foreign exempt organization created by a will or lifetime contribution, other than certain organizations listed in IRC Sec. 509(a), such as public charities. A private foundation may be created either as a corporation or a trust.

A private foundation may be a nonoperating (i.e., grant-making) foundation or an operating foundation. A private nonoperating foundation does not engage in a charitable activity itself, but accumulates and disburses funds for charitable purposes. By contrast, operating foundations (e.g., certain museums) use their funds in their own charitable activity, including purchasing and maintaining assets. Usually, individual donors establish nonoperating foundations. This discussion is limited to nonoperating foundations.

The foundation's assets must be used for religious, charitable, literary, scientific, and educational purposes, preventing cruelty to children or animals, or fostering amateur sports competition (other than providing athletic facilities or equipment).[59] A private foundation can also contribute to governmental entities described in IRC Sec. 170(c)(1).[60]

A private foundation is not limited to making public charity donations. It can, under certain circumstances, make grants to individuals or other private foundations. However, grants to individuals can only be made using a selection process approved by the IRS. If a foundation makes grants to other private foundations, it accepts expenditure responsibility (i.e., overseeing the recipient organization's use of those funds and taking all reasonable actions to ensure that the funds are expended for the intended purpose). To avoid that responsibility, a private foundation's bylaws or governing instrument can specify that the foundation will only contribute to publicly supported charities.

[59] IRC Secs. 170(c)(2)(B) and 4942(g)(1).
[60] Reg. 53.4942(a) -3(a) (2).

The donor (or executor or trustee) deducts contributions to the foundation when made. The foundation can hold those funds for a substantial period before distributing them. The foundation is required to distribute only 5% of its net asset value, redetermined annually. Often, the donor is a foundation officer who controls the investment and charitable distribution of those assets.

A private foundation does not pay regular income tax, but is subject to a 1.39% excise tax on net investment income. Private foundations are also subject to tax on unrelated business taxable income (like IRAs) and to penalty taxes for certain activities.

Before recommending a private foundation, the planner should inform the client about the following:

- Organization and Operating Expenses. The donor will incur costs to organize and operate a private foundation. Usually, professional fees are incurred to draft the organizational document, ensure that all state filing requirements are met, file the application for exemption from federal income tax (Form 1023 or Form 1023-EZ), maintain accounting records, and prepare annual tax returns (Form 990-PF). The expenses vary depending on the foundation's size and complexity.
- Limited Income Tax Deduction. The annual limit on the income tax deduction for donations to private nonoperating foundations is 20% of adjusted gross income (AGI), compared to 50% (60% if cash; 100% if cash for 2021 under the Taxpayer Certainty and Disaster Tax Relief Act of 2020) for most other charitable contributions.
- Penalty Taxes. The activities subject to excise tax include failure to distribute the minimum amount, self-dealing, having excess business holdings, making investments that jeopardize the organization’s charitable purpose, and making certain expenditures. The rules for determining whether the foundation has engaged in any of these activities place an extra burden on the foundation manager to ensure compliance.
- Records Subject to Public Inspection. A private foundation's annual tax returns (Form 990-PF) and supporting documents, including names and addresses of contributors, must be available for public inspection.
- Administration. Many individuals do not realize the administrative time required to comply with the various rules for reporting foundation activities. Likewise, the individual may not fully understand the complexity of the restrictions placed upon disqualified persons.

Contributions to a private foundation are deductible for income tax as a charitable contribution, limited to a percentage of the individual's adjusted gross income (AGI. In some instances, the income tax deduction is limited to the lesser of the donor's basis or the property's FMV. An income tax charitable deduction is available for income earned by an estate that is, pursuant to the terms of the will, paid or permanently set aside for charitable purposes.[61]

[61] IRC Sec. 642(c).

The charitable deduction for federal estate tax, most state death taxes, and gift tax is the full FMV of the property transferred. There are no limitations on federal estate or gift taxes deductions based on the type of recipient (e.g., private nonoperating foundation), or the type or percentage of property transferred.

J. Qualified Disclaimers

A disclaimer or renunciation of an interest in property may constitute an indirect transfer, as when a beneficiary refuses to accept his or her share in an estate or a trust and thereby enlarges the share of the other beneficiaries. Never. theless, if the requisite formalities are observed, a disclaimer may escape being treated as a transfer for purposes of state property law: The disclaimed interest will be deemed to pass directly from the original owner to the ultimate recipient, without ever passing through the hands of the disclaimant. In some early cases, the courts looked solely to state law in deciding whether to afford similar treatment to disclaimers for federal gift tax purposes. If the disclaimer prevented any interest from vesting in the disclaimant under state law, there was no taxable gift; but if the interest was deemed to reach the ultimate recipient as the result of a transfer by the disclaimant, the gift tax was applicable. See Brown v. Routzahn, 63 F.2d 914 (6th Cir 1938), cert. den., 290 U.S. 641 (1933); Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir: 1952), cert. den., 344 U.S. 836 (1952). The regulations now provide that, if the disclaimed interest was created by a transfer before 1977, the disclaimer escapes gift tax only if it is effective under state law and is made "within a reasonable time after knowledge of the existence of the transfer." Reg. Section 25.2511-1(c). Thus, for example, a trust beneficiary's disclaimer of his contingent remainder interest, made shortly before the death of the life beneficiary and 33 years after the creation of the trust, though valid under state law, was held to be a taxable gift.[62]

IRC Section 2518 was enacted in 1976 to provide definitive and uniform federal transfer tax rules concerning disclaimers. This provision applies to any disclaimer of an interest created by a transfer after 1976. If a person makes a "qualified disclaimer" (as defined in Section 2518(b)) of an interest in property, the gift tax applies "as if the interest had never been transferred to such person." IR.C. Section 2518(a). Accordingly, for gift tax purposes the disclaimed interest is deemed to pass directly from the original transferor to the ultimate recipient. The effects of a qualified disclaimer extend also to the estate tax and the GST tax. IRC Section 2046 and 2654(c). Section 2518(b) defines a qualified disclaimer as "an irrevocable and unqualified refusal by a person to accept an interest in property," made in writing. The refusal must be made within nine months from the date of the "transfer" creating the interest, or from the date on which the disclaimant reaches the age of 21, whichever is later. See IRC Section 2518(b)(2); Reg. Section 25.2518-2(c).

Two additional conditions must be met, and they introduce considerable complexity into the operation of the disclaimer provisions. First, Section 2518(b)(3) states that the disclaimant must not have accepted the interest or "any of its benefits." In general,

[62] Jewett v. Commissioner, 455 U.S. 305 (1982).

acceptance of one interest does not preclude a disclaimer of other separate interests created by the original transferor in the same property, but acceptance of any consideration for making a disclaimer is treated as an acceptance of the entire interest disclaimed. Reg. Section 25.2518-2(d). Partial disclaimers are allowed with respect to an "undivided portion" of an interest, including a portion consisting of severable property or a pecuniary amount, if all the other statutory requirements are met. I.R.C Section 2518(c)(1); Reg. Section 25.2518-3. Second Section 2518(b)(4) requires that the disclaimed interest must pass to the original transferor's spouse or to some person other than the disclaimant, without any direction on the part of the disclaimant. This means that the disclaimer must also be valid under state law. Thus, Section 2518 does not operate as a uniform federal disclaimer rule pure and simple, but rather as a set of federal requirements superimposed on the disparate rules already in existence under state law.

Section 2518(c)(3) was enacted in 1981 to provide a purely federal disclaimer rule. This provision dispenses with the "pass without direction" requirement of Section 2518(b)(4) in the case of a "transfer disclaimer," if all the other requirements of a qualified disclaimer are met. Thus, if a person makes a timely written transfer of his or her entire interest to the person who would have received it pursuant to a valid disclaimer under applicable state law, the transfer will be treated as a qualified disclaimer Some uncertainty remains, however, because Section 2518(c)(3) applies only to disclaimers of interests created after 1981. Thus there are three different sets of disclaimer rules governing interests created before 1977, after 1976 but before 1982, and after 1981, respectively. Note also that Section 2518(c)(3) covers only disclaimers of "the transferor's entire interest in the property," so that partial disclaimers are still governed by Section 2518(6).

