ESTATE TAX PLANNING

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Estate Tax Planning  
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## Introduction to the Course

*Estate Tax Planning* examines the various aspects of planning for the estate tax liability. The course begins with a discussion of the genesis of estate taxation in English common law and continues with an examination of the estate and its administration.

The subjects discussed in the course are a) the estate and its administration, b) federal gift and estate taxes, c) common estate planning trusts, d) calculating federal estate taxes, e) state inheritance and estate taxation, and f) estate tax payment. The text serves as an introduction to the issues of estate settlement and includes a discussion of the probate estate and the federal gross estate.

The steps taken to calculate federal estate tax liability are discussed. In that discussion, the federal gross estate, tentative taxable estate, taxable estate and tentative tax are examined. The various estate tax credits and deductions are considered and their place in the federal estate tax calculation is explained.

The role of trusts in estate tax minimization is considered. The common trusts employed in estate tax planning are explained, and the uses of credit shelter trusts, QTIP trusts and irrevocable life insurance trusts are demonstrated. State death taxes are considered, and inheritance taxes are compared to estate taxes with respect to the party liable for payment and the role of decedent/beneficiary relationships in inheritance taxation. Finally, the traditional sources of estate tax payment are examined and compared.

## Learning Objectives

Upon completion of this course, you should be able to:

* Explain the differences between an estate for tax purposes and a probate estate;
* Identify the assets that comprise the federal gross estate;
* Compare state inheritance taxes and estate taxes and the typical beneficiary classifications for state inheritance tax purposes;
* Explain how gifts are taxed under the federal gift tax system;
* List the deductions and credits allowed under the federal system of estate taxation;
* Describe the common trusts employed in estate tax planning;
* Perform an estate tax calculation; and
* Identify the methods of estate tax payment and their cost consequences.

# Chapter 1 The Estate and Its Administration

## Introduction

Federal estate taxation has long been an obstacle to the transfer of accumulated wealth from one generation to the next. Although it has undergone many changes and liberalizations since its initial imposition, it remains a serious concern for some individuals and families and can cause an estate to lose a substantial part of its value, depending on its size.

Not only is the imposition of taxes the way governments fund their operations, including paying for standing armies, wars, foreign aid, and feeding the poor, it is also a means of bringing about a result the government feels is desirable. Estate tax is a perfect example of the latter objective.

Much of United States law had its basis in the English common law. The common law is the body of law that was developed in England over the centuries and constitutes the foundation of the English and United States legal systems. It was developed based on custom and usage and the decisions of the law courts - as distinguished from statute law.

The early English property ownership system was feudal; in the feudal system, vast property ownership was concentrated in the hands of relatively few families. Often, the property owned by these feudal landowners was a gift from the ruling monarch. In return for the land grant, the monarch demanded that the property owner be available to fight the monarch’s battles. Over time, with the development of a monetary system, the enterprising property owner hired mercenaries to fulfill his obligation to the monarch or paid a tax.

Two social and economic classes arose out of this feudal system: a landed gentry and a peasant class. Although the perquisites enjoyed by the gentry were always significantly greater than those available to the peasant class, the difference in quality of life eventually took on an almost Dickensian quality as property became ever more concentrated in the hands of the few. The English system of primogeniture, providing an exclusive right of inheritance to the eldest son, further concentrated those holdings.

In an effort to break up the concentration of landholding, a system of inheritance taxation was introduced by the British parliament. The result for many families, often land rich but cash poor, was the sale of some or all of their ancestral land. With considerable modification, of course, this system continues in the United States and is the basis of estate taxes.

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Explain the differences between the probate estate and the federal gross estate;
* Identify the components of a decedent’s probate estate;
* Describe the assets that comprise a decedent’s federal gross estate; and
* Explain the duties of an executor or administrator of a decedent’s estate.

## The Probate Estate

We are going to focus our attention on the tools and techniques of planning for estate taxes. In order to get the most out of this course, we will need to begin with some definitions, and a good place to begin is with the definition of an “estate.”

When we use the word “estate,” we need to make a distinction between the *probate estate* and the *federal gross estate*. Although there is some relationship between the two concepts, they are fundamentally different.

A probate estate is:

* The estate for distribution purposes
* Property passed by will or intestacy laws

When we talk about the probate estate, we are really talking about all of the decedent’s property that passes at his or her death either by will or by the applicable state intestacy laws. The intestacy laws are those state laws that govern the distribution of the property of a decedent who dies without a will. Accordingly, such a decedent dies *intestate.*

The probating of an estate has two major purposes:

* Settle the decedent’s debts
* Establish title to the assets owned at death

The probate estate includes life insurance that is payable to the estate and any other property that is distributed by the decedent’s last will and testament. It may include property that the decedent owned at his or her death either individually or as a tenant in common with others. We can see, then, that the probate estate really has little to do with estate taxes. It refers to that property that is transferred by will or intestacy.

Not unexpectedly, a great deal of the decedent’s property avoids inclusion in the probate estate, including:

* Life insurance death benefit proceeds payable to a named beneficiary other than the estate
* Property owned as joint tenants with right of survivorship
* Property owned as tenants by the entirety

Let’s consider the property that falls in these three categories.

Although life insurance death benefit proceeds payable to a named beneficiary avoid probate, death benefit proceeds payable to the estate do not. By definition, death benefit proceeds payable to the estate are payable to the probate estate. They are then distributed by the decedent’s will and are subject to probate costs.

Although there are valid estate-planning reasons for arranging a beneficiary designation so that death benefit proceeds are payable to an individual’s estate—for example, to fund a credit shelter trust—they should not normally be paid in that way. In fact, life insurance death benefits should be payable to the estate only to facilitate the decedent’s specific objectives that can best be met by funneling cash into the estate rather than in some other fashion.

Let’s turn our attention to the other principal categories of property that avoid probate.

* Property held by the decedent as a joint tenant with right of survivorship
* Property held by the decedent as a tenant by the entirety

Although there are other differences between these two types of property ownership that do not impact on their distribution at death, for purposes of our discussion of probate, the principal difference between these two types of ownership is that a tenancy by the entirety can exist only between a husband and a wife.

Property that is held either as a joint tenant with right of survivorship or as tenants by the entirety passes to the surviving joint tenant immediately upon the decedent’s death. In addition, it passes to the survivor entirely free from the claims of the decedent’s creditors, heirs, or personal representatives.

A type of property that is often owned by a husband and wife as joint tenants is their residence. Although not all married couples own their residence jointly, a residence is commonly held in that manner. When one of the joint owners dies, the other joint owner immediately owns the property. The property does not pass by virtue of the decedent’s will or according to intestacy laws.

This distinction between probate property and non-probate property is made as a way of beginning our main discussion—estate taxes. As you can see, often a considerable amount of property owned by a decedent avoids inclusion in his or her probate estate.

What about that property? Does the fact that some property avoids inclusion in the probate estate mean that it also avoids inclusion in the federal gross estate? The answer, of course, is “no.” Just because certain property avoids inclusion in the decedent’s probate estate does not mean that it also avoids inclusion in his or her federal gross estate.

Clients are often confused when they try to distinguish between the probate estate and the gross estate for federal estate tax purposes. Unfortunately, this may lead them to believe that by avoiding probate they also avoid estate taxes, and this incorrect belief may keep them from doing appropriate estate planning. It is important that this myth be dispelled as quickly as possible.

## The Federal Gross Estate

Now that you understand that the probate estate is comprised simply of that property that passes by the decedent’s will or under the laws of intestacy, you need to distinguish it from the federal gross estate. Simply stated, the federal gross estate is the decedent’s property that is subject to federal estate taxation.

The federal gross estate is generally comprised of:

* Property owned by the decedent at death
* Property in which the decedent had any incidents of ownership
* Life insurance death benefits under policies owned by the deceased insured
* Certain gifts

The decedent’s federal gross estate consists not only of property owned by the decedent at his or her death that passes to the probate estate, but also the non-probate property that the decedent owned at death, any property in which the decedent retained any incidents of ownership, any life insurance death benefits under policies the decedent owned, and certain gifts. Let’s look at the property that falls into each of these categories.

Our first category is the property owned by the decedent at his or her death. The broad, general types of property that might be owned by the decedent at death are:

* Personal property
* Real property

In a general sense, real property consists of land and anything permanently attached to it—such as a building. This property is commonly known as real estate. Personal property is all property that is not real property.

Both real property and personal property can be owned individually or jointly. When we discussed the two kinds of property ownership that allow owners to avoid probate, we noted that they were:

* Joint tenancy with right of survivorship
* Tenancy by the entirety

Both the joint tenancy with right of survivorship and the tenancy by the entirety avoid probate because their ownership passes *by operation of law*. The property held passes automatically to the survivor at death. A third type of joint ownership, called tenancy in common, does not cause the decedent’s interest to automatically pass to the surviving owner upon the decedent’s death. Instead, the decedent’s property rights in property owned as a tenancy in common pass to his or her heirs just as any other property would—by will or intestacy. So, although this third type of property ownership is joint, it does not avoid probate.

Since the federal gross estate includes all of the property owned by the decedent, certainly, any property owned by the decedent *individually* would be included in the federal gross estate. However, what about property that is held in joint ownership? Would that jointly-owned property also be included in the federal gross estate?

The answer to whether jointly-owned property is included in the federal gross estate is “yes.” The federal gross estate includes *all* property owned by the decedent, whether it was owned individually or jointly with someone else.

As long as the decedent owned property at his or her death, the portion owned by the decedent will be included in the federal gross estate.

