

Appendix:

Outline of the Federal Estate Tax

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OUTLINE OF THE FEDERAL ESTATE TAX

1. ESTATE TAX RETURNS

a. **Federal Estate Tax Return (Form 706).**

i. *In general.* Federal law imposes a tax on the transfer of property during life and at death. §§ 2001 and 2501 (unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended). Prior to 1977, the gift and estate taxes operated independently. The Tax Reform Act of 1976 unified the estate and gift taxes so that a single set of rates and a unified credit applies to both.

Consequently, when the estate tax is figured, gifts during life are added to the gross estate and credit is allowed for any gift tax paid. The integration of the taxes in this way has the effect of applying the graduated rates in a uniform manner. The 2001 EGGTRA law unlinked the two to some extent by specifying different credit amounts for transfers during life and death after 2003. See I(B) of this outline.

ii. *Estate tax return.* The estate tax return is filed on IRS Form 706. The return is due within 9 months from the date of death, but extensions of time to file can be secured by filing form 4768. Only estates exceeding the unified credit deduction equivalent (currently \$1,000,000) are required to file an estate tax return. The return is the responsibility of the executor or administrator.

iii. *Personal liability.* The executor or administrator is personally liable for the estate tax if he or she makes distributions from the estate of lower priority than federal taxes. See Treas. Reg. §1.641(b)-2. The executor or administrator may apply for release of personal liability and, if made, the IRS is required to notify the executor or administrator of the amount of tax within nine months of the later of the application or the date the return is filed. § 2204.

b. Estate and Trust Income Tax Return. An estate is treated for federal income tax purposes as an entity distinct from the decedent and the beneficiaries. In general, income which is received and passed on to a beneficiary in the same year is taxed to the beneficiary while income retained by the estate is taxed to the estate. As a separate entity, the estate must file a federal income tax return on Form 1041. A return must be filed if the estate has gross income in excess of \$600 and is due on the 15th day of the fourth month following the end of the tax year. The tax year will generally be the calendar year unless the executor/administrator elects otherwise. If an estate is expected to meet the \$600 threshold, the executor or administrator should obtain a federal employer identification number by filing Form SS-4. The estate will also be required to make quarterly estimated tax payments. An estate is taxed in general in the same manner as an individual and pays tax on the

same brackets but the higher brackets apply at much lower income thresholds.

c. Arizona estate tax. Arizona imposes estate and generation-skipping taxes equal to the federal credits allowed for state taxes (see IV.B.3 of this outline). The Arizona return must be filed on or before the due date of the federal return and is only required when a federal return is required. See A.R.S. §§ 42-1501 et. seq. (42-4001 et seq. under the revision of Title 42 effective January 1, 1999).

2. TAX RATES

The estate tax rates are specified in §2001 and are based on the amount of the taxable estate. The taxable estate is the gross estate plus taxable gifts made by the decedent after 1976 less allowable deductions. The application of the unified credit effectively provides a zero-bracket amount equal to the deduction equivalent (currently \$1,000,000). The current tax rate table is reproduced in Part I(B) of this outline.

3. THE GROSS ESTATE

a. Valuation.

i. *Property included.* The gross estate of a decedent for tax purposes includes all property in which the decedent held an interest on the date of death, whether real or personal, tangible or intangible, and wherever located. The property included is not synonymous with the probate estate. Consequently, the inventory of assets must be done separately for

estate and probate purposes. Property is included in the gross estate based on its value at the date of death.

ii. *Alternate valuation date.* Section 2032 allows the executor to elect an alternate valuation date six months following the date of death. This alternate date is available only if it results in a lower valuation. If elected, property is valued at the subsequent date.

iii. *Valuation in general.* The general rule is that the value of property is its fair market value on the valuation date. Fair market value means the price that a willing buyer would pay a willing seller, both being under no compulsion and in full possession of the facts. Reg. § 20.2031-1. Property cannot be valued based on a compelled sale price. For items available at retail, valuation is based on the retail rather than wholesale price.

iv. *Certain property values.* The regulations under section 2031 provide specific rules for valuing certain types of property.

