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A Continuing Education Course (12 hrs)

"Estate Planning Basics"

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The course material which follows was written and designed to help licensed insurance agents develop a fundamental appreciation for the complexities of legal ownership concepts with respect to future property transfer. Although such concepts tend to be quite complex, it is the aim of Dohrn Insurance Training, Inc. to present the material in a basic and easily understandable fashion.

The focus of this material is to define terminology and review specific federal and state property transfer concepts. Specific tax threshold amounts which are normally subject to change will not be emphasized. This course has not been designed with the tax professional or attorney as the typical end user. The insurance licensed professional can hopefully better understand his or her role in utilizing existing risk transfer products in this stated vein. We encourage the use and retention of this material as a reference source in conjunction with the previous DISCLAIMER as stated above.

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CHAPTER I:

ESTATE PLANNING PURPOSES AND DEFINITIONS

The term **"estate planning",** in the broadest sense, **combines the elements of wealth accumulation, conservatorship and distribution into cohesive strategic and tactical action.** As wealth grows according to the dictates of sound financial planning, a later need to conserve the assets accumulated becomes paramount. Ultimately the assets are distributed according to the wishes of the accumulator upon death. It is arguable then, that financial planning is really the first step of estate planning, for the fruit of one endeavor creates the necessity for a well conceived estate plan.

A well executed estate plan is required because, in the absence of a plan, federal and state governments force one upon citizens. If the individual does not take an active role in directing the orderly disposition of property at death, the laws of government are poised ready to relieve the citizen of this fundamental obligation.

Financial burdens, asset transfer and care of minors are directly affected if poor estate planning is involved. Financial burdens are created by probate fees and various death taxes. If estate assets are improperly arranged and there is an absence of cash liquidity then estate settlement cost must be paid from the liquidation of assets. The actual transfer of assets can be subject to probate delays and possibly extra death taxes resulting from lack of planning. The care and custody of minor children can be adversely affected in the face of poor asset management.

The main purpose of estate planning is to achieve a client's objectives while minimizing potential taxation liability. Tax minimization as the only estate planning goal is neither realistic nor acceptable as a means of satisfying a client's financial needs at death.

IMPEDIMENTS TO SOUND ESTATE PLANNING

Although sound planning strengthens an individual's financial security, there can be barriers of a psychological nature when it comes to estate planning and asking a client to contemplate mortality. The thought of what happens to assets when you die is not a particularly popular conversational topic. Another obstacle is procrastination since estate planning is a relatively complex and time consuming

Failing to plan is evidenced by either possessing no will, referred to as "intestacy", or a will which was drawn so long ago it no longer reflects the person's current situation, needs or desires. When a person dies intestate, state succession laws dictate the manner in which property is disposed (i.e. to spouse, children, siblings, and distant relatives or to the state itself if no living relative exists).

Tax liability can strongly affect the manner in which property is disposed but, as mentioned earlier, minimization can not be stressed to the extent that client needs are compromised. Yet another problem encountered in estate planning is the long term cost of inflation which can render the future purchasing power of assets nearly useless. Lack of liquidity, or unavailable cash necessary to meet the income needs of beneficiaries or estate liability requirements, can also create severe future cash flow problem. Finally, a long term disability can result in reduction of estate value unless costs associated with lasting illness can be offset with insurance benefits.

THE ROLE OF FINANCIAL ADVISORS

Occupations involved in the estate planning process can include financial planners, insurance agents, attorneys, accountants and trust officers of banks. In many cases the insurance agent is the first individual to contact the client in addressing the estate planning need. The financial planner

usually possesses superior knowledge or education in the areas related to asset accumulation, which then leads to the need for estate planning. Perhaps one of the financial planner's most significant contributions to the estate planning process is their unique ability to bring together the various financial disciplines required for proper advisement.

The accountant, or generally the tax advisor, is a team member who is singularly aware of the intimate financial details of the client's life. The accountant's role includes being able to ascertain whether or not a client's asset valuation necessitates more profound planning advice. The caution to the typical client is to consider the accountant's advice seriously but not to make it the sole basis of estate planning activity concerning estate tax liabilities.

The trust officer should be familiar with the various methods of creating and supervising asset conservation and distribution. Often the bank for which the trust officer works is charged with the fiduciary duties related to proper estate filings and income tax returns.

The attorney utilizes perhaps the most fundamentally important aspect of estate planning, knowledge of the law. Only the attorney may draft the appropriate legal documents which will facilitate the estate planning process. Typically attorney drafted documents include wills and trusts and perhaps buy-sell agreements if the client is an owner in a business. Of all the potential estate planning participants, the attorney has the obligation to insure that the client's wishes are enforced from a legal view after death.

Regardless to which discipline the estate planner is associated, only the attorney is allowed by society to draft legal documents and to dispense legal advise. The line to be crossed in this regard is nebulous at best, but the individual estate planner shall be held accountable for any activity which enters the territory of the lawyer.

ELEMENTS OF THE ESTATE PLANNING PROCESS

The estate planning process has in common with financial planning the same major elements, namely,: data gathering, existing activity analysis, new plan design, client analysis of new plan, plan implementation and periodic plan review and updating. Data gathering includes recording important facts as well as ascertaining client motivation and objectives. Does the client wish to reward or punish heirs? Is charitable giving high or low on the list of priorities? Does the client have more that one family (i.e. more than one spouse and children by more than one spouse). It is obvious that estate planning fact gathering requires asking questions of an extremely personal and intimate nature.

There are several client fact or data finders currently available for purchase in the marketplace. The best suggestion is for the planner to examine various fact finders available and determine which best meets their needs. No fact finder will be perfectly suited to every planner's needs, therefore deletions and additions should be considered which reflect actual information requirements.

Subsequent to fact finding the planner is obligated to thoroughly analyze the existing situation to determine whether or not the recently obtained facts support current activities. Does the client's existing plan consist of an up to date will? An analysis of existing client planning tools must be made to determine whether or not current attitudes are reflected in past planning activities. Notations of current plan improvements must be made by the astute planner. This analysis should then lead to the formation of a new plan design which offers alternative solutions to identified problem areas. Explaining the new design in language which is understandable to the client is the next step. Without a fundamental understanding of what is being offered by the planner, the estate plan concept will likely not proceed.

Plan implementation is next achieved with the participation of the team attorney who is responsible for drafting appropriate legal documents or effecting possible changes in property ownership status. After all necessary legal documentation has been completed the final element of the sound estate plan is to periodically review the existing solutions to determine whether any revision is necessary.

CHAPTER II:

ESTATE ADMINISTRATION AND PROPERTY OWNERSHIP

Property is described as being either "real" or "personal". These terms **are mutually exclusive:** if something is real property it cannot be personal property and vice versa. Real property is land and anything permanently affixed to the land. Personal property is best defined as any property other than real property.

Personal property can be further segmented to include property which **is either tangible or intangible.** If you can feel, touch and see an object, such as an automobile, it is regarded as being tangible. The value of an auto is in its functional use as a method of transportation. Intangible property has value because of what it represents not because of what it does. For instance, **ownership of a life insurance contract is an intangible.** It has no functional use but value exists in the financial rights it provides to a beneficiary upon the death of an insured.

The term **"estate"** may conjure up the serene pastoral setting of a fox hunt taking place against the backdrop of a mansion in the rolling English countryside, but from a modern legal sense it simply **refers to ownership as a possessory right** to either personal or real property. Ownership can be absolute and unlimited or subject to use and/or time restrictions. The notion of possessory interest can include both present and potential future rights.

The broadest possible ownership available in real estate is referred to as "fee simple" or "estate in fee simple absolute". Such ownership in real estate is absolute in the sense that it belongs to the individual with no strings attached and can be owner for an infinite length of and passed to anyone the owner selects upon death. The only limits of use imposed upon the owner are those restrictions enforced by society as to zoning or other legal conditions. Furthermore, through the use of "eminent domain", the government can take privately owned property by providing just compensation.

Lesser ownership interests include life estates, estates for a term of years and estates with reversionary and remainder interests. A **life estate** provides a right to possess property in an absolute fashion but only during the life span of a specified individual (or individuals). There is no right to pass ownership accorded to a person enjoying a life estate.

The party to whom property reverts upon the passing of the measuring life is referred to as the **"remainderperson".** To protect the remainderperson's right in the property, the life estate holder must not "waste" the property. Therefore the life estate holder owes the following duties: pay property taxes in a timely fashion, insure the property against loss and protect any income producing source of the property. Any breach of these duties by the life estate holder can enable the remainderperson to institute a legal cause of action against them.

An **estate for a term of years** specifies the exact time of possession for the estate holder. The same restrictions found in a life estate apply to the term of years property holder. If the individual enjoying the property for a term of years dies prior to the term period, the remaining time can be passed to someone else by the original holder of the term.

The concepts of **remainder and reversionary** interests must be explained. A remainder interest refers to the current right of a party to enjoy property in the future after a currently held estate right expires. Remainders can be vested or contingent. Vested interests are absolute and current and future enjoyment of property can never be removed. The **broadest possible remainder** interest in which the entire property shall be received in an absolute fashion is referred to as an **"indefeasibly vested remainder."** Contingent interests create an uncertainty that a possessory interest may never become available. If a stated contingency is not realized, the possessory interest at stake will not occur.

Reversionary interests, which are always vested, enable the owner (referred to as the grantor) to have some or all of the original property rights which were transferred returned at some future point in time. A reversion exists when less than the estate owned by the grantor has been transferred.

Another property **ownership concept is the difference between legal and equitable ownership.** The person holding title to property is considered to be the legal owner. The equitable (also known as beneficial) owner is the party who uses, possess and enjoys the property. Legal ownership is most commonly split between a legal and equitable owner when property is held in trust. The trustee is bound as a fiduciary to the terms of the trust and holds the legal title to the property while the beneficiary who is benefiting from the trust holds the equitable title. Upon the termination of the trust the legal and equitable distinctions are merged back to one complete title of ownership held by the beneficiary of the original trust arrangement.

Under the terms of law, the **physical location of property,** or **"situs",** is a crucial point to proper estate planning. Since state and local governments have the authority to tax real property located within their boundaries, the residence state of the real property owner is not relevant when different from the location of the property. Any real and tangible personal property owned within a state is subject to the laws of the situs state and local jurisdiction prevails.

The place a person considers to be his permanent residence is deemed to be that person's "domicile". However, people sometimes live and own property in more that one state. Can a person have more than one domicile state? The U. S. Supreme Court has ruled in the affirmative on this point and has created the possibility of multiple taxations. Once a person dies, their property is taxed and distributed according to the laws of the domicile state.

Since laws regarding distribution and taxation of estates vary, **the issue of domicile is crucial to the estate planning process.** Real property is only taxed by the state in which the property is located. However, personal property, both tangible and intangible, may be subjected to taxation by both an owner's domicile and property situs state simultaneously.

Domicile state can be established in a variety of ways according to activity. Included are voter registration, bank account locations, auto registrations and the state in which property and income taxes are paid.

FORMS OF CONCURRENT OWNERSHIP

There are three basic ways one individual can own the same property at the same time with one or more other individuals:

1) **Tenancy in Common** - two or more people have an undivided ownership interest which may or may not include an equal ownership share. Each co-owner has the right to dispose of his or her ownership interest by gift, sale or will without being in any way accountable to any other person have a concurrent ownership share. There are no survivorship rights. At death, a co-owner in a tenancy in common has their interest pass through the estate to legal heirs and not to other property co-owners when those co-owners are not among the legal heirs entitled to ownership through the estate.

2) **Joint Tenancy With The Right of Survivorship** - in this form, each of two or more property owners owns equal obligations and rights and there can be no disproportionate ownership. The key to this form is that, upon death, the co-owners interest passes to the surviving co-owner(s), outside of a will. This right of survivor means that ultimately, the property will be owned by the last surviving owner. Joint tenancy does not prevent one co-owner from selling their interest in the property to someone other than another co-owner. However, to do so, destroys the joint tenancy and creates another form of ownership, usually tenancy in common.

3) **Tenancy by The Entirety** - this form of ownership can only exists between a husband and wife during the time of a marriage and it is unlike joint tenancy because during marriage, the property cannot be conveyed to anyone else unless both husband and wife agree. If two owners are not married and do not want joint tenancy, only Tenancy in Common is available as a form of ownership.

The above forms of ownership are associated with common law states. However, nine states are called **community property** states including Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and, most recently, Wisconsin. Community property deals with co-ownership of property held between spouses and is an important consideration in the estate planning process.

CHAPTER III:

ESTATE ADMINISTRATION

Estate administration begins at death and it involves settling all matters associated with property and property rights held by the decedent. Settlement of debts as well as transfer of property ownership must be resolved. The first duties associated with estate administration are arranging the decedent's funeral and notifying friends and family. The next step is to discover whether or not the individual left a will.

PROBATE AND DETERMINATION OF ASSETS

When a will is filed in the county court of the decedent's domicile state, **the probate process officially begins.** Technically probate means proving a will is valid but, in actual modern usage, probate has come to mean the disposition of all matters relating to the probate process. After the will is filed the decedent's signature must be verified by attesting witnesses or by any other substitute process allowed by statute. **Upon determining the will's validity, an estate "executor"** (or administrator if no valid will is found) **is duly sworn** by the court and "letters" testamentary (or letters of administration as they are called if no will exists) are sent.

A decedent's property consists of either probate or nonprobate assets. Property which passes directly to a named beneficiary (i.e. life insurance proceeds) avoids the probate process. All real and personal property payable to the estate of the decedent is subject to the probate process and will be paid to any lawful recipients of the decedent according to law or by disposition of the valid will.

Although property may pass outside of probate, state inheritance or estate taxes may still be payable. For instance, property belonging to the decedent but held in trust (i.e. a Totten trust) avoids probate but still will be listed as an asset of the estate and will therefore be taxable by the state. This same property may avoid taxation in some states if held in joint ownership with the right of survivorship. Another tax complication arises when property owned by the decedent has a situs in more the one state.

DUTIES OF THE ADMINISTRATOR OR EXECUTOR

A valid will names the executor who is responsible for settling all matters of the estate. The executor must manage the estate, gather assets, collect payments, pay debts including any expenses and taxes and distribute assets to the appropriate beneficiaries. The **executor must petition the court to be appointed** and must be formally recognized by all persons associated with the estate as the estate's personal representative.

When the decedent had no will, a petition is filed with the court to appoint an administrator. State law prescribes parties entitled to be administrator in order of preference dictated by relationship to the decedent. The qualified administrator must be legally competent which means being of sound mind and of legal adult age. Differences between state laws must be dealt with, including the problem that in some states only a state resident can be an administrator.

A **surety bond may have to be posted** with the court by the executor. Bond penalty amounts normally vary according to the size of the estate. It is customary for the penalty amount of the bond to be double that of the size of the estate. After posting bond, the letters testamentary or letters of administration are sent by the court. These letters advise all concerned parties that the person named has the authority to act on behalf of the estate until discharged by the court from that duty.

The **executor or administrator is the estate's personal representative** and must advertise the probate process to any party who may have an interest in the estate including debtors and creditors. A local periodical carries the ad and announces a notice to all estate debtors and creditors that a time limit is now running during which a claim can be filed with the court. If a creditor's claim is not brought to the attention of the executor or administrator within a statutory time frame, the claim is barred thereafter.

Another preliminary duty of the executor is to **assemble the property** belonging to the estate. This activity can be simple or complex and may even lead to negotiating the sale of a business. If the decedent's property ownership included concurrent titles, limited partnership ownerships or property ownership in other than domicile states (or even in foreign countries), the assembling of property can become extremely complicated.

The executor will locate any safe deposit boxes held in the name of the decedent as they tend to hold valuable papers and crucial information relating to the estate. However, **the will itself should not be kept in a safe deposit box** as this can lead to delays in probating. Many states require that a bank representative and an official from the state revenue department be present for safe deposit box openings after the death of an owner.

All life insurance contracts and other intangible property rights such as assets held through qualified plans should be located as quickly as possible for purposes of filing a claim. If the distribution from proceeds of a life insurance contract has not already been selected by the decedent, the beneficiary has various distribution options available besides taking the entire lump sum. Several annuity payout types including life payment, fixed amount and fixed period payments can be selected.