In addition to property that might relate to the decedent’s personal life, such as a personal automobile or residence, the decedent’s business-related or employee-related property is also included in his or her federal gross estate. Property included in this category includes:

* The value of the decedent’s business interest
* Vested, accrued qualified retirement benefits
* Employee death benefits
* The present value of nonqualified deferred compensation benefits

When we listed the components of the decedent’s federal gross estate, we noted that it included both the property the decedent owned—whether individually or jointly—and property in which the decedent had any *incidents of ownership*. It is time to examine what an incident of ownership is.

An incident of ownership can be broadly defined as a right in and to property. It refers to a right that is less than complete ownership. In fact, it may be far less than *complete* ownership and still be sufficient to cause the property, in its entirety, to be included in the decedent’s federal gross estate. Let’s consider an example of an incident of ownership.

Suppose that a client makes a gift to his 21-year-old daughter. This gift is $1 million in trust from which she is entitled to receive an annual income. Furthermore, at the client’s death she will receive the $1 million trust corpus outright.

Unfortunately, she is dating a young man that the client considers inappropriate. Since she is currently dating this person, the trust document contains a provision that if she marries this person before the client’s death she forfeits all claim to the income and corpus of the trust. If that forfeiture occurs, the trust corpus would then revert to the client. At the time of the client’s death, she still has not married this young man. In fact, she is no longer dating him.

Given this situation, there are two important questions that we need to ask. First, is the corpus of the trust—the $1 million—a part of the client’s probate estate? (The corpus of a trust is the amount of principal in the trust.) Second, is it considered a part of the client’s federal gross estate?

The answers are different for the two questions. Since the trust document, rather than the client’s will, has provided for the distribution of the trust corpus, it does not become a part of the probate estate. However, although the $1 million is not distributed by the client’s will and, therefore, not a part of the probate estate, it is certainly a part of the client’s federal gross estate.

The reason for the inclusion of the trust corpus—the $1 million—in the client’s federal gross estate is because he had a reversionary interest in it. In other words, if the client’s daughter had married the young man, the $1 million would have reverted to the client. The fact that it did not revert to the client because she did not marry him is immaterial. It is only necessary that the client possess that reversionary right to give him an incident of ownership in the trust corpus.

In the case of life insurance, an incident of ownership includes, but is not limited to, the right to:

* Change the beneficiary
* Revoke a policy assignment
* Surrender the policy
* Pledge the policy for a loan
* Assign the policy
* Obtain a policy loan
* Receive dividends

Any incident of ownership in property will cause it to be included in a decedent’s federal gross estate.

The next category of property that we listed as being included in the federal gross estate was life insurance proceeds. Does this conflict with the general principle that life insurance death benefits are received tax-free?

There really is no conflict between these two principles of tax law. Life insurance benefits are generally received income tax-free, not estate tax-free. When we talk about life insurance death benefits generally being tax-free, we are talking about income taxes, not estate taxes. Death benefits under life insurance that is owned by the insured become a part of the insured’s estate and are subject to estate taxes.

Death benefit proceeds of life insurance policies may or may not become a part of the insured’s probate estate, as distinguished from the federal gross estate. Life insurance death benefits may become a part of the insured’s probate estate if they are payable to the estate—in other words, if the estate is the beneficiary of the proceeds.

If death benefits are payable to a named beneficiary—for example to a spouse, son, or daughter, or to a friend—they do not become part of the probate estate.

So, the determining factor in whether the death benefit proceeds of a life insurance policy will be included in the insured’s federal gross estate is whether the policy is owned by the insured. If the life insurance policy was owned by the insured, the death benefit proceeds payable under it are included.

Generally, if the life insurance policy is not owned by the insured its death benefits are not includible in the estate upon the insured’s death. There are a couple of exceptions to this general rule; however, we will examine them in a moment.

To clarify this principle, let’s return to our client with the 21-year-old daughter. What if he gave her a $1 million life insurance policy on his life rather than the trust fund that we discussed earlier? However, the client retained the right to name the policy’s beneficiary since his daughter would probably name the inappropriate young man the beneficiary if she could. If the client gave her the life insurance policy on his life, would that keep the death benefit proceeds from being included in his federal gross estate?

The answer to that question is “no.” By retaining the right to change the beneficiary, the client effectively kept the death benefit proceeds in his federal gross estate. The principle is identical to the one that applied to the $1 million trust fund in which the client retained a reversionary interest. He retained an incident of ownership.

It is not only the retained right to change the policy beneficiary that would have kept the policy in the client’s federal gross estate, his retaining any of the essential contract rights or privileges would have been sufficient. As noted earlier, these essential contract rights, the retention of which would cause the death benefits to be included in his federal gross estate, include, among other rights, the right to:

* Assign the policy
* Surrender the policy
* Take a policy loan
* Receive dividends

The important concept to remember with respect to the inclusion of life insurance policy death benefit proceeds in an insured’s federal gross estate is that if the insured retains any rights to the policy, its death benefit proceeds will be included.

Remember that this discussion of the inclusion of life insurance proceeds began with a discussion of the gift of the life insurance policy to the client’s daughter. We pointed out that the reason for the inclusion of the death benefit proceeds in his federal gross estate was his retention of the right to change the beneficiary. Let’s change the facts somewhat.

Suppose that the gift of the client’s life insurance policy to his daughter was made without his retaining any incidents of ownership. Would the life insurance proceeds have avoided inclusion in the client’s federal gross estate? The answer is “it depends.” A gift of the life insurance policy may keep the death benefit proceeds out of the estate, but it may not. Let’s dig a little deeper.

To avoid including the death benefit proceeds of the gifted policy in the client’s federal gross estate, he must live at least three years after the gift was made. To curtail deathbed gifts of life insurance designed to avoid the inclusion of their death benefits in the insured’s federal gross estate, the Internal Revenue Code provides that gifts of life insurance made by the insured within three years before his or her death are included in the donor’s estate.

Although gifts, other than gifts of life insurance, made within the three years preceding the decedent’s death are not brought back into the decedent’s federal gross estate, certain gift taxes are. Any gift taxes paid by the decedent in the three years preceding his or her death are includible in the decedent’s estate, although the gift itself (that resulted in the tax) is not.

We will examine the federal gift and estate tax law shortly, and that reference to gift taxes will become clearer. For now, remember that gifts that exceed the annual gift tax exclusion amount are subject to gift taxes. Those gift tax rates are the same as estate tax rates.

## The Executor and Administrator

Before examining the estate and gift tax law, we will complete our look at the estate and its administration by considering the role of the executor and administrator, beginning with an understanding of the difference between them.

The fundamental difference between an executor and an administrator is:

* Executor is named in the will
* Administrator is appointed by the court when individuals die without a will

An administrator and an executor have much the same powers and responsibilities. The difference is that an executor is named in the decedent’s will, and an administrator is appointed by the court to administer the estate of an intestate decedent.

Sometimes court records refer to an executrix or administratrix. The only difference between an executor and an executrix, or an administrator and administratrix, is gender. An executor or administrator is a male; an executrix or administratrix is a female. An executor or executrix is also referred to as the decedent’s personal representative since he or she stands in the shoes of the decedent with respect to legal matters.

Whether or not the decedent had a will designating an executor at the time of death, the administering of the estate—the process called probate—is nonetheless supervised by a local court called a probate court or surrogate’s court.

The executor or administrator has three major functions that he accomplishes under the probate court supervision. Those functions are:

* Safeguarding and collecting the decedent’s assets
* Paying the decedent’s debts and taxes
* Distributing any remaining assets to the heirs specified in the will or pursuant to state intestacy laws

In short, the executor or administrator collects any money owed to the decedent, pays his or her debts and taxes, and distributes the remainder. Often, when an executor or administrator is a stranger rather than a family member, the job becomes doubly difficult, because the location of bank accounts, brokerage accounts, safe deposit boxes and other repositories of the decedent’s assets are unknown. In that event, the executor is required to monitor the decedent’s incoming mail for account statements, fees, etc. as a means of learning the identity and location of any decedent accounts.

As a part of the estate administration process, the executor or administrator completes and files various tax forms, including the federal estate tax Form 706 for estates that are in excess of the exemption equivalent amount of the estate tax unified credit.

We have used three additional terms that deserve explanation:

* Form 706
* The estate tax unified credit
* The exemption equivalent of the estate tax unified credit

Although you will become familiar with these terms when we examine the federal gift and estate tax law—the subject of our next discussion—let’s take a moment to briefly explain them.

The IRS Form 706 is titled “United States Estate (and Generation-Skipping Transfer) Tax Return.” Generally, the executor or administrator must file this form no later than nine months following the date of the decedent’s death if the total value of the estate exceeds the amount that may be transferred tax-free under the estate tax unified credit.

The amount that may be transferred tax-free under the unified credit is the asset value of the estate tax unified credit amount. This is also known as the exemption equivalent of the estate tax unified credit. The exemption equivalent of the estate tax unified credit is that amount that may be transferred at death by any decedent without the imposition of estate transfer taxes. The unified credit is a dollar amount that each taxpayer can apply against any gift tax and estate tax owed and is the same amount for both lifetime transfers and transfers at death.

## Summary

The use of the term “estate” in connection with both the assets distributed by will, as well as to identify the assets subject to estate taxation has led to some confusion, including the occasional belief that avoidance of probate will permit an individual to avoid estate taxes. Nothing could be further from the truth: the probate estate and federal gross estate are distinct, although related, concepts.