A gift is not complete unless the donee accepts it. A qualified disclaimer is the refusal (that meets certain requirements) by the done to accept a gift. If a person makes a qualified disclaimer for any property interest, the property is treated as if it had never been transferred to that person (IRC Sec. 2518). Instead, the interest is considered to pass directly from the donor to the contingent beneficiary. Accordingly, the disclaimant is not making a gift to the person who ultimately receives the property because of the qualified disclaimer, and there are no tax consequences to the person disclaiming. The person disclaiming the property cannot direct how the disclaimed interest is distributed; the interest must pass according to the transferor's directions.

To be a qualified disclaimer, a refusal to accept an interest in property must meet the following conditions[63]:

- The refusal must be in writing. It must identify the interest in property disclaimed, and must be signed by the disclaimant or his legal representative [Reg. 25.2518-2(b)(1)].
- The refusal must be received by the transferor of the interest, the legal representative of the transferor, the holder of the legal title to the property to which the interest relates, or the person in possession of the property within nine months after the later of:
    - the day on which the transfer creating the interest is made, or

[63] IRC Sec. 2518(b).

    - the day on which the disclaimant reaches age 21.
- The disclaimant must not have accepted the interest or any of its benefits.
- As a result of the refusal, the interest must pass without any direction from the disclaimant to either:
    - the spouse of the decedent, or
    - a person other than the disclaimant.
- It must be an irrevocable and unqualified refusal by the done to accept an interest in the property.
- The disclaimer must generally meet the requirements of local law.

Though some states (including Texas) allow more time to file a disclaimer, the nine-month rule still applies for federal tax purposes.

For lifetime transfers, the nine-month period begins on the date the transfer is completed for gift tax purposes. However, any done under the age of 21 at the time of transfer can make a qualified disclaimer nine months after the day the done attains age 21. For example, a beneficiary recently turned age 14 will have seven years, plus nine months to make a qualified disclaimer. A newborn beneficiary will have 21 years and nine months to make a qualified disclaimer. A surviving joint tenant of a brokerage account or similar fund may disclaim the one-half survivorship interest within the nine-month period following the date of death (rather than the date of creation of the joint tenancy) of the first joint tenant to die.[64] For a general power of appointment, the person who would be the power holder has nine months after the creation of the power to disclaim. The person to whom the property passes because of the exercise, release, or lapse of a general power may disclaim within a nine-month period after the exercise, release, or lapse. Even though a disclaimer of a general power of appointment has the same economic effect as a release of the power, a disclaimer that meets the qualified disclaimer standards of IRC Sec. 2518 does not result in a gift.

K. Grantor Retained Annuity Trusts (GRATs)

IRC Sec. 2702 (special valuation rules in case of transfers of interests in trusts) is intended to prevent using trusts to artificially reduce the value of transfers to family members. Generally, a parent-grantor's income or life estate interest is valued at zero, so the full value of the transfer in trust becomes a gift to the family member beneficiaries. However, there are exceptions for certain qualifying interests (GRATs, GRUTs, and GRITs) that can be used to reduce the taxable gift to trust beneficiaries.[65]

The primary purpose of a GRAT is to transfer asset appreciation, usually to a member of the grantor's family, but the beneficiary can be anyone the grantor chooses to designate. A GRAT is created when the grantor transfers appreciating property (likely to appreciate faster than the current Section 7520 rate) to an irrevocable trust. The GRAT is required to pay the grantor an annuity (a fixed dollar amount, or a fixed percentage of

[64] Reg. 25.2518-2(c)(4)J.
[65] IRC Sec. 2702(b).

the initial value of the trust) over a set number of years. When the GRAT terminates, the trust beneficiary receives the remaining assets. If the grantor dies before the annuity term expires, a portion of the trust assets is included in the grantor's estate.

For the GRAT to be successful, the assets must appreciate at a rate greater than the Section 7520 rate and the grantor must outlive the term of the trust. If the value of the property increases, the grantor has transferred some appreciation free of gift tax, whereas if the property value declines, the grantor is in essentially the same position he or she would have been in without the GRAT (less the cost of trust set-up and administration fees, as well as the gift tax, if any, paid at the inception of the trust). The initial funding of the trust is a taxable gift of the remainder interest.

A GRUT is similar to a GRAT except that the amount to be paid to the grantor each year is a unitrust income interest (a percentage of the trust property that is recomputed at the beginning of each year during the trust's term). If the trust assets earn more than the percentage needed for the unitrust payout, the excess earnings will be added to the trust principal and, assuming the total value of the trust assets increase, there will be a higher dollar payment to the grantor the following year. A unitrust income interest to the grantor will grow over time if the value of the trust grows. The increasing unitrust payment to the grantor may be contrary to the primary objective of the trust (e.g., transferring the largest amount to beneficiaries at the lowest possible tax cost). However, for individuals wanting to transfer assets to family members while retaining an increasing annual return of income, the GRUT may be the appropriate tool. The initial funding of the trust is a taxable gift of the remainder interest.

A GRIT is the predecessor to GRATs and GRUTs. The grantor transfers assets to the trust while retaining his or her right to receive all of the income that is generated by the trust assets for a period of time. The net income from the trust is distributed to the grantor each year. When the trust term ends, the remainder of the principal is distributed to the beneficiaries, such as the grantor's nieces, nephews, or unmarried partner (the beneficiaries cannot be lineally descended from the grantor or the legally married spouse of the grantor). GRITs were effectively eliminated for family transfers with the Revenue Reconciliation Act of 1990 but can still be useful planning tools in certain situations:

- The personal residence GRIT, where the trust principal consists of a personal residence used by the term interest holder(s), is not subject to the Section 2702 valuation rules, as discussed in section 408.
- Because IRC Sec. 2702 does not apply to transfers to individuals outside of the transferor's family, GRITs may still be used in nonfamily transfer situations. Aunts, uncles, nieces, nephews, cousins, and significant others (including unmarried partners), are all outside the Code's definition of a family member for this purpose. Because the U.S. Supreme Court ruled in Obergefell v. Hodges that same-sex marriages are to be recognized as legal in all 50 states, and because Reg. 301.7701-18 defines the terms spouse, husband, and wife as an individual lawfully married to another individual, a sale of the residence held in a qualified personal residence

trust (which is a type of GRIT) to a legally married same-sex spouse is no longer allowed.
- Nondepreciable tangible property, in which the exercise or nonexercise of rights of the term interest holder would not affect the value of the property, is not subject to the valuation rules of IRC Sec.2702.

A unitrust or annuity amount payable to the grantor, or to the grantor's estate if the grantor dies before the stated term of the trust, is considered a qualified interest. Therefore, the value of the property transferred to the remainder beneficiary is reduced both by the amounts payable to the grantor and to the grantor's estate as calculated under Section 7520. This can effectively zero out (or significantly reduce) the value of the property transferred by gift. Other requirements of a qualified interest are as follows[66]:

- The term of a qualified interest must be fixed and ascertainable at the creation of the trust document.
- The term must be for the life of the holder, a specified term of years, or the shorter of the two periods.
- The interest must be payable to or for the benefit of the holder of a qualified annuity or unitrust interest for the fixed term of the interest.
- The governing instrument must prohibit distributions from the trust to or for the benefit of anyone other than the holder of the annuity or unitrust interest during the term of the trust.
- The governing instrument must prohibit prepayment of the holder's interest.
- Payment of the annuity amount cannot be made by issuance of a debt instrument, option, or other financial arrangement (for trusts created after September 19, 1999).

1. Zeroed-Out GRAT

A zeroed-out GRAT is structured so that the value of the annuity interest retained by the donor equals the value of the property transferred to the trust. The IRS treats the full amount of the retained annuity as a qualified interest when payable to the grantor's estate in the event the grantor dies during the annuity term[67], which can significantly lower the remainder (gift) interest. GRATs are often structured with shorter terms, with the annuity to continue to be paid to the grantor's estate if he or she dies during the trust term. Therefore, no taxable gift occurs when either (a) the property transfers to the trust (because the actuarial value of the remainder interest was zero), or (b) the remainder beneficiary receives the property at the end of the trust term. Note, however, that although there is no taxable gift, most zeroed-out GRATs or GRATs with minimally valued remainder interests will result in 100% of the trust being included in the grantor's gross estate if the grantor dies during the annuity term.

The trust document should specifically require that the annuity continue to be paid to the grantor's estate in the event of the grantor's death before the end of the trust term.

[66] Reg. 25.2702-3(d),-3(b)(3), and -3(c) (3).
[67] See Reg. 25.2702-3(e), Ex. 1 and 5.

If the GRAT does not provide for payments of the annuity to the grantor's estate if the grantor dies during the term, mortality will have to be taken into account in valuing the annuity, which will result in a higher remainder (gift) value.