DUTIES OF BASIC ESTATE MANAGEMENT

After identifying and obtaining the property belonging to the estate, the executor or administrator must oversee all assets and business affairs. All cash which was assembled should be deposited into a checking account bearing the name of the estate and all previous accounts held in the name of the decedent should be closed. It is the duty of the executor to calculate the value of assets belonging to the estate as of the date of death (Refer to **Section VIII** for a synopsis entitled **“Valuation of Estate Assets"** for additional information). Upon property appraisal, an inventory is filed with the probate court.

When estate settlement matters are complex and beyond the scope of his or her knowledge and abilities, the executor is charged with obtaining help from qualified personnel such as accountants and attorneys. This is necessary because the **estate is charged with filing appropriate tax and legal forms.** One alternative to individually seeking out professional help is to contact a reputable trust company that can handle all the required details in exchange for a fee based on actual service rendered.

ESTATE CLAIMS PAYMENT

All debts and taxes owed by the estate must be accounted for and paid by the executor. Any creditor of the estate must either submit a claim for payment within a time limited by statute or be barred from collection. Some creditor claims are paid on a priority basis as compared with other creditors, according to a creditor class structure. The highest priority is given to the payment of special property liens, attorney fees (surprise, surprise!) and funeral expenses followed typically by taxes and debts owed to the state and federal government and then to court judgments, wages owed, medical expenses and any other miscellaneous claims.

Perhaps the most complex and potentially costly element of estate planning concerns filing required tax returns. Returns which may have to be filed can include gift taxes, taxes on real and personal property, state and federal income taxes, state inheritance taxes and federal estate taxes. A major issue concerning the payment of estate taxes is deciding upon the asset valuation date.

ESTATE DISTRIBUTION

One of the final administrative steps for the executor is to complete an "accounting" for the court and estate beneficiaries. Although this procedure can vary from state to state, the accounting is filed in the county of probate. All parties to the estate must file any objections to the accounting at this time. If there is no objection or objections have been resolved, final distribution commences.

Sometimes the situation arises when a qualified beneficiary does not wish to accept assets to which he or she is legally entitled as a result of the probate process. In such an instance the **beneficiary must file a "disclaimer" in order to refuse acceptance of the legacy or bequest.** For IRS purposes there are four requirements to filing a valid disclaimer:

1) the refusal by the beneficiary must be unqualified;

2) the refusal must be in writing and made to the donor, legal representative of the donor or to the legal property titleholder within 9 months of the decedent's death or within 9 months after the beneficiary attains the age of 21;

3) neither the property interest nor any of its benefits must have been already accepted by the beneficiary prior to making a disclaimer; and

4) the property interest must pass to anyone but the beneficiary or spouse of the beneficiary without any direction by the beneficiary as to whom the disclaimed property may pass.

Under federal law, **once a beneficiary has accepted a bequest, it can no longer be validly disclaimed.** Once a disclaimer qualifies under federal law, no state law can affect federal acceptance of a disclaimer.

The reason a beneficiary would file a disclaimer includes not wishing to add to his own already sizable estate and therefore creating another estate planning headache.

CHAPTER IV:

COMMUNITY PROPERTY

DEFINITION

Community property is a civil law concept equating marriage with a partnership which provides each spouse with an equal ownership interest in all property acquired during that marriage. When America was colonized several hundred years ago, the English lived along the Atlantic coast region (common law influence), the French in Louisiana (French civil law influence) and the Spanish settled what is today Mexico and the American west and southwest (civil law influence). The legal systems of these European powers were somewhat divergent from one another and each system tended to take root in a region based on these early settlements.

The Spanish influence upon the residents of Texas, California, New Mexico and Arizona lead to the institutionalizing of community property in these states while eventually spreading to Washington, Idaho, Nevada, Louisiana and most recently, to Wisconsin.

The **basic rules of community property** are as follows:

1) **"Separate" Property** is

   a) any property owned by either spouse before marriage,

   b) any property acquired during marriage but using individual funds to make the acquisition,

   c) any property received by an individual, either married or unmarried, through gift or inheritance.

2) "Community" Property is **ALL** property acquired during marriage which is not "separate" property.

3) Changing state residence affects estate planning as follows:

   a) movement from a common law state to a community property state means the property brought with the married couple keeps its original (common law) character; and

   b) movement from a community property state to a common law property state means the community property stays community property unless the spouses each agree to change these rights to common law.

LEGAL PRESUMPTIONS OF COMMUNITY PROPERTY

In Section I of this text, joint tenancy as a form of ownership was discussed. In common law states it is customary for spouses to hold real property title in some form of joint ownership. When one spouse dies the other acquires the ownership interest in a common law state.

However, **in civil law community property states,** the **ownership notion of joint tenancy is not favorably viewed.** For instance in the state of Texas, there is a statutory presumption against joint tenancy in favor of tenancy in common. Even if married couples indicate they prefer joint tenancy and it is placed on a property title, Texas will not recognize the joint tenancy unless a separate written document expresses that joint tenancy was the intent of the spouses.

Life insurance and its ownership also receive different treatment in community property states. Three distinct rules have evolved in the community property environment over the years and they are:

1) Life insurance is community property if the **final premium payment** was made with community funds (Arizona).
2) The **Apportionment Rule**: the percentage of proceeds which are separate or community property are contingent upon what percentage of premiums were paid with community or separate funds (California).

3) **Inception of Title Doctrine**: policies bought with community funds after marriage is community property. If separate funds are used, either before or after marriage, it is separate property. There is a right to premium reimbursement if the non owner spouse of the policy used separate funds to help pay premiums (Texas).

The planner must be acutely aware of the community versus common law distinctions when counseling clients holding property in states governed by such systematic variations. Without a through review of client ownership records matched against statutory regulation, any developed plan runs considerable risk of not carrying out the wishes of its creators.

CHAPTER V: FIDUCIARY RELATIONSHIPS

DEFINING A FIDUCIARY

A **fiduciary is a person or institution** (such as a trust department in a bank) **holding and managing property for the benefit of another party.** The fiduciary holds only legal title while the other party or beneficiary is the beneficial owner and holds equitable title. The ethical principles to which fiduciary parties are held are defined according to state laws.

There is no obligation to become a fiduciary when asked however, upon acceptance, there is a legal obligation to perform properly until the fiduciary relationship is dissolved.

A fiduciary draws the power to act from possibly one or more than one source. In one instance the power source is state law as in the case of court appointment of an executor (or administrator) or a guardian to a minor or incompetent person.

The fiduciary must account for their actions to the court who oversees all fiduciary activity. Another method of creating fiduciary power without the court is through a trust (a more detailed discussion of trust creation appears later in this section). This private creation is established when a "grantor" appoints another person or an institution (trustee) to hold legal title for the benefit of the grantor. The power of the trustee flows directly from the written trust agreement.

When a fiduciary has been appointed by the court as in the case of an estate matter, the executor must file an accounting with the court as a final element of the discharge of duty. A trustee makes no such accounting to a court, but may be required to regularly account to the trust beneficiaries.

The fiduciary powers and duties of a court appointed fiduciary are relatively short since it is the goal of the legal system to complete its business in a timely fashion. The estate process is ideally designed to take no more than 12 to 24 months to complete. Once an estate is closed the fiduciary obligation evaporates with the completion of duty.

Although a **trust may exist** for only a short time, it is much more common for it to exist **for many years, sometimes for many decades.** The trust and ensuing fiduciary relationship begins once property has been transferred to a trust. The powers and duties of the trustee are thus terminated when the trust ends.

FIDUCIARY DUTY

Regardless of the power source, **a fiduciary owes nothing less than absolute loyalty to all beneficiaries in matters related to actual fiduciary duties.** Rules governing the fiduciary relationship have evolved through common law and are today embodied by statutes written and passed by individual state legislatures. There are **three fundamental principles common** to every fiduciary relationship:

1) responsibilities borne by the fiduciary cannot be delegated to another if they can be performed by the fiduciary; and

2) it is the duty of the fiduciary to act solely for the benefit of the beneficiary for all matters within the confines of the fiduciary relationship; and

3) anytime a fiduciary transacts personal business with another who is a party to a fiduciary relationship, the fiduciary must fully disclose all facts related to the transaction to the power source.

Furthermore, when a fiduciary is a professional (i.e. attorney), they will be held to an even higher standard than would be the case with a lay person.

Four main elements of fiduciary duty will be discussed. The **first duty requires a trustee (fiduciary) to be impartial** when dealing with beneficiaries. The legal standard imposed upon the conduct of the trustee when dealing with the beneficiary is one of ordinary prudence, skill and care. When the trustee exercises the same ordinary prudence he would with his own property as he does with trust assets, then he has fulfilled this requirement.

Secondly, the trustee must preserve trust property yet make it productive. Income must be produced by the trust or the trustee can be held personally liable. It is advisable for a trustee to generate an amount equal to generally prevailing rates of return for the same or similar assets.

A **third duty concerns the special responsibility of a trustee when acting on behalf of a corporation.** The corporate beneficiary must be especially cautious not to profit from the relationship. This includes when a bank is a trustee and the corporation wishes to maintain an account at the bank. Although rules vary from state to state, generally such a practice is acceptable when the bank handles the trust funds in a reasonable and prudent manner.

A special problem arises when a trustee is fiduciary for two separate accounts and property ownership is being transferred from one account to another. This is a conflict of interest even when fair market price is involved. An extension of this prohibition also prevents the corporate trustee from selling any entrusted property to any employee, director, or business affiliate by which the trustee is employed.

In the reality of the fast paced economy of modern times, trust companies do have authority to pool the assets of many small estates and trusts into one commonly managed fund **called a "common trust fund".** The small trust client saves on expenses while the trust management has greater investment flexibility because of a larger pool of assets. Federal regulation allows their existence and the common trust fund is not a taxable entity.

Perhaps the **oldest and most universal fiduciary responsibility is the duty not to self deal** at the expense of the beneficiaries. The trustee must not personally buy trust assets regardless of whether or not fair market price is offered. The only exception might be if all pertinent facts were disclosed to each beneficiary as long as each beneficiary was competent to accept the offer. However, the trustee who purchases trust assets in an approved sale for less than fair market price would be legally liable for the difference. The duty of the trustee to the trust is always greater than duty to self when trust assets are involved.

When self dealing is at issue and one or more beneficiaries are incompetent due to either mental incapacity of age, the transaction which would otherwise be valid can be set aside. Even if the trustee wishes to sell personal assets to the trust at bargain prices and all beneficiaries agreed, the transaction is **not binding on the incompetent beneficiary.**

To complete this discussion of fiduciary duty, the concept of breaching the duties must be addressed. Clear breach of duty includes personal use of trust assets or leaving trust property idle rather than making the property productive. There are however, more subtle ways to breach duty including electing to invest trust funds in a very low but safe return vehicle, when other relatively safe investments are offering greater returns. Such grey areas tend to place the fiduciary in situations rife with personal liability. This does not imply the fiduciary may select higher yield at the expense of safety. However, when two equally safe opportunities are present, there is a clear duty on the part of the trustee to place the assets in the greater yielding investment.

FIDUCIARY POWER

Fiduciary power is usually broadly based but it could also be quite restrictive depending upon the powers granted in the trust agreement. Common duties include the right to keep or sell trust assets, mortgage property, take a loan or use assets as collateral; hire attorneys, investment advisors or accountants.

If no specific investment provision defining fiduciary investment power has been written into the trust agreement, then common law, state statutes or the courts will define the qualifications.

Most states use **the "prudent-man" rule or,** in other words, under similar conditions what action would an average, ordinarily intelligent person take? Following the law and or the written provisions of the trust are required but, in situations not clearly addressing the matter at hand, the prudent-man rule is the prescribed duty.

While the prudent-man rule is widely followed, some states use **the "legal-list" method** which describes by statute the investments which are available to the trustee for trust assets. Investing outside of the list is an automatic breach of fiduciary duty and all resulting loss would become the personal liability of the trustee.

Fiduciary power includes the restriction that conflicts of interest between the trustee and beneficiaries are not allowed. This includes the corollary concept that impartiality of trustee action among different classes of beneficiaries must be maintained. When a trust contains the corporate stock of the trustee at the inception of the trust, the shares may be retained in prudent-man states, but may have to be sold in legal-list states. When the trust did not already contain trustee corporate stock, there is a duty not to purchase.

FIDUCIARY SELECTIONS

Although this text has generally been referring to the **fiduciary as a trustee, the fiduciary can also be called an executor (administrator when a written will does not exist) and a guardian, depending upon the type of fiduciary relationship.** Regardless of the occasion, the suitable candidate for selection as a fiduciary should be honest, possess a high degree of integrity and be interested in the welfare of the beneficiary.

Fiduciaries with prior background in property management and asset investment are also preferable. The ability to serve the beneficiary is foremost and the ideal fiduciary should always have enough time to devote to the fulfillment of the obligation involved.

The Trustee

In establishing the trust, a grantor faces a formidable task when selecting the trustee. Sometimes the temptation to name a spouse, other relative or even one's self is too great to overcome. Such a selection tends to defeat diversification and flexibility otherwise available to a trust when an independent third party, usually a corporation (bank), is named as trustee. The following **five elements need to be evaluated when deciding upon whether to select either a corporation or an individual as the trustee:**

1) The individual can become incapacitated or die and therefore a disadvantage of selecting the individual is the inherent temporary nature of such an appointment.

2) An individual who is a relative of the grantor can be placed in an environment ripe with conflicts of interest leading to breaching of duty or, the very least, to hard feelings among family members.

3) If the individual trustee breached fiduciary duty and caused economic loss to the beneficiaries, holding the trustee liable may be useless if the individual lacks sufficient assets to make restitution. On the other hand, the corporate trustee who is held accountable has the assets of the corporation available to make restitution.

4) A beneficiary is sometimes named as the trustee. This can create many unfavorable tax consequences especially when the trustee is not the only beneficiary. Tax rules can lead to gift taxes being owed or to having the entire value of the trust being includable in the estate of the trustee. Seeking the advice of a competent tax expert is always advisable prior to naming a beneficiary as a trustee.

5) Since tax laws are complex and can change quickly, the trustee responsibility is one of increased specialization, not to mention a comparatively arduous assignment.

In analyzing the above considerations, the conclusion to be drawn **favors the corporate trustee** if the goals of the grantor include flexibility of management and investment, properly meeting beneficiary needs and "positive" taxation.

The Guardian

The **guardian is a court appointed** position charging a party with the **responsibility of caring for another person** who is legally incompetent (mentally of physically impaired of not of legal age). The individual needing the care is called a **"ward".** Guardians do not take legal title to the property of a ward but instead discharge specified duties according to the authority they are granted. The guardian serves until his or her duties are formally discharged by the court. Although guardianship runs concurrently with the incompetency of the ward it can include a ward's entire lifetime.

A person who assumes the status of guardian falls into one or more of the following types of guardianship:

1) **Testamentary Guardian** - named as the guardian of minor children in a will. Absent a bona fide reason to the contrary, the court will accept such a choice automatically.

2) **Guardian of person or property** - this is the most common variety. If only the ward's property is involved then it is a simple business relationship and the guardian receives a fee for services rendered. When the guardian is to care for the person, any property managed by a different guardian is given to provide for the ward's necessities including food, shelter, clothing and education.

3) **Guardian ad litem** - is appointed by the courts to engage and complete a specific purpose such as when a minor is named as a party to a legal action. Once the legal issue involved has ended, so to does the guardianship.

4) **Guardian de son tort** - sometimes an individual assumes the role of caring for a minor or incompetent person but was never officially appointed by the court for such a purpose. Such a guardian is still held to the same standard of action that would be applied to a court appointed guardian.

The responsibilities attached to the guardian mirror that of the trustee or executor: do not assume the position unless you are willing to perform all required services and a duty according the dictates of the position as it was established.

The Executor

The requirements for being an acceptable executor include mental competency and the absence of a felony conviction and, in some states, a surety bond must be posted. Special attention should be given to the selection of an executor because **experience managing assets as well as knowledge of the workings of the court system can be helpful.** Even if the executor is a close relative of the decedent, the same standard to duties applies and all beneficiaries must be treated on an equitable basis. Expertise and/or background in the following areas and/or matters will prove valuable as well as the considered evaluation of certain situations, as follows:

1) business or administrative ability to assemble, conserve and distribute estate property properly;

2) if there is a conflict of interest between the executor and other beneficiaries, the individual under consideration may not be suitable;

3) the candidate should have the time to carry through with the responsibilities involved; and

4) personal knowledge of the decedent's personal and business affairs can be helpful.