The federal gross estate—the estate subject to transfer tax at death—is comprised of the value of all property owned by the decedent (or in which he or she retains incidents of ownership), life insurance death benefit proceeds and certain gifts. One of the principal duties of an executor or administrator is the filing of IRS Form 706 generally within nine months following death and the payment of any taxes due.

|  |  |
| --- | --- |
| Chapter 1 Thumbnail Summary | |
| Probate estate | The decedent’s property that is distributed by will or intestacy laws. Probate estate assets are part of the federal gross estate, but assets included in the federal gross estate may or may not be part of the probate estate. |
| Purpose of probate | To settle debts or to establish the title to assets. |
| Property avoiding probate, i.e. not passed by will or intestacy laws | * Life insurance death benefit proceeds that are payable to a named beneficiary. * Property that is owned as joint tenants with right of survivorship. * Property that is owned as tenants by the entirety. |
| Federal gross estate | Decedent’s property that is subject to federal estate taxation; it may or may not be part of the decedent’s probate estate. |
| Property constituting the federal gross estate | * Property that is owned by the decedent at death. * Property in which the decedent had any incidents of ownership. * Death benefit proceeds payable under decedent-owned policies. * Certain gifts. |
| Real property | Land and anything permanently attached to it. |
| Personal property | All property that is not real property. |
| Jointly owned property included in the federal gross estate | The portion of jointly-owned property owned by the decedent will be included in the federal gross estate. |
| Incident of ownership | A right in and to property; the term refers to a right that is less than complete ownership. In the case of life insurance, an incident of ownership includes the right to   * Change the beneficiary; * Revoke a policy assignment; * Surrender the policy; * Pledge the policy for a loan; * Assign the policy; * Obtain a policy loan; or * Receive dividends.   A donor’s retention of an incident of ownership in gifted property will cause the property to be included in the donor’s federal gross estate at death. |
| Life insurance “bring-back” rule | The bring-back rule refers to gifts of existing life insurance policies. To avoid including the death benefit proceeds of a gifted policy in a decedent’s federal gross estate under the bring-back rule, the insured donor must live at least three years after the gift was made. If an insured’s death occurs less than three years following a life insurance gift, the death benefits will be included in the insured’s federal gross estate. | |
| Executor(trix) | The person named in a decedent’s will who is charged with administering the decedent’s estate. | |
| Administrator(trix) | The person appointed by the court to administer the decedent’s estate when a decedent dies without a will or when no executor is named in a decedent’s will. | |
| Functions of executor or administrator | * Safeguarding and collecting the decedent’s assets. * Paying the decedent’s debts and taxes. * Distributing any remaining assets to the heirs specified in the will or pursuant to state intestacy laws. | |
| IRS Form 706 | A form entitled “United States Estate (and Generation-Skipping Transfer) Tax Return.” The form must be filed by the executor or administrator no later than nine months following the date of the decedent’s death if the total value of the estate exceeds the amount that may be transferred tax free under the estate tax unified credit. | |
| Estate tax unified credit | The tax credit applied against any federal estate tax payable that is available to the estate of every decedent. In 2015, the estate tax unified credit is $2,117,800. | |
| Unified credit exemption equivalent | The amount of assets that may be transferred tax free at death because of the estate tax unified credit. The exemption equivalent of the estate tax unified credit applicable to deaths occurring in 2015 is $5.43 million. | |

## Chapter Review

Which of the following is NOT correct with respect to property owned as joint tenants with right of survivorship?

1. Property owned as joint tenants with right of survivorship avoids inclusion in the decedent’s federal gross estate
2. Property owned as joint tenants with right of survivorship avoids inclusion in the decedent’s probate estate
3. Property owned in joint tenancy passes free from the claims of the decedent’s creditors
4. The principal difference between joint tenancy with right of survivorship and a tenancy by the entirety is that the latter may only exist between spouses
5. Under which of the following beneficiary designations would life insurance death benefit proceeds become a part of the insured decedent’s probate estate?
6. To my wife, Sarah
7. To the trust created in my last will and testament, dated August 1, 20xx
8. To my children, equally, or the survivor
9. To my cousin, Robert
10. Upon Alison’s death her executor found that she owned several types of property under various ownership arrangements. Which of the following would be included in her probate estate?
11. Raw land she owned with her brother as tenants in common
12. A rental house she owned with her cousin as joint tenants with right of survivorship
13. Death benefits payable to her son under a life insurance policy she owned at death
14. A wood lot she owned with her husband as tenants by the entirety

# Chapter 2 Federal Gift and Estate Taxes

## Introduction

To better understand the current gift and estate tax system, we need to have a sense of its evolution. As noted in the introduction to the first chapter, United States law owes much of its form and substance to the English common law. As a result, many of the concepts and institutions that we think of as almost uniquely American were, in fact, English.

Under English law, estates were inherited by the decedent’s eldest son, a concept called primogeniture. This had the effect of consolidating enormous holdings in the hands of relatively few landed gentry. To help break up the massive estates that resulted and, at the same time, produce additional tax revenue, estate taxation was instituted. That is the canvas on which we will paint a picture of the U.S. estate and gift tax law.

The year 1976 was an important year in the history of estate taxation in the United States. Although there were gift and estate taxes before 1976, they were separate and distinct taxes. Each individual was allowed a $30,000 lifetime gift tax exemption. In addition, his or her estate was entitled to a $60,000 estate tax exemption. The gift and estate tax rates were dissimilar as well, the gift tax rate being 75 percent of the estate tax rate.

Before 1976, there was a rebuttable presumption that gifts made within three years of death were made in contemplation of death. They were termed *causa mortis* gifts and were included in the donor’s federal gross estate. Taxpayers, however, were quite successful in rebutting that presumption. So, many deathbed gifts were not deemed made in contemplation of death and, thereby, avoided inclusion in the estate.

In 1976, the Tax Reform Act of 1976 (TRA ‘76) became law. A unified transfer tax structure for estate and gift taxes was adopted, and the $30,000 lifetime gift tax exemption and the $60,000 estate tax exemption were repealed. In their place, TRA ‘76 provided a single unified tax credit of $47,000.

In 1981, additional tax legislation phased in an increase to the $47,000 unified tax credit, eventually raising it to $192,800. This $192,800 unified tax credit is equal to the tax-free transfer of $600,000, which was the exemption equivalent before the Taxpayer Relief Act of 1997 (TRA ’97) was passed. TRA ’97 increased the $600,000 exemption equivalent in a series of gradual increments between 1998 and 2006, at which time the exemption equivalent was scheduled to be $1 million.

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Identify the principal estate tax provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act);
* Describe how the current annual gift tax exclusion permits the tax-free transfer of property ownership;
* List the deductions allowed in calculating the federal estate tax liability;
* Define the estate tax unified credit and its exemption equivalent; and
* Explain how the portability provision of the 2010 Tax Act operates to reduce federal estate tax liability.

## Economic Growth and Tax Relief Reconciliation Act

In 2001 the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) made substantial changes to both estate and gift tax law.

The principal estate tax changes made by EGTRRA include the following:

* A gradual reduction of the estate tax rate applicable to the largest estates from 55 percent in 2001 to 45 percent in 2007
* Repeal of the federal estate tax for deaths occurring in 2010
* A gradual increase in the unified credit exemption equivalent for estate taxes from $675,000 in 2001 to $3.5 million in 2009

## 2010 Tax Act

In December 2010 the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Act) was signed into law. The 2010 Tax Act:

* Reinstituted the federal estate tax for deaths occurring in 2010, 2011 and 2012;
* Provided an estate tax exemption of $5,000,000;
* Contains a portability provision allowing a surviving un-remarried spouse to use the unused portion of the estate tax exemption of the last deceased spouse;
* Imposed a maximum estate tax rate of 35 percent; and
* Provided for a full step-up in basis with respect to assets acquired from the decedent.

In addition, it permitted the estate of a decedent who died in 2010 to elect not to be subject to any federal estate tax but to be subject to the modified carryover basis regime that existed under prior law. (Under the modified carryover basis that applied to deaths occurring in 2010, the cost basis of inherited assets in the hands of the heirs is the lesser of the decedent’s cost basis or the fair market value at death, rather than a full step-up in basis.)

## 2012 Tax Act

Unless additional legislation was enacted, the estate tax exemption would have reverted to $1 million and the maximum federal estate tax rate would have increased to 55 percent for deaths occurring in years after 2012. However, early in January 2013, the **American Taxpayer Relief Act of 2012 (2012 Tax Act)** was signed into law. The 2012 act, in addition to extending the basic estate tax provisions of the 2010 Tax Act:

* Continues the estate tax exemption applicable for 2012 (inflation-adjusted to $5.43 million for 2015 deaths); and
* Increases the maximum estate tax rate to 40%.

## Annual Gift Tax Exclusion

A gift tax is a federal tax on an individual’s right to gratuitously transfer property to another person during his or her lifetime. The tax is a liability of the person making the gift—known as the donor—not the person receiving it.

When we talk about a gratuitous transfer, we mean an uncompensated transfer of ownership. In other words, it is not a bona fide sale. If the ownership transfer is made during a person’s lifetime, it is known as a gift. If it is made at a person’s death, it is known as a bequest.

We need to make a distinction with respect to gifts. Charitable gifts are those gifts made to charitable organizations and for which the donor generally receives an income tax deduction. No gift tax is payable when a donor makes such charitable gifts. It is non-charitable gifts to which the gift tax applies.

Under existing tax law, an individual may make a non-charitable gift each year up to the annual gift tax exclusion amount and be liable for no gift tax. The amount of this annual gift tax exclusion in 2015 is $14,000 and is indexed for inflation. So, if a father makes a gift with a value not exceeding $14,000 to his daughter in 2015, for example, no gift tax form need be filed nor is any gift tax liability created. However, if he makes an additional gift to her in that year, he must file a gift tax return and is liable for gift taxes.

A donor may make any number of gifts during the year and avoid gift tax liability provided that no gift to a donee by that donor exceeds the annual gift tax exclusion amount. If an individual chose to make gifts to each of his five children, he could make a total annual gift in 2015 of $70,000 without incurring gift tax liability; as the annual gift tax exclusion increases, the total excludible amount of the combined gift to the donor’s 5 children would also increase. In order to qualify for the gift tax exclusion, the gift must be a *completed* gift of a *present* interest. If, for some reason, the gift is deemed to be an inchoate gift—one that is not yet completed—or is a gift of a future (rather than a *current*) interest, the annual gift tax exclusion will not apply, and the entire gift will be taxable.