The tax savings on zeroed-out GRATs depend on the rate of return of the assets transferred to the GRAT compared to the Section 7520 rates used to actuarially determine the value of the assets. When the assets' value outperforms the established rates, a greater portion of the asset appreciation is transferred to the remainder beneficiary at a gift tax savings. Conversely, if the value of the assets decreases over time, there is insufficient income generated to pay the required annuity to the grantor. In that case, the value of the assets transferred to the remainder beneficiary is less than the actuarial value computed using the Section 7520 rates, which results in no tax savings.

Zeroed-out GRATs are risk-free in the sense that if the assets decline in value, the trust will be exhausted and nothing will have been lost (except trust set-up and administration fees), but if the assets produce a sufficient return, property can be passed free of the estate or gift tax.

Some commentators believe that a zeroed-out GRAT is too aggressive. The IRS could argue that funding a zeroed-out GRAT does not transfer anything to the beneficiaries. Instead, the transfer (and the taxable gift) occurs when the beneficiary receives the property at the end of the trust's term. It may be prudent to set the payout rate so that the remainder interest has some value often sheltered by a portion of the $12.06 million basic exclusion amount for 2022). Also, a large annuity payment will be required to zero out a GRAT. Assuming a 3% Section 7520 rate, the payout rate necessary to zero out a two-year GRAT will be 52.265%. Unless the contributed assets are capable of producing enough income to make the required annuity payments, they must be sold to make the required payment or distributed in kind to the grantor, reducing any planned benefit. Transfer tax savings occur only to the extent that the assets generate income or appreciation that exceeds the Section 7520 rate.

L. Annual Exclusion Gifting Program

Gift tax is imposed on taxable gifts, which includes the total amount of gifts made during the year, less certain deductions. The total amount of gifts made during the year generally does not include the first $16,000 (for 2022) of qualified gifts made to any individual.[68] This allowance is commonly referred to as the annual gift tax exclusion. The annual exclusion applies on a per-donee basis, and there is no limit to the number of donees to whom gifts subject to the annual gift tax exclusion can be made.

Example: Using the annual gift tax exclusion to reduce gross estate.

[68] IRC Sec. 2503(b).

Alice Hubert, a widow, has three children and seven grandchildren. On December 31, 2021, she gave $15,000 to each child and grandchild. On January 1, 2022, she gave an additional $15,000 to each child and grandchild.

Assuming Alice made no other gifts in 2021 and 2022, she has transferred $300,000 ($150,000 in 2021 and $150,000 in 2022) to lower-generation family members with no gift tax consequences by effectively using of the annual gift tax exclusion. No gift tax returns are required to be filed. If, when she dies, Alice's estate is subject to estate tax, the $300,000 of lifetime gifts will save $120,000 of estate tax, assuming a marginal estate tax rate of 40%.

Gifts to the grandchildren could have GST tax consequences. A similar but more limited annual exclusion exists for GST tax purposes.

The purpose of the annual exclusion is to allow taxpayers relief from reporting numerous small gifts. The amount was intended to be large enough to cover wedding, holiday, birthday, and other occasional gifts. However, many taxpayers fail to take these occasional gifts into consideration when making annual exclusion gifts. Planners should remind clients that the annual exclusion amount includes all gifts made to the done for the year.

To qualify for the annual exclusion, a gift must be completed before the end of the year in which the transfer is made. A gift is completed when the donor has parted with dominion and control over the transferred property. If the donor reserves any power over the disposition of the property, the gift may be incomplete.

The annual exclusion is not available unless the done can be identified. For example, a gift in trust that gives the trustee authority to distribute income and principal among the donor's children (known as the sprinkling power) at the trustee's discretion does not qualify for the exclusion because it is not possible to identify and value the gift to each child. Likewise, a gift in trust that requires the trustee to distribute all of the trust income annually to the donor's children, but does not specify the actual amount to be distributed to each child, does not qualify for the annual exclusion. By granting each beneficiary a right to a fixed dollar or percentage amount of the income, the gift will qualify for the annual exclusion.

A property interest can be a present or a future interest. The annual exclusion does not apply to gifts of future interests in property.[69] However, a special exception allows a donor to fully use his or her annual exclusion to transfer assets to a trust for the future benefit of a minor child. A transfer to an individual under age 21 will be treated as a present interest (qualifying for the annual exclusion) if the conditions of IRC Sec. 2503(c) are met.

A future interest is one in which the donee's use, possession, or enjoyment of the property or its income does not begin immediately when the property is transferred.

[69] IRC Sec. 2503(b).

However, an unrestricted right to the immediate use, possession, or enjoyment of property or its income is a present interest in the property (if it can be valued) that qualifies for the annual exclusion.

Common types of future interests include discretionary income interests and remainder interests, which most often arise in transfers to trusts. For a gift in trust, each beneficiary is treated as a separate person for determining the number of annual exclusions. However, the present interest rule still applies and the annual exclusion is not available for a gift of a future interest in a trust. If the trustee has the power to accumulate income, no part of the transfer is a gift of a present interest, making the annual exclusion unavailable (even if all income is distributed). If the trustee is reguired to distribute the income at least annually, the value of the income interest qualifies for the annual exclusion (Reg. 25.2503-3). However, if the property is incapable of producing income, the annual exclusion is not available (Calder).

If a trustee has the power to distribute principal to the income beneficiary, the income interest still qualifies for the annual exclusion because the beneficiary has the right to the property or its income elther as an income or remainder beneficiary. However, if the trustee possesses a discretionary power to distribute income to one beneficiary with the remainder interest distributed to different beneficiaries, the income beneficiary's interest is no longer an unrestricted right to the immediate use, possession, or enjoyment of the property or its income and therefore, the annual gift tax exclusion would not be available.

A single transfer can result in two gifts-the gift of a present interest and the gift of a future interest.

The valuation tables are available on the IRS's website at www.irs.gov/Retirement-Plans/Actuarial-Tables. The IRS updates its actuarial tables every 10 years.

Transferring assets to the next generation through gifts of family limited partnership interests has become a popular gifting strategy. For these gifts to qualify as gifts of a present interest, the partnership agreement must provide the limited partners with an economic benefit resulting in an unrestricted right to immediate use of the property, or income from the property. Too much retained control by the donor can disqualify classification as a present interest.

The courts in the Hackl, Price, and Fisher (1) cases disallowed annual gift tax exclusions for gifts of partnership or LLC interests. In each of these cases, the restrictions on access to capital, partnership distributions, and the transferability of the interests caused the courts to rule that the recipients did not have the right to the immediate use, possession, or enjoyment of the property. However, when the powers of a general partner under a partnership agreement were consistent with powers granted under state law, the general partner's (donor's) power to determine the amount and timing of cash distributions or to approve the admission of an assignee substituted limited partner did not result in classification as a future interest.[70]

[70] TAM 199944003.

For clients who wish to obtain annual exclusions for gifts of closely held interests, planners should emphasize the need to establish an unrestricted and noncontingent right to the immediate use, possession, and enjoyment of the property or the income from the property. Economic benefit to the property may be established by giving unilateral noncontingent rights of withdrawal to capital interests or by permitting the done to sell or transfer ownership interests unilaterally. The Tax Court concluded that if annual exclusions are to be used for transfers of FLP or LLC interests, the interests should include income producing assets, and there should be mandated, actual, ascertainable distributions of the income to the beneficiaries.

Annual exclusion gifts can be made outright or in trust. If a trust is used, the trust instrument should include terms that cause the transfer to be a transfer of a present interest.

If the donor is married, a gift by one spouse can be considered as made half by each spouse if both spouses consent (on the gift tax return).[71] In addition, each spouse can use the full amount of the annual exclusion ($16,000 for 2022) and the lifetime applicable exclusion amount ($12.06 million for 2022) to offset the gift. If the election to split gifts is made, all gifts made by the spouses during the calendar year must be split if those transfers qualify for gift-splitting. The election will also cause gifts to be treated as if made one-half by each spouse for GST tax purposes.[72]

M. Gifts of Fractional Interests

An alternative to transferring a successive (remainder) interest in property is the transfer of a concurrent interest, usually in real estate. This technique involves a gift of a fractional undivided interest in the property to one or more donees. The donor will often make annual gifts of fractional interests in the property using (a) the annual gift tax exclusion per year per done, and (b) valuation discounts for lack of marketability or for being a minority interest to shelter the transfers from gift tax. Thereafter, the donor and donees own the property as tenants in common.