When the will is being written it is a good idea to name a second party as the executor in case the first choice is either unwilling or unable to fulfill the responsibility involved. Sometimes it may be wise to name a corporation and an individual as coexecutors to make certain that complex matters are properly handled while at the same time, the personal touch is not overlooked. Ultimately, however, **the size of the estate is the probable determinant of executor selection.**

Substitution of Trustee

Who should have the power or authority to remove a trustee? Should the beneficiaries be able to do it, or should some other party have the authority for removal? When a beneficiary can remove a trustee and appoint himself as a successor, the tax consequences of the estate may alter. Therefore it usually wiser to name a different corporate trustee as a successor. Arguments supporting the position that a mechanism to change the trustee should exist, include:

1) new changes in the tax law or local requirements; it may prove beneficial to switch the situs of the trust from one jurisdiction to another;

2) corporate trust personnel may change and the relationship could become less than harmonious between the new regime and beneficiaries, prompting the urge to switch; and

3) when a beneficiary moves further away, the relationship between the trustee and beneficiary can make it quite inconvenient to transact trust business.

TRUST CREATION

A trust can be created for many different reasons including professional property management, trust asset investment, assure income for designated beneficiaries or it may be quite useful in strengthening a financial or estate plan. Also, changing family relationships such as second marriages and having children by more than one spouse can utilize the trust structure to achieve multiple goals. **The central concept of trust creation is a grantor's objective of income and principal payment to beneficiaries can be achieved through the flexibility afforded because of creating a trust.** Some common purposes for trust creation include the following:

1) estate taxes can be saved through the use of certain irrevocable trusts;

2) relatively modest amounts of trust assets can be invested in common funds and thus enjoy high quality portfolio management which would otherwise not be available;

3) a grantor can make desired income and principal arrangements for a spouse which will enhance the spouse's life even after the grantor is dead; and

4) wealth accumulation can be achieved with favorable income tax results which allow income to be taxed at a lower beneficiary's rate rather than the higher rate of the grantor.

The **trust is usually defined as a legally binding relationship in which a fiduciary acts on behalf of the best interest of the property of another for some desired benefit to a beneficiary.** The fiduciary is the "trustee" who holds title to property from a "grantor" for the benefit of a "beneficiary" according to the terms of a trust agreement.

ELEMENTS OF THE TRUST

All trusts consist of the following five elements:

1) The grantor (sometimes referred to as the trust creator

2) The trustee (fiduciary who owes the highest duty of good faith to beneficiaries)

3) the beneficiaries (the party benefiting from the property being held in the trust)

4) The property, legal title of which passes to the trustee

5) The terms of the trust as written in the trust document

The **"grantor" creates the trust** and is also called the "trustor", "settlor" or, in the case of a testamentary trust, a "testator". The grantor transfers title to property to a trustee who agrees to manage the property for the benefit of the beneficiary. Unless the grantor keeps some type of power over the trust, his interaction with the trust is completed once the trust begins operation.

The **"trustee"** can take the form of one or more individuals, a corporation (bank) or a combination of corporation and individual appointees. The trust requires a trustee but the incapacity or death of an individual who is a trustee will not invalidate the original trust. The worst that will happen is a new trustee will have to be appointed and the trust would temporarily become inactive until the new trustee is named. It is wise to designate a trustee successor at the inception of a trust, but in the absence of such a designation, a court appointment will have to be made.

An exception occurs when there is but one trustee and one beneficiary and it happens to be the same individual: the trust ends and the legal and equitable title become one again according to the common law **legal doctrine of "merger".**

The beneficiary is the party for whom the benefits of the trust were created. Whereas the trust holds legal title to property, **the beneficiary owns equitable title.** Various classes and corresponding beneficial interest can be created by the trust. Designations can include primary and contingent beneficiaries. A beneficiary may be entitled to only the income from a trust with the principal passing to a "remainderperson" upon the termination of the trust. Trusts created in the United States must include as beneficiary only legal persons (individuals or corporations) and may not include animals such as a pet.

The **trust property is also known as "principal", "res" or "trust corpus".** Although not all property should be placed in a trust for various practical reasons, virtually any property capable of being owned can be placed in trust. Therefore real and personal property, as well as contractual rights including life insurance contract ownership can be held in a trust.

The **terms of the trust are written in** a document referred to as either **the "trust instrument", "indenture of trust" or "deed of trust".** All conditions of the trust are recorded and they, along with applicable law according to the jurisdiction in which the trust was created, will apply. The duties and powers of all parties to the trust are defined and any restrictions or limitations on the powers of the trustee are also included in the deed of trust.

Investment of trust principal can be designated by the grantor or broad discretionary powers of investment may be given to the trustee. In the event trust terms and state law conflict, it is the law which must control. When no trust directive exists on a particular point, again state law will provide the answer.

The **sprendthrift clause is** an important provision which can be included in a trust. It prevents the creditors of a trust beneficiary from being able to attach the assets of the trust. Therefore the trust protects the beneficiary who exercises poor judgement, from unpleasant consequences.

Another standard trust clause protects the trust from violating **the rule against perpetuities** (the next concept to be discussed). A provision outlining the grounds required for removing a trustee is also a common part of a trust instrument. Finally, the deed of trust spells out the exact manner in which the corporate trustee is to be compensated.

RULE AGAINST PERPETUITIES

A trust may last quite a long time even after the grantor's death, but it cannot last forever. The rule against perpetuities has been followed for hundreds of years dating back to English common law to determine the viability of a trust from inception. **If any interest in property granted through a trust vests later than 21 years and 9 months after any living being who was in existence at the time the trust was created, then the trust is invalid.**

Determining the inception date of the trust becomes important when considering the rule against perpetuities (RAP). The RAP beginning date varies depending upon whether the trust was revocable or irrevocable. In an irrevocable trust the RAP clock begins ticking the date upon which the trust is created. When a **revocable trust** in involved, the **RAP begins when the interest in the trust becomes irrevocable.** When an interest is created by will the RAP starts upon the date of the testator's death. When a trust is being assembled, the drafter of the document must take care to make certain that no interest in the document will be vested so far into the future that the RAP will be violated. Therefore the creation date of the trust is critical. **The RAP creates a problem for a trust if the possibility of a RAP violation exists; whether or not the RAP is actually violated at a later time is irrelevant.**

Applying the RAP is extremely complicated. Completely eliminating a RAP violation is simple as long as the trust or will includes what is referred to as a **"perpetuities-saving clause".** Typically, such a clause may read, in part, as follows:

"... every trust established by this Will shall terminate, if it is not already terminated, 21 years after the death of the last survivor of my wife, my children, and any lineal descendant of mine alive on the date of my death. At the termination of such trust, my trustee shall immediately transfer, convey and pay over the principal of each trust to the lineal descendants then living of the child of mine on whose account the trust was established, in equal shares..."

If the above trust was **"inter-vivos" (a living trust)** then the date of death language above should be replaced with "on the date of the creation of this trust."

Another common law rule applied to interests vesting too far into the future is called the rule against accumulations. It operates under the same principle as the rule against perpetuities as the interest must vest within the same time frame. Some states have shortened the period when implementing the rule against accumulations and a few states allow accumulations only during a child's minority or for charitable purposes.

FLEXIBILITY OF THE TRUST

One of the distinct advantages of trust establishment is the **extraordinary flexibility the grantor has,** especially in the areas of locale and trustee discretion. The situs (geographic presence) of the trust can be anywhere, not necessarily the grantor's domicile state. The trust instrument will indicate in which state the situs of the trust is located. The trustee is usually granted wide discretionary powers of management and investment actions.

Ideally the grantor wants the trustee to have powers sufficient to implement distributions to beneficiaries in much the same way the grantor himself would have done. Correspondingly, the greater the latitude given to the trustee, the more likely it is the grantor's wishes in establishing the trust can be achieved.

LIVING TRUSTS

A living trust accomplishes the goals of property transfer during the lifetime of the settlor and is legally referred to as an "inter vivos" trust. **The living trust can be revocable or irrevocable.** The revocable trust can be changed or ended by the grantor at any time and all trust property ownership is returned. **There are no tax benefits to be realized through the creation of the living trust,** but there are many other reason to establish one. The **living trust should be viewed as an incomplete gift** and the main reasons for creation are as follows:

1) the grantor can evaluate the operation of the trust under the auspices of a current trustee and decide if this trustee is acceptable prior to the trust becoming irrevocable. The trustee can also become more comfortable with the grantor and gain a better knowledge of how to achieve the grantor's goals;

2) since the revocable trust becomes irrevocable upon the death of the grantor, probate cost is avoided;

3) the grantor may be incapable of managing the property while a need for professional management exists;

4) the grantor has the ability to create a gift arrangement with the ability to take back the gift before the grantor's death;

5) intangible property not located in the grantor's domicile state can be included in the trust thus eliminating the possibility of multi-jurisdictional review; and

6) the sole proprietor or partner in a business can transfer ownership of the business to a trust and avoid the termination of the business at the owner's death.

Alternatively, an irrevocable living trust can be created whereby property is permanently transferred to the trust and cannot be reclaimed by the grantor until or unless the trust otherwise terminates allowing such reclamation. Unlike a revocable trust, **the irrevocable trust is a completed gift for estate, gift and income tax purposes.** An irrevocable trust enables the grantor to reduce his estate value and to shift income to beneficiaries. A drawback to the irrevocable trust is the possibility of gift tax liability. Unless the client feels comfortable in permanently relinquishing ownership of property, an irrevocable trust may not be desired. In addition to tax benefits, the other reasons for establishing an irrevocable trust include the following:

1) trust property is out of reach of the grantor's creditors and will provide benefit to beneficiaries;

2) trust property is not subject to probate when the grantor dies;

3) a beneficiary with special or peculiar needs can be cared for under the terms of the trust and with professional money management. In this manner the beneficiary must deal with the trustee rather than with the grantor thus avoiding interpersonal conflict; and

4) the trust can protect assets from spousal election rights upon the grantor's death and enable children from a former marriage to be provided for.

Any living trust must clearly state whether or not it is revocable. If revocable it must be stated within the trust document when and to whom property ownership is retrievable.

CHARITABLE TRUSTS

The **motivation** behind the creation of the charitable trust is not one based on tax savings but rather **is the result of the grantors desire to aid one or more worthy causes** which can ultimately benefit all of mankind. The creation of the charitable trust is the same as any other: the intent to create a trust as well as the transfer of property must take place.

The difference between the charitable trust versus some other purpose is one of public versus private **in that a charitable purpose, not an individual, is the beneficiary.** The benefit is to society as a whole and includes advancement to government, science, education, religion or relief of poverty. When establishing the charitable trust, the Internal Revenue Code specifies the parameters of what is charitable. The charitable trust may not benefit an individual but a definite class of beneficiaries must be stated.

Perhaps the greatest difference between the charitable and private trust is the duration of time for which it may exist. Although the private trust may not violate the rule against perpetuities, **the charitable trust has no time limit** and will continue until it ends according to its own terms or due to some other purpose. Even if the charitable trust cannot achieve the purpose for which it was created, it may still continue to serve some other related cause. The **legal doctrine of "cy pres" prevents** charitable trusts which are unable to achieve their original purpose from failing by finding a different but similar charitable purpose for the trust to serve. Cy pres is applied by the courts when the original purpose of the trust has already been satisfied or when it cannot be satisfied (due to lack of assets to accomplish the purpose or some other reason). It is usually the responsibility of the Attorney General of a state to enforce the terms of a charitable trust.

APPOINTMENT POWERS

When the owner of property, known as a **"donor", gives an interest** in that property to another, known as the **"holder" or "donee",** a power of appointment has been granted. When the donee designates the property to someone else according to the conditions of the appointment, the donee is said to **"exercise" the** power. If the donee then fails to exercise the power of appointment, the power **"lapses"**. The party to whom the property is designated by the donee is called an "appointee".

The broadest power of appointment is called "general" and it means the donee may appoint anyone. All property subject to a general power of appointment belongs to the gross estate of the donee. **When a power of appointment is limited** to a specific class of appointees **the power is called "special".**

The power of appointment may last for a specific time period or be available from the donee to exercise at any time. However, when the appointment power can only be exercised upon the death of the donee according to provisions of the donee's will it is known as **a "testamentary power".**

Although powers of appointment are sometimes utilized because of gift and estate tax consequences, the flexibility they allow to dispose of property is a nontax consideration for their use. The power of appointment allows the decision of to whom and when to dispose of property to be delegated to another or to postpone the decision altogether. **The donor can keep some control of the property while empowering someone else with the ownership transfer decision.**

The specific uses of power of transfer are as endless as the number of individuals for whom they are exercised. The ability of a donee to play a waiting game to determine who gets the 'goodies'(and when) is an imposing power. It allows the donee the opportunity to designate property at a time when a greater number of circumstances can be evaluated.

Testamentary Trust

One more type of trust is the testamentary trust which is originated as the result of a legal will. The testamentary trust is always revocable until the death of legal incapacity of the testator. This type of trust is discussed more fully in the next section.

CHAPTER VI :

PROPERTY TRANSFER AND CORRESPONDING FEDERAL TAXATIONLIFETIME TRANSFER BY GIFTING

Although the tax code does not specify a definition of gift, the common law says **a gift is a voluntary transfer of property ownership without consideration** (any exchange of value). **Tax regulations concern themselves with whether or not property was transferred for full value.** When property is transferred for less than full value, a gift, which may be taxable, has been created. This represents the gift tax law concept of **"sufficiency of consideration"** test. Mathematically, the formula would be:

Value of Property Transferred - Consideration Received = Gift

The courts consider three factors when evaluating whether or not a gift was made:

1) a donor who is competent,

2) a donee competent to accept a gift and

3) the unambiguous intention of the donor to irrevocably relinquish control of the gifted property.

If all three factors above are met, then the following three considerations must also be present:

1) the title to the property must irrevocable be transferred to the donee;

2) the gift must be delivered to the donee and;

3) the gift must be accepted by the donee.

If all the above considerations were met, then the gift amount is subject to tax. The only way to avoid such a tax is to transfer ownership of property by adequate or full consideration.

Types of Gifts: Direct and Indirect

Direct gifts include situations where cash, real property and tangible personal property are delivered to the donee. In the case of real property the executed deed, which is delivered to the donee, constitutes a transfer. Income earned in the future, such as the case with expected future royalties, creates a gift currently subject to taxation. The royalty situation is unusual because the entire tax is due in the present on expected income, yet if the expected income is never realized there is no rebate on taxes already paid.

Forgiving a debt, other than in a business situation, **constitutes a gift for which tax may be due.** Conversely paying more than your legal obligation can be construed as gift. For instance, providing necessities for your children is required but when a mother buys a brand new Corvette for her teenage son, she goes above and beyond the call of taxation tolerance.

Indirect gifts are also subject to gift taxes. Paying expenses which legally belong to another party are gifts. A corporation which provides property to someone and receives less than full value has created a gift.

Life insurance ownership or the payment of premiums can constitute an indirect gift when:

1) an existing policy is assigned to someone else or

2) an irrevocable beneficiary designation has been made or

3) a policy is purchased for the benefit of another.

Avoiding the Gift Definition

A key advantage in creating a gift is to shift income or estate tax liability from a high income earner to a party in a lower tax bracket. **The economic basis of the transfer must transcend mere intent to realize a tax savings; otherwise it is not a gift according to the tax code.** Such a case, referred to as a **"sham gift"**, does not result in the desired tax shifting. Trying to shift income to avoid taxation is thwarted by various tax, gift and estate rules but irrevocable gifts of property and the income they produce are more easily created.

The Business Gift

Assume a corporation wants to transfer property to an individual as a gift. Is this a gift or compensation for personal services? The IRS strongly holds the view that any such transfer is not a tax free gift. The issue of "donative intent" becomes crucial in resolving the this question. A transaction is gift (the corporation pays gift taxes, but the recipient pays no income tax) when the main reason for the transfer was due to generosity and not to reward past, present or future service. The factors considered to determine donative intent:

1) How long was the individual an employee?

2) How valuable were the employee's services?