The gift tax exclusion does not apply only to gifts made by the donor to his or her children; it generally applies to non-charitable gifts made to anyone other than a spouse. (Gifts made to an eligible spouse are not subject to the annual gift tax exclusion since a donor may make unlimited gifts to an eligible spouse, and those gifts generally qualify for the marital deduction.) So, our donor with the five children could have made the non-charitable gift to a neighbor or friend—or even an enemy—and still received benefit of the gift tax exclusion.

In addition, there is no composite maximum tax-free annual gift that a donor may make each year. The limitation is by *donee* only. In 2015, a donor can make a $14,000 gift each year to 1,000 (or more) individuals—and, thereby, give away $14 million gift tax-free each year.

In many non-charitable gift cases involving married couples, a spouse elects to join in the gift. Known as a split gift, such gift-joining doubles the applicable annual gift tax exclusion. So, if the spouse of the parent who gave each of his five children $14,000 had joined in the gift, it could have been increased to $28,000 for each child and still have been within the annual gift tax exclusion.

Gifts that exceed the annual gift tax exclusion amount give rise to the donor’s gift tax liability. A donor faced with that gift tax liability has two choices:

1. Pay the gift tax due, or
2. Use some or all of the gift tax unified credit

If some or all of the gift tax unified credit is used to offset the donor’s gift tax liability, the amount of the credit used is no longer available to offset the decedent’s estate tax liability. As you can see, gift taxes and estate taxes are intertwined.

## Estate Tax Deductions

Let’s now turn our attention to the focus of this course: estate taxation. The federal estate tax is a tax on an individual’s right to transfer property to another person at his or her death. It is the liability of the estate rather than a liability of the beneficiary.

The amount of tax payable is based on the value of the property transferred. For transfers made at death, the value of the transfer is measured as of the date of death or the alternate valuation date. The alternate valuation date generally is the date six months after the decedent’s death. It is sometimes used when assets have declined substantially in value following death. An all-too-common example is the value of the family-owned business that has declined sharply following the death of the individual who managed it.

If the executor chooses to use the alternate valuation date, all of the estate assets—not just the asset whose value has declined—must be valued as of that date. The value of the property transferred is then subject to the unified estate and gift tax rates—rates with which you will become familiar as this course continues.

Earlier, we described the property that becomes a part of the decedent’s federal gross estate as generally all of that property the decedent owns or in which he or she has any incidents of ownership *plus* certain additions. When we add up all of this property we arrive at the federal gross estate.

From the gross estate, the executor is allowed to subtract various deductions to arrive at the tentative taxable estate:

* Funeral expenses
* Net losses during administration
* Costs of estate administration
* The decedent’s debts and income and property taxes

The executor is allowed to deduct the costs of the funeral, the costs to administer the estate, the debts that the decedent owed at the time of his or her death and property and casualty losses that were not reimbursed. Claims against the estate that are based on a simple promise or agreement are not deductible unless they were contracted for an adequate consideration.

Although most of these deductions seem fairly straightforward, the costs of administration might not be. So, let’s take a moment to consider these costs.

The costs incurred in administering the estate may include all of the following:

* Executor fees
* Appraiser fees
* Attorney fees
* Commissions
* Accountant fees
* Probate court costs

Since the executor’s job is to wrap up the estate by collecting and valuing all of its assets, paying the debts and taxes, and then distributing the balance of the assets, substantial costs may be involved.

The costs incurred in the settling of the estate are often the fees charged by various professionals, such as appraisers, attorneys and accountants. In addition, if the executor must sell property, those commission costs payable to the realtor or other seller are also deductible. Finally, the executor may also charge a fee for performing his or her duties. When the executor is a family member, he or she often agrees to act without payment.

In addition to those administration expenses, decedent’s debts and taxes, and unreimbursed losses, the estate also receives a deduction for:

* Charitable and public bequests
* Bequests to a surviving spouse

No limits are generally imposed on these deductions permitted from the tentative taxable estate. In fact, the decedent may bequeath all of the property included in the gross estate to a charity and reduce his or her taxable estate to zero. The same is true, for the most part, for the marital deduction.

The marital deduction is an unlimited deduction for inter-spousal transfers. It effectively permits married couples to avoid estate taxation upon the death of the first spouse. However, certain qualifications apply in order to take advantage of the marital deduction.

Those qualifications are as follows:

* Recipient must be married to decedent on the date of death
* The property being transferred must be includible in the decedent’s estate
* The spouse must survive the decedent
* The spouse must be a U.S. citizen

Although these conditions attach to the marital deduction, the fact is that property given to a spouse, in most cases, will pass without incurring either estate taxes or gift taxes. The property that is passed to the spouse tax-free does not necessarily avoid taxation, however. If the property so passed is still owned by the surviving spouse at the time of the surviving spouse’s death, it is included in his or her estate.

In addition, unless the surviving spouse has remarried, the tax liability may be substantial.

## Estate Tax Credits

We have examined the significant deductions that affect an estate. There is, in addition, an important credit. Before we discuss the credit, however, it is important that the difference between a deduction and a credit is understood.

While deductions and credits are certainly similar to the extent that they both reduce the amount of tax that must eventually be paid, they work differently. Deductions reduce the assets against which the tax rates are applied. Credits, however, reduce the actual tax.

The important tax credit that applies to estate taxes that would otherwise be payable is known as the unified tax credit. The unified tax credit is so-called because it applies to both gift taxes and estate taxes. The value of the assets that pass tax-free because of the unified tax credit is known as the exemption equivalent of the credit.

Earlier in this course when we briefly discussed TRA ’76, we noted that the legislation repealed the distinct estate and gift tax systems that existed prior to 1976 and enacted unified gift and estate tax regulation. This credit applies to this unified tax system and may be applied to either gift taxes or estate taxes. However, when a portion of the credit is used to offset gift taxes, that portion is no longer available to subsequently offset estate taxes or other gift taxes.

The unified tax credit is available to all decedents, whether they are married or single, and can be taken against any federal estate or gift tax due. As a result of the Economic Recovery Tax Act of 1981 (ERTA), the credit grew from $47,000 to $192,800 by 1997 when TRA ‘97 was enacted. The Taxpayer Relief Act of 1997 increased the unified tax credit incrementally, beginning on January 1, 1998. The credit was increased to $202,050 for deaths occurring in 1998, $211,300 for 1999 deaths, and $220,550 for deaths occurring in 2000 and 2001.

Although TRA ’97 provided for continued increases in the credit through 2006, new legislation substantially increased the unified credit.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased the estate tax unified credit to $345,800 for deaths occurring in 2002 and provided for additional increases through 2009. In 2009, the estate tax unified credit was $1,455,800. In 2010, there was no unified credit because, for that year, there was no estate tax. The estate tax was reinstated for 2011 and 2012, and under the 2010 Tax Act, the unified credit is $1,730,800 for 2011 deaths and $1,772,800 for 2012 deaths—the federal estate tax that would have been due on the transfer of $5 million and $5.12 million, respectively. The 2012 Tax Act, by exempting $5.43 million and imposing a 40 percent maximum estate tax rate, effectively set the estate tax unified credit at $2,117,800 for deaths occurring in 2015.

One of the terms often used in connection with the unified credit is the “exemption equivalent.” The exemption equivalent of the unified credit is the value of property that passes tax-free because of the tax credit. In a sense, it is the value of the property that is equivalent to the tax credit.

|  |
| --- |
| Exemption Equivalent |
| The exemption equivalent of the unified tax credit is the value of the assets that pass tax-free because of the credit. The estate tax unified credit and its exemption equivalents are shown in the following table.   |  |  |  | | --- | --- | --- | | Year Of Death | Estate Tax  Unified Credit | Exemption  Equivalent | | 2002 – 2003 | $345,800 | $1,000,000 | | 2004 – 2005 | $555,800 | $1,500,000 | | 2006 – 2008 | $780,800 | $2,000,000 | | 2009 | $1,455,800 | $3,500,000 | | 2010 | $1,730,800\* | $5,000,000\* | | 2011 | $1,730,800 | $5,000,000 | | 2012 | $1,772,800 | $5,120,000 | | 2013 | $2,045,800 | $5,250,000 | | 2014 | $2,081,800 | $5,340,000 | | 2015 | $2,117,800 | $5,430,000 |   \*The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. |

The estate tax unified credit is substantial and is certainly something that no estate would want to lose. However, the estate tax unified credit can be lost if there was no tax liability against which to apply it.

In simpler terms, if the decedent has reduced estate taxes to less than the unified credit and the portability provision in the estate tax law does not apply, he or she will have effectively lost some or all of the unified credit. The method that is often employed and which results in a loss of the unified credit is the overuse of the unlimited marital deduction.

By a decedent’s leaving all of his or her assets to an eligible spouse under the marital deduction the decedent may avoid all federal estate taxes. However, the couple may be giving up the estate tax unified credit that is available at the time of the first death. The spouse that provides for all assets to pass to a surviving spouse has created an “I love you” will. The tax result is the eventual possibility of a greater than necessary estate tax liability upon the second death. An example will make this problem clear.

Let’s assume that George has accumulated a federal gross estate of $6,430,000 at the time that he dies in the year 2002. In order to avoid estate taxes—and knowing that anything he leaves to his eligible spouse at his death will qualify for the unlimited marital deduction—George leaves his entire estate to his wife, Barbara. George’s estate has incurred no estate taxes because of the tax-free inter-spousal transfer.