When the facts of the situation allow, the IRS will likely contend that an implied agreement existed between the donor/decedent and done, giving the donor an unrestricted right to use and enjoy the entire property until death, triggering IRC Sec. 2036. Even though an individual gives away a significant fractional share, the IRS may assert that the decedent had the right to possession and enjoyment of the entire property in absence of a negotiated limitation to the contrary. However, the Tax Court has held that a decedent's continued use of property as a residence was not a retained life estate and was therefore not included in the decedent's gross estate.

The IRS's position ignores the rights of the other cotenants. While the rights of cotenants, in aggregate, equal those of a sole owner, the rights of each are limited by the

[71] IRC Sec. 2513.
[72] IRC Sec. 2652(a) (2); Ltr. Rul. 200551009.

rights of the others. This limitation is significant because possession or enjoyment by one cotenant may be inconsistent with possession or enjoyment by another cotenant. Accordingly, an allocation of possession and enjoyment is necessary to resolve the inconsistencies. Because the rights of a tenant in common (or other cotenant), being subject to an allocation, are less than that of a full owner, only the tenant's own undivided interest should be included in his gross estate under IRC Sec. 2033, and IRC Sec. 2036 should not apply.

N. Substitution of Assets

To qualify as a grantor trust for income tax purposes, the trust instruments are often drafted to give the grantor power, in a nonfiduciary capacity (i.e., without the approval or consent of any person in a fiduciary capacity), to substitute trust property with other property of an equivalent value. This technique will cause the income of the trust to be taxed to the grantor while keeping the assets out of the grantor's estate (Rev. Rul. 2008-22; Ltr. Rul. 9227013). If the grantor of a trust holds a nonfiduciary power to replace trust assets with assets of equivalent value, the trust assets will not be includable in the grantor's gross estate under IRC Sec. 2036 or 2038 if the following conditions are met (Rev. Rul. 2008-22):

- The trustee has a fiduciary obligation (under local law or the trust instrument) to ensure that the properties acquired and substituted are of equivalent value.
- The substitution power cannot be exercised in a manner that could potentially shift benefits among the trust beneficiaries.

The IRS has indicated that a substitution power will not be treated as though it could shift benefits among the trust beneficiaries if (Rev. Rul. 2008-22)

- the trustee has both the power (under local law or the trust instrument) to reinvest the trust principal and a duty of impartiality to the trust beneficiaries; or
- the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

One of the most important advantages of the substitution power is the continuing control it gives the grantor over the income tax basis of the trust assets. By retaining this power until death, the grantor can take full advantage of the step-up in basis rules of IRC Sec. 1014 by reacquiring appreciated assets from the trust prior to death, which would be eligible for the step-up in basis, and substituting them with other, less appreciated assets. Although the value of the property exchanged must be the same as the property reacquired, leaving the trust with assets that have a higher income tax basis (i.e., less appreciation) will result in less gain (or a larger loss) to the beneficiaries when they eventually dispose of the property.***

O. Utilize Deceased Spousal Unused Exclusion (DSUE)

Portability is the transferring of a deceased spouse's unused exclusion (DSUE) amount to his or her surviving spouse under IRC Sec. 2010(c). Portability offers a significant estate planning opportunity for married couples and may be one of the planners' most effective tools. Until 2011, when portability was introduced, estate planning typically implemented an estate plan that combined two separate bequests by the first spouse to die--one using the applicable exclusion amount (typically a bypass trust) and the other the unlimited marital deduction. Using this combination of a marital deduction bequest with a bypass trust, the applicable exclusion amount of the first spouse to die could be preserved for the benefit of his or her children (or others), and no federal estate tax was due until the death of the surviving spouse.

The portability rules allow the executor of the deceased spouse to elect to transfer the deceased spouse's unused exclusion amount to the surviving spouse. If the election is made, any or all of the basic exclusion amount ($12.06 million for 2022) not used by the decedent's estate can be transferred to his or her surviving spouse. The surviving spouse can use this amount, in addition to his or her own basic exclusion amount, for lifetime gifts or transfers at death.

The increased basic exclusion amount is temporary for the years 2018-2025 after which they are scheduled to revert to pre-2018 amounts (approximately half of the current amount). Though the assets of a married couple currently fall below the filing threshold at the death of the first spouse, when the second spouse dies the exclusion amount may be greatly reduced. The executor at the first death should consider filing Form 706 to elect portability to preserve the unused higher exclusion amount for the second spouse to use.

Individuals taking advantage of the temporary increase of the gift and estate tax exclusion amounts in effect from 2018 to 2025 will not be adversely impacted after 2025 when the exclusion is scheduled to be reduced to pre-2018 levels. The final anti-clawback regulations affirm that if the larger exclusion ($12.06 million in 2022) is applied to gifts made before 2026, the exclusion will not be clawed back into the estate.[73]

To determine the amount of the DSUE that can be transferred to the surviving spouse, it is important to distinguish between the definitions of applicable exclusion amount and basic exclusion amount.

An individual's basic exclusion is simply the amount that can be transferred during life or at death free of gift or estate tax. This amount, which is adjusted for inflation each year, is $12.06 million in 2022.

A surviving spouse's applicable exclusion amount includes his or her basic exclusion amount, which for 2022 is $12.06 million. It may also include, if the deceased spouse's executor has elected to transfer it, up to $12.06 million (for 2022) of the DSUE amount. In other words, the applicable exclusion amount may consist of two parts--the basic

[73] Reg. 20.2010-1(c).

exclusion amount and the DSUE.[74] For individuals who have no DSUE amount received from a prior deceased spouse, their basic exclusion and applicable exclusion amounts are the same.

The DSUE, which is the amount that can be transferred to a surviving spouse, is the lesser of[75]:

- the basic exclusion amount in the year of the decedent's death ($11.7 million for 2021) or
- the excess of the last deceased spouse's applicable exclusion amount over that spouse's taxable estate plus adjusted taxable gifts (i.e., the adjusted taxable estate.[76]

Portability does not apply to the GST tax exemption. Also, the DSUE is a provision of federal law that may not be allowed for state purposes. Planners should know appropriate state law and how the federal DUE election impacts state estate or inheritance tax.

Because the GST tax exemption is not portable to the surviving spouse, even in estates where the marital assets do not exceed the $23.4 threshold and therefore estate tax will not likely be due), a QTIP trust should be considered so that a reverse QTIP election can be made to avoid losing the GST tax exemption of the first spouse to die.

The portability election is not available for a nonresident decedent who was not a U.S. citizen at the time of death.[77] In addition, a nonresident surviving spouse who is not a U.S. citizen at the time of making a gift or at the time of his or her death may not take into account any DSUE amount of a deceased spouse, except as may be allowed under an applicable treaty with the U.S.[78]

The unused exclusion amount available to the surviving spouse is the DSUE of the most recent deceased spouse. If the surviving spouse remarries, the surviving spouse keeps the DSUE transferred from his or her deceased (first) spouse. However, if the new (second) spouse dies before the surviving spouse, the DUE transferred from the first spouse will be lost and replaced with the DSUE, if any, from the new (second) spouse. This is because the prior spouse is no longer the last deceased spouse.

A client who is contemplating remarriage after having received DSUE amounts from a previously deceased spouse should consider whether the availability of the portability

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[74] IRC Sec. 2010(c)(2).
[75] IRC Sec. 2010(c)(4).
[76] The final regulations make it clear that, after 2025, when the enhanced estate tax exclusion under the 2017 Tax Cuts and Jobs Act sunsets, the DSUE created before 2026 will not be limited to the post-2025 basic exclusion amount. The surviving spouse's basic exclusion amount, plus all of the DSUE amount, without limitation, will be available to the surviving spouse's estate. Accordingly, DUE originating during 2018-2025 will not be reduced after 2025 [Reg.20.2010-1(c)].
[77] Reg. 20.2010-2(a)(5).
[78] Regs. 20.2010-3(e) and 25.2505-2(1).

election is important in negotiations for a prenuptial agreement. Alternatively, the DSUE could be used in lifetime gifts.

Remarriage alone does not affect who will be considered the last deceased spouse, nor does it prevent the surviving spouse from using the DSUE amount of the last deceased spouse. If a surviving spouse has a DSUE amount from a prior marriage and subsequently remarries and predeceases his or her new spouse, the new surviving spouse can receive the benefit of the DSUE from the prior surviving spouse's first marriage (if the executor elects).