3) What was the manner in which the amount of the gift was determined?

4) How did the corporation treat the transaction on its corporate books?

Gifts Which Are Exempt

Several transfers of property are specifically exempt from gift tax including:

1) paying the medical expenses of another, regardless of whether or not the donor is related to the donee,

2) tuition paid to a qualified educational institution, regardless of relationship of the donor to the donee,

3) political gifts if the property is used by a political organization as opposed to a contribution to a specific individual and

4) various property transfers as the result of a divorce decree.

Gift Completion

Before a gift tax can be charged, the donor must have irrevocably given control over the subject property to the donee. If it is at all within the donor's power to change or revoke the gift in any manner, a complete has not been made. There are several situations when determining whether or not control has been relinquished is difficult:

1) **Incomplete trust gifts** - the donor transfers property to a trust but keeps the right to revoke the transfer. Tax liability is applied based on the date the gift becomes complete and not when the property was originally transferred to the trust.

2) **Incomplete delivery -** many types of property have technically not been delivered, and therefore do not constitute gifts, as follows:

a) **a gift "causa mortis"-** given in the anticipation of *imminent* death. The donor recovers and the donee returns the property;

b) **checks or notes -** the payor writes a check in the current tax year but the payee waits until next year to cash the instrument. The gift did not occur until the check was cashed;

c) **Totten trust -** a bank savings account where the donor deposits money on behalf of the donee but the transfer is revocable. No gift exists until the donee withdraws funds;

d) **Stocks -** the date upon which properly endorsed stock certificates are delivered to the donee is the completion date. If the donor gives the certificate to a broker or transfer agent for switching ownership to the donee's name, the gift is complete upon the date recorded on the books of the corporation;

e) **U.S. Government bonds** - federal law prevails no matter what state law says with respect to a transfer date;

f) **Joint bank account -** a gift is not complete unless a donee withdraws the funds from an account;

g) **Real estate -** a deed must be executed and recorded otherwise the donor who has simply executed a deed and kept it, has not completed a gift.

Gift Tax Property Valuation

Property must be valued before any determination of gift tax can be applied. **Gift value is fair market value** (defined as the price a buyer is willing to pay and at which the seller is willing to part with property as part of an arm's length transaction) **of the property as of the date the gift is complete.** There is no alternative valuation date associated with the concept of gift tax; the valuation date is always the date the gift is made.

There is a problem of gift valuation which is specific to transfers of large blocks of stock. Known as the **"blockage rule"**, the taxpayer may be able to enjoy a discount from the market value of transferred stock. When a truly large block of stock is traded in a short (reasonable) period, the market price can be depressed. The taxpayer has the gift valuation of stock assessed at the discount price rather than listed market value.

Another gift valuation difficulty concerns the life insurance contract. The main rule regarding valuation of a life insurance contract: the gift value equals the replacement value of the policy (the cost of the same or similar policies issued by the same company). There are several methods of valuation:

1) **A policy transferred** within the first year of purchase: gift value equals the gross premium paid to the insurance company;

2) **A policy in the premium payment stage,** but after one year: gift value is equal to the interpolated terminal reserve plus unearned premiums as of the gift date;

3) **A paid-up policy is assigned:** gift amount equals the premium the issuing company would charge for the same type of single-premium policy of the same face amount on the life of the insured, based upon the age of the insured at the transfer date.

PROPERTY TRANSFER AT DEATH

In this section three methods of transferring property upon death will be examined. The discussion begins with factors and terminology associated with the will. Transfers by contract will be described including those achieved through marriage and by operation of the life insurance contract. Finally, automatic transfers including intestacy (death without a will) and joint tenancy will be explained.

The Will

The will, or last will and testament, of an individual is a voluntary legal document describing the property transfer wishes of the individual upon his or her death. The will has no legal effect until the death of its maker. Once a will has been constructed but prior to the death of the maker, it can be changed, revoked or eliminated.

The main purpose served by a will is the ability to dispose of the property of an individual in an orderly fashion. This is accomplished by naming a personal representative, or executor, to carry out the final wishes of the decedent. The intelligently written will directs the executor as to how the decedent, also called a **"testator",** wants his affairs to be conducted after his death. The executor can be an individual or a corporate fiduciary.

Section III of this text covered estate administration but, in terms of a quick review, the executor is responsible for the following basic duties:

1) bring together all estate assets,
2) entering the will into probate,
3) paying all taxes and filing all corresponding forms associated with tax paying,
4) paying all other debts of the estate,
5) the disposition of the decedent's business interest, if any,
6) file an accounting with the court,
7) dispose of property to rightful beneficiaries,
8) terminate the estate.

It is through a will that the individual can direct any type of property transfer to whomever he sees fit. Taxation of estate proceeds can be paid by beneficiaries or the decedent can direct that taxes for specific bequests be paid from estate funds. A guardian can be appointed in a will to take care of minor children or an incompetent adult. There may be a trust clause designed to protect estate beneficiaries from creditors. Most importantly, the will allows the individual to direct disposition of assets rather than leaving it to the state
to decide the decedent's intentions.

Before a will can be valid, the following primary condition must be met:

1) the testator must have "testamentary capacity", or the legal capacity to make a will. Depending upon the particular state, the individual may be required to reach the age of legal majority (adult age) before gaining testamentary capacity.

The testator should posses the following qualities:

a) be of sound mind (*understanding* what the will means),
b) know which property he or she owns,
c) recognizes friends and relatives for whom he or she has love of affection,
d) an understanding of who is a beneficiary and what property is being distributed.

If the above conditions were met at the time the testator made the will, then it is valid even if the testator was mentally incompetent at the time of death.

Most of the time a will is drawn (written) by an attorney. The number one rule of written will making is to be certain the document is signed at the conclusion of the writing. The second rule would be to make certain it is dated. Any wording after the signature is not considered part of the body of the will. In some states a number of witnesses are required to attest that the signature of the testator is authentic. In other states a self-proving will, one which acknowledges the authenticity of signature due to a notarized statement at the time of signing, is allowed. A witness to the will should be a competent individual who has nothing to gain from the testator, rather than having a beneficiary witness the signature.

Property can be distributed in a will by one of two forms:

1) **"Per stirpes",** a latin expression meaning members of a designated class of beneficiary inherit as a class, regardless of whether or not the beneficiary in the designated class is alive or dead. The legal heirs of a dead beneficiary take the estate share of the dead beneficiary and split it among themselves.

EXAMPLE: Grandpa Jones had three children: Brandy, Candy and Mandy. Of the three children only Candy is still alive at the death of Grandpa Jones. Brandy and Mandy left two and five children, respectively. The per stirpes distribution means Brandy, Candy and Mandy each get a one-third share of grandpa Jones' estate. Candy gets the full one-third share all to herself. Brandy's two children will divide her one-third equally (each child getting 1/2 of the 1/3 share). Mandy's five children will divide 1/3 of the estate five ways.

2) **"Per Capita,"** a Latin expression meaning members of a class, whether dead or alive, share in an estate as individuals. In the previous example using a per capita distribution, Candy and her seven nieces and nephews would have each received an equal share of Grandpa Jones' estate (8 descendants each get an equal share, or 1/8 of the estate).

The contents of a will begin with a statement of identifying the testator as a resident of a particular state who is revoking any former wills or amendments and stating that he is of sound mind. All stated disposition of property should be written in definite and positive terminology and expressions like "it is my hope' or "I wish" should be avoided for reasons of clarity. Other directions including burial preferences should be stated in the will. **Specific bequests** of property, cash or other specifically identified source property should be made near the beginning of the will. If the assets of the estate are insufficient to meet the directives of the decedent, state law will prescribe further action. If a specific piece of property had been disposed of by the testator prior to death (the issue of "ademption"), the named beneficiary is out of luck unless the will contained a provision which substituted other property. After specific bequests and personal property is transferred, the **"residue"** (whatever is left) is distributed.

Types of Wills

1) **Handwritten** - a minority of states accept into probate the "holographic will", a will handwritten by the testator. It must be signed but need not be witnessed.

2) **Oral** - the so-called "noncuperative will" is made orally by the testator in the presence of witnesses during an illness which shortly thereafter ends in death without the ability to make a written document. This oral method is accepted by some states but not by others.

3) **Joint** - called "love wills'", two related people draw one will jointly when both agree to the same disposition of their property. This form is usually written by a husband and wife. Problems associated with this form include the fact that the will is admitted into probate upon the death of the first party to die. Whether or not the surviving spouse is contractually bound to this original property disposition can later become an issue.

4) **Living** - is a written document directing that health care professionals are not to keep the party alive solely through the use of extraordinary medical artificial life support systems. This is a conscious decision not to extend the process of death when chances of recovery are virtually nonexistent.

5) **Codicil** - is usually a minor amendment to an existing written will. One or two provisions are revoked or changed but the majority of the original document remains unchanged.

When a will is already in existence but the maker wishes to make significant alteration, **"revocation"** of a will in its entirety can be accomplished in one of several ways. First, a new will can be written which states that all previous testamentary documents are no longer valid. Without clarity on this point however, it may become a matter for the courts to interpret whether the new document replaces a previous will or merely amends it. Sometimes a will is revoked by codicil, but new drafting with prior revocation is preferred. Another revocation method is for the maker to intentionally tear or mutilate the existing will.

In some states the act of divorce will automatically invalidate an existing will in which divorce was not mentioned or originally contemplated. In other states divorce will only invalidate clauses pertaining to the former spouse but will leave other directions intact.

Will validity can have great impact on other significant life changes such as remarriage and parenting additional children after a will has been made. According to statutes in most states, the surviving spouse of a decedent cannot be completely disinherited, even if such a directive is included in the will itself.

A testamentary trust is created upon the death of a testator because of a trust provision which was included in the will. Since a will must be probated and is therefore a matter of public record, any testamentary trust directives also become a matter of public record. The testamentary trust can be used to accomplish any of the wide range of needs for which a trust can be created.

A **disadvantage of the testamentary trust is increased cost** because the trust assets become part of the probate process. Another factor to consider is no income tax savings are realized by the testator in his lifetime. The testamentary trust ideally suits the maker who wishes to retain control of property during his lifetime but understands a trust will be necessary for property disposition after death. The testamentary trust is revocable until the death of the testator.

Sometimes there is the need for the **"pour-over"** trust, a legal device for disposing of property from one estate or trust into a pre-existing estate or trust. The main objective of the pour-over trust is to take all of the assets of a grantor and put them in one place for simpler administration. **The key is to pour the assets into an already existing trust instrument.**

The last concept to discuss concerning the will is the contesting of the will. **To contest means to seek to set aside the enforcement of will by legal channels.** After a will is submitted to probate, any party having an interest (would benefit by having the will invalidated) in the estate has the ability to contest. There are six possible legitimate grounds for contesting a will:

1) the will is not properly executed, meaning some essential element is not present;

2) the will is a forged document;

3) the testator was not competent at the time the will was drawn and signed;

4) the testator was under duress or subjected to undue influence by another party with a stake in the financial outcome of the will;

5) the will was made by the decedent due to the fraud of another; and

6) the will admitted to probate had been previously revoked by the decedent.

If the directions of the will cannot be carried out because they were not legally enforceable, then by operation of law it may be rendered invalid. The **goal of a contest is to destroy the validity of the will.**

TRANSFER BY CONTRACT

Two types of property transfer by contract will be discussed: life insurance and marriage contracts. Regardless of whether the life insurance contract beneficiary is an individual or a trust, proceeds from the policy pass outside of the probate process. This is desirable because the proceeds are not then subject to probate fees (assets which do pass through probate are, of course, subject to probate fees). Even if the will attempts to name someone other than the beneficiary designated in the policy, the will has no effect. In the absence of a named beneficiary, the proceeds of a life insurance contract do pass to the estate and are then subject to probate.

Marriage contracts, including "pre" (before) and "post" (after) nuptial (marriage) agreements also can transfer property by contract. When a couple is about to be married and one, or both, owns substantial assets, agreement to disposition of property upon the death of one or the other is a very valuable planning tool. The prenuptial agreement is considered an arm's length transaction and, barring any fraud, will be upheld in court. The postnuptial is used in cases of a divorce. In this agreement each spouse relinquishes any creditor rights they may have regarding the other's estate.

AUTOMATIC TRANSFERS

When a decedent dies without the existence of a valid will, all property passes according to applicable **"intestate"** succession laws. This means the automatic operation of existing legal statutes decide all elements of property title transfer. The succession laws which apply are based upon the actual property situs state. The succession statute has essentially constructed a pecking order, based on relationship to the decedent, for property distribution. In most jurisdictions, the **surviving spouse automatically is provided with one-third to one-half of the decedent's assets with the remainder divided between any living children.** With no surviving spouse, all living children receive equal shares of the intestate's property. The next rung on the succession ladder includes parents and siblings, followed by more distant relatives. In the event no living relative can be unearthed, the decedent's property will **"escheat",** pass to the state.

Another property ownership transfer that is automatic upon death involves jointly held property with the right of survivorship. In addition to jointly held property, a bank account can be passed to a named beneficiary outside of probate, even if there is a will provision to the contrary. Such an arrangement concerning a bank account is called a "Totten trust."

FEDERAL TAXATION OF THE LIFETIME GIFT

To prevent people from giving away all their property before death and thus circumvent paying estate taxes, the federal government created the gift tax law. The purpose of the federal taxation of lifetime gifts is to tax the right of an individual to transfer ownership of assets in exchange for something less than full and adequate value. The tax rate is progressive and is computed based on cumulative lifetime gifts as opposed to only taxing gifts on a periodic basis (such as a calendar year).

The application of the IRS regulation is widespread, including virtually any ownership transfer of property. Gifts which are direct, indirect or in trust are subject to the tax regardless to whom ownership is shifted, be it an individual, partnership, trust, foundation or corporation.

With the change in the estate and gift rules of 1976, which tried to assess the same taxation of property ownership transfer regardless of whether they were made during life or at death, at first glance it would seem without advantage to make lifetime gifts. There are many possible tax advantages to making an inter vivos gift, but perhaps the most significant allows that up to $10,000 may be given gift tax free every year to an unlimited number of donees. If married, each spouse can give $10,000.

The special sections illustrate specific gifting concepts:

SECTION I: LIFETIME GIFTS

SECTION II: CHARITABLE GIVING

SECTION III: THE MARITAL DEDUCTION

SECTION IV: ANNUAL EXCLUSION GIFTS

SECTION V: GIFTS OF LIFE INSURANCE POLICIES

SECTION VI: UNIFORM GIFTS TO MINORS ACT

SECTION VII: UNIFORM TRANSFERS TO MINORS ACT

SECTION VIII: SECTION 2503(c) TRUSTS FOR MINORS
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SECTION I: LIFETIME GIFTS

Under the Internal Revenue Code, the gift tax law applies to "all transactions whereby property or interest are gratuitously passed or conferred upon another, regardless of the means or device employed...". The requirements for a completed gift are that the donor: has a clearly expressed donative intent; makes an irrevocable transfer of legal title; is legally competent (the donee must also be competent to *accept* the gift); completes delivery to the donee; and the donee expresses his acceptance of the gift.

There are certain exceptions to the general rule that all gifts are subject to gift tax. These include: Qualified Disclaimers; Irrevocable Assignments of Death Benefits Under a Qualified Deferred Compensation Plan; Transfers of Property Between Spouses; Tuition Payments; Payments for Medical Care and Contributions to Political Organizations.

For obvious reasons, this exemption is currently, and usually, the subject of political argument and continued legislative efforts. Moreover, gift tax is paid only on *taxable gifts*. The taxable gift is the value of the transferred property less the allowed reductions. Allowed reductions include: a) annual exclusions; b) the marital deduction; c) the charitable deduction; and d) splitting of gifts.

Annual Exclusion

The annual exclusion allows a donor to give $10,000 per year ($20,000 if the gift is made with the spouse) to an unlimited number of donees. The exclusion applies only to **present interests** in property. A transfer is of a present interest if the recipient is immediately entitled to use the transferred property. Gifts of future interests, such as remainders, reversions or interests which will come into the donee's possession in the future, are not excluded for gift tax purposes.

Marital Deduction

The gift tax marital deduction permits a donor to give an unlimited amount of property to a spouse free of gift tax. The gift must be given to the spouse during the marriage. Terminable interests, property interests which cease under some specified condition (such as a life estate), are not deductible unless they are QTIP's (Qualified Terminable Interest Properties).

