

Issue Outline
Estate & Gift Tax Exam
Fall 2018

Question 1

When Mimi establishes Trust No. 1, it is a completed gift of the entire corpus. She can accumulate income to Sota's detriment, but only with Sota's consent, and since he is therefore an adverse party, the gift is complete. *See* Reg. § 25.2511-2(e). Is the gift eligible for the gift tax annual exclusion? Mimi's accumulation power raises the issue of whether Sota's interest is a future interest, for which no exclusion would be available. (Gina's interest in Trust No. 1 is clearly a future interest.) Because Sota can veto Mimi exercise of the power, he probably does have a present right to the income from the trust corpus, and so one annual exclusion is probably allowable.

When Mimi dies, the corpus of Trust No. 1 is included in her gross estate under IRC § 2036(a)(2).

When Mimi establishes Trust No. 2, it is a completed gift of the entire corpus. She can accumulate income, but eventually all of the income will be paid to Gina or Gina's estate, and so the gift is complete. *See* Reg. § 25.2511-2(d). Mimi's accumulation power renders the gift tax annual exclusion inapplicable, because Gina does not have an unrestricted present right to income.

When Mimi dies, the corpus of Trust No. 2 is included in her gross estate under IRC § 2036(a)(2).

When Mimi dies, the assets in her gross estate are valued at their fair market values on the date of her death, or on the alternate valuation date if it is elected. This includes the values of the securities in the trusts. The securities may be eligible for a blockage discount if they constitute an unmarketably large block of stock, and they may be subject to a control premium if they possess control over the corporation issuing the stock.

The values of the securities will not be taxed twice, once under the gift tax and again under the estate tax. In calculating the estate tax, credit is given (in effect) for the gift tax paid when the trusts were transferred to the trusts in the taxable gifts.

Mimi's one-half interest in the Plant is included in her gross estate under Section 2033. The value is one-half the fair market value of the Plant, likely reduced by a discount for the shared control imposed on the owner of an interest as tenant in common. Again, valuation is determined as of the date of death or the alternate valuation date.

Mimi's one-half interest in Blackacre is included in her gross estate under Section 2040(a). Because both she and Bram received their interests as gifts, with neither providing any consideration, the last proviso of Section 2040(a) includes one half of the value of Blackacre in

Mimi's gross estate. No discounts are available. Again, valuation is determined as of the date of death or the alternate valuation date.

Mimi's estate will be entitled to a unified credit. Depending on whether a marital deduction wiped out her late husband's estate tax liability, she may also be entitled to an unused portion of the unified credit of her deceased spouse.

The formation of Trust No. 1 is not a taxable transaction for generation-skipping-transfer (GST) tax purposes, because Trust No. 1 is not a skip person. In contrast, the formation of Trust No. 2 *is* a taxable transaction for generation-skipping-transfer (GST) tax purposes – a direct skip – because Trust No. 2 *is* a skip person. Mimi and her estate have an exemption available in calculating the GST tax. The exemption must be allocated between the trusts; if the taxpayer does not do so, the Code provides a default allocation. There are no GST tax issues with the Plant or Blackacre.

Question 2

The recapitalization of Corp is an indirect gift by Hugo to Kenta and Liam. The amount of the gift is the increase in the fair market values of their shares, or \$4,000,000 each. The gifts may not be eligible for the annual exclusion because Corp pays no dividends, which may cause Kenta's and Liam's interests to be future interests. As a married couple, Hugo and Wadi can elect to spilt the gift, that is, treat it as being made one half by each of Hugo and Wadi.

When Hugo dies, the lapse of his voting rights is treated as a taxable transfer under IRC § 2704(a). The gross estate includes the diminution in value caused by the lapse. In addition, the stock, now nonvoting, is included in Hugo's gross estate at its fair market value, under IRC § 2033. The stock, whose value likely bore a control premium prior to the recapitalization, is subject to discounts for a lack of marketability and possibly for the business' loss of Hugo if he is a key person.

The transfers of checks are incomplete gifts because they were not deposited prior to Hugo's death. Thus, no annual exclusions are available. At Hugo's death, his checking account, undiminished by the checks, is property included in his gross estate under IRC § 2033.

Hugo's claim against Eli is also property included in Hugo's gross estate under IRC § 2033. The claim is valued as of the date of Hugo's death, or the alternate valuation date if it is elected; in either case, the value is determined taking Hugo's death into account (except to the extent that *McClatchy* might call for the opposite result).

The attorney's fee is deductible as an administrative expense. It is necessary for the collection of estate assets. *See* Reg. § 20.2053-3(a).

When Hugo dies, the life insurance proceeds paid to the children are a taxable gift by the owner of the policy, Wadi. The full death benefit is subject to gift tax. Wadi is entitled to two annual

exclusions, one for each of Kenta and Liam. The life insurance is not in Hugo's gross estate because he did not have incidents of ownership.

The gift tax on the recapitalization is included in Hugo's gross estate because he died less than three years from making the indirect gifts that arose out of that transaction. IRC § 2035(b). Hugo's estate is entitled to a marital deduction on assets passing to Wadi. Hugo and his estate are entitled to a unified estate and gift tax credit.

Question 3

The retirement annuity is not a lifetime gift by Xena. However, the value of the annuity is included in her gross estate under Sections 2038 and 2039. She had the right to change the contingent beneficiary of the Bigco plan, and had she retired in good standing, the annuity would have been payable to her. The estate tax value is the present value of the annuity, determined as of the date of Xena's death.

Xena's disclaimer presents issues under IRC § 2518. In order to be a valid disclaimer of the power for federal tax purposes, it must be made within the nine-month period specified by the Code (which would begin on Val's death), and it must be effective under state law. Here, it is not clear that the disclaimer met the statutory requirement, because when the time period expired, the disclaimer may not yet have been effective under state law. (Xena receiving monthly income does not constitute accepting the benefits of the power over the corpus. The two interests are separate. *See* Reg. § 25.2518-3(a)(1)(iii).)

If the first disclaimer document was not effective, then Xena's later actions, which were, constitute the release of a general power of appointment over the trust corpus. Thus, Xena would be treated as transferring the corpus to the trust. This would constitute a gift of the remainder to Cora, with Xena retaining a life income interest. In valuing the gift to Cora, Xena's retained interest would be assigned a zero value under IRC § 2702. Thus, the gift to Xena would be the full value of the corpus on the date of the release. Because Cora's interest is a future interest, no gift tax annual exclusion would be available. In addition, when Xena dies, the trust corpus would be included in her gross estate under IRC § 2041(a)(2) (first sentence, last clause).

If the first disclaimer document *was* effective, then there are no gift or estate tax consequences to Xena. However, at Xena's death, a taxable termination would occur as the property passes to Cora, who is a skip person as to the original transferor, Val. The amount of the GST tax would depend on how much GST exemption has been allocated to the trust, such as by Val or Val's executor. The liability for the GST tax on a taxable termination is imposed on the trustee – here, Tara. IRC § 2603(a)(2).

Assets in Xena's gross estate are valued at their fair market values on the date of Xena's death, or the alternate valuation date if it is elected. The property passing from Xena to York is eligible for the marital deduction. The survivorship condition, or "delay clause," is not an issue because of IRC § 2056(b)(3), which provides an exception to the terminable interest rules.

Xena and her estate are entitled to a unified credit for estate and gift tax purposes. Whatever of that credit is not used by Xena or her estate may be “ported” to York.