

QUESTION ONE

When Betty and Nic buy Blackacre, assuming that they are in one of the states in which a joint tenancy is severable, neither is treated as making a gift.

Betty's loan to Greta is a "below-market loan" covered by section 7872 of the Code. Better is treated as making a gift to Greta of the forgone interest. Because it is a demand loan, the gift is deemed to occur every year. The forgone interest each year is the \$1,000,000 outstanding balance multiplied by the applicable federal rate, determined each month. The gift is eligible for the annual exclusion. Each gift under section 7872 is a direct skip for GST tax purposes. As the transferor, Betty is liable for the resulting GST tax.

When Betty funds the trust, she makes a gift of the 10-year income interest to Nic and a gift of the contingent remainder to Greta. The gift is valued by subtracting from the \$500,000 transferred in trust the value of Betty's retained contingent reversion. The value is determined applying the valuation tables under section 7520. Section 2702 is inapplicable because neither Nic nor Greta are members of Betty's family under section 2704(c)(2).

The gift is eligible for an annual exclusion for Nic's interest. In addition, because Greta is given a *Crummey* power, a second annual exclusion is available for her interest. When Greta's power lapses, Greta is treated as making a gift in trust of the annual exclusion amount, subject to her own annual exclusion for Nic's interest and subject to the "5 or 5" exception to the rule that lapses of general powers of appointment are gifts. Section 2702 applies in valuing Greta's deemed gift to Nic.

When Betty dies, one half of the value of Blackacre is included in her gross estate. Betty's gross estate also includes the value of the trust remainder after Nic's term interest, under section 2037. The value of Greta's promissory note is also included in the gross estate. Any gift tax paid on gifts in the last three years of Betty's life, such as gift tax due on account of section 7872, is included in her gross estate under section 2035(b).

The transfer of the note to Greta is a direct skip for GST tax purposes. As the transferor, Betty's estate is liable for the GST tax.

When the trust terminates and the corpus distributed to Greta, a taxable termination occurs for purposes of the GST tax. The trustee is liable for the resulting GST tax.

Betty and her estate are entitled to gift and estate tax unified credits, and a GST exemption. The estate may be eligible to elect the alternate valuation date under section 2032.

QUESTION TWO

When Mai and Zia form FLP, a question arises whether either of them has made an indirect gift to the other. Although each partner's capital account and partnership profit share is equal to the partner's contribution to the percentage of FLP's initial capital, Mai's interest has control while Zia's interest lacks it. This may suggest that Zia has made a gift to Mai, as opposed to vice versa.

Mai's gift of the 30 percent limited partner's interest to Zia is a taxable gift. In valuing the gift, discounts for lack of control and lack of marketability may be available. Thus, the gift's value may be less than 30 percent of \$5,000,000 (that is, less than \$1,500,000).

A question arises under *Hackl* whether the gifts of partnership interests are eligible for the annual exclusion. The result may depend on whether the partnership actually generates income and makes distributions.

As a married couple, Mai and Foster may elect to split all of the gifts either of them make during any taxable year. This election would treat each gift either of them makes as coming one half from Mia and one half from Foster.

Mai makes gifts to Foster and Zia upon paying their expenses. The gifts to Foster qualify for the marital deduction.

When Mai dies, the question arises whether the assets Mai transferred to FLP should be included in her gross estate at their date of death values under section 2036(a) of the Code. The question may hinge on whether there was an implied agreement between Mai and Zia that Mai could have all of the partnership income if she so desired. The uneven distributions indicate that this may be the case. Although the partnership held meetings, they were informal and occurred around the time of social activities. On the other hand, Mai did not transfer substantially all of her assets to FLP; she retained many other assets that she died owning outright. The establishment of the partnership's bank account is also a fact slightly in favor of the taxpayers.

Regardless of any implied agreement, section 2036 is inapplicable if Mai's transfer to FLP was a bona fide sale for full and adequate consideration in money or money's worth. Although the partners' capital accounts satisfy the consideration requirement, the question remains whether the transfer was a bona fide sale. The fact that Zia transferred \$50,000 of her own funds indicates that a bona fide sale may have taken place. However, the partnership was formed on the advice of an estate planning lawyer, and no apparent nontax purpose is evident from the facts. If the partnership assets are included in Mai's gross estate, the estate will get credit for any gift tax Mai paid on transfers of FLP interests; those transfers should not be considered part of the adjusted taxable gifts.

The inventory that Mai leaves to Zia is included in Mai's gross estate. The items are valued taking into account Mai's death, which may tend to increase their values due to the renewed market interest. Given that an "inventory" of art is transferred, a blockage discount may be appropriate.

Any gift tax paid on gifts made within three years of Mai's death is included in her gross estate under section 2035(b) of the Code.

The assets left to Foster outright are eligible for the marital deduction. The delay clause does not render Foster's interest a terminable interest.

The assets transferred to the trust are eligible for the marital deduction if Mai's executor makes a QTIP election. The trustee's power to invade corpus for Foster does not violate the requirement that all of the income from the trust be paid to Foster no less frequently than annually. Nor does the trustee's discretion not to fund the trust violate this requirement, so long as the trustee actually funds the trust and makes the QTIP election.

Mai, her estate, and Foster are entitled to gift tax and estate tax unified credits. Upon Mai's death, any unused unified credit may be "ported" over to Foster if Mai's estate so elects. Mai's estate may be eligible to elect the alternate valuation date under section 2032.

QUESTION THREE

When Dhani establishes the trust, transferring \$1,000,000 worth of Lope stock to it, has he made completed gifts? The gift of the income interest to Som is complete because the power merely to affect the timing of the beneficiary's income rights does not render the gift incomplete. The gift of the remainder to Wali is incomplete because of Dhani's retained power to change the beneficiary. The need to obtain a nonadverse party's consent does not render the gift complete. Som's interest is not a present interest eligible for the annual exclusion because of Dhani's right to force accumulation of income. The values of Som's and Wali's interests are determined using the actuarial tables promulgated under section 7520, based on Dhani's life.

Dhani's transfer of the \$100,000 cash to PSP is an indirect gift by Dhani of a \$50,000 to each of Som and Carla. Under the reciprocal trust doctrine, Dhani's transfer may be treated as a gift of \$100,000 to Dhani. In either event, no annual exclusion may be available if there is no expectation that PSP will be generating income in the near future.

Dhani's release of the power to change the remainder beneficiary results in a completed gift of that remainder interest to Som. The actuarial tables under section 7520 are applied to the current value of the corpus, \$1,200,000, to determine the amount of the taxable gift. No annual exclusion is available for this gift of a future interest.

As a married couple, Dhani and Wali may elect to split all of the gifts either of them makes during any taxable year. This election would treat each gift either of them makes as coming one half from Dhani and one half from Wali.

When Dhani dies, the entire \$1,500,000 value of the Lope stock is included in his gross estate because of his power to affect who shall possess or enjoy the income of the trust, under section 2036(a)(2) of the Code. The release of the power during the last three years of Dhani's life is ineffective to get the trust assets out of his gross estate, under section 2035(a). The earlier gifts of interests in the trust are not treated as adjusted taxable gifts; thus, the estate is effectively given credit for the gift tax paid when those transfers were made.

Any gift tax paid on gifts made within three years of Dhani's death is included in his gross estate under section 2035(b) of the Code.

Dhani's testamentary transfers of assets to his surviving spouse, Wali, are eligible for the marital deduction.

The real estate commission and other selling expenses regarding Flatrock may not be deductible under section 2053 because they may not be necessary for administration of the estate. Although the executor's concerns about state taxes are valid, query whether it is necessary to sell an \$8,000,000 asset to pay \$400,000 in taxes. A relevant fact might be whether other, less valuable assets of the estate may have been available to be sold to raise the necessary cash. To be deductible, the expenses must also be allowable under state law.

The state taxes may be deductible, depending on what types of taxes they were, and when they accrued. State death taxes are deductible under section 2058. The deductibility of other state taxes is limited by section 2053(c)(1)(B) of the Code.

Dhani, Dhani's estate, and Wali are entitled to gift tax and estate tax unified credits. Upon Dhani's death, any unused unified credit may be "ported" over to Wali if Dhani's estate so

elects. Dhani's estate may be eligible to elect the alternate valuation date under section 2032. Flatrock may be eligible for special use valuation under a section 2032A election.