(A) Stocks and bonds. If quoted on an exchange, the average of the high and low price on the valuation date is used. If not traded on that date, the average of the preceding and succeeding dates on which the security was traded are used, if the dates are within a "reasonable time" of the valuation date. Options to purchase stock held by the decedent are often ignored. Reg. §20-2031-2(h) states "(l)ittle weight

will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime". If the decedent held securities which were subject to an obligation on the part of his estate to sell to another at a set price (e.g., a buy-sell agreement), the effect of the obligation to sell on the value is determined under the special rules of §§2701-2704.

(B) Closely held businesses. Reg. § 20.2031-3 lists several factors to be considered, including the value of the business assets (including good will) and the earning capacity of the business. The financial and other data upon which valuation was based must be submitted with the estate tax return.

(C) Outstanding checks at the valuation date are excluded from the value of bank accounts if they are subsequently honored, represent obligations incurred for full consideration and are not claimed as deductions. Reg. § 20.2031-5.

(D) Household and personal effects. Either an appraisal report or an itemized list must be attached to the return. Items having a value in excess of \$3,000 must be supported by an appraisal given under oath. See Reg. § 20.2031-6.

(E) Annuities, life interests, remainder interests etc., are valued by tables taking into account interest discount rates and mortality factors. Tables are given in Reg. § 20.7520-1 through -4. See also IRS Publication 1457, "Actuarial Values, Alpha Volume."

(F) Insurance contracts held on the life of another (e.g., on the life of the spouse) are valued based upon what the quoted premium would be for a single-premium paid-up policy on the date of death. Reg. § 20.2031-8.

(G) Stock options. Revenue Procedure 98-34 gives methods acceptable to the IRS to value stock options for gift and estate tax purposes. The method is based on pricing models taking into account such factors as the option's term, exercise price and the volatility of the underlying stock.

iv. *Valuation understatement penalty.* The Code imposes a 20% penalty on any estate which reports a total value which is 50% or less of the correct value. § 6621(b)(5). The penalty is increased to 40% for gross under valuations (reported value less than 25% of true value). § 6662(h).

b. Jointly held property. Property held jointly by the decedent and another person is includable in the estate. This includes property held as joint tenants with right of survivorship and joint bank accounts. Under the provisions of § 2040(a), the *entire* value of the property, without reduction on account of the ownership interest of the other party, is

includable except to the extent the executor can demonstrate that the other party contributed provided consideration for the property. Property acquired by the decedent and the co-owner or owners as a gift are excluded from this presumption. Community property is also excluded. In addition, property held by the decedent and the decedent's spouse, with no other party having an interest in the property, are includable only to the extent of one-half of the value. These are qualified interests under § 2040(b). For example, assume decedent and decedent's brother were joint owners of a bank account. The bank account would be included in the decedent's estate except to the extent the brother's contribution can be demonstrated. If the decedent and his brother inherited the account, or received it by gift, one-half would be includable in the estate.

c. Community property. The ownership of community property as established under local law is respected for estate tax purposes. This means that generally only one-half of the value of community property is included in the gross estate. For example, half of life insurance proceeds payable to a beneficiary are included in the estate (assuming the decedent had incidents of ownership) where the premiums were paid from community funds. Reg. § 20.2042-1(b)(2).

d. Life Insurance. Life insurance on the decedent's life payable to the estate, or to others where the decedent exercised incidents of ownership of the policy, are includable in

the gross estate. § 2042. All types of insurance are included in this rule: whole life, term, group term provided by an employer, temporary travel insurance, etc. Incidents of ownership include the power to change beneficiaries, to pledge the policy or borrow against it, or to receive the cash value. Possession of any of these interests is sufficient to cause the proceeds to be included in the estate. The right to receive dividends is, by itself, not considered an incident of ownership under Reg. § 20.2042-1(b). Also, powers which can be exercised only in the decedent's fiduciary capacity for the benefit of another are not considered incidents of ownership. For example, if the decedent had placed a policy on his life into an irrevocable trust for the benefit of his child, under the terms of which amounts could be spent only for the benefit of the child and could not revert to the insured, the policy proceeds would not be includable in the decedent's estate. As mentioned above, to the extent the proceeds are considered community property under local law, only one-half of the proceeds are includable.

e. Retirement benefits and annuities. Under Code § 2039 the value of retirement benefits included in an IRA, an employer's retirement plan or an annuity are included in the estate of the decedent to the extent of the benefits are attributable to the decedent's contributions if: (1) the payments are receivable by a beneficiary by reason of surviving the decedent; (2) the payments are made under a contract or

agreement; (3) the decedent had the right to receive the payments during his lifetime; and (4) payments under the contract are based on the decedent's life expectancy. Payments made to a retirement plan by the decedent's employer are considered made by the decedent. In community property states such as Arizona, employment earnings during the marriage are generally considered community property and as such only one-half of the benefits would be considered to have resulted from the decedent's contributions. The value to be included in the estate includes benefits which were not yet payable at the time of decedent's death. For example, if the decedent participated in a pension plan which would pay benefits upon his retirement at age 60 to himself and his spouse for life, the death of the employee prior to that age will not cause the benefits payable to the spouse to be excluded. See the examples given in Reg. § 20.2039-1(b). The amount includable is the value of the benefit multiplied by a fraction, the numerator of which is the decedent's payments and the denominator of which are the total payments or contributions. For example, if the decedent contributed \$15,000 to the cost of a single-premium annuity and another person \$10,000, 60% of the value of the benefits are included in the gross estate.

f. Retained interests.

i. *Right to income, possession (Sec. 2036).*

The gross estate includes property which had been transferred by the decedent during life but as to which the decedent retained

the right to possession (e.g., a life estate), income, enjoyment, or the power to name another person to receive them. § 2036(b) specifically includes the retention of voting rights of transferred stock in a corporation owned 20% or more by the decedent, overturning the Supreme Court's decision in U.S. v. Byrum, 408 U.S. 125 (1972).

The IRS takes the position that the power retained does not have to be legally enforceable to trigger section 2036. See, IRS Publication 468; Instructions to Form 706, Schedule G. The tax court agrees. Est. of Rapelje, 73 T.C. 82 (1979). Care must be exercised in navigating around the restrictions of this section. For example, the power to withhold income in an irrevocable trust where the principal beneficiary differs from the income beneficiary has been held to constitute the power to name another to enjoy the income, resulting in the trust being included in the estate of the settlor. Old Colony Trust Co. v. U.S., 423 F.2d 601 (1 Cir. 1970). Retention of the power to change trustees in an irrevocable trust (without the power of the settlor to name herself) is, by itself, not enough to trigger the section. Est. of Wall, 101 T.C. 300 (1993).

ii. *Contingent Reversions*. § 2037 provides a de minimis rule for inclusion of property in the estate where there is a possibility of reversion to the decedent and possession of the property cannot be obtained without surviving

the decedent. The value of the reversionary interest must exceed 5% of the value of the property in order for § 2037 to apply.

Example 1: A transfers property to a trust with income payable to his wife W for life, remainder to his son S; but if S does not survive W then the remainder reverts to A or A's estate. If A predeceases W and S, no part of the trust is included in A's estate because neither W nor S had to survive A to enjoy the property.

Example 2: A transfers property to a trust with income payable to his wife W for life and remainder to him, if he survives her, or otherwise to his son S. If A dies before his wife, the value of his interest in the trust might be includable in his estate because S was not entitled to the property unless he survived A. If the value of the possibility of reversion to A exceeds 5% of the value of the trust property at the date of A's death, A's estate would have to include the value of the reversionary interest (the corpus minus W's life income interest). The value of the possibility of reversion to the decedent - i.e., the possibility of him surviving his wife - would be determined by use of mortality tables. In this example, the trust would be caught by § 2037 unless the decedent were very old and the wife young.

iii. *Power of revocation.* Code § 2038 includes in a decedent's estate property which the decedent had transferred but as to which the decedent had, at the time of his death, the power to alter, amend, revoke or terminate any person's enjoyment of the property. The power may be exercisable by the decedent alone or in conjunction with one or more other persons. This section does not apply to transfers for full consideration or for powers exercisable only with all others who have an interest in such property and if the power adds nothing to the rights of the parties under local law. Reg. § 20.2038-

1(a). §2038 applies to both the property and the income from the property and may apply even though exercise of the power does not change the beneficiary. For example, the power to accumulate or pay income from a trust is a §2038 power even though the income beneficiary (or his estate) is also entitled to the corpus.

iv. *Powers of Appointment.* § 2041 includes in the gross estate property over which the decedent held (or relinquished or exercised within his lifetime) a general power of appointment. A power of appointment must be given by someone other than the decedent. It is a right given to someone other than the donor of property to dispose of it. The holder of the power has a *general* power only if he can exercise it in favor of himself, his creditors, his estate, or the creditors of his estate. Also included is the value of property interests over which the decedent exercised or released the power during lifetime if the exercise or release was with a retained life interest in the property appointed (under § 2036); with a retained reversionary interest in the property appointed (under § 2037); or with a retained power to alter, amend, revoke, or terminate the appointment (under §2038).

Examples:

(1) A decedent received the power to appoint the corpus of a trust to any of six persons not including the decedent. The decedent would not be considered to hold a general power of appointment.

(2) Same as (1) above, except the decedent could also name his heirs as recipients. The decedent would be considered to hold a general power of appointment.

(3) Same as (1) above, except he could also invade the corpus for his own reasonable support, education, and medical expenses. He would not be considered to have a general power of appointment.

v. *Ascertainable Standard*. A power which is limited by an *ascertainable standard* relating to health, education, support or maintenance is not considered a general power of appointment. However, a power to use property for the comfort, welfare, or happiness of the decedent is not an ascertainable standard and therefore is a general power of appointment. Reg. § 20.2041-1 states that powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism" will all be considered powers measurable by an ascertainable standard. The regulation also provides that it is not necessary for the beneficiary to exhaust his other funds before using the power.

g. Certain transfers within three years of death.

i. *Life Insurance*. The gross estate includes any transfer by the decedent with respect to a life insurance policy within 3 years before death. § 2035(a).

ii. *Certain other transfers.* The gross estate also includes any transfer within 3 years before death of a retained section 2036 life estate, section 2037 reversionary interest, or the transfer or relinquishment of a section 2038 power to revoke, if the property subject to the life estate, interest, or power would have been included in the gross estate had the decedent continued to possess the life estate, interest, or power until death. § 2035(a).

iii. *Gift taxes.* Any gift tax paid with respect to a transfer within three years of death must be added to the gross estate. § 2035(b).

iv. *Living trusts.* The IRS once held the view that the distribution of property from a living trust within three years of the settlor's death constituted a relinquishment of a power to revoke with respect to that property. The IRS took the view that transfers from the trust within the three years preceding decedent's death were includable in the estate under § 2038 on the theory that the transfers constituted relinquishment of the right to revoke the trust with respect to the property distributed. In Jalkut, 96 T.C. 675 (1991), the Tax Court agreed. In Estate of Kisling, TC Memo 1993-262, the Tax Court held that transfers of an undivided interest in trust corpus was included in the gross estate under §2038, distinguishing the transfer of an interest in the trust itself from the assets distributed in Jalkut. On appeal, the Eighth Circuit reversed,

32 F.3d 1222 (8th Cir. 1994), rejecting the entire theory of deemed revocation. The Taxpayer Relief Act of 1997 clarified the Code by adding § 2035(e), which specifies that transfers from a revocable trust are to be treated as coming directly from the settlor.

4. CREDITS AGAINST THE ESTATE TAX

a. Unified Credit. This credit has been substantially changed by EGTRA and is no longer unified. See I(B) of this outline.

b. State death taxes. Also modified by EGRRRA and explained in I(B).

c. Gift tax. Gift taxes paid with respect to pre-1977 gifts are allowed as a credit. § 2012.

d. Tax on prior transfers. To avoid cascading of taxes on transfers, a credit is allowed for estate tax paid by a transferor of property to the decedent where such property is also included in the decedent's estate. A credit is allowed for any transfers on which an estate tax was paid occurring within a period from 10 years prior to 2 years after the decedent's death. The credit is reduced on a sliding scale with respect to transfers occurring between three and ten years prior to decedent's death. § 2013.

e. Certain foreign death taxes. The U.S. estate tax is imposed on the total property of decedents, wherever located. To avoid double tax on property included in the gross estate

which is also subject to a tax in a foreign country, credit is allowed against the U.S. tax for tax paid to a foreign jurisdiction with respect to property also included in the U.S. taxable estate. § 2014.

5. MARITAL DEDUCTION.

a. Basic requirements. Section 2056 provides for a deduction for the *value* of any *interest in property* which *passes* or has passed from the decedent to his *surviving* spouse, but only to the extent that the interest is included in the gross estate of the decedent. Each of the italicized words is a term of art and the subject of one or more regulations.

i. The *value* of an interest is generally the fair market value at the date of death. The value must be reduced by any estate or inheritance tax, including the federal estate tax, which is paid from the interest and the amount of any encumbrance on the property. Code § 2056(b)(4). Further, as will be seen later in this outline, the fractionation of an interest, as when a single piece of real property is left to two or more devisees, or even when a portion is left to the spouse outright and a portion is left in trust, can affect the value of the deductible interest.

ii. *Reduction for taxes.* Since a bequest to a spouse is generally deductible, it is not normally allocated any estate tax. However, where the spouse is a residuary legatee and the will directs that taxes be paid from the residuary estate, or the will is silent and state law so requires, some sophisticated mathematics is required to determine the amount of the marital deduction. See Example 1 in the appendix.

iii. *Reduction for administrative expenses.* In *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997) the Supreme Court held that the marital deduction was not reduced if the executor of the estate elected to pay the expenses from the income generated by the property constituting the marital bequest. In reaction to this case, Treasury amended Reg. § 20.2056(b)-4 to specifically provide that certain administrative expenses will reduce the marital deduction. The regulation breaks administrative expenses into two types, *management* expenses, which would be incurred regardless of whether there was a death (for example, commissions on security transactions) and *transmission* expenses, which are incurred only because of the death (for example, attorney fees for probate of the estate). Management expenses paid from the marital share and attributable to the marital property will not reduce the marital deduction unless the executor elects to deduct them on the estate tax return instead of the income tax return. Transmission expenses paid from the marital share will always reduce the marital deduction. See Example 2 in the appendix.

iv. An *interest* in property must be a deductible interest. All interests are deductible unless they fall into one of the classes of non-deductible interests.

v. Property *passes* to the spouse through either a lifetime or testamentary transfer. To pass during life, the transfer has to be a completed gift. To pass after death, the spouse must survive the decedent by the minimum time set by the will or trust. Specifically, Code § 2056(c) provides that property is considered to pass from the decedent if it is . . .

β bequeathed or devised by decedent;

- ℳ inherited from decedent
- ℳ a statutory allowance
- ℳ transferred during life by the decedent
- ℳ held with decedent as joint tenant with right of survivorship
- ℳ passing because of the exercise or failure to exercise a power of appointment
- ℳ life insurance proceeds on the life of the decedent.

b. Non-deductible interests. All interests in property passing to the spouse are deductible unless they fall in to one of the following categories:

- ℳ An interest which was not includable in the decedent's estate;
- ℳ An interest used to satisfy an expense of estate administration or a claim against the estate.
- ℳ An interest to the extent its value is diminished by a deductible loss under § 2054;
- ℳ A terminable interest.

c. Terminable Interests.

i. Definition. Code § 2056(b) defines a non-deductible terminal interest as an interest passing to the spouse which will *terminate* or *fail* because of the *occurrence or non-occurrence* of an *event* or *contingency*, AND either (1) an interest in the property passes (or has passed) to a person other than the spouse and that person will possess or enjoy the property upon the termination or failure of the interest, OR (2) the

interest will be acquired for the spouse by an executor or trustee. Observe that not only must the interest be subject to a contingency which might cause it to fail, but either someone else must come to enjoy the property as a consequence or the interest must have been acquired for the spouse by direction of the decedent. A non-deductible terminable interest would include a life estate or a term of years with the remainder interest passing to another. Examples of deductible terminable interests include wasting assets, such as a patent or an annuity with no death benefit. Although the spouse's interest will terminate, no other person will enjoy the property as a result; i.e., there is no property value left at the death of the surviving spouse which could escape taxation.

ii. Event or contingency. The mere possibility, however remote, that an event could happen to dispossess the spouse of the interest will be enough to classify the interest as a terminable interest. See Examples in Reg. § 20.2056(b)-1.

Unidentified Assets. If the spouse is left a bequest which may be satisfied out of a class of assets which include both assets which would qualify for the marital deduction and assets which would not, the deduction must be reduced by the non-deductible assets, even though the executor does not choose to utilize them to fulfill the bequest. See Reg. § 20.2056(b)-2.

iii. Exceptions to the Terminable Interest Rule. Certain terminable interests are deductible by virtue of specific code provision.

(A) Life Estate With Power of Appointment. Prior to the enactment of Code § 2056(b)(7) (qualified terminable interest trusts), this was the most popular method of leaving property in trust which would qualify for the marital

deduction. A LEPA is a trust arrangement under which the surviving spouse is entitled to all of the income for life, distributable at least annually, and is granted a power to appoint the property to herself or her estate to the exclusion of any power of appointment others may have. The power of appointment and income rights extend to a specific portion of an interest as well as the whole. However, if they are different, then the property interest qualifies only as to the smaller of the specified interests. If the spouse is left an annuity payment instead of a percentage of income, the annuity is converted into a corpus amount by using the interest rates provided under Code § 7520. These rates are published monthly. To determine whether the spouse is entitled to all of the income of the interest, local law and trust definitions of income and corpus are relevant. For example, a trust provision that arbitrarily classified any interest payment in excess of 8% as corpus would cause the trust not to qualify as LEPA. In addition, the spouse must be granted the power to compel the trustee to invest in income producing property. Consequently, if the decedent leaves stock in his closely held corporation to his spouse, the spouse must be able to compel the trustee to sell the stock and invest in income producing property. The foregoing limitations and restrictions have caused the LEPA to fall out of favor.

(B) Life Insurance or Annuity with Power of Appointment.

Life insurance proceeds left at interest with the insurance company can qualify as deductible even if not immediately available to the surviving spouse, provided that under the insurance contract the spouse is entitled to installments or all the interest earned, with the first installment due not later than 13 months after the date of death and the spouse has the power to appoint the principal amounts to herself or her estate.

(C) Qualified Terminable Interest Property. By far, the most popular method of leaving property in trust for the spouse where it is desired to qualify for the marital deduction is the QTIP trust. The QTIP is usually called for where there are children of one or both spouses from prior marriages. The alternatives may not work well. For example, assume that a married couple come in to see you about an estate plan. They both have children from former marriages. They desire reciprocal wills leaving everything to the surviving spouse upon the first death and upon the second death, everything is to be divided equally among their children. This is a formula for disaster. Case law is full of examples where this happened and, after the death of the first spouse, the survivor eventually changes his or her will to leave everything to her side of the family. The excluded children of the first spouse now show up at the probate and challenge the will. One form of challenge is to maintain that the reciprocal wills constituted a contract between the spouses for third party beneficiaries (the children), which contract was breached when the surviving spouse changed his or her will. The QTIP trust avoids all this. This type of trust provides for the surviving spouse during his or her lifetime but at the spouse's death the trust principal will be distributed to the beneficiaries named in the trust (often the decedent's children). The surviving spouse cannot change the trust, which becomes irrevocable at the first death, and does not have a general power of appointment. Even where there are no prior marriages, a QTIP is still indicated where there is a need for (a) asset protection from the spouse's potential creditors; (b) the management of an independent trustee; or (c) protection against the

infirmities of old age which might leave the surviving spouse vulnerable to the influence of one of the children to the exclusion of others, or, worse, to an unrelated caregiver.

(1) Requirements. To qualify as QTIP, the property must (i) pass from the decedent; (ii) provide the spouse a qualifying income interest for life; and (iii) be the subject of an election made by the executor, trustee or personal representative on the federal estate tax return. A “qualifying income interest for life” requires that the spouse receive all of the income at least annually or have a usufruct interest for life, and that no one other than the spouse can appoint any part of the property to anyone other than the spouse during the spouse’s lifetime. The spouse must also have the power to compel the trustee to dispose of property which is not income producing. Property for which the QTIP election is made may be an interest in property or a specific portion of property. Once made, the QTIP election is irrevocable. While QTIP property is often thought of as a trust, it does not have to take that form. For example, a devise of Blackacre to my wife for life, remainder to B, will qualify, provided the life estate is without restrictions (for example, a restriction that it must be maintained as a residence) and local law will require the spouse’s consent to any sale of the property.

(2) Contingencies. The income interest cannot be contingent. For example, a provision that the income will cease if the spouse remarries will cause the interest to fail as QTIP. Similarly, the ability of another to appoint the property to anyone other than the spouse will disqualify the property even if the ability is contingent and remote.

(3) Election. QTIP treatment must be elected. An executor or trustee may make the election for only part of the trust if the trust is then split into its qualified and non-qualified components.

(4) Charitable Remainder Trusts. A CRT can qualify for the marital deduction with respect to its annuity value (and a charitable deduction with respect to its remainder). To qualify, the spouse must be the *only* non-charitable beneficiary of the trust (other than an employee stock ownership plan)

d. Qualified Domestic Trusts

i. Denial of Deduction. Code § 2056(d) denies the marital deduction to a spouse who is not a U.S. citizen. This subsection was added by the Omnibus Budget Reconciliation Act of 1989, effective for estates of decedents dying after November 10, 1988. The theory behind this restriction on the marital deduction is that a non-citizen spouse could remove the estate property from the U.S. after inheritance, thus avoiding U.S. estate tax. A partial relief from this prohibition is provided by the qualified domestic trust (QDOT). The relief is partial because the property is afforded relief from the estate tax only so long as it remains in trust and within the jurisdiction of the United States.

ii. Definition. A QDOT is a trust (1) having at least one trustee who is an individual U. S. citizen or U.S. corporation; (2) granting the citizen trustee or U.S. corporation the power to withhold the recapture tax imposed on withdrawals; and (3) for which the trustee files an election. In addition, the QDOT must also qualify for

the marital deduction on its own right under the other provisions of § 2056. For example, it could qualify as QTIP or LEPA or an “estate trust” under Reg. § 20.2056(c)-2.

iii. Security Requirements. If a QDOT exceeds \$2 million in value, special security requirements apply to secure the U.S. of collection of the recapture tax. Either (1) a U.S. bank must be a trustee; or (2) the U.S. trustee must furnish a bond or letter of credit to the IRS equal to 65% of the value of trust assets. The specific form of bond is found in Reg. § 20.2056A-2(d)(1)(i)(B)(2). For small QDOTs, those less than \$2 million, the above requirements do not apply, but not more than 35% of trust assets may consist real property located outside of the U.S. Look-through rules apply to corporations of which the trust owns 20% or more of the stock.

iv. Recapture Tax. A QDOT acts as a deferral mechanism. As long as property remains in the trust subject to U.S. jurisdiction, the estate tax is postponed. When withdrawals are made, or the spouse dies with assets still in the trust (called “taxable events”) each taxable event is subject to tax except to the extent they meet income or hardship exceptions. The tax is the amount of incremental tax which would have been imposed on the estate of the decedent had the taxable event been included in that estate. The incremental tax takes into account prior taxable transfers. The tax is due on the April 15 of the year following the year of a taxable event during the life of the non-citizen spouse. If the taxable event is the death of the spouse, the tax is due nine months following the date of death.

v. Exceptions to Tax. The tax does not apply to withdrawals from the trust for income or hardship. Income does not include capital gains and does not

include any other transaction or distribution (such as stock dividends) that under local law or the terms of the trust instrument are not considered income. Hardship is defined as an “immediate and substantial financial need relating to the spouse's health, maintenance, education, or support, or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support.”

vi. Post-Mortem Fixes. A problem which frequently arises is that a decedent dies, leaving no QDOT provision in his will or trust for his non-citizen spouse. Even if the QDOT was thought of, it is considerably more complex and restrictive than the straightforward QTIP. Fortunately, there are actions which can be taken after the death of the decedent.

(A) Spouse becomes U.S. Citizen. § 2056(d)(4) provides that if the surviving spouse becomes a U.S. citizen before the return of the decedent is filed, and has been a resident of the U.S. since the date of death of the decedent, the spouse will be considered to have been a citizen at the date of death of the decedent, qualifying for the marital deduction. The return is considered filed on the due date of the return, including extensions, if filed on or before such date. Reg. § 20.2056A-1. If filed after the due date (i.e., a late filed return), it is considered filed when actually filed. This gives the personal representative of the decedent the option to intentionally file the estate tax return late, and incur the resultant penalty, to allow the surviving spouse additional time, if needed, to obtain citizenship.

(B) Reformation of Trust. If the decedent left a QTIP trust, the trust can be reformed, or a judicial proceeding commenced to seek such

reformation, to meet QDOT requirements prior to the date the estate tax return is filed. In this event, the trust will be treated as QDOT from the date of death.

(C) Post-mortem QDOT. Even if the decedent dies without establishing a trust, but leaves property outright to his non-resident spouse, the spouse can establish a QDOT before the estate tax return is filed or irrevocably assign property by that date to a QDOT to be established.

(D) Spouse Dies a U.S. Resident. If the surviving spouse does not want to become a U.S. citizen but wishes to remain resident, the last strategy is to simply do nothing. If the surviving spouse dies a resident, her estate will be permitted a credit for tax paid by her late spouse with respect to property that, except for § 2056(d), would have qualified as a marital deduction. If this strategy is chosen, the cost is the time value of money if all of the first decedent's tax on property passing to the survivor is recouped. However, if the survivor spends down her estate, the credit may not suffice to recover the tax. In any event, counsel would be well advised to state the potential pitfalls and the alternatives to the spouse in writing before deciding on the do-nothing strategy.

6. GENERATION-SKIPPING TRANSFER TAX

a. **Taxable Transfers.**

i. *Direct Skips.* A direct skip is a transfer of an interest in property to or for the benefit of a *skip person* - an individual two or more generations below that of the transferor, such as from a grandparent to grandchild. §§ 2612(c) and 2613. If the parent of a transferee grandchild is dead, then the transfer is not taxable. In the case of transfers

to individuals who are not lineal descendants of the grandparents of the transferor or the transferor's spouse, an individual more than 12 _ years younger than the transferor is assigned to the generation immediately below that of the transferor and a new generation is deemed to occur every 25 years. § 2651.

Taxable terminations. A taxable termination occurs when an interest in property held in trust terminates and trust property is held for, or distributed to, a skip person. After termination, all interests in the trust are held by or for the benefit of persons two or more generations below that of the transferor. § 2612(a).

ii. Taxable distributions. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination). § 2612(b).

b. Computing the tax. A separate estate tax is imposed at a flat rate of 55% on taxable transfers. There is a lifetime \$ 1 million exemption granted each taxpayer. This exemption can be allocated to taxable transfers and the reciprocal of the ratio of the allocated exemption (called the *inclusion ratio*) multiplied by the 55% rate yields the *applicable rate* to be applied to the transfer.

Example: A taxable transfer of \$ 1 million is made. The transferor chooses to allocate \$ 600,000 of his lifetime exemption to the transfer. The inclusion ratio would be 40% (the reciprocal of 60% - the ratio of the allocated exemption to the value of the transfer). The applicable rate would be 22% (40% X 55%).

c. Paying the tax and filing returns.

i. Direct Skips Occurring at Death. The executor files the return and pays the tax.

ii. Direct Skips During Life. The transferor files the return and pays the tax.

iii. Taxable Terminations. The trustee files the return and pays the tax.

iv. Taxable Distributions. The transferee files the return and pays the tax.

d. Grandfather rule. The GST tax will not apply to any transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer was not made out of corpus added to the trust after September 25, 1985.