When Barbara dies, the entire $6,430,000—or whatever is left of it—will become part of her federal gross estate. And, unless Barbara remarries, her estate will have no marital deduction.

Let’s assume that Barbara has neither increased the size of the estate nor reduced it. So, upon her death in 2015, the entire $6,430,000 is still intact and is the amount of her tentative taxable estate. Using the estate tax rates in effect for 2015, calculate the amount of the tentative tax payable at her death.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Federal Estate Tax Rates – 2015 | | | | | |
| **Value of Estate** | | **Tax** | | | |
| **Over** | **But Not Over** | **$** | **Plus** | **%** | **Over** |
|  | $10,000 |  |  | 18% | $0 |
| $10,000 | $20,000 | $1,800 |  | 20% | $10,000 |
| $20,000 | $40,000 | $3,800 |  | 22% | $20,000 |
| $40,000 | $60,000 | $8,200 |  | 24% | $40,000 |
| $60,000 | $80,000 | $13,000 |  | 26% | $60,000 |
| $80,000 | $100,000 | $18,200 |  | 28% | $80,000 |
| $100,000 | $150,000 | $23,800 |  | 30% | $100,000 |
| $150,000 | $250,000 | $38,800 |  | 32% | $150,000 |
| $250,000 | $500,000 | $70,800 |  | 34% | $250,000 |
| $500,000 | $750,000 | $155,800 |  | 37% | $500,000 |
| $750,000 | $1,000,000 | $248,300 |  | 39% | $750,000 |
| $1,000,000 | …….. | $345,800 |  | 40% | $1,000,000 |

The answer, of course, is $2,517,800. If you didn’t arrive at that answer, return to the tax rate table. You will notice that the amount of tax shown in column 3 for a tentative tax base of $1,000,000 is $345,800, and the amount in excess of $1,000,000 is taxed at 40 percent.

Let’s take this calculation a step further and subtract the amount of the unified credit available to Barbara’s estate when she dies in 2015. How much estate tax is payable at her death?

|  |  |  |
| --- | --- | --- |
| Unified Credit | | |
| **Year Of Death** | **Estate Tax  Unified Credit** | **Exemption  Equivalent** |
| 2002 – 2003 | $345,800 | $1,000,000 |
| 2004 – 2005 | $555,800 | $1,500,000 |
| 2006 – 2008 | $780,800 | $2,000,000 |
| 2009 | $1,455,800 | $3,500,000 |
| 2010 | $1,730,800\* | $5,000,000\* |
| 2011 | $1,730,800 | $5,000,000 |
| 2012 | $1,772,800 | $5,120,000 |
| 2013 | $2,045,800 | $5,250,000 |
| 2014 | $2,081,800 | $5,340,000 |
| 2015 | $2,117,800 | $5,430,000 |
| **\***The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. | | |

The answer that you should have gotten is $400,000. Barbara’s tentative tax, as we noted, is $2,517,800. Since everyone receives the benefit of the unified credit, Barbara’s executor can reduce the federal estate tax due by the amount of the unified credit available in 2015—the year of her death. Since the unified credit in that year is $2,117,800, the executor simply subtracts that amount from the tentative tax due to arrive at the resulting tax liability of $400,000. ($2,517,800 - $2,117,800 = $400,000)

As a result, the total amount of federal estate taxes paid after both George’s and Barbara’s death is $400,000. It is important to keep that amount in mind as we re-plan George’s estate to see if they can avoid some of these taxes.

We noted that when George died, his estate amounted to $6,430,000 all of which he transferred to his wife under the unlimited marital deduction. If, instead of giving her everything outright, he had placed the amount of the exemption equivalent of his unified credit—that was $1 million in 2002—in an appropriate trust rather than bequeathing it to her, the amount of assets that would have been included in his wife’s estate upon her death would have been $5,430,000. ($6,430,000 - $1,000,000 = $5,430,000)

George’s estate would still have paid no federal estate taxes. The $1 million placed in trust passes tax free because of his estate tax unified credit. The remaining $5.43 million also passes tax free because it is transferred to his eligible wife, Barbara, under the unlimited marital deduction.

However, what would Barbara’s estate have paid in federal estate taxes if George had placed the $1 million in trust?(Remember that since Barbara does not own the assets that George placed in trust neither those assets nor any growth of the assets become a part of her federal gross estate.)

Consult the federal estate tax rate chart and the unified credit chart to see if you can determine the correct answer.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Federal Estate Tax Rates – 2015 | | | | | |
| **Tentative Tax Base** | | **Tax** | | | |
| **Over** | **But Not Over** | **$** | **Plus** | **%** | **Over** |
|  | $10,000 |  |  | 18% | $0 |
| $10,000 | $20,000 | $1,800 |  | 20% | $10,000 |
| $20,000 | $40,000 | $3,800 |  | 22% | $20,000 |
| $40,000 | $60,000 | $8,200 |  | 24% | $40,000 |
| $60,000 | $80,000 | $13,000 |  | 26% | $60,000 |
| $80,000 | $100,000 | $18,200 |  | 28% | $80,000 |
| $100,000 | $150,000 | $23,800 |  | 30% | $100,000 |
| $150,000 | $250,000 | $38,800 |  | 32% | $150,000 |
| $250,000 | $500,000 | $70,800 |  | 34% | $250,000 |
| $500,000 | $750,000 | $155,800 |  | 37% | $500,000 |
| $750,000 | $1,000,000 | $248,300 |  | 39% | $750,000 |
| $1,000,000 | …….. | $345,800 |  | 40% | $1,000,000 |

|  |  |  |
| --- | --- | --- |
| Unified Credit | | |
| **Year Of Death** | **Estate Tax  Unified Credit** | **Exemption  Equivalent** |
| 2002 – 2003 | $345,800 | $1,000,000 |
| 2004 – 2005 | $555,800 | $1,500,000 |
| 2006 – 2008 | $780,800 | $2,000,000 |
| 2009 | $1,455,800 | $3,500,000 |
| 2010 | $1,730,800\* | $5,000,000\* |
| 2011 | $1,730,800 | $5,000,000 |
| 2012 | $1,772,800 | $5,120,000 |
| 2013 | $2,045,800 | $5,250,000 |
| 2014 | $2,081,800 | $5,340,000 |
| 2015 | $2,117,800 | $5,430,000 |
| **\***The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. | | |

Did you get the answer that Barbara’s estate would have ***no federal estate tax liability***?That’s right. George’s estate would still have paid no estate taxes following his death in 2002, and Barbara’s estate would not have paid anything either. Since her tentative taxable estate was reduced from $6.43 million to $5.43 million, her tentative tax declined from $2,517,800 to $2,117,800. Since that is the amount of her estate tax unified credit, her estate has no federal estate tax to pay. By simply using George’s unified credit and placing a portion of the estate in a credit shelter trust rather than giving all the assets to Barbara, the combined estates would have saved $400,000 in federal estate taxes.

What possible objection might Barbara have had to George’s placing the $1 million in trust rather than leaving it to her? The answer to that question is a fairly easy one. Barbara might well have objected to her loss of the $1 million that was placed in trust. She might object that she will lose the income from that $1 million.

If we can overcome the problem of Barbara’s receiving less income, it might make sense for George to use his estate tax unified credit in this way to fund a trust. That brings us to our next chapter which deals with the common trusts used in estate planning. In the next chapter we will see that, when it comes to estate taxes, George and Barbara—and anyone else, of course—may be able to have their cake and eat it, too.

### Estate Tax Portability Provision

The 2010 Tax Act contains a portability provision, pursuant to which a surviving spouse can use the unused part of his or her deceased spouse’s estate tax exemption for both gift tax and estate tax purposes. For example, if a husband dies in 2014 and uses only $4 million of his $5.34 million estate tax exemption, the estate of the surviving spouse who subsequently dies in 2015 will have an aggregate federal estate tax exemption of $6.77 million. That $6.77 million federal estate tax exemption would be comprised of her $5.43 million regular estate tax exemption and the $1.34 million unused estate tax exemption from her deceased husband’s estate.

In order for a surviving spouse’s estate to use a deceased spouse’s unused estate tax exemption, certain conditions must be met:

* Both spouses must die in or after 2010;
* The surviving spouse must not be remarried; and
* The executor of the estate of the first spouse to die must elect portability on a timely filed federal estate tax return.

## Summary

Federal taxes are imposed on the transfer of assets during the donor’s lifetime (gifts) and at his or her death. Lifetime non-charitable transfers are tax-free to the extent they do not exceed the annual gift tax exclusion amount. If a spouse joins in the gift, the annual gift tax exclusion amount is doubled. Non-charitable gifts that exceed the annual gift tax exclusion are taxable. The tax may be paid in cash or may reduce the donor’s unified credit.