Charitable Deduction

A taxpayer may take an unlimited deduction for gifts to charities.

Gift Splitting

The amount of an individual's taxable gifts can also be reduced by gift splitting. Married donors may treat the gift as having been given one-half by the donor's spouse, as long as the spouse consents.

In addition, the amount of gift tax which must be paid is reduced by the Unified Credit. The credit must be used in each year in which a person makes taxable gifts until the credit is used up. The amount of the unified credit is $192,800, representing an exemption equivalent of $600,000.

Gift tax returns (IRS Form 709) are filed on the 15th of April in each tax year. The federal gift tax is cumulative, meaning that the gift tax on the current year's gifts is calculated by adding the total of taxable gifts made since 1932 to the total amount of taxable gifts made for the current year. The tax rates are applied to the total lifetime taxable gifts.

The federal gift tax due is calculated as follows:
Determine the value of lifetime gifts and current year gifts;

- Split gifts between spouses where appropriate;
- Subtract annual exclusion per donee for present interest gifts;
- Subtract marital deduction;

. Subtract charitable deduction;

. Add taxable gifts since 1932 to the current year's gifts;

. Apply the tax rates from the unified schedule of estate and gift tax rates to the total of all gifts made since 1932, including the current year's gifts;

. Subtract the amount of gift tax paid on account of gifts made in prior years; and

. Reduce the gift tax payable by the amount of the available unified credit.

However, no return need be filed for present interest gifts until the value of gifts to one person exceeds $10,000. The use of gifts allows donors to reduce probate costs and estate administration expenses by removing property from the estate.Gifts are particularly useful when the donor has an asset which is likely to appreciate in value over a period of time and would like to save estate taxes on the potential growth.

SECTION II: CHARITABLE GIVING

Gifts made to charities during the life of the donor will remove the gifted property from the donor's estate free of taxes. Therefore, charitable giving can be a useful technique for reducing the size of the donor's estate. An unlimited amount of property can be transferred to qualified charities without incurring federal gift tax. The charitable organization incurs no income tax liability on either the gifted property or income which may result from the property after the gift. Moreover, if the transfer is made during the donor's life, the donor may be eligible for an income tax deduction.

IRS Publication 78 details the requirements for qualified charities. Basically, such organizations are either Public Charities or private Non-operating Foundations. Public Charities are charitable, educational, scientific, religious medical or other non-profit organizations which are publicly supported. Such an organization is the Red Cross, or one's local church. Income tax deductions for gifts to public charities in any given year are limited to 50% of the giver's adjusted gross income (AGI), or to only 30% of AGI if the gift is of long-term capital gain property.

Private non-operating foundations are private charities, fraternal societies, veteran's organizations or cemeteries which are not operated for profit. The income tax deduction for gifts to such organizations is limited to 30% of the donor's AGI for the year in which the gift is made (20% AGI if the gift is of long-term capital gain property).

Contributions, to qualify, must: a) be made to charitable organizations; b) be a gift of *property*, as opposed to *services*; c) be made before the end of the year in which the deduction is claimed; d) have a value greater than the benefit received by the charitable organization; e) be a gift of the donor's entire interest in the property; and f) be claimed as an itemized deduction.

<u>Techniques for Charitable Giving</u>

The charitable gift can be extremely simple. During the donor's lifetime, the gift can be accomplished merely by writing a check, assigning or transferring life insurance policies, signing a deed to property or a deed of gift, or utilize any other method of conveying title to the property.

In addition to simple techniques, other rather more sophisticated tactics may be used.

. *Charitable Remainder Annuity Trusts*

This is established by transfer of money or securities to a trust. The trust provides an annual income stream to a noncharitable beneficiary for a period not exceeding 20 years from the time the trust is established. The remainder goes to the designated charity. The annuity payable to the noncharitable beneficiary must provide for an annual payment of at least 5% of the initial value of the property placed in the trust.

Charitable Remainder Unitrusts

Income payments from the unitrust must be at least 5% of the annual value of the trust property. Payments from the annuity trust will therefore be the same amount each year and payments from the unitrust will be annually variable. The unitrust is more difficult to administer because of the requirement for annual revaluation.

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Pooled Income Fund

Similar in nature to both the CRAT and the CRUT, except that the fund is created by the public charity. The gifted property is commingled with that of other donors. The noncharitable beneficiary retains a lifetime interest.

The unlimited deduction for gifts to charities applies only to interests passing to a qualified charity so that there is no gift tax owed when the CRAT, CRUT or pooled fund is created. Similarly, no federal estate tax is owed since the property belongs to the charity as of the death of the noncharitable beneficiary.

. *Charitable Lead Trust*

In several respects, this device is the opposite of the trusts discussed above. The donor gives away the income stream and receives a remainder interest. the donor places income property in a reversionary trust and directs that the trust income be transferred to the charity for a period of time not to exceed 20 years. The annual income is taxable to the donor, and the donor derives no income tax benefit. However, the donor receives a <u>very large</u> income tax deduction in the year that the trust is funded. The value of the deduction is the present value of the total anticipated income during the lead period when the charity receives the income.

Wealth Replacement Trusts

Wealth replacement trusts are normally a funded or nonfunded life insurance trust, which provides for death benefits to be paid to the grantor's family members. The donor makes a charitable gift of an asset such as a parcel of land, and takes a charitable deduction. The annual tax savings are used to pay the premiums on the life insurance policy on the donor's life. The proceeds of the policy replace the value of the property given to charity, and are payable to the donor's beneficiaries.

SECTION III. THE MARITAL DEDUCTION

When referring to the gift tax, the *marital deduction* is an amount subtracted from the value of a gift of property in calculating the amount of the taxable gift, as set forth above. Similarly, because of the unified gift and estate tax system, when referring to estate tax the marital deduction is an amount subtracted from the adjusted gross estate in calculating the taxable estate. In each case, it is based on the value of property given to one's spouse.

<u>Qualification</u>

In order for the amount to be available for subtraction: a) the property must be transferred to the spouse *during* the marriage; b) the spouse must be a U.S. citizen; and c) the transfer must be complete enough to vest the property in the spouse. In other words, it must be a completed gift.

Assuming the gift meets such qualifications (a gift of a terminable interest does <u>not</u>), an *unlimited* marital deduction is available under both the gift tax and estate tax rules.

Overqualification

Although the estate of the first spouse to die will pass to the surviving spouse without tax being imposed, the estate of the last to die will not, because the marital deduction is not available to it. Therefore, the estate of the second to die will contain all of the assets of both estates, and could be subjected to considerable tax. The progressive nature of the rates, which range from 39% on estates around $750,000 to over 55% on very large estates, can cause the second estate to pay a significantly higher tax.

Terminable Interests

Terminable interests do not qualify for the deduction. A terminable interest is one that will fail by reason of a lapse of time or the occurrence of a specific event, such as a life estate which terminates upon the death of the holder. However, if a lifetime interest is coupled with a general power of appointment, the deduction is available.

Also, Qualified Terminable Interest, or QTIP property, is an exception to the terminable interest rule. For a property to be treated as a QTIP, the donor spouse must irrevocably elect QTIP treatment for gift tax purposes, and the donee spouse must receive a *qualified income interest* for life. An income interest is qualified in this sense if the donee is entitled to receive *all* of the income from the property, payable at least annually. The surviving spouse is the only one who can possess a power of appointment over the property, and the

property's value is includible in the surviving spouse's gross estate for death tax purposes.

Some types of marital gifts, and their treatment, include:

. **Outright bequests** qualify for the deduction;

. **Joint tenancy** property qualifies, to the extent of one-half the interest value;

. **Life insurance** proceeds qualify when the proceeds are payable to the surviving spouse in a lump sum or in installments.

Marital Trusts

Persons with large estates may make extensive use of trusts to add flexibility to their estate plans. There are three basic types: power of appointment trusts, QTIP trusts, and estate trusts.

A *power of appointment trust* refers to a general power of appointment given to a spouse to dispose of estate assets of the first to die. Such a trust may be referred to as a **marital trust** (the "A" trust in a will-trust arrangement). The surviving spouse is entitled to the income from the corpus, payable annually, and has a general power of appointment over the trust assets. The power may be restricted to exercise during life or at death, or may be allowed at any time. The power must be unlimited in the sense that it can be exercised in favor of the holder, and cannot be forfeited by operation of unrelated events (such as remarriage of the surviving spouse).

The *QTIP trust* is a current income trust, or "C" trust. It is normally created as part of a decedent's estate plan. Property placed in such a trust is subject to the marital deduction if the income is payable to the spouse at least annually. The surviving spouse may have the power to invade the corpus of the trust, but the grantor can direct the disposition of the remainder interest. Therefore, a power of appointment need not be granted to the surviving spouse. The executor of the estate makes the decision as to what percentage of the decedent's property is placed into the trust.

In an *estate trust* there is no requirement that the income be paid annually to the surviving spouse. In this respect it differs from the types discussed above. The trust may accumulate income, and the trustee may be empowered to distribute both principle and income to the surviving spouse. At the death of the surviving spouse the contents of the trust are distributed to the spouse's estate.

SECTION IV: ANNUAL EXCLUSION GIFTS TO REDUCE FEDERAL ESTATE TAX

Taking advantage of the gift tax exclusions and marital and charitable deductions can result in the removal of tremendous amounts of property from the estate, if pursued for a lengthy period. For example, the following table shows the amount of money removed from the estate of a person who follows a regular giving strategy. The table assumes that the assets continue to grow at an annual rate of 6%. Recall that gifts of up to $10,000 per year can be given free of tax.

SECTION V: GIFTS OF LIFE INSURANCE POLICIES

Gifts of life insurance policies are subject to gift tax on the actual value of the gift. However, the value of a life insurance policy is not its face amount. Some policies are easier to value than others.

A whole life policy is valued, for gift tax purposes, at the sum of the interpolated premium reserve and the unearned premium. However, if the policy is completely paid up, the value is the replacement cost of a comparable policy at current premium rates with the same company that issued the original policy. Gifts of a brand-new policy are valued at the premium just paid by the donor of the gift.

If a policy is transferred to an irrevocable trust, the transfer is a gift of a future interest to the beneficiary of the trust. The value of the gift is determined by the rule applicable, as set forth above. The annual exclusion value ($10,000) cannot be used, because the gift is of a future interest.

Estate Tax Treatment of Life Insurance

The death proceeds of a contract of life insurance owned by a decedent are includible in his estate for estate planning purposes. Any incident of ownership, such as the ability to change or appoint beneficiaries, serves to make the face value includible. Moreover, if the beneficiary of the policy is the estate, the proceeds are includible.

If the decedent did not own the policy, the proceeds are not includible. For example, where the premiums are paid by a spouse more than three years after the transfer of the policy, or on a new policy, the proceeds are not included in the decedent's estate.

Summary Life insurance provides, in essence, a way to pay federal estate taxes at a "discount." Consider the case where a decedent has purchased a $200,000 policy and died in the first year, after first paying $3,500 worth of premiums. Then the proceeds can be used to pay up to $200,000 worth of taxes, at a cost of only $3,500. If the insurance has been owned by a third party who is also a named beneficiary, the face amount will avoid federal and state death taxes, income taxes and transfer fees.

SECTION VI: UNIFORM GIFTS TO MINORS ACT

The Uniform Gifts to Minors Act, UGMA, provides that an adult, while alive, may make a gift of certain types of property, such as securities, money or a life insurance policy or annuity contract, to a minor person by registering the property in the name of an adult person (including the donor) or a trust company as custodian for the minor person. So made, the gift will be considered to be of a present interest sufficient to qualify it for the $10,000 gift tax exclusion

Many states have amended their Act to provide that real property may also be the subject of such a gift. Moreover, an increasing number of states have repealed the UGMA and replaced it with the Uniform Transfers to Minors Act in somewhat amended format.

The custodian uses the assets for the child's wellbeing, support, education and assistance during the child's minority. The custodianship terminates when the child reaches majority (in Illinois, attainment of the age of 18).

SECTION VII: UNIFORM TRANSFERS TO MINORS ACTS (UTMA's)

This uniform act, adopted by Illinois in 1986, provides a revised scheme for dealing with gifts to minor persons.

The donor transfers the gift property either during his lifetime or by bequest. A custodian receives the gift property and holds it for the benefit of a minor. The custodian may be named in the gift itself, or may be appointed by a court. The custodian has a fiduciary duty to the minor beneficiary, and must manage the property in the beneficiary's best interest. He must keep detailed records of transactions involving the gift property. He may make payments to the minor beneficiary in amounts he determines to be advisable, without regard to other income the minor might receive from other sources.

The UTMA has basically no restrictions on the type of property which may be the subject of the gift. It also permits lifetime and temporary transfers, whereas UGMA only allowed lifetime gifts. The trustee under UTMA has more investment discretion.

The income earned on assets held by a custodian under such an arrangement is includible in the gross income of the minor for income tax purposes. For minors under 14 years old, unearned income in excess of $1,200 per year is taxed at the parent's marginal rate.

How it is Done

The donor designates his gift as being subject to the Act. For example, a gift of stock may be transferred under the Act by registering it in the name of: **"*{Custodian's Name}* as custodian for *{Donee}* under the Illinois Uniform Transfers to Minors Act." Such a gift is a present interest, and would qualify for the $10,000 annual gift tax exclusion.**

SECTION VIII: IRS SECTION 2503 TRUSTS

Section 2503(b) Trusts

A 2503(b) trust may be used for making gifts to minors, and there are no restrictions on the kinds of property that may be placed into the trust. The transfer to the trust must be irrevocable, and the trust must provide that income will be distributed annually to the beneficiary. The corpus will pass at the death of the beneficiary to a third party. The income from trust assets is not accumulated. Because it is paid out annually, it is taxable to the beneficiary.

Because the property in the trust passes to a third party at the death of the beneficiary, it is a gift of a future interest. Therefore it is not eligible for the $10,000 annual gift tax exclusion. However, since the donor does not have a reversionary interest, the corpus of the trust is excluded from his estate for estate tax purposes.

Section 2503(c) Trusts

A 2503(c) trust is useful for purposes of gifting to minors. The trustee has very broad powers to control investment of the assets. Moreover, any kind of property may be placed in the trust.

The transfer must be irrevocable. However, a 2503(c) trust is an accumulation trust. Because of this the income need not be distributed annually, and may be accumulated until the minor beneficiary reaches age 21. At age 21, both principal and income are made available to the beneficiary, who will be considered to be in constructive receipt unless the trust agreement limits his access to the property for a longer period.

The accumulated income is taxed annually to the trust itself. Although the trust need not distribute the income and principal annually, the trust agreement may require that it do so. In such a circumstance, the gift will be of a present interest.
{Chapter VI Continued)

GIFT TAX PAYMENTS AND RESPONSIBILITIES

Gift tax payments or reporting can apply to present interest gifts, future interest gifts and gifts to charities. When a present interest gift is involved, a gift tax return is due when the gift amount to an individual exceeds $10,000, the annual exclusion limit.

The return and any tax due would have to be filed by April 15 of the year following the year during which the taxable gift was made. When a future interest is involved, a gift tax return is due regardless of the amount. There is no reporting requirement for charitable contributions of $10,000 or less. For charitable contributions exceeding $10,000, a reporting must be made on the gift tax return filed for that year.

Although it is the donor's responsibility to pay the gift tax, the donee will become liable if the donor fails to pay. The tax is due at the time the return is filed unless "undue hardship" is demonstrated.

Determination of Cost Basis

"Basis" means the amount of original acquisition dollars the property is worth. The donor's basis is transferred to the donee and any subsequent transfer or sale by the donee will result in the donee being charged with the donor's cost basis.

> **For example:** John is the donor of ABC stock which was purchased by John for $25 per share: $25 per share is John's cost basis. John gives the ABC stock to Sara. Sara's cost basis is also $ 25 per share. If Sara sells the stock for $40 per share, she has realized a gain of $15 per share.

If gift tax was paid by the donor, a percentage of the tax paid can be added to cost basis according to the following formula:

Net Appreciation in Value of Gift
X Gift Tax Paid

Amount of Gift

Relationship To Income Taxation

The gift tax law was written with the goal of preventing an individual from transferring sizable assets as a gift with the intent of escaping income tax payment. However, some tax overlap can occur between gift and income taxes. Whether or not a transfer is subject to the gift tax must be balanced with whether or not income taxes might be due. In a trust property transfer situation, is the donor responsible or is income tax owed by a beneficiary? The best advice in assessing actual tax liability is to consult an expert.

Relationship To Estate Taxation

As shown previously, the estate tax and gift tax system is unified according to the 1976 Tax Reform Act. The rules are related in the following ways:

1) both testamentary transfers and lifetime gifts are taxed at the identical rates;

2) a single unified tax credit is applied to both lifetime gifts and testamentary trusts; and

3) estate tax assessed at death upon gifted property is calculated by adding gifts made during the lifetime to the taxable estate.

Deciding on the Gift

What property shall be selected in making a gift? This is a central question because it assumes a comprehensive gifting and financial planning strategy has been developed. Gift planning involves the use of the following considerations:

1) the selection of property likely to appreciate in value because it will serve to lessen the future estate tax liability of the donor;

2) transfer high income producing property from the high tax bracket donor to the lower tax bracket donee;

3) understanding the relationship of the cost basis of the property at the time of transfer in relation to the fair market value of the property.

SECTION IX : GENERATION SKIPPING TRANSFERS
SECTION X : GENERATION SKIPPING TRANSFER TAX

SECTION IX: GENERATION SKIPPING TRANSFERS

Generation Skipping Transfers

This type of transfer was traditionally used as a device to save estate and gift tax by keeping property out of the taxable estate of members of the intermediate generation. The beneficiary would serve as trustee, have all the income, invade the principal for needs and control distribution of the property as long as the beneficiary did not have a general power of appointment. However, imposition of the generation skipping tax is intended to eliminate the effect of such arrangements.

Nonetheless, generation skipping is a useful technique in three types of circumstances:

1) Where a client stands to inherit a substantial estate from a parent and already has a substantial estate of his own;

2) Where the parents wish to minimize transfer taxes in a child's estate but still give the child use and benefit of the property; or

3) Where the grandparent wishes to directly benefit the grandchild, or to avoid estate taxes in the succeeding generation.

There is no special form of generation skipping transfer. It can simply be a gift or bequest to the "skip" person, or a trust may be established for the purpose. The only real requirement is a gift, whether *inter vivos* or testamentary, which will benefit a skip person.

The generation skipping transfer tax (GST) is imposed on lifetime gifts or on property passing at death to persons who are at least 2 generations younger than the donor, as calculated by federal law. The tax is intended as a deterrent to grandparents who would give assets to their grandchildren to avoid having the assets taxed in the estates of their children prior to passing onward to the grandchildren. It is intended to assure the taxation on transfer of wealth at each generation.

The GST is imposed at a flat rate of 55%, which is equivalent to the highest marginal tax rate that could be imposed on the estates of the transferor's children. It is imposed in addition to estate or gift tax. During their lifetime or at death, each person is entitled to a $1 million exemption for the GST. Gifts which directly benefit skip persons will be subject to the tax unless they qualify for the exemption. In calculating the GST, the rules for split gifts and annual exclusions apply.

How It Is Done

Typically, an *inter vivos* trust is created as a receptacle for lifetime gifts and to receive assets at the death of the donor. The trust instrument typically creates two separate trusts. The child's share of the donor's $1 million exemption would be allocated to one trust (the "exempt" trust). The other trust would be nonexempt. Usually, assets with the best growth potential are used to fund the exempt trust. The exempt and nonexempt trusts are established so that they have GST tax inclusion ratios of zero and one, respectively. If the exempt trust maintains its zero inclusion ratio, it will remain immune from the GST tax.

Essentially, the GST rate is equal to the highest gift and estate tax rate at the time a taxable distribution from a trust, the taxable termination of the trust, or at the time a direct skip is made. It must be paid by the trustee. The GST is reported on either the Gift Tax Return (Form 709), the Estate Tax Return (Form 706), Form 706GS(d) or Form 706GS(T).

Generation Assignment

For GST purposes, all persons are assigned to a generation. For related persons, the reference point is the ancestral chain. Unrelated persons are assigned to the transferor's generation if the unrelated person is no more than 12 1/2 years younger than the transferor. A person assigned two or more generations below the transferor is a "skip person."

Taxable Distributions

A taxable distribution is a distribution of income or principal from a trust to a skip person, where the distribution is not otherwise subject to estate or gift tax. An example would be a distribution from a trust to a grandson of the transferor, in which the grandson would be the skip person. A distribution from one trust to another trust may be a taxable distribution if all interests in the second trust are held by skip persons.

The taxable amount of the distribution is the net value of the property distributed reduced by the consideration paid by the beneficiary. The transferee is obligated to pay the GST tax on a taxable distribution. The tax levied on a taxable distribution is **tax inclusive**. That is, the amount tax includes both the property and the tax.

Taxable Termination

A taxable termination of a trust can occur as a result of death, lapse of time, release of powers of appointment. Anything which results in skip persons holding all of the interest in the trust will serve as a taxable termination. As an example, if the donor leaves a life interest in the income of trust assets to his son, with a reversion to his granddaughter, the death of the son is a taxable termination. No such termination occurs as long as any interest holder is a non-skip person.

The taxable amount in the case of a taxable termination, as in the case of the distribution, is the net value of the property in the trust less the consideration paid for it by the beneficiary, if any. The trustee is responsible for payment of the tax. The tax is **tax inclusive**. The property subject to the transfer includes the GST itself.

Direct Skips

A direct skip is a transfer subject to an estate or gift tax, but which is made directly to a skip person. An example would be a bequest in a will made directly to the grandson or granddaughter of the donor. Likewise, establishment of a trust in which all of the beneficiaries are skip persons is a direct skip. However, in assigning generations for direct skip purposes, a grandchild whose parents are deceased at the time of the gift is treated as a *child*, rather than as a skip person. His children are then treated as skip persons.

The taxable amount is the value of the property reduced by consideration paid for it by the beneficiary. However, the tax on a direct skip is **tax exclusive**. The taxable amount does not include the amount of the GST. The tax is not paid out of the gift, but rather out of the donor's funds. Thus, the beneficiary realizes a greater portion of the intended gift.

SECTION X: THE GENERATION SKIPPING TAX

Computing the Tax

In computing the GST, recall that the donor can make use of a $1 million dollar lifetime exemption. Moreover, spouses can utilize gift-splitting to treat the transfer as if half was made by each, thereby doubling the effective amount of the effective level of the exemption.

The *inclusion ratio* is calculated in a two step procedure. The first step is to compute the *applicable fraction.* This is done as follows:

1. State the portion of the $1 million exclusion allocated to the trust or direct skip (EXCLUDE)

2. State the value of the property transferred (VPT)

3. State the total of federal estate or gift tax recovered from the trust allocated to the property (RECOVER).

4. State the amount of charitable deduction allowed under the estate or gift tax law with regard to the gift (CHAR).

5. Calculate RECOVER + CHAR = SUM

6. Calculate VPT - SUM = DIFF

7. Calculate EXCLUDE/DIFF = APPLICABLE FRACTION

The next step is to calculate the inclusion ratio

8. Calculate 1 - DIFF = EXCLUSION RATIO

To calculate the tax, multiply the taxable amount by the applicable rate. A credit for state death taxes is allowed.

CHAPTER VII: EXAMINATION OF SELECTED FEDERAL TAX DEDUCTIONS

Calculating the Adjusted Federal Gross Estate

Once all the assets of the decedent's estate have been determined, the following deductions are applied in calculating the adjusted gross estate value:

1) **death expense (funeral):** only reasonable costs are allowed including burial lot/vault, tombstone, grave site care, and traveling expenses of the corpse to interment.

2) **estate administration costs:** all expenses incurred due to accumulation, preservation and distribution of assets are deducted. Included are court and lawyer costs and any accounting fees. If the expense was required in settling the estate, it is deductible. If decedent medical expenses were involved they may be deducted on the income tax return, if the estate has waived this right of deduction.

3) **claims payable by the estate:** all debts plus interest owed by the estate are deducted from the gross estate. Taxes, including income, gift and estate are deductible by the estate.

4) **unpaid mortgages/debts**: if the decedent's estate is responsible for paying a mortgage debt, such payment is deductible.

5) **losses**: casualty and theft losses not reimbursed by insurance are deductible if they happened while the estate administration was in progress but not yet finished.

Two additional deductions, the charitable and marital deduction which are treated more comprehensively in the next few pages, are also applied in determining the adjusted gross estate.

A general rule for the deductions listed above is these expenses can not be claimed by both an income tax and an estate tax return or by only the estate tax return. While the executor must take responsibility to minimize the tax burden of the estate, obviously deducting the same expenses more than once is not allowed. Consultation with a qualified tax expert will reveal the most advantageous strategies for utilizing deductions whether they are taken on the income or estate tax return.

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THE CHARITABLE DEDUCTION

Property belonging to the gross estate of the decedent which is donated to a qualified charity may be deducted for full value. The charitable deduction has no limit and qualified organizations are limited to:

1) **fraternal organizations** using the contributions exclusively for religious, scientific, charitable, literary or educational purposes.

2) **corporations** using the contributions exclusively for religious, scientific, charitable, literary or educational purposes. This includes the areas of supporting the arts as well as preventing cruelty to children or animals.

3) **Any political subdivision** (USA, a state, etc.) if the funds are supplied solely for public purposes.

4) **veteran's organizations** incorporated by Congress or as the result of Congressional action.

The deductions described above will only be denied if the funds are used to benefit a specific individual or private stockholder. Donations made to organizations which primarily exist to engage in political lobbying are not deductible. **The key to deductibility is making certain the use of the money is marked for charitable purposes.**

When an estate beneficiary disclaims property and that property is transferred to a qualified charity, a deduction is allowed for the actual amount transferred.

There are several **types of charitable bequests** including:

1) **Powers of Appointment** - when a decedent had a power of appointment and passes it to a charitable organization it is considered a deductible bequest;

2) **Partial Interests** - when less than the entire interest of property is passed to charity, such as a remainder interest in a personal residence.

3) **Charitable Remainder Interest** - must be made in the form of one of the following

   a) **Unitrust** - a fixed percentage of not less than 5% of fair market value of the trust assets as annually valued must be paid annually or more frequently to one or more noncharitable income beneficiaries (refer to point c, below)

   b) **Pooled Income Funds -** comparable to a mutual fund in that donations from many sources are commingled and the decedent's share of the pool is paid to a specified charitable beneficiary.

   c) **Annuity Trusts -** a noncharitable income beneficiary receives not less than 5% of the initial fair market value of the property paid in the trust. The payment must be at least annually until the death of the last income beneficiary or at the end of a term of years not to exceed 20 years, with the remainder paid to a charitable organization (this information applies to point a, above).

Another type of charitable interest which operates in the reverse of a remainder trust is a charitable **"lead trust".** In a lead trust the income from property is paid to a charitable beneficiary with the remainder paid to a noncharitable beneficiary. To be valid, this interest must take the form of either a guaranteed annuity interest or a unitrust interest.

THE MARITAL DEDUCTION

The discussion of the marital deduction which follows is designed to help the reader understand the concept and its applications in a general manner. These concepts as enforced by the Internal Revenue Service are quite complex and actual usage must be recommended and implemented by a qualified tax authority.

The marital deduction, when used properly and wisely, can eliminated all or most of the estate tax burden to a surviving spouse upon the death of the other spouse.

The marital deduction is allowed on "net value" of a "qualifying interest" which passes to a decedent's surviving spouse. Net value equals the valuation date gross estate tax value of the property interest minus any charges against that interest. Therefore the gross value of the property interest which is to pass to the surviving spouse is reduced by

1) the taxes payable from the interest,

2) mortgages/debts owed from the interest and
3) estate administration expenses paid from the interest.

Before property qualifies for marital deduction treatment, the following limitations and qualifications must be satisfied:

1) **Property must be included** in the estate of the decedent before a deduction can be applied.

2) **The surviving spouse must be a U.S. citizen** at the date of the decedent's death, or before the estate tax return is filed.

3) **The surviving spouse must have been legitimately married to the decedent at the date of death.**

    Legally separated spouses are entitled to the marital deduction if there was no divorce decree by the date of death. Former spouses do not qualify for the deduction.

A problem can arise when a surviving spouse barely lives longer than the decedent or will not live long enough to enjoy the property transfer. In such instances, a second round of estate and income taxes may be assessed. Furthermore, the original decedent's property may wind up in the hands of his spouse's heirs, an unintended result. Another concern is when both spouses die as the result of the same accident and chronological order of death is impossible to determine. A presumption-of-survivorship" clause, stating the decedent's request that the spouse automatically survives, can make a big difference in the ultimate assessment of taxation, due to the application of the marital deduction. When no presumption clause has been inserted into a will, state laws will dictate the course of action to be followed for property transfer

4) **Requirement that property must pass or have passed-** the surviving spouse, and not someone else, must actually receive the property. Furthermore, the surviving spouse must be the beneficial owner of the transferred property and not merely the trustee for someone else. In the event a surviving spouse disclaims the property, the property is treated as if it never went to the spouse.

5) **The Terminable - Interest Rule** - this is a barrier to deductibility and its goal is to allow the marital deduction only when the nature of the interest passing to the surviving spouse is such that, if retained until death, it will be taxable in the spouse's estate. In other words, this law will deny the deductibility of any interest acquired by a surviving spouse which would not be includable in the surviving spouse's estate for federal estate tax purposes if held until death.

Underqualification and Overqualification

Underqualification occurs when property passes to a surviving spouse in a qualifying manner when it should have instead passed tax free. In this instance the marital deduction is under utilized. Overqualification happens when the estate owner's unified credit is under utilized. In this case, more property than necessary (that which is needed to lower the estate owner's federal estate tax to zero) goes to the surviving spouse. This means that when the surviving spouse dies, some property is needlessly exposed to taxation.

A **"formula bequest"** can be inserted into a will for the purpose of utilizing the estate owner's unified credit and coordinating it properly with the unlimited marital deduction. There are two types of formula bequests:

1) **The Pecuniary Amount bequest** - the surviving spouse receives a fixed dollar amount and all property qualifying for the marital deductions taken into consideration, and not just the property passing according to the will.

2) **The Fractional Share** bequest - seeks to obtain the same goal as the pecuniary amount bequest by providing the surviving spouse with a fractional share in the residue of the estate (a fractional share of each asset, after specific bequests have been made).

MARITAL BEQUEST PROS AND CONS

The advantages of an outright bequest can be summarized as follows:

1) the spouse can use and manage the assets as he or she sees fit;

2) when the spouse gets his or her marital share of property, there is less chance of contesting the will;

3) there are no trustee fees or court accounting requirements to meet;

4) estate liquidity needs can be meet by the surviving spouse and can be made available to the executor;

The disadvantages of an outright bequest:

1) the spendthrift spouse can go on a spending spree;

2) no investment expertise is automatically provided;

3) creditor's can attach the property provided in the bequest;

4) bequest assets still in existence when the surviving spouse dies are includable in his or her estate.

CHAPTER VIII:

FEDERAL ESTATE TAXATION

The Taxation Process

During the lifetime of the financially successful person, large sums of money and property can be accumulated. Since, as the old adage goes, "you can't take it with you", a more imposing dilemma presents itself: where should "it" go after you die. Many attempts to transfer ownership of your property either during life or at death are taxed by the government. It is almost as if society pats us on the back for lifetime financial success and then wraps a napkin around its stout neck and prepares itself to share, via income, estate and gift taxes, in our hard earned bounty. The right of the government to tax property ownership transfer must be recognized or far less of your property will find its way to relatives and friends, while more will go to support government.

The current climate in America reveals an estate and gift tax code written in 1976 and adjusted in the early and middle 1980's. As we live in an America which is now reeling from mounting financial deficits, the battle cry is aimed at the wealthy to raise more taxes. Increased revenues from gift and estate taxation look ever the more likely source. Therefore, all estate planning functions already completed may have to be reexamined or even redone soon. As the rules of the game are in an ever changing state of flux, so to must the players be prepared to study and readjust strategies before existing advantages can be maximized.

The existing federal estate tax subjects all property owned by citizens or residents of the United States to the progressive rate structure in force, regardless of location of the property. The property is valued at fair market price on the date of death or at the alternative valuation date of six months after death. The noncitizen (nonresident alien) is only subjected to estate taxation on property actually located in the United States.

THE GROSS ESTATE

All property is fair game for estate taxation. It is not relevant to consider the specific method of ownership transfer be it by will, intestacy or by contract. Property types included in the gross estate are:

1) **The value of all property in which the decedent had an interest (IRC Section 2033)** - State law has domain over determining whether or not a property right exists while the federal courts decide the taxation issue. However, the federal court also has the power to apply state law to attach the requisite level of interest and make it taxable.

   The **property interest must be "beneficial",** meaning merely holding legal title as a fiduciary does not qualify. When a decedent had no rights in property and was not qualified to direct the ownership transfer to another, then such property is not includable in the estate. For instance, ownership of a life estate dos not enable the holder to pass the property right at death, instead ownership reverts to some other party.

Three concepts must be evaluated in determining whether or not the requirements of Section 2033 have been met:

a) Is the property a type which qualifies under the section?

b) Was the decedent's interest in the property significant enough to qualify as inclusive to the estate? and

c) To what extent, if any, did the decedent possess an interest at the point of death?

Types of property - real property and the following forms of personal property: cash, stocks, expected dividends on stocks not yet received, bonds (including tax-exempt), expected income tax refund, notes, mortgages, patents, copyrights and trademarks. Any accrued right to income property is part of the estate (salary, bonus, commission, etc.).

Significant ownership - interests in partnerships and even unincorporated business can be included. Property owned in conjunction with other people such as tenancy in common ownership.

2) **Dower/Curtesy Interests (IRC Section 2034). Dower** is a property right set aside for a **widow,** according to state law, when it is established that the decedent had an interest in the property. **Curtesy** is the right a **widower** has in his deceased wife's property. In many states the old dower and curtesy rules have been replaced with statutory rights to surviving spouses. The main idea of this section: the amount of an includable property interest in the gross estate is not lowered by an existing dower or curtesy right.

3) **The Three Year Rule of IRC Section 2035** - The 1976 Tax Reform Act stated that the value of all transfers made within three years of death are includable in the gross estate. In 1981 a rule amendment said that gifts made within three years of death are not included in the gross estate for decedents dying after December 31, 1981 with these five exceptions:

   a) **the transfers with retained interests for life** - where the decedent retained the right to:

      1) receive or determine who receives income from the property unless given up more than 3 years before death;

      2) designate a party entitled to enjoyment or possession of the property either for life or for a period that did not actually end before death or that cannot the determined without reference to the death unless given up more than 3 years before death.

   b) **Transfers taking effect upon death** - are includable in the gross estate including:

      1) transfers to others that can be obtained only by surviving the decedent and if the decedent retained a reversionary interest in the property which exceeds 5% of the property's value at death;
      2) the transfers described in the previous point 1 are includable if the decedent exercised the power or transferred the power within three years prior to death; and

      3) if the decedent retained the power, the property is includable under Section 2037 (dealing with reversionary interests).

   c) **Transfer in which the decedent reserved the right to alter, amend, revoke or terminate** the transfer or the power to affect the beneficial interest in the transferred property until death are includable in the gross estate under Section 2038 (Revocable Transfers).

   d) **Transfers by the insured of life insurance policies** - within 3 years are includable in the gross estate at full value of the proceeds whether or not a gift tax return was required, EXCEPT: premiums paid or deemed paid within three years of death, to the extent that the payments would not have caused policy proceeds to be included in the gross estate under prior law, are not included.

e) Gift Taxes paid - on gifts within three years of death made by the decedent or the decedent's spouse are includable in the gross estate. The "Gross-up Rule" includes the amount of the tax paid on gifts made after 1976 and within 3 years ending on the donor's death date and any taxes attributable to the decedent's consent to split gifts within three years of death.

Exceptions to the 3 year inclusion rule are

. Gifts worth less than the annual exclusion amount of $10,000 because no gift tax is required (are included for determining qualification for tax benefits only).

. The value of all property effectively transferred within three years of death is included only for determining qualification for

a) stock redemption to pay administrative and funeral expenses and estate taxes under Section 303;

b) Section 6166 estate tax deferral;
c) estate tax liens and d) Section 2032A special-use valuation.

Retention of Life Interest (IRC Section 2036)

The gross estate includes all property transferred gratuitously by the decedent during the decedent's lifetime in which the decedent kept or reserved either the right to use, posses or enjoy the property or to receive the property income or the right to designate, either alone or with someone else, the persons who should possess or enjoy the property or its income. The rights must be kept or reserved for any of the following three cases:

1) the decedent's life - transfers with retained interests are taxable in the gross estate when the transferor keeps the possession of, enjoyment of or right to the income from the transferred property.

There are six types:

a) retention of rights to the property during the decedent's lifetime;

b) the donor's retention of a substantial economic benefit

c) a decedent retains the right to income to the extent that the income is to be used to discharge the decedent's legal obligations;

d) principal contributed by a decedent to a testamentary trust created by someone else is considered a retained interest and is includable in the gross estate;

e) Reciprocal trusts- created by a husband and wife for each other as life beneficiaries: the property of each trust is includable in the life beneficiary's estate if the arrangement leaves both grantors in the same economic circumstances in which the grantors would have been had the grantors named themselves as life income beneficiaries;

f) transfers of stock - of controlled corporations (one in which the decedent owned directly or indirectly or had the right, other alone or with someone else, to vote stock having at least 20% of total voting power) with the retention of voting rights are considered retentions of the enjoyment of the property and the stock's value is includable in the gross estate.

2) A period not ascertainable without reference to the decedent's death - is includable in the gross estate.

Example: John transfers property to a trust and directs that he receives quarterly income but that no part of an accrued quarter in which he dies is to be paid to him or his estate - the value of the accrued property is still part of his estate.

3) Decedent's retention or reservation for a period that does not end before the decedent's death - is includable in the gross estate.

Example: John gives a piece of land to his son but keeps the right to receive income for the property for ten years. John dies in the ninth year of this agreement but the entire value of the land is included in his estate.

Transfers at Death (IRC Section 2037)

Included in the gross estate is the value of property transferred by the decedent for less than full value and adequate consideration if the possession or enjoyment of the transferred property can be obtained only by the beneficiary surviving the decedent and if the decedent retained a reversionary interest worth more than 5% of the transferred property's value immediately before death.

A **reversionary interest is one in which there is the ability to have transferred property returned to the decedent.** This includes the possibility that the transferred property either may return to the decedent or the estate or may be subject to the decedent's power of disposition. It does not apply to the reservation of a life estate or to the possibility of receiving income solely from the transferred property only after someone else's death. Also not included is the possibility that the decedent may receive an interest in the transferred property by inheriting the property through another's estate.

Revocable Transfers: The Power to Alter , Amend, revoke, or <u>Terminate or to Affect Beneficial Enjoyment (IRC Section (2038)</u>

If any of these powers exists at death, the value of the property subject to the power is includable in the decedent's gross estate.

1) This is true whether the power is exercisable by the decedent alone or with someone else.

2) Types of powers covered under this section include the power to:

. Change beneficiaries

. Hasten the time that the beneficiary can receive the property

. Increase or decrease the amount of property allocated to any beneficiary

3) Two exceptions to the inclusion rule:

. If the decedent's power can only be exercised with the consent of all parties having an interest in the property

. If the power added nothing to the parties' rights under local law

4) Section 2038 includes powers to:

. Revoke or terminate a trust to which property is transferred

. Control and manage trust property except as limited to mechanical or administrative duties only

. Change beneficiaries or vary amounts distributable

. Appoint by will or change beneficiaries' shares by will

. Revoke

. Invade a trust created by another for whose benefit the decedent created a reciprocal trust

. Replace without cause the trustee with another

5) Section 2038 does not cover powers:

. In other than the grantor to revoke the transfer or return part to the grantor

. To add to corpus

. As to mechanics or details only

. Contingent on the happening of some event

. Over trusts created by others with funds not derived from the decedent and not supported by similar trusts created by others.

Estate Taxation of Annuities (IRC Section 2039)

A general definition of annuity is the concept of periodic payments over a set time (e.g., life annuity with named beneficiary). A decedent's gross estate will include the present value of an annuity receivable by a beneficiary as a result of surviving the decedent.

Annuity is included in the gross estate when payable to decedent in any of the following ways:

1) For life, then payable to beneficiary

2) For a period that did not end before death

3) For a period ascertainable only with reference to date of death

If the annuity ends, at the decedent's death, annuity is not includable if payments to a beneficiary are not provided afterward. A key factor: Whether or not the decedent had an enforceable right to receive payments from the plan during his lifetime.

Five annuities includable in the gross estate:

1) Contract under which decedent received or was entitled to receive annuity or other payment immediately before death and for duration of life with stipulation that payments continue to beneficiary after decedent's death

2) Contract under which decedent received payments prior to death together with another person for joint lives with the stipulation that payments continue to survivor after death of other individual (i.e., joint and survivor annuity).

3) Contract between decedent and employer under which decedent received or was entitled to receive annuity or other payment after retirement for life with payments to beneficiary upon death.

4) Contract between decedent and employer that provided for an annuity or other payments to surviving beneficiary if decedent died prior to retirement or before expiration of a certain time.

5) Contract under which decedent was receiving or was entitled to receive an annuity or other payment for a specified time period immediately before death with payments to continue to named beneficiary if decedent died before time expiration.

Property Held in Joint Tenancy (With Right of Survivorship Between Spouses)

Where property is held jointly with right of survivorship between spouses, the estate of the first spouse to die will include one-half of the value of the property regardless of which spouse furnished the money to purchase that property.

1) The rule is mandatory for jointly held property between spouses.

2) When the surviving spouse dies, 100% of the property will be included in the surviving spouse's estate.

3) When the decedent died, only one-half of the property was included in the gross estate; therefore, only that one-half will receive a “stepped-up" basis if the surviving spouse sells the property.

4) Creation of a joint interest in property between spouses is no longer considered a gift. Present-interest gifts between spouses will now, under ERTA (Economic Recovery Tax Act), qualify for the unlimited gift tax marital deduction.

The estate tax treatment of joint property acquired by gift of inheritance:

1) Property acquired by decedent/spouse through gifts or inheritance: one-half of value is included in decedent's estate.

2) Property acquired as joint tenants (other than spouse) with rights of survivorship: fractional interest of decedent is included in the estate:

   a) Each joint tenant owns an undivided interest in entire property

   b) Each joint tenant owns an undivided interest in entire property

Four advantages of joint tenancies with right of survivorship between husband and wife:

1) Nonprobate property, which will reduce estate administration costs

2) Uninterrupted ownership left to surviving spouse

3) Decedent's one-half ownership is entitled to full benefit of unlimited marital deduction (i.e., no estate tax liability)

4) Enhances family solidarity

Two disadvantages of joint tenancies with right of survivorship between husbands and wife:

1) Decedent can provide no restrictions or management advice as can be done through a will and trust. (An alternative would involve keeping the property in sole ownership.)

2) Step-up in basis is only available on one-half of the property. This means this tax savings may not be worth as much as the potential capital gains tax and fully stepped-up basis.

Sole ownership as an alternative to joint ownership:

1) Planner may recommend that clients terminate joint tenancy and transfer sole ownership to one spouse:

   . Entire property is eligible for marital deduction

   . Entire property receives stepped-up basis in hands of surviving spouse

   . Spouses may transfer property back and forth with no gift tax consequences

   . In cases of closely held business, transferring some nonbusiness assets to spouse increase proportion of business value in client's estate, which increase the chance of qualifying for Section 303 redemption (redeeming stock to pay estate taxes), Section 6166 (deferral of estate taxes) and Section 2032A (special-use valuation).

   Disadvantage: property becomes probate property (i.e. higher administrative costs and delays in transfer to surviving spouse).

Powers of Appointment (IRC Section 2041)

General power (ownership) of appointment: A power over property that is so broad that the power approaches actual ownership or control of the property. An estate owner may reserve a power by which the estate owner can appoint property to anyone without limitation, including self or estate. **Six elements of power of appointment:**

1) Creator (donor): The owner of property who directs that the property will be transferred subject to a power of appointment. This is generally done in the will, but can be done during life by including the power in the deed.

2) Recipient (donee): Takes the power given to donee by the donor.

3) Subject matter (property, either real or personal property): Property over which the donee will exercise the power of appointment. "Appointive asset" is another name for this property.

4) The power which is transferred: This can be either a general power (ownership) or a special (limited) power.

5) Objects of the power: The donee may appoint the property to any number of entities (e.g., other persons, charities of corporations).

6) Appointees for the power: The ultimate beneficiaries of the exercise of the power; property is received**.** by the appointees.

Property over which an individual has a *general power (ownership) of appointment* is included in the estate for estate tax purposes whether the power is exercised or not and whether a person is competent to exercise the power or not

. If the general power is exercised or completely released during life, a gift tax will be incurred. Reason: Ownership.

. Property subject to power will not be includable in holder's gross estate if consent is required from donor, person having a substantial adverse interest to donee or person in whose favor power may be exercised.

. A general power includes the unlimited rights of the decedent-donee to use the trust corpus for the decedent's own benefit.

If the donee of a power does not want the property included in donee's estate, the donee must release or exercise the power during the donee's lifetime. A release must occur more than three years prior to death or property will still be included in the donee's gross estate.

In the event of a *qualified disclaimer*:

1) Disclaimer: Decedent refused to accept power of appointment; nothing is included in the disclaimant's estate.

2) Qualified disclaimer: Not taxable gift.

3) To be qualified, disclaimer must be received in writing by transferor/representative within nine months of transfer or by disclaimant's 21st birthday. Person disclaiming must not direct to whom power of appointment passes.

Limitations which exclude the "general power" label (and do not enter gross estate):

1) The decedent's power to invade is limited by an "ascertainable standard" (e.g., to be used only for reasons of health, education, support or maintenance).

2) The power (created after October 21, 1942) can be used only with consent of creator of power or person with adverse interest in the property (stands to gain).

3) A power created before October 21, 1942, and exercisable only in conjunction with another person, is not a general power.

4) When a person is given a power that can only be exercised in conjunction with others in whose favor the power could be exercised, a fractional portion of the property will be includable in donee's estate. A fractional portion is determined by dividing the value of the property by the number of persons in whose favor the power could be exercised.

<u>Five-and-five exception rule</u>: A release is considered a gift only to the extent that the property which could have been appointed exceeds the higher of $5,000 or 5% of the assets subject to appointment. Property enters an estate to the extent the property could have been appointed during the year of death.

Time of creation: a power created by will is considered to be created on the date of the testator's death. A power created by deed/other instrument during creator's lifetime is created on date the power becomes effective.

Special power of appointment: Any power that is not a general power. the holder of power may exercise power only in favor of someone other than holder or in favor of a limited class of persons:

1) These may be freely retained and freely exercised without tax consequences. Also includes those powers donee can exercise only with consent of adverse party

2) A fairly broad (e.g., retained, exercised, released, allowed to lapse) power may be given to another person without adverse tax consequences but a power reserved by the grantor, even though limited, will likely result in tax problems.

3) The property that a decedent has a special power over will not be includable in the decedent's estate.

POWERS OF APPOINTMENT

The purpose of powers of appointment used in estate planning is **flexibility** -- the following powers may be given without tax consequences:

1) Beneficiary can withdraw $5,000 or 5% of the value of the corpus each year, whichever is greater.

2) Beneficiary can be given right to withdraw in excess of the five-and-five rule in order to maintain standard of living or for medical expenses.

3) Trustee may be given power to distribute principal to beneficiary at own discretion.

4) Beneficiary can be given special power by deed to appoint corpus to a limited class (e.g., to spouse or to children)":

a) Estate tax savings: Property left to wife as life tenant with remainder to son escapes estate tax and GSTT (generation skipping transfer tax) at wife's death; property can be left to wife outright who can give son a life estate with remainder to grandchildren; the GSTT exclusion will apply at the son's death!

b) General purpose of donor can be specified and details left up to donee.

ESTATE TAXATION OF LIFE INSURANCE

Life insurance proceeds are included in the estate for tax purposes if:

1) the decedent had incidents of ownership in policy

2) proceeds are paid to the estate

3) proceeds are received by another for benefit of the estate (e.g., received by personal representative to pay estate taxes)

The treatment of a decedent's life insurance on the life of another (e.g., wife insurance; partnership cross-purchase buy-sell agreement policy; children's insurance):

. Valued at replacement value (normally the CSV).

. Included in the estate as an asset rather than as insurance.

Incidents of ownership: Rights of insured or insured's estate to economic benefits of policy. Incidents of ownership include the right to:

1) Name/change beneficiaries.

2) Assign the policy.

3) Revoke as assignment.

4) Surrender/cancel policy.

5) Pledge policy for a loan.

6) Get loan or surrender value of policy.

7) Change beneficiary on a policy owned by closely held corporation.

8) Purchase policy purchased by employer.

9) Change ownership, benefits, proceeds in policy owned by a trust.

10) Deal with policy even after policy is physically transferred.

11) Control policy owner.

12) Retain reversionary interest worth more than 5% of policy value.

Proceeds payable to or used for benefit of the estate is defined as: any life insurance receivable by the estate, the executor or anyone empowered to act for the estate can be included, even if purchased and controlled by someone else during the decedent's lifetime. If they are used to pay estate taxes, life insurance proceeds enter the estate.

Group life insurance rules:

1) Included in decedent's estate if decedent had the “right to"

a) Change beneficiaries.

b) Terminate policy.

c) Prevent cancellation of contract by purchasing policy.

2) The group life contract is not included (no incidents of ownership) if:

a) Power to terminate policy is limited to terminating employment.

b) Right to convert group policy to individual policy at end of employment is assigned to another.

The term **"incidents of ownership"** does not apply to proceeds of a life insurance policy received by inheritance through the estate of another.

Life insurance proceeds do not qualify for the marital deduction if life insurance is payable to the surviving spouse but is not in the decedent's gross estate (i.e., no incidents of ownership). Transfers of life insurance within three years of death are included in gross estate as gratuitous transfers.

ASSET EVALUATION

The valuation of assets is crucial to the estate planning process because it is necessary in determining the potential liquidity needs of the estate executor, realizing the maximum benefit from a strategy of lifetime gifting and arranging a possible buy-sell agreement. It is a fact of estate planning that the lowest value is not always the most beneficial.

In order to accurately calculate the federal estate (and state death) tax liability, the value of the decedent's estate must be determined with precision. Each person, during his life, accumulates assets in a unique combination. The assets are of different types. Those different types of assets are valued by different methods for purposes of determining the value of the taxable estate.

In most cases, *fair market value* is used to identify the value of assets. For some types, such as listed securities, valuation is not difficult. For others, however, such as closely held shares, the problem of accurate valuation is considerably more demanding. The general valuation rules of the IRS value assets at "fair market value" of the value a willing buyer would pay a willing seller, neither being desperate to buy or sell and both aware of the relevant factors. The factors examined by the IRS include the frequency of sales, the relationship between the buyer and seller and existing options to buy and sell.

For fair market value determination, the date of death or the **alternative valuation date** (defined in IRC, Section 2032 to be six month after the date of death).

Examples of valuation methods applied to different types of assets follow.

Type of Asset	Method
Publicly traded securities	Average of the spread between the high and low on the valuation date.
Mutual Funds	Redemption value which Shareholder would receive if Shares were redeemed on the valuation date.
Real Property	Fair market value as determined by licensed appraisal.
Mortgages/ Notes	Amount of unpaid principal plus Payable accrued interest.
Life insurance	If on decedent's life, the face amount payable to the named beneficiary or the estate, if decedent has incidents of ownership. If on life of third person, replacement value.

Type of Asset	Method
Closely held shares	Value is determined by taking into account book value, outlook for the business, goodwill, and any recent stock sales or issue prices. Accuracy is very difficult!
Property held in joint tenancy	If held with spouse, one-half the value of the property. If held with an unrelated person, the entire value.

CHAPTER IX: STATE DEATH TAXES

Unless state death taxes are taken into consideration when planning the estate, the decedent's intentions can be circumvented. It is no secret that state governments are constantly seeking new methods to increase tax revenue and property transfer taxes are no exception. The surviving spouse typically fares better through exemptions and lower tax rates than do more distant relatives when state death taxes are computed.

A Decedent owning property in more than one state is especially vulnerable because of the significant differences in tax laws which exist. There is no substitute for hiring experts competent in the differences between jurisdictional taxation. One example is through the state taxation of the power of appointment. Even if the power was created by an out of state donor, the power is taxable by the donee's state, including powers given regarding out of state intangible personal property.

Three types of death taxes can be imposed by a state:

1) **Credit Estate Tax:** may be charged as the only death tax or in conjunction with one or both of the next two listed below. The federal estate tax credit known as "Credit for State Death Taxes" lists state death tax credits which can be claimed depending upon the size of the estate. When a state taxes in this manner it is designed to allow the state to tax up to the federal exemption limits therefore enjoying maximum taxation.

2) **State Estate Tax:** similar to the federal estate tax, it enables the state to tax the transfer of property from a deceased person to heirs.

3) **State Inheritance Tax:** this is a tax levied on a beneficiary's right to become the owner of property passed from the estate of a decedent. The value of the property and the relationship of the beneficiary to the decedent determines the taxable rate which is graduated. More states are moving away from this type toward the Credit Estate Tax, described above.

The lowest assessment rate of state death tax is usually applied to beneficiaries with the closest familial relationship, including the surviving spouse and/or children, parents and grandchildren of the decedent. The actual rate of taxation as it may or may not apply to a specific beneficiary class depends upon the particular state and their regulations.

The tax will have to be paid by some specified point in time, as early as the date of death or an established number of months. States will impose penalties for late payments unless some acceptable excuse is exercised. A state may even allow an extension of time during which estate taxes due are payable. A fair number of states have adopted the federal payment rules which specifies that returns must be filed with taxes due within nine months of the date of death.

There are three general categories of property which may be taxed by a state:

1) **Real Property:** can only be taxed by the state within whose borders the property is located as a matter of U.S. Constitutional Law as well as being a basic common law concept.

2) **Personal Property (tangible):** is taxable only in the state in which it has a taxable situs and the location of the property must be definite. Any movement of property from one state to another is allowable but it must be temporary.

3) **Personal Property (intangible):** it is possible that this type of property may be taxed by several states, if a state has had significant contacts with the property. This turbulent area of estate law has shifted from allowing tax in only one jurisdiction to allowing more than one state the right to collect taxes.

The last point, #3 above, is important because a decedent with a residence in more than one state may be opening himself up to multiple taxation of intangibles like stocks and bonds. Another multiple taxation situation arises when a decedent lives in one state and establishes a trust in a different state. Both the state of residence and the trust situs state may have the right to tax the property of the trust. Most states have reciprocal exemption on intangible property of non-resident decedents and the only danger of multiple taxation occurs in the situations discussed earlier in this paragraph.

Life Insurance

Life insurance proceeds which are payable to the insured's estate are subject to estate taxation while a few states exempt all or part of such proceeds. State laws consider to whom the proceeds are payable as well as whether or not the proceeds were used to pay death taxes. Many states do not tax life insurance proceeds when someone other than the estate of the insured is the named beneficiary. Still other states tax proceeds if the decedent held ownership in the policy even when an individual and not the estate has been named as a beneficiary.Community property states may tax proceeds of life insurance completely differently than do common law states. Some community property states allow half of the proceeds to be taxed and the other half exempted while others exempt all proceeds when an individual and not the estate has been named as the beneficiary.

CHAPTER X: INCOME TAXATION

Trusts and estates are legal beings according to tax law and therefore are responsible for paying taxes. One of the first acts of an executor is to get a tax identification number for the estate. It has been stated that **tax savings is not the primary goal of every estate plan; however maximizing tax savings from a legal viewpoint should not be overlooked.** The estate exists but for a brief period of time, from either a few months to a few years, ending when assets have been properly transferred to their new rightful owners. An estate typically remains open for 3 years, but it is in the best interest of everyone to settle all estate matters quickly and efficiently.

The emphasis of this final section is to explain the similarities and differences between trusts and estates and to examine any tax paying benefits available to each. The main similarity of a trust to an estate is the fact that a fiduciary is appointed to transfer the benefits of property for stated beneficiaries. Both the grantor and the decedent are creators of the trust or estate.

TAXATION

The income tax rate for the trust and the estate, as of this writing is identical. Since trusts and estates exist for the benefit of someone other than the grantor or decedent, the manner in which the income tax is applied does differ from the manner in which it is applied to individuals or corporations.

Trusts and estates are taxed using what is known as the **"sharing concept",** a method avoiding the double taxation experienced by corporations while assuring beneficiaries are not taxed on benefits not yet received (as is sometimes the case with a partnership). The sharing concept makes trusts and estates pay tax on income generated but not yet distributed while making beneficiaries pay tax on income distributed to them. Applying the sharing concept eliminates the problems caused by the corporate and partnership taxation rules cited above.

Check with qualified tax advisors at any given time to be certain of the current taxation status.

Taxation of Estates

The fiduciary of the estate must file two separate tax returns including the decedent's final return as well as an income tax return for the estate. In whichever year the taxpayer's life ends it marks the last year in which an income tax return is due. A return is due no later than April 15 of the following year. A full standard deduction and full personal exemption may be used even if the taxpayer expired but few days into the New Year. A surviving spouse may file a joint return for any taxable year during which the other spouse was still alive.

In the final return, only income received by the taxpayer during that year must be declared as income (cash-basis). Any income paid to the taxpayer after death will be taxed to the beneficiary upon receipt. Therefore the estate beneficiary pays tax on the income of the decedent in the same manner as the taxpayer would have.

Furthermore since an estate is a legal being, it must also pay tax on any income it produces. Gross income is added together and typically includes income from stocks, bonds, sale of property, royalties, rental property and possibly income from a business. All expenses directly attributable to the administration of the estate are fully deductible while all other itemized deductions must exceed a specific percentage of adjustable income.

There is a **special tax rule on specific bequests which are made in three installments or less from estate principal** rather than from income. In this instance, the estate and not the beneficiary is taxed. However, any specific bequests paid from estate income are taxable to the beneficiary. Aside from the special rule just discussed concerning specific bequests, the **"income-first rule"** states all estate distributions are paid from income first when principal is fact distributed (i.e. ownership of stock is transferred to a beneficiary rather than dividends from the stock).

Taxation of Trusts

Irrevocable trusts (including testamentary and inter vivos) are separate legal beings that must pay income tax while the income from property in revocable trusts is taxable to the grantor who still has control over the trust assets. The trustee has the discretionary power to let the trust assets and the income they produce accumulate or he can distribute the income to beneficiaries who can each claim a personal exemption and who are responsible for paying taxes according to their own particular bracket.

Trust taxation focuses on the idea that income from the trust is taxed but one time, either to the trustee or beneficiary. When the trustee has to distribute all trust income annually to the beneficiaries, then the beneficiaries must pay the income taxes. In cases where the trustee has authority to add some or all of the income earned to the trust assets, the beneficiaries are not taxed on what they may never receive.

Simple and Complex Trusts

The status of a trust at any given can be either "simple" or "complex". When the trust deed mandates all trust income be paid on a current basis to beneficiaries, it is a simple trust. When a trustee is authorized to accumulate income (add it to the trust assets rather than distribute it) then it is a complex trust.

The simple trust does not allow the trustee to distribute principal. Only current income may be distributed and no charitable gifts are allowed. Since the simple trust is a tax paying legal entity, it enjoys a personal exemption amount as well as the ability to deduct allowable expenses from income. Current income distributed to beneficiaries is exempted as income to the trust since the beneficiaries will report the amount as income and be responsible for income taxes. The definition of income as it pertains to a trust includes both dividends and capital gains amounts. Although the simple trust distributes all dividend income, **all capital gains amounts are considered to be part of the principal and are added to the**

other assets of the trust. The capital gains amount kept by thee trust is still income and taxable to the trust as income since capital gains are excluded from the trust law definition of income.

The complex trust, which can distribute principal and make charitable gifts, is also a tax paying legal entity. Actual distributions made by the complex trust are deductible as an expense but any income not distributed is income taxable to the complex trust. Technically, a trust which authorizes the trustee to distribute principal is still a simple trust as long as no principal was actually distributed during a tax year. Tax rules applying to the complex trust are also usually the same as those governing income taxation of a decedent's estate.

Distributable Net Income

Distributable net income (DNI) equals taxable income prior to the deduction for distributions and before the personal exemption of the trust, but after excluding capital gains and losses. There are three primary functions of DNI:

- the trust (or estate) receives a deduction for amountsdistributed while providing a limit for the deduction.

- A portion of distributions that are taxable to beneficiaries is limited.

● The character of the income is retained whether it is in the hands of the beneficiary or remains in the trust. For example, tax-exempt income to the trust is tax-exempt income to the beneficiary.

When more than one beneficiary receives trust income, each is taxed on their own share of DNI. Each beneficiary receives a proportionate share unless the trust specifies that certain types of income are paid to specific beneficiaries. This makes it possible for beneficiaries in high tax brackets to receive tax-exempt income while taxable income is paid to beneficiaries in low tax brackets.

Grantor Concepts

Generally, a **"grantor-trust"** has been created when the grantor maintains certain controls and prescribed powers over a created trust. In such an instance, trust income will be taxable to the grantor as an individual. This would defeat a main purpose of trust creation: a wealthy grantor transferring property to a trust for the benefit of less fortunate family members. As discussed in an earlier section when trust income is taxed to the grantor it is a revocable trust. Therefore, to obtain maximum benefit from tax laws, a grantor must establish an irrevocable trust.

When a grantor has a reversionary interest in trust principal or income, grantor-trust tax treatment will apply with the following exception, known as the **"reversionary-interest rule"**:

1) if the reversionary interest takes effect at the death of a beneficiary who is a lineal descendant of thegrantor, and

2) the beneficiary described in point 1, above, has notattained the age of 21.

Beneficial enjoyment is another issue of grantor control. Grantor taxation is applied when the grantor keeps the beneficial enjoyment of the trust corpus and/or the power to dispose of trust income without the consent of an adverse party. **An adverse party is defined as a beneficiary with an interest which is opposed to another beneficiary's interest in the same trust property.** There are some exceptions to the above rule, and a few powers which can be held by the trustee (no matter who the trustee is) but do not trigger grantor trust taxation include:

1) the power to provide income to charitable beneficiaries,

2) the power to provide income to support the grantor’s beneficiaries, but not where the support is legally required,

3) the power to appoint the principal or income of the trust by will other than income accumulated in the trust (at the discretion of the grantor or nonadverse party).

Income to Children Under Age 14

The current tax rule which applies to the net unearned income of children under 14 years of age is, after the standard exemption and a paltry amount subject to the child's tax bracket, everything else is taxable at parent's rate of taxation (which is presumably higher than the child's). This rule, instituted in TRA of 1986, is **designed to stop adults from transferring income to children for the purpose of lower overall income tax paid.**

When constructing a trust which is designed to benefit minor children, this tax rule on a child's unearned income must be strategically dealt with. A trust should be created which accumulates income until the child reaches the age of 14. Alternatively, the trust can invest in assets providing deferred income, such as government bonds, growth stocks paying little or no dividends, tax-free municipal bonds or life insurance or annuity contracts.

Life Insurance Purchases

Unless state law prohibits it, a trustee of a testamentary trust can be authorized to buy life insurance on the lives of beneficiaries. The income used to pay for the premium is taxable to the trust when a beneficiary other than the grantor or grantor's spouse is involved. When the grantor is being benefited, trust income used is taxable to the grantor.

The benefit to the beneficiary who is able to enjoy the purchase of life insurance through the use of trust income is one of tax savings. If the trust income used to pay premiums was distributed to the beneficiary instead, the entire amount is taxable income to the beneficiary. Since the trust income is used to pay premium, on the other hand, the trust pays the income tax on the amount and the beneficiary has more premium dollars.

Sprinkle Clauses

A sprinkle clause allows a trustee the power to distribute any or all income or principal to beneficiaries in equal or unequal shares. This will enable a trust to divide income among many family members who can each apply the individual personal exemption against the income received from the trust. An advantage unrelated to tax savings includes the ability to sprinkle income on a needs basis to beneficiaries. For instance, the grantor can direct that trust income can be paid to the family of a deceased child but only so long as there is a minor child or the surviving spouse does not remarry.