P. Irrevocable Life Insurance Trusts (ILITs)

The abolition of the premium payment test in the estate tax has created a strong incentive for intervivos transfers of life insurance policies which, if retained until death, would cause the proceeds to be included in the insured person's gross estate under the "incidents of ownership" test of IRC Section 2042. A taxpayer can remove the proceeds of the insurance from his gross estate by transferring all incidents of ownership during life, assuming the transfer will not produce inclusion under some provision other than Section 2042. To avoid such other inclusionary rules, the transferor must be careful not to make the transfer within three years of death (see Section2035) and must not retain any right to income from the transferred property or any power to re-woke the transfer or change beneficial enjoyment or any reversionary interest.[79]

The price of making an inter vivos gift of life insurance, to minimize estate taxes or for any other purpose, is exposure to gift taxation. Just like any other item of property, a life insurance policy can be the subject of a transfer by gift, potentially taxable as such under the gift tax, whether the policy given away is one on the life of the donor or on the life of some other person. Also, a gift may take place if one person (the donor) pays premiums on a life insurance policy owned by another person (the donee), whether or not the policy itself was ever the subject of a transfer. The payment of premiums itself amounts to a gift when the policy is owned by someone other than the person paying the premiums.

As the regulations state, if the insured purchases a life insurance policy or pays a premiums on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to revest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or it the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), the insured has made a gift of the value of the policy, or to the extent of the premium paid. even though the right of the assignee or beneficiary to receive the benefits is conditioned upon surviving the insured.[80] Although this portion of the regulations refers to a gift by the insured person under the policy in question, it is equally clear that a donor

[79] See Section 2036-2038.
[80] Reg. Section 25.2511-1(h)(8).

may make a gift for gift tax purposes by transferring ownership rights in a policy or by making premium payments on a policy insuring the life of some other person.

As indicated by the regulations, the time when a transfer of a life insurance policy is complete for gift tax purposes is when the donor has divested himself or herself of all dominion and control (i.e., all incidents of ownership) over the policy.[81] If the donor retains the power to name the beneficiary of the proceeds at the death of the insured person, no gift fax will be imposed at the time of transfer. If the donee surrenders the policy for its cash value, how-ever, a completed gift will be deemed to take place at that time. (If the donee does not surrender the policy and the donor-insured retains the power to designate a beneficiary until his death, the proceeds will be included in the donor's gross estate at that time under Section 2042. In this way, the regulations seek to coordinate the gift and estate tax treatment of transfers of life insurance policies.)

When a donor makes a gift of a life insurance policy, valuation of the policy for gift tax purposes is determined under the principles set forth in the regulations. In general, the valuation of a policy is determined by its cost or by the price of comparable contracts issued by the same company. If the policy has been in force for some time and is not fully paid-up, so that valuation through the cost method is not readily ascertainable, the value may be approximated by adding to the interpolated terminal reserve value of the policy at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value, this method may be unavailable.[82] (The formula for determining the value of an insurance policy transferred inter vivos for gift tax purposes is essentially the same as the formula for determining the value of a policy owned by a decedent on the life of another person for estate tax purposes. See Reg. Section 20.2031-8(a).) When life insurance is the subject of, or vehicle for, a gift transfer, the question arises whether one or more annual per-donee exclusions will be avail. able to the donor under IRC Section 2503(b). If the gift qualifies for an annual exclusion, the first $10,000 (indexed for inflation, $16,000 in 2022) will not be taxed. Since Section 2503(b) allows an exclusion in the case of a gift other than a gift of a future interest made to any person by the donor, it is necessary to determine whether a gift of life insurance is a gift of a present interest or a future interest. This ques. tion arises both when the gift consists of an assignment of ownership rights in a policy and when the donor pays premiums on a policy owned by another person.

In general, a gift of a life insurance policy, even one having no immediate cash value, will be treated as a gift of a present interest for purposes of determining the gift tax exclusion under Section 2503(b). See Reg. Section 25.2503-3(a). Of course, to be a gift of a present interest, the transfer must give to the donee all present rights and interests in the policy, including the right to surrender it for its cash value (if any), the right to borrow against it, the right to designate a beneficiary, and so on. If the rights or interests of the donee are restricted, for example, by the terms of a trust or some other instrument of

[81] Reg. Section 25.2511-2 and 25.2511-1(h)(8).
[82] See Reg. Section 25.2512-6(a).

transfer, the gift may be deemed to be a transfer of a future interest that will not qualify for the annual exclusion.[83]

1. 3-Year Rule

In 1976, Congress amended Section 2035(a) to provide for automatic inclusion in the gross estate of gifts made within three years of death, thus eliminating the old three-year rebuttable presumption (as well as the old irrebuttable presumption that gifts made more than three years before death were not made "in contemplation of death'). Under the 1976 amendment, all gratuitous transfers made within three years of death were drawn back into the gross estate at death. Since there was no conclusive presumption, nor any presumption at all, the three. gear rule appeared not even to raise any due process question.

As a practical matter, perhaps the most important application of Section 2035(a) involves deathbed gifts of life insurance. Under Section 2042(2), the proceeds of a policy on the decedent's own life are includable in the gross estate if the decedent held any "incidents of ownership" at death. Since the value of a life insurance policy on a living person is often considerably less than the proceeds payable at death, the owner of a policy may seek to avoid estate taxation on the full amount of the proceeds by making a gift of the policy shortly before death. By including Section 2042 in its list of enumerated sections, Section 2035(a) blocks this gambit and ensures that the proceeds will be included in the gross estate is the insured person transferred any incidents of ownership within three years before death.

When all is said and done, Section 2035-after being substantially restricted in 1981 (so that it no longer includes in the gross estate all property simply transferred within three years of death)-serves two principal functions. First, as noted above, Section 2035(a) ensures that if a taxable "string" under Section 2036-2038 or 2042 is released within three years before death, presumably to prevent inclusion under one or more of those sections, the decedent will be treated as if the string had been retained until death. In addition, Section 2035(b) increases the gross estate by the amount of any gift tax paid by the decedent (or his estate) on a transfer made by the decedent or his spouse within three years of death. This "gross-up provision is designed to erase the benefit of making large deathbed gifts so as to remove the resulting gift tax from the estate tax base.

Q. Qualified Personal Residence Trusts (QPRTs)

Regulations under IRC Sec. 2702 create a safe harbor known as a qualified personal residence trust (QPRT), which, if all pertinent requirements are met, will be treated as a qualified personal residence trust, this allows a little more flexibility with regard to assets that can be held by the trust. QPRTs are sometimes referred to as house GRITs.

[83] See Reg. Section 25.2503-3(a) and (b).

Requirements of QPRTs that must be reflected in the governing instrument are summarized as follows[84]:

- Except for cash as otherwise described in item e, the trust is prohibited from holding, for the entire term of the trust, any asset other than one residence to be used or held for use as a personal residence.
- The trust is prohibited from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse, or an entity controlled by the grantor or the grantor's spouse during the retained term interest of the trust, or at any time after the retained term interest that the trust is a arantor trust. A sale of the residence by the trust to the grantor's unmarried partner is allowed.
- Any income of the trust must be distributed to the term holder at least annually.
- Distributions of principal to anyone other than the transferor before the end of the retained interest are prohibited.
- The trust may receive and hold cash, but not in excess of the amount required for the purchase of the initial residence within three months of the trust's creation; the purchase of a residence to replace another residence within three months of the transfer of the cash to the trust; improvements to the residence to be paid within six months from the date of the transfer; and payment of trust expenses, including mortgage payments, already incurred or expected to be incurred within six months of the transfer.
- Cash held by the trust in excess of these requirements is to be distributed at least quarterly to the term interest holder.
- The residence can only be occupied by the term holder, term holder's spouse, or a dependent.
- Prepayment of the term holder's interest must be prohibited. The trust ceases to be a QPRT if the residence is not used or held for use as a personal residence of the term holder (or his or her spouse or dependent). Within 30 days of the time the trust ceases to be a QPRT, the trust must terminate or convert the term interest into a qualified annuity interest (i.e., the trust becomes a GRAT) [Reg. 25.2702-5(c)(8); Ltr. Rul. 200220015],

1. Split-interest QPRT.

A split-interest QPRT is a trust that purchases a residence on behalf of the beneficiaries, typically granting the parent a lifetime interest in the home and the remainder interest to the child. The parent contributes funds equal to the value of the lifetime interest, and the child contributes funds equal to the value of the remainder interest. The values of the interests are determined using the Section 7520 rates. The trust's terms should comply with the QPRT rules.

[84] Reg. 25.2702-5(c).

In Ltr. Rul. 9841017, the IRS held that this arrangement qualified for the QPRT exception to the Section 2702 rules, no gift occurred on formation of the QPRT, and (if the parent survived the QPRT term) the trust property would not be included in the parent's gross estate.

R. Spousal Lifetime Access Trusts (SLATs)

A spousal lifetime access trust (SLAT) is an inter vivos irrevocable trust that includes the grantor's spouse as one of the permissible beneficiaries (usually, in addition to children). The goal of a SLAT is similar to a bypass trust - to transfer assets into a trust that can provide some financial assistance to the spouse, but to exclude those assets, and any future growth of those assets from the spouse's estate. Typically, the spouse will be a discretionary beneficiary of both income and principal, which provides the greatest flexibility. This means that, if the family's financial situation changes (and assets previously gifted into the trust are later needed by the donor), the trustee may make distributions to the spouse beneficiary. If the grantor is uncomfortable about giving an independent trustee this much discretion, the trust can provide that the spouse is entitled to all of the trust's net income, in conjunction with a five and five withdrawal power over the principal.

Clients should be made aware that actual distributions from the trust to the spouse will reduce the estate tax benefits of the trust because it increases the spouse's estate. Additionally, the trust is taxed as a grantor trust (i.e., the grantor bears the income tax burden for any trust earnings) and should the beneficiary spouse die before the grantor, the grantor may lose indirect access to the trust assets.

It is important that the term spouse is properly defined in the trust instrument. This includes provisions addressing remarriage and other spousal changes, such as through death or divorce. For example, one court ruled that spouse was determined on the date the trust was created and not a later date when another individual was the spouse.

Flexibility is created when each spouse creates a SLAT for the benefit of the other spouse. However, planners should be cautious to avoid the application of the reciprocal trust doctrine that would defeat the plan and cause the inclusion of the assets in the beneficiary's estate. The trusts should not be identical, Instead, the terms of the trust should include differences in provisions for distributions and beneficiaries.

Grantors may fund gifts to a SLAT using annual exclusion gifts (rather than marital deduction gifts) to avoid the ultimate inclusion of the assets in the donor's estate. Assets in trust are protected from the creditors of both spouses. With careful planning, assets are transferred to maximize gift, estate, and GST tax savings, while still permitting the donor some limited indirect access to the assets if needed.

SLATs are beneficial in an environment where the exclusion amount is scheduled to go down (e.g., after 2025). A SLAT allows a donor to use their increased exclusion

amount for transfers to the SLAT and still have funds available to the spouse if the spouse needs them.

Because the goal of creating a SLAT is to maximize transfer tax savings, the ideal assets to transfer to the trust are those likely to appreciate (such as securities, art, and collectibles). Jointly owned assets or community property assets should not be used to fund the SLAT unless the assets can be converted into two separate properties.

Although the opportunity to transfer a decedent's unused exclusion amount (I.e., the portability election) will cause most clients to avoid federal estate tax without the need for sophisticated estate planning strategies, many will still be subject to state death tax. In those situations, creating a SLAT has the potential to avoid or reduce state death taxes by reducing the donor's estate.

The terms of a SLAT must be carefully drafted to permit only discretionary distributions to the spouse without causing the trust to be included in the grantor's estate. If assets are used to discharge the grantor's legal obligation of support, the trust will be included in the grantor's estate.[85]

If funds are needed by the grantor-spouse, it is generally preferable, from a tax perspective, for the trust to lend the money to the grantor-spouse rather than make distributions to the beneficiary spouse, which would be includible in the surviving spouse's estate. If the distribution is structured as a loan to the grantor, and the loan is respected as bona fide, it would be a debt of the grantor's estate.

The trust may include a provision allowing that, if the beneficiary-spouse were to die before the grantor-spouse, the beneficiary-spouse can be given a broad limited testamentary power of appointment to anyone other than himself, his estate, creditors, or the creditors of his estate. He or she may be given the power to appoint the trust property to a trust for the grantor-spouse. However, if the beneficiary spouse dies first and appoints the property to a trust for the grantor-spouse, state law may consider the trust to be a self-settled trust subject to the grantor's creditors, which would likely cause it to be includible in the grantor-spouse's gross estate at the grantor's death.

S. Beneficiary Defective Inheritor’s Trusts (BDITs)

Beneficiary defective inheritor's trusts (also referred to as Section 678 trusts and BDITs) have been recommended by some planners as a means to transfer additional wealth while allowing the beneficiary to access the trust property, benefit from any appreciation in value of the trust assets, and provide asset protection from the beneficiary's creditors. Some estate planners have hailed a sale to a BDIT as the panacea or nirvana of all estate planning, assuming the trust is carefully designed, implemented, and the right set of facts and circumstances exists.

[85] Reg. 20.2036-1(b)(2).

The IRS will not issue a private letter ruling on BDITs (Rev. Proc. 2021-3, Section 5, item 10).

A BDIT is an irrevocable trust that is structured to be a grantor trust to the beneficiary (not the grantor), yet allowing the trust assets to be accessible to the beneficiary. A grantor trust is disregarded for federal income tax purposes, and all income, losses, deductions, and credits otherwise attributed to the trust are generally attributed to the grantor (or other owner). As is true for sales to IDGTs, gains or losses in transactions between the grantor (or other owner) and the trust are not recognized.

Similarly, nonrecognition treatment applies to a beneficiary of a grantor trust who is not the grantor but is treated as the trust's owner for income tax purposes because he or she can withdraw income and principal from the trust.[86] A BDIT is designed to satisfy the requirements of IRC Sec. 678(a)(1), which provides that a person, other than the grantor, is treated as the owner of the trust for income tax purposes if he or she has the power to vest the principal or income in himself or herself. The beneficiary can be the deemed owner for income tax but not estate or gift tax) purposes.

A BDIT is designed to allow the trust to purchase assets from the beneficiary in exchange for an installment note payable to the beneficiary. In essence, the value of the assets sold to the trust is frozen at their current value at the time of sale, which removes future appreciation and the discount associated with these assets from the beneficiary's estate.

BDITs are created when the grantor (usually a parent) transfers assets to a nongrantor trust for the grantor, but as a grantor trust for the beneficiary/owner (usually a child). This is typically created by the beneficiary's power to change the disposition of trust assets through a withdrawal power over all trust principal in the form of a Crummey withdrawal power. This withdrawal power ensures that the beneficiary is treated as the owner of the trust for income tax purposes.

BDITs are typically structured with two trustees: the primary beneficiary as the investment trustee and an independent trustee (usually a corporate fiduciary) as the distribution trustee. The terms of the trust usually provide the beneficiary with a limited power of appointment. This helps to ensure that if the beneficiary's transaction with the trust is later considered to be for less than full and adequate consideration, an incomplete gift has occurred, and no gift tax will be due.

The value of trust assets should not be includable in the estate of either the grantor or the beneficiary. In addition, because the value of the assets at the time of being sold to the trust is effectively frozen at the time of sale, any future appreciation is removed from the beneficiary's estate.

Although the grantor's contribution (often $5,000) to the Section 678 trust will qualify for the gift tax annual exclusion, any gratuitous transfer by the beneficiary to the trust (i.e.,

[86] IRC Sec. 678(a)(1).

one for less than full and adequate consideration) will probably be considered a gift of a future interest, which will not qualify for the gift tax annual exclusion ($16,000 for 2022).

The IRS may use the step-transaction doctrine (i.e., a number of transactions are treated as though they were integrated parts of a single strategy for tax purposes) to deny the benefits of a BDIT. This is because, unlike a sale to an IDGT, the seller (beneficiary/owner) and buyer (trust) are economically the same person (i.e., the trust is for the benefit of the beneficiary, and the beneficiary is generally the trustee).

If the beneficiary's withdrawal power lapses, the lapse may be considered a transfer for gift tax purposes.[87] However, the lapse will not be treated as a transter to the extent that the power does not lapse in an amount greater than $5,000 or 5% of the value of the property over which the power is exercisable in any calendar year.[88]

To avoid taxable transfers by the beneficiary/owner and the loss of grantor trust status due to lapses of the beneficiary's withdrawal powers, the grantor should not contribute more than $5,000 to the trust.

If the BDIT does not have enough capital to purchase assets from the beneficiary (i.e., the debt to equity ratio in the installment sale is too high), the IRS may recharacterize the sale to the trust as a disguised gift with a retained income interest, which could cause gift tax and inclusion of the assets in the beneficiary's estate (IRC Secs. 2036 and 2702). To ensure sufficient capitalization, some planners recommend "seeding" the trust with 10% of the purchase price (similar to the IDGT). The facts should support the trust's ability to make the installment note payments to the beneficiary as the payments come due. Because BDITs are not recommended to be funded with more than $5,000, ensuring sufficient capitalization may not be possible. However, some estate planners consider seeding the trust unnecessary if the beneficiary or unrelated third party provides a proper guarantee. A reasonable guaranty fee should be paid by the trust to the guarantor to avoid the appearance of a gratuitous guarantee, which could be considered a taxable gift.

The IRS could challenge the sale under IRC Sec. 2036(a)(1) if the beneficiary retains the right to possess or enjoy the property sold or the income from the property. The IRS could also challenge the sale under IRC Sec. 2036(b)(2) if the beneficiary retains the right to designate the persons who will possess or enjoy the property sold.

Because of the additional risks of BDITs, the limited amount that should be funded in the trust, and the costly legal and set-up fees, in the authors' opinion, these trusts should only be considered to purchase assets of fairly insubstantial value that are likely to significantly appreciate in value. However, the downside to this strategy is limited. Other than the legal expense to set up the trust, if the Section 678 BDIT transaction does not work, the donor is in the same position as before the transaction.

[87] IRC Secs. 2514(b) and (e); 2041(a)(2) and (b)(2).
[88] IRC Secs. 2514(e) and 2041 (b)(2).

T. Gifts to Spouse

1. Lifetime QTIP Trust

A lifetime QTIP trust provides a qualified income interest to the donee spouse for life and allows the donor spouse to name who receives the remainder interest in the trust assets when the donee spouse dies. This ability of the donor spouse to direct who will be the ultimate beneficiary of the QTIP trust assets is a primary consideration in choosing to use a QTIP trust. However, the property does not escape estate tax entirely. The fair market value of the property at the date of the surviving spouse's death is included in the surviving spouse's estate (IRC Sec. 2044). If the surviving spouse's estate owes estate tax, its executor generally can recover from the person(s) receiving the QTIP property that portion of the tax attributable to the inclusion of the QTIP property in the gross estate (IRC Sec. 2207A). However, if the surviving spouse specifically directs (according to the will) that the estate tax attributable to the QTIP property is to be paid from other sources, the taxes are to be paid as provided in the will.

A QTIP trust provides assurance to the grantor that his or her wishes for the ultimate disposition of assets willot be thwarted by the surviving spouse. For example, an individual may want to provide for his or her surviving spouse during their lifetime but also wants to provide for his or her children (either from the current marriage, assuming his or her spouse were to remarry after the grantor's death, or from a prior marriage). A QTIP trust allows the decedent to meet these objectives because the children can be named as remainder beneficiaries, and the surviving spouse is not granted the power to change that designation.

QTIP Trust Requirements. A QTIP trust must meet the following requirements:

- All trust accounting income is payable to the surviving spouse, at least annually for life.[89]
- No one has a power to appoint or distribute the trust assets during the surviving spouse's life to any person other than the surviving spouse.[90]
- The trust may hold unproductive assets (assets that do not generate income) only if the trust document requires, or permits the surviving spouse to require, the trustee to either make the property productive or convert it to productive property within a reasonable time.[91] However, certain exceptions apply for residential property and tangible assets held for use by the surviving spouse.
- The executor of the decedent's estate must elect on a timely filed estate tax return to have some or all of the trust property qualify for the marital deduction.[92]
- The surviving spouse must be a U.S. citizen.[93]

[89] IRC Sec. 2056(b)(7).
[90] IRC Sec. 2056 (b)(7).
[91] Reg.20.2056(b)-5(f) (4); Ltr. Rul. 9717005.
[92] IRC Sec. 2056(b)(7).
[93] IRC Sec. 2056(d)(1).

2. Non-Citizen Spouse

The marital deduction will be allowed at the first spouse's death if the surviving spouse becomes a U.S. citizen before the due date of the first spouse's Form 706 and was a U.S. resident at all times after the date of the decedent's death and before obtaining citizenship. For various reasons (e.g., requiring the noncitizen spouse to renounce citizenship in his or her home country), this may not be the optimum choice for the noncitizen spouse.

Although lifetime gifts to a noncitizen spouse are also ineligible for the unlimited marital deduction afforded to citizen spouses (IRC Sec. 2523), present interest gifts to noncitizen spouses do qualify for a special annual exclusion, $164,000 for 2022.[94] Therefore, by maximizing lifetime transfers to the noncitizen spouse, transfer tax is avoided to the extent the noncitizen spouse consumes the gifted assets prior to his or her death. If the surviving spouse is still a U.S. resident at death, his or her basic exclusion amount will be available to offset remaining assets (unlike QDOT assets.

Even though the decedent's spouse is not a U.S. citizen, the unlimited marital deduction is available for testamentary transfers to the surviving spouse if the property is transferred to a qualified domestic trust (QDOT) [IRC Sec. 2056(d) (2)]. A QDOT can be formed under the terms of the decedent's will, by the executor of the decedent's estate, or by the decedent's surviving spouse. Basically, the assets passing from the decedent to the surviving spouse are transferred to the QDOT. Although the marital deduction is not allowed, the federal estate tax on the value of the assets transferred into the QDOT is postponed until the surviving spouse receives distributions from the QDOT or dies. At that point, the QDOT assets are added back to the decedent's gross estate, and the deferred estate tax becomes due.

The DOT arrangement only defers the federal estate tax liability. It does not reduce or avoid the tax liability. However, if the surviving spouse later becomes a citizen, he or she can receive all the assets in the QDOT, and the deferred estate tax liability will disappear.

The QDOT requirements (IRC Sec. 2056A) are as follows:

- The trust instrument must require at least one trustee to be either an individual U.S. citizen or a domestic corporation. However, several countries prohibit the use of a trust. Therefore, the IRS may allow a legal arrangement similar to a trust and waive the U.S. trustee requirement.
- Any nonincome distributions from the QDOT must have the approval of the trustee, who has the right to withhold from the distribution the applicable estate tax.
- The trust must comply with regulations to ensure collection of the estate tax imposed on taxable events.

[94] IRC Sec. 2523(i); Rev. Proc. 2020-45.

- The executor must make an irrevocable election on Form 706 to have the trust treated as a QDOT. The election must be made no later than one year after the extended due date of Form 706.

To qualify transfers to the trust for the unlimited marital deduction, the trust must meet the following general rules [IRC Sec. 2056(b)(5)]:

- All income must be payable to the surviving spouse at least annually for life.
- The surviving spouse has the power to appoint principal to the surviving spouse or to his or her estate.
- No other person has the power to appoint any part of the property to anyone other than the surviving spouse.

There is no partial QDOT election; however, if a trust meets the requirements for a QDOT, the planner may sever the trust into two or more trusts and elect QDOT treatment for the applicable severed trust.

A QDOT is an ordinary trust, so trust equivalents do not qualify except in the case where the nonresident spouse lives in a country that does not recognize or permit trusts. The IRS is granted regulatory authority to treat as trusts legal arrangements with substantially the same effect as a trust. While the arrangement does not have to have a U.S. trustee, the arrangement must allow the U.S. to maintain jurisdiction and security over the assets so the spouse can be properly taxed. No guidance has been issued. The trust instrument must specify that the law of a specific state or the District of Columbia govern the QDOT's administration.[95]

QDOTs effectively defer the estate taxes that would have been paid at the first spouse's death if no marital deduction had been allowed. Unlike the standard marital deduction which adds the property transferred to the surviving spouse's gross estate, a QDOT is not added to the surviving spouse's gross estate. Because it is assumed the surviving spouse will not be subject to estate taxation, the QDOT must pay the estate taxes (computed using the first spouse's tax brackets) when a specific event occurs that would have been paid if no marital deduction had been taken at the first spouse's death.

To assure that the QDOT pays the first spouse's deferred estate taxes, certain security requirements apply to the trustee if the fair market value of the trust's assets exceed $2 million. QDOTs with assets of $2 million or less need not satisfy the security requirement if their holdings of foreign real property are limited to 35% of the fair market value of the trust. Multiple QDOTs are combined to determine if the $2 million threshold has been reached.[96] The trustee is liable for the payment of any estate tax owed.

A QDOT election is made by listing the qualified domestic trust or the entire value of the trust property on Schedule M of a timely filed Form 706 and deducting its value.

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[95] Reg. 20.2056A-2(a).
[96] Reg. 20.2056A-2(d).

The QDOT tax will no longer apply if the surviving spouse becomes a U.S. citizen after the QDOT is established providing (a) the spouse was a U.S. resident at all times after the death of the decedent and before becoming a U.S. citizen, or no taxable distributions are made from the QDOT before the spouse becomes a U.S. citizen and b) the U.S. trustee notifies the IRS that the surviving spouse has become a U.S. citizen. Notice is made by filing Form 706-QDT by April 15th of the year following the year in which the surviving spouse becomes a citizen, unless an extension of time is granted [IRC Secs. 2056(d) (4) and 2056A(b) (12)].

Estate taxes are imposed on the QDOT at the occurrence of certain taxable events, which include: (i) distributions of principal (and capital gains if includable in principal) to the surviving spouse; (ii) death of the surviving spouse with property remaining in the QDOT; and (iii) subsequent failure to meet the requirements of a QDOT.

No tax is imposed on any distribution of principal on account of hardship. Hardship applies to immediate and substantial financial need relating to health, maintenance, education, or support of the surviving spouse or anyone the surviving spouse is legally obligated to support. The surviving spouse's other financial resources are considered to determine if a hardship exists.

The amount of estate taxes equals the amount of tax that would have been paid by the decedent, net of any applicable credits, if the decedent's taxable estate had been increased by the sum of: (i) the amount involved in the taxable event; (ii) the total amount involved in previous taxable events (cumulative rule); minus (iii) the tax that would have been paid by the decedent's estate if the decedent's taxable estate had been increased by the amount in item b.

In other words, the QDOT is taxed at the first spouse's estate tax rate. Property is valued at the surviving spouse's date of death or the fair market value at the time of the distribution. Lifetime distributions include any amounts withdrawn to pay the estate tax (tax inclusive). While income distributions are not subject to tax, it is unclear whether undistributed income at the surviving spouse's death should be taken into account when valuing trust assets subject to tax. To avoid any future valuation issues, all of the income should be distributed annually.

U. Incomplete Nongrantor Trusts (ING) Trusts

In addition to transferring wealth, trusts can be used for asset protection and for state income tax savings. Taxpayers in high income tax states may want to consider transferring assets to an incomplete non-grantor trust in a state that does not tax trust income (e.g., Wyoming, Delaware, Nevada, and Texas) to avoid income tax in their home state.

Determining when a trust is subject to state income tax varies among the states. The laws of the grantor's home state, as well as those in each place where any trustee resides, and in the state where the trust is administered, should be carefully reviewed.

This type of planning initially developed using what is commonly referred to as Delaware incomplete nongrantor trusts (DINGs) (Ltr. Rul. 200502014). More recent IRS letter rulings have involved trusts established in Nevada (NINGs) because Nevada has enhanced creditor protection, and Wyoming (WINGs).[97]

There are a variety of terms that can be included in trust documents to create grantor trust status. While this is often planned, as in an intentionally defective income trust, planning with an ING requires avoiding grantor trust status. Powers that cause grantor status must be carefully excluded in ING trusts.

For a gift not to be considered complete and subject to gift tax, the grantor must have a retained power of control. Ltr. Ruls. 201310002, 201729009, and 201908003 provide a detailed path to simultaneously arrange a trust without grantor trust powers but with incomplete gifts due to retained powers.

The IRS has added ING type trusts to its list of areas on which it will not issue a private letter ruling.[98]

A large transfer of assets is generally needed to make the state income tax savings worth this planning strategy. Trusts with undistributed income exceeding $13,450 (in 2022) are taxed in the highest federal income tax bracket. Therefore, a strategy of state tax savings could generate increased federal income taxes that would offset the state tax savings.

The sale of a highly appreciated capital asset transferred to an ING trust may avoid state income taxes on the gain and generate sufficient savings to make this strategy worthwhile. The federal income tax effect of transferring the asset to the trust will generally be a wash because trusts and individuals have the same long-term capital gain rate (though the threshold for the 20% capital gain rate is much lower for trusts than individuals).

V. Creation of a Conservation Easement

A qualified conservation easement is a restriction on the use of real property granted in perpetuity to a qualified charitable done exclusively for conservation purposes.[99] The donor typically executes a written agreement granting an easement to a qualified organization. This agreement specifies the types of uses that will be restricted and any prohibited activities. The contribution of a qualified conservation easement can generate substantial income tax and estate tax benefits.

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[97] Ltr. Ruls. 201310002 through 201310006 and 201410001 through 201410010.
[98] Rev. Proc. 2021-3, Section 5, item 9.
[99] IRC Secs. 2031 I(8)(B) and 170(h)(1).

Because the IRS is concerned about abuses in this area, it closely reviews these transactions, particularly when the deduction is inappropriately large, appraisals are questionable, modifications of the easement are allowed, or the land is developed in a manner that is inconsistent with the easement's restrictions. Also, certain conservation easement transactions claiming to give investors the ability to take charitable contribution deductions in excess of the amounts invested are now identified as listed transactions that require additional reporting.[100] Planners should carefully review the terms and restrictions of the easement and the appraisal to help ensure that the charitable contribution will not be disallowed.

Individuals and certain grantor trusts may claim an income tax charitable deduction for a lifetime contribution of a qualified conservation easement [IRC Secs. 170(f)(3)(B)(iii) and 170(h)(1)]. The amount of the deduction is equal to the value of the qualifying easement. Note, however, that it is possible for the property retained by the donor to increase in value as a result of the conservation easement. In that situation, the charitable contribution will be deductible only to the extent that the value of the donated interest exceeds the value of the benefits received.[101]

If the requirements are met, an estate of a decedent who transfers property subject to a conservation easement at his or her death is eligible for an estate tax charitable deduction. Additionally, estates may be eligible for an estate tax exclusion for a qualified conservation easement.

If the donor owns the property subject to the easement at his or her death, the property is included in the donor's gross estate at its post-easement value. The value of a qualified conservation contribution, which is a contribution of a qualified real property interest transferred upon the donor's death to a qualified organization, is deductible as an estate tax charitable deduction.[102] Therefore, the value of the easement generally reduces the property's estate tax value.

The requirements for claiming an estate tax deduction are not as stringent as those for claiming the exclusion. The bequest of a conservation easement does not have to satisfy the exclusive conservation purpose requirement to be eligible for the estate tax charitable deduction.

Property subject to a qualified conservation easement created during the decedent's lifetime or upon his or her death is eligible for the qualified conservation easement estate tax exclusion. The executor may irrevocably elect to exclude up to 40% of the value of the land subject to a qualified conservation easement.[103] The maximum exclusion amount is limited to $500,000.

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[100] Notice 2017-10.
[101] Ltr. Rul. 200002020; Reg. 1.170A-1 (h) (2)(i).
[102] IRC Sec. 2055(f).
[103] IRC Sec. 2031 I(1).

The exclusion may be claimed on property for which the income tax charitable contribution has been claimed under IRC Sec. 170(h). In addition, it may be claimed in conjunction with the estate tax charitable deduction under IRC Sec. 2055. Therefore, the lifetime contribution of a qualified conservation easement generates an income tax deduction for the value of the easement and a potential $500,000 estate tax exclusion for the remaining value of the property subject to the easement. The exclusion must be reduced by the amount of any estate tax charitable deduction (i.e., the value of the qualifying easement).

The estate tax exclusion is applied for each estate in which the value of the land is included in the gross estate. With proper planning, exclusions are available for the estates of both spouses. If the land passes to a child, the exclusion will also be available to the child's estate. (The exclusion is as permanent as the easement.)

The terms deduction and exclusion are used throughout this chapter. Although the tax effects can be identical, the definitions are not the same. The terms need only be distinguished for testamentary charitable contributions, because the exclusion does not apply to lifetime contributions. For testamentary contributions, deduction indicates that the value of the charitable contribution is subtracted from the decedent's gross estate in arriving at the adjusted taxable estate. An estate exclusion, however, refers to the post-easement property value retained by the donor that is not included in the decedent's gross or taxable estate.

IX. Conclusion

Although the federal estate tax exemption is at an all-time high, attorneys and advisors still need to be familiar with planning tools for assisting clients desiring to make transfers of assets but who may lack remaining gift tax exemption. A client's advisors should not discount using one or more planning techniques to accomplish a client's objectives and to minimize transfer taxes. The author hopes that this paper is helpful to advisors as they work with clients to meet their objectives.