Various deductions reduce the amount of assets on which federal estate taxes are calculated. These deductions include the costs of estate administration, funeral costs, the decedent’s debts, and un-reimbursed casualty losses. In addition, the estate may generally deduct any charitable gifts and amounts passed to an eligible spouse. Finally, every estate may pass, tax-free, assets equal in value to the exemption equivalent of the unified credit.

|  |  |
| --- | --- |
| Chapter 2 Thumbnail Summary | |
| Gift tax | The federal tax on an individual’s right to give property to another person during his or her lifetime. Applies only to a noncharitable gift. |
| Gift tax exclusion amount | The dollar amount of a noncharitable gift that may be made by a donor to a donee tax free each year. The gift tax exclusion amount in 2015 is $14,000. |
| Split gift | A noncharitable gift made by a donor and his or her spouse. Split gifts effectively double the amount of tax-free gifts that may be made to a donee each year. |
| Gift tax unified credit | The tax credit that may be used to pay federal gift taxes due on taxable gifts, i.e., gifts in excess of the annual gift tax exclusion. The gift tax unified credit in 2015 is $2,117,800. Use of the gift tax unified credit will reduce the individual’s estate tax unified credit dollar-for-dollar. The gift tax unified credit in any year is equal to the gift tax that would be due on taxable gifts of assets equal to the gift tax exemption equivalent. |
| Tentative taxable estate | The tentative taxable estate is equal to a decedent’s federal gross estate less:   * Funeral expenses * Net losses during administration * Costs of estate administration * The decedent’s debts and income and property taxes * Marital deduction * Charitable and public |
| Estate administration costs | The costs incurred in administering a decedent’s estate may include:   * Executor fees * Appraiser fees * Attorney fees * Commissions * Accountant fees * Probate court costs |
| Marital deduction | An unlimited deduction for transfers of property from a person to his or her eligible spouse during lifetime and at death. |
| Estate tax unified credit | The tax credit applied against any federal estate tax payable that is available to the estate of every decedent. In 2015, the estate tax unified credit is $2,117,800. |
| Exemption equivalent of the estate tax unified credit | The amount of assets that may be transferred tax free at death because of the estate tax unified credit. The exemption equivalent of the estate tax unified credit applicable to deaths occurring in 2015 is $5.43 million. |

## Chapter Review

Arthur made a gift of a used automobile to his son in 2015. If the automobile’s value was $16,000 at the time of the gift, how much of the gift is taxable, assuming Arthur made no other gifts to his son during the year?

* + 1. $16,000
    2. $14,000
    3. $2,000
    4. $0

1. What is a split gift?
   * 1. A gift designed to be given to two or more donees
     2. A gift in which the donor’s spouse joins
     3. A gift of one-half to a non-charitable donee and one-half to a charity
     4. A gift that qualifies for one-half of the annual gift tax exclusion amount
2. Jim Powers has five children and two grandchildren. If he and his wife, Sheila, make split gifts to each of these 7 donees, what is the maximum amount that they can gift within the annual gift tax exclusion in 2015?
   * 1. $98,000
     2. $14,000
     3. $196,000
     4. $28,000

# Chapter 3 Common Estate Planning Trusts

## Introduction

The situation that we briefly discussed in the last chapter—the one in which a decedent leaves all his or her property to an eligible surviving spouse and which escapes federal estate tax under the unlimited marital deduction—is not unusual. Although there may be good reasons for leaving all of one’s assets to a spouse outright, doing so could result in higher combined federal estate taxes when the estates of both spouses are considered and, for whatever reason, the surviving spouse’s estate cannot use the deceased spouse’s unused tax exemption available under the estate tax portability provision. A will that leaves all of an individual’s property to a surviving spouse is commonly referred to as an “I love you” will.

In this chapter, we will briefly consider certain trusts often employed in estate planning to meet a decedent’s objectives. Although many other trusts may be profitably used, these three trusts are particularly common:

* Credit shelter trusts
* Qualified terminable interest trusts
* Irrevocable life insurance trusts

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Describe how a credit shelter trust works to reduce federal estate tax liability in suitable estates;
* List the client estate planning objectives met through a qualified terminable interest (QTIP) trust; and
* Explain how an irrevocable life insurance trust (ILIT) facilitates the use of life insurance to pay estate tax and settlement costs without increasing the federal gross estate.

## Credit Shelter Trust

If the value of property in the combined estates of both the husband and wife is less than the unified credit exemption equivalent amount, there is no adverse estate tax impact if everything is left to a surviving spouse. No estate taxes are payable by either estate in any case.

However, if federal estate taxes are payable in the estate of the surviving spouse, care should be taken so that the estate tax unified credit available to the estate of the first spouse to die is not lost. A credit shelter trust is an important tool to help ensure that does not happen.

|  |  |  |
| --- | --- | --- |
| Unified Credit Exemption Equivalent | | |
| **Year Of Death** | **Estate Tax  Unified Credit** | **Exemption  Equivalent** |
| 2002 – 2003 | $345,800 | $1,000,000 |
| 2004 – 2005 | $555,800 | $1,500,000 |
| 2006 – 2008 | $780,800 | $2,000,000 |
| 2009 | $1,455,800 | $3,500,000 |
| 2010 | $1,730,800\* | $5,000,000\* |
| 2011 | $1,730,800 | $5,000,000 |
| 2012 | $1,772,800 | $5,120,000 |
| 2013 | $2,045,800 | $5,250,000 |
| 2014 | $2,081,800 | $5,340,000 |
| 2015 | $2,117,800 | $5,430,000 |
| **\***The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. | | |

A credit shelter trust (CST) is a popular method for using the estate tax unified credit to pass assets to children or others while giving the surviving spouse all the income from the property placed in the trust or allowing the growth of the assets to remain in the trust and avoid subsequent estate taxation. The trust is also referred to by other names, such as “by-pass” or “exemption” trust. The purpose of the trust is to shelter the estate tax unified credit and any asset growth on the amount placed in trust—hence its name, the Credit Shelter Trust.

Under current law, an individual can pass any size estate to his or her eligible spouse and avoid federal estate taxes because of the unlimited marital deduction. When the surviving unmarried spouse subsequently dies and transfers his or her combined estate (i.e. the decedent’s estate *and* previously-deceased spouse’s estate) to heirs, the estate may use his or her estate tax unified credit and any estate tax unified credit carried over from the estate of the first spouse to die to reduce the federal estate tax. (The estate of a spouse who re-marries is eligible to use the marital deduction and the estate tax unified credit but not the amount of any unused unified credit carried over from a previously-deceased spouse’s estate.) The credit to which the first spouse to die was entitled is wasted if unavailable to the surviving spouse under the estate tax portability provision.

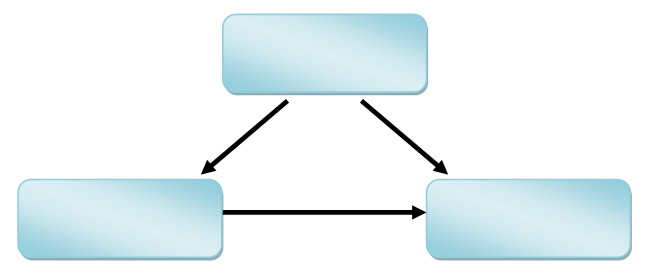
As we noted earlier, a decedent can transfer to someone other than his or her spouse an amount equal to the exemption equivalent of the estate tax unified credit without incurring estate taxes on that amount. Likewise, a decedent can place an amount equal to the estate tax unified credit exemption equivalent into an appropriate trust, give the balance of property to his or her spouse, and still avoid estate taxes at death. In 2015, the exemption equivalent of the estate tax unified credit is $5.43 million.

When the surviving spouse subsequently dies, only the amount passed outright to the spouse (plus the surviving spouse’s own assets and any additions, of course) will become part of the survivor’s federal gross estate. The total amount placed in trust by the first decedent, *along with any earnings* that remain in the trust, will be passed to its ultimate beneficiary estate tax-free since such assets are not included in the now-deceased surviving spouse’s federal gross estate.

The assets placed in the credit shelter trust usually—but not always—pass ultimately to the children. The trust document can be written so that the surviving spouse receives an income from the trust for his or her life or, alternatively, the income can be accumulated and paid to the ultimate beneficiary along with the trust principal.

In the first case, the surviving spouse’s income is not reduced because of the strategy and use of the trust; in the second case, a greater amount is passed, tax-free, to the children.

**Upon Death of First Spouse to Die**



Assets equal to exemption equivalent

Balance of assets

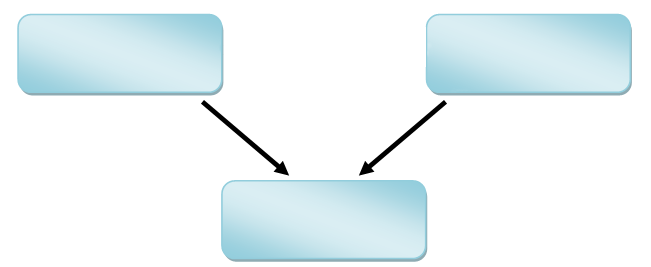
Decedent’s  
estate

Income

Credit shelter trust

Spouse

**Upon Death of Surviving Spouse**

Although a credit shelter trust may be created during the decedent’s lifetime or at death, it is often a testamentary trust. This simply means that the trust is created and funded through the decedent’s last will and testament. Although the decedent, during his or her lifetime, can change the provisions of the testamentary trust—and even eliminate the trust entirely—after the testamentary trust becomes operative at the decedent’s death, it is irrevocable.

Credit shelter trust

Total assets

Remaining trust corpus

Surviving spouse’s  
estate

Children (or other heirs)

If the assets being placed in a credit shelter trust will come through the decedent’s will, it is vital that there be sufficient assets passing by will. That means that there must be sufficient probate assets to adequately fund the trust.

The assets designated to fund a testamentary trust should be assets that the decedent owns individually. Obviously, they should not be assets that are held in a joint tenancy with right of survivorship or as tenants by the entirety. The reason for that requirement is because assets owned in these joint ownership ways pass automatically to the joint tenant upon the decedent’s death and are, therefore, not available to fund the trust when the individual dies. Not unexpectedly, a particularly appropriate source of funds for a testamentary credit shelter trust is life insurance payable to the estate.

In order to take full advantage of the unified credit to which every decedent’s estate is entitled, the amount available to fund the credit shelter trust should be equal to the exemption equivalent of the estate tax unified credit. For deaths occurring in 2015, the exemption equivalent of the estate tax unified credit is $5.43 million.

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| --- | --- | --- |
| Unified Credit Exemption Equivalent | | |
| Year Of Death | Estate Tax  Unified Credit | Exemption  Equivalent |
| 2002 – 2003 | $345,800 | $1,000,000 |
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| 2015 | $2,117,800 | $5,430,000 |
| **\***The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. | | |

If life insurance death benefit proceeds are to be used to fund the testamentary credit shelter trust, the policy’s beneficiary designation should make the death benefit proceeds payable to the insured’s estate rather than to a named beneficiary. If the surviving spouse is named as the beneficiary of the death benefit, the funds will not be payable to the estate and will not be available to fund the trust, thereby frustrating the decedent’s intent in creating the credit shelter trust.

Although the resulting increase in the decedent’s probate estate will increase estate administration costs, the increased costs may be more than offset by reduced estate taxes on the surviving spouse’s death.

Sometimes, of course, life insurance is simply not an available option for a particular individual perhaps because he or she is uninsurable. In the event that the life insurance option is not available to fund a testamentary credit shelter trust—for whatever reason—the individual should allocate liquid assets already owned to fund it or consider using a credit shelter trust created during the spouse’s lifetime and funded by those available liquid assets.

Liquid assets are cash and other assets that can be converted into cash easily with little or no loss of value.

### Credit Shelter Trusts vs. Portability

The estate tax portability provisions, in allowing an eligible spouse to carry over his or her deceased spouse’s unused unified credit, will accomplish the same objective as a credit shelter trust in some cases. As long as the surviving spouse continues to be eligible to use a deceased spouse’s unused unified credit by remaining unmarried, his or her estate may use it. However, two concerns suggest that a credit shelter trust may be more desirable in some cases:

* + - 1. A surviving spouse who remarries will lose the ability to carry over a deceased spouse’s unused unified credit; and
      2. A credit shelter trust permits the estate of a surviving spouse to avoid estate taxes at the death of the surviving spouse on both the amount of the assets placed in the trust *and any growth on the assets placed in trust*. In the case of a carryover of an unused unified credit, only the amount of the unused credit will reduce the decedent’s estate tax; the growth on the assets passed to the surviving spouse is subject to income taxation (at the time the income needs to be recognized) and estate taxation upon the death of the surviving spouse.

## QTIP Trust

Now that we have briefly examined credit shelter trusts and their use, let’s turn our focus towards another trust that is often used in estate planning: the Qualified Terminable Interest Property (QTIP) trust. The particular value of the QTIP trust is that it permits a decedent to control the eventual disposition of the trust assets at the surviving spouse’s death—rather than giving the surviving spouse control over them—while still allowing the estate to take the marital deduction for the assets placed in the trust.

Two important concepts are implied in the name of the trust:

* Qualified
* Terminable interest

We noted earlier, when discussing the credit shelter trust, that the assets placed in the credit shelter trust were not given to the spouse. We said that since the spouse did not receive them, they did not qualify for the marital deduction. This is not the case with assets placed in the QTIP trust. Assets placed in a QTIP trust—although not transferred to the spouse—nonetheless qualify for the marital deduction. That is the “qualified” in a QTIP trust.

The second important concept is “terminable interest.” A terminable interest is an ownership interest that is less than complete and which may terminate at some point. Since this is unlike the ownership of most property, it deserves some additional explanation.

In most cases, property given outright to an individual entitles the new owner to various rights in it, including the right to:

* Use it
* Sell it
* Use the income from it
* Give it away

These are the rights that normally come with owning something outright. If you own it outright, you can use it, use the income from it, sell it, or give it away. In simple terms, you can do pretty much anything you want with it.

The surviving spouse who receives property in a QTIP trust has some, but not all, of those rights. He or she can:

* Receive income from the property
* Use the trust principal only to meet health, education, support, or maintenance needs

What the surviving spouse cannot do with the property in the QTIP trust is sell it or give it away either during the surviving spouse’s lifetime or at death. In a very real sense, the QTIP trust is a tool that allows the decedent who establishes and funds the trust to control the eventual disposition of his or her assets from the grave.

A QTIP trust can be very useful to protect the inheritance of children from a prior marriage. Multiple marriages are fairly common in our society, and a wealthy spouse with children from a prior marriage can use the QTIP trust to protect their inheritance.

Consider the case of Bill Walters, a successful business owner with two grown children, whose wife died three years ago. Bill is 65 years old and has spent most of his life building the business, and both of his children work in it. He would like to retire and travel the world, but the prospect of doing that alone is uninviting.

Bill met Joan several months ago, and they have decided to marry. She is a 45-year-old widow with three adult children. Bill is concerned that in the event he should pre-decease Joan—a likely outcome considering their 20-year age difference—his children might not inherit his estate at Joan’s subsequent death. By using a QTIP trust, Bill can overcome that problem.

In a typical QTIP trust arrangement, the trust would provide an income to Joan beginning at Bill’s death; the income would continue for the duration of her life. At Joan’s death, the corpus of the trust would go to Bill’s children.

The QTIP trust is often used to ensure that the first decedent’s estate does not pass to the surviving spouse’s children (rather than to the decedent’s children) or to a subsequent marriage partner. Often, a QTIP trust is used along with a credit shelter trust to produce the desired result.

Not all property may be placed in a QTIP trust; it must be *qualified terminable interest property*. Qualified terminable interest property simply means property:

1. That passes from the decedent grantor of the trust
2. In which the surviving spouse has a qualifying income interest for life
3. With respect to which the executor of the decedent grantor’s estate makes an irrevocable election on the federal estate tax return to have the marital deduction apply to the property

For the surviving spouse to have a qualifying income interest for life, all of the following must apply:

* The surviving spouse must be entitled to all the income from the property, payable annually or at more frequent intervals, or have a usufruct interest (see inset below) for life in the property
* No person may have the power to appoint any part of the property to any person other than the surviving spouse unless that power is exercisable only at or after the surviving spouse’s death

|  |
| --- |
| Usufruct Interest |
| A usufruct interest in property refers to the right to use property—or income from property—that is owned by another. |

The drafting of any trust is a job for an attorney. Careful drafting of the QTIP trust is especially important to make certain that it qualifies for the marital deduction. Although a QTIP trust may be created during the decedent’s lifetime or at death, it is often established and funded through the decedent’s last will and testament. Like a credit shelter trust, a marital QTIP trust created in the decedent’s will becomes irrevocable upon the decedent’s death. However, there is an important difference between the credit shelter trust and the QTIP trust that needs to be understood.

Unlike the credit shelter trust, the QTIP trust corpus is included in the surviving spouse’s federal gross estate and is subject to estate taxes upon his or her death. The grantor’s executor must make an irrevocable election on the federal estate tax return to have the marital deduction apply to the terminable interest property.

In this case, Bill’s $4 million in assets that were placed in the QTIP trust upon his death in 2002 will be included in Joan’s federal gross estate at her death.

See how a QTIP trust might work for Bill and Joan:

|  |
| --- |
| QTIP Trust |
|  |

It is important to have an understanding of those situations in which the various estate-planning tools apply. The QTIP trust is indicated when the decedent wants to:

* Determine the ultimate beneficiary of some or all his or her assets but wants to provide a lifetime income to the surviving spouse
* Protect the inheritance of children from a previous marriage
* Ensure that his or her estate does not pass to a subsequent marriage partner

## Irrevocable Life Insurance Trust

The credit shelter trust and the QTIP trust—the two trusts that we have examined so far—may be testamentary trusts or *inter vivos* trusts, depending on whether they are established by and funded through the decedent’s last will and testament or established during the grantor’s lifetime.

Although QTIP trusts and credit shelter trusts may be created during the grantor’s lifetime or at his or her death, no such flexibility applies to the last trust we will consider: the irrevocable life insurance trust. Irrevocable life insurance trusts (ILITs) are created by the individual, who is also called the grantor or trustor, during his or her lifetime. Because they are created during the grantor’s lifetime, they are called *inter vivos* trusts, rather than testamentary trusts.

Not unexpectedly, considering its name, the principal reason for creating an ILIT is to enable it to own life insurance on the grantor’s life. The reason why a grantor would want an ILIT to own the grantor’s life insurance policy is to avoid inclusion of its death benefit proceeds in his or her estate at death while still enabling the life insurance death benefits to be available to pay estate taxes and settlement costs.

Let’s back up momentarily to our earlier discussion of the federal gross estate. When we examined the federal gross estate, we saw that it contained four broad categories of property:

1. Property owned at death
2. Life insurance death benefits paid under policies owned by the deceased insured
3. Property in which the decedent retained incidents of ownership
4. Certain gifts

In addition, we noted that, although usually income tax-free, life insurance death benefits are not necessarily estate tax-free. If the insured owns the life insurance policy at the time of death, the policy’s death benefits are included in his or her federal gross estate and may increase the estate taxes due.

To gain some sense of just what the inclusion of life insurance proceeds means to the estate’s tax bill, let’s consider the case of Aaron Golden, a widower with an estate of $7.93 million and four children to whom to leave it. Unfortunately, Aaron’s estate is entirely non-liquid, and it would be required to sell off some of the family’s irreplaceable antiques to pay the $1 million in federal estate taxes that would be owed, assuming he died in 2015.

The obvious answer for Aaron to help pay his estate taxes is the purchase of a $1 million life insurance policy. However, if Aaron adds an additional $1 million of life insurance proceeds to his $7.93 million estate, he will also increase his estate taxes by $400,000. ($1,000,000 x .40 = $400,000) Unfortunately, his attempt to remedy his estate tax problem would have increased the problem. The answer for Aaron—and for anyone else who finds himself or herself in this kind of a situation—may be an irrevocable life insurance trust (ILIT).

### Operation of an ILIT

An ILIT could apply for, own and be the beneficiary of the $1 million life insurance policy on Aaron’s life. When Aaron dies, the death benefits are paid to the ILIT. The ILIT would then use the life insurance policy death benefits to buy assets from the estate or lend the funds to it. In either case, the estate would then have the funds needed to pay the federal estate taxes.

Aaron has accomplished two important objectives by using an ILIT to own life insurance on his life:

1. His federal estate taxes are paid.
2. The life insurance proceeds from which the funds were derived to pay taxes were kept out of his estate.

Since Aaron didn’t own the life insurance policy at the time of his death or have any incidents of ownership in the policy, the death benefits are not included in his estate for tax purposes.

In addition to Aaron’s owning the policy at death or retaining an incident of ownership in it, there is another way in which the death benefit proceeds of the life insurance policy on Aaron’s life would be included in his federal gross estate. That would happen if he owned the life insurance policy at any time within the three-year period preceding his death. This is the bring-back rule.

For this reason, it is vitally important that Aaron not have owned the life insurance policy at any time during the three-year period prior to his death in order to avoid the inclusion of its death benefits in his estate. If he had owned the life insurance policy at any time during that three-year period, even if the life insurance was owned by a trust or another person at the time of his death, the death benefits would be brought back into his federal gross estate. The death benefits would not be included in his *probate* estate unless it was his policy’s beneficiary, but they would be included in his estate for tax purposes.

What the bring-back rule tells us is that when life insurance is to be purchased solely for the purpose of paying estate taxes, it is generally important that the insured not own the policy at any time. What that means in the case of trust-owned life insurance is that the *trustee* of the ILIT—not the person who will be insured—should apply for the policy, and the trust should own it from the outset. The role of the individual whose death would trigger the death benefit is a simple one: he or she is simply the policy’s insured.

One alternative possibility in arranging for trust-owned life insurance—particularly if the trust grantor is uninsurable—is for existing life insurance owned by the insured to be assigned to the trust through an absolute assignment. The concern with that approach from a tax perspective is that if the insured owns the policy and then transfers ownership of the policy to the trust, the policy proceeds will be included in his or her estate if death occurs within the first three years after the ownership transfer. However, if that is the only option, it is worth taking the chance of its possible inclusion particularly since the death benefit proceeds of the personally-owned life insurance policy would be included in the estate anyway if the insured died without transferring ownership of the policy.

We have been discussing trusts and their use in estate tax planning. It is important to understand, however, that the life insurance policyowner who owns the insured’s policy can also be a natural person, such as the insured’s child or children rather than an ILIT. The federal estate tax result would be identical.

Although the life insurance policy on the decedent could, for example, be owned by the insured’s adult child and, thereby, avoid inclusion of its death benefits in the estate, there is often a concern about control. Specifically, the insured cannot be certain that the adult child will use the life insurance proceeds to provide liquidity to the insured’s estate. To the contrary, in the case of an ILIT-owned policy, the grantor-insured usually has greater certainty that his estate liquidity strategy will be implemented.

We noted earlier that the insured must retain no incidents of ownership in the life insurance policy in order for its death benefits to avoid federal estate inclusion. Even if the insured had transferred ownership to an ILIT or to an adult child and lived more than three years after the transfer, if he retained a right in the policy—the right to receive dividends, for example—the death benefits would be included in his federal gross estate. Simply stated, that retained right amounts to an incident of ownership that is sufficient to cause the proceeds to be brought back into the insured’s federal gross estate.

### Funding the ILIT

Let’s return to Aaron Golden. Aaron is a widower who has four children, and each of his children has a child. He wants to be sure that as much of his $7.93 million estate as possible is transferred to his children and grandchildren upon his death. Furthermore, he understands that life insurance is the appropriate method for paying the $1 million estate tax bill, and he believes that an ILIT should be the owner in order to obtain the significant estate tax advantages.

Two important questions remain to be discussed with respect to the life insurance:

1. How should the life insurance policy be applied for?
2. How should the policy premium be paid?

Let’s examine these somewhat mechanical, but important, issues. We stated earlier that, if the trust grantor is uninsurable, existing life insurance should be transferred to the ILIT. It is not generally the most desirable arrangement, but if the grantor is uninsurable it may be the only option. However, if the grantor is insurable, the ILIT trustee should normally apply for new life insurance on the grantor’s life. In this case, Aaron should meet with his attorney and direct him or her to create an irrevocable life insurance trust, and Aaron should name the trustee.

When the trust has been created and the trustee appointed, the trustee should complete an application for the life insurance and sign it as the applicant for the insurance. In this case, the insured-grantor (Aaron, in our example) should not be the applicant.

The ILIT trustee should make a trust check payable to the life insurer in payment of the life insurance premium. Although payment of the premium may usually be made either at the time of the application or when the policy is delivered, some companies will issue a conditional receipt for very large face amount applications; in such a case, it usually makes sense to submit the initial premium at the time of the application.

There is another important question, however, that needs to be addressed. Specifically, how do the funds get to the trust to enable the trustee to pay the life insurance premium?

The not-unexpected answer is that the insured-grantor transfers funds to the ILIT to pay the premiums. The trustee then simply draws a check on the trust’s assets in order to pay the life insurance premium.

There are two ways in which funds may be transferred to an ILIT to pay the premiums on trust-owned life insurance. Both methods involve non-charitable gifts, usually from the ILIT grantor.

1. The insured-grantor can make annual transfers in the amount needed to pay premiums.
2. The insured-grantor can transfer sufficient income-producing assets to the trust, the income from which will then fund the life insurance policy premiums.

The difference in the two methods of paying for life insurance premiums in an ILIT is the difference between a funded ILIT and an unfunded ILIT. An irrevocable life insurance trust that receives income-producing assets whose income will pay the premium on the trust-owned life insurance policy is called a funded ILIT. An ILIT to which the insured simply makes annual transfers to pay the premiums on trust-owned life insurance is referred to as unfunded ILIT.

The issue with respect to transferring funds to the trust to pay the premiums is that the transfers are gifts. As gifts, the transfers are subject to gift taxation—and gift tax rates are equal to estate tax rates.

Let’s assume that Aaron chooses to make the ILIT a funded trust by transferring to it sufficient assets so that he will not be required to make further transfers to pay premiums. If the annual premium on the $1 million trust-owned life insurance policy is $112,000 and Aaron believes that the trust can obtain an 8% after-tax annual yield, he might choose to make a one-time transfer of $1.4 million to the trust. At an 8% after-tax annual yield, the trust could expect to realize sufficient income each year to pay the premium when due.

In light of the significant amounts of cash involved in the transfer of funds to a funded ILIT and the substantial level of gift taxes that would normally be due upon making the transfer, these trusts are usually unfunded.

Even in an unfunded ILIT, however, gift taxes may be a problem. The problem is resolved somewhat because everyone has an annual gift tax exclusion that can be used to avoid gift taxes.

In 2015, the gift tax exclusion amount is $14,000 to each donee. That means that a donor—Aaron Golden, in this case—can make a gift each year of $14,000 to anyone he wishes without incurring any gift taxes. (If Aaron’s wife were still living she could join in the gift with Aaron, and they could give away $28,000 each year to each donee tax-free.)

Aaron has four children and four grandchildren. So, he can give each of them $14,000 each year gift tax-free and direct those funds to the trust to pay the life insurance premiums. Since the annual premium for his life insurance policy is $112,000 and he has 8 trust beneficiaries, the entire premium can be transferred to the trust without incurring gift taxes. ($14,000 x 8 = $112,000) Aaron manages to reduce his estate by $112,000 each year, pay for the life insurance policy and avoid the gift taxes on the $112,000 as well because of the annual gift tax exclusion.

There is one potential problem with the transfer of the $112,000 premium into the trust each year to pay the premiums. The problem is that contributions to the trust are considered future interests rather than present interests. (The eight trust beneficiaries can’t immediately enjoy the money transferred to the ILIT.) Unfortunately, future interests don’t qualify for the annual gift tax exclusion; rather the interest in the gifted property must be a *present* interest.

The problem of annual gifts directed to pay the premium on trust-owned life insurance not being considered gifts qualifying for the annual gift tax exclusion is overcome by giving the trust beneficiaries a limited right to withdraw the funds from the trust. This limited withdrawal right is sufficient to change the donee’s future interest in the gift into a present interest and, thereby, enable the transfer of funds to qualify for the annual gift tax exclusion.

In Aaron’s case, the beneficiaries are given a limited power to withdraw certain sums from the trust for a short time after he makes the contribution. These powers of withdrawal are called Crummey powers and are so named for the *Crummey v. Comm.* case, decided in the federal courts in 1968. *397 F.2d 82 (9th Cir. 1968)*

It is seldom that an estate tax planning strategy is completely without drawbacks; the ILIT is no exception. Despite the benefits that can result from using an irrevocable life insurance trust, a significant drawback to its use is that Aaron has no rights to the life insurance policy in the trust or to the premiums that have been paid. (Remember that if Aaron had retained the right to borrow from the policy, for example, that retained right would be considered an incident of ownership and sufficient to cause the policy’s death benefits to be included in his estate at death.)

Simply stated, Aaron, the trust grantor, cannot get anything out of the trust once it is put into it. If he wants to use the cash values to invest in a business opportunity or borrow the cash to help him through an emergency, he cannot do it. Since Aaron does not own the life insurance policy, he has no access to its values.

Because of the client’s loss of access to the life insurance policy and its cash value—a value that is often substantial—the client must fully understand the consequences of an ILIT before employing the strategy. However, when employed by the right client in the proper estate-planning situation, an ILIT can provide the client and his or her family with significant benefits.

The primary benefit, however, is the obvious one: it enables the executor to pay the estate liabilities *for* the estate rather than *from* the estate using the most economical vehicle available for the purpose, a life insurance policy.

## Summary

A wide range of estate tax planning tools and techniques are available to practitioners to assist clients in limiting their estate tax liability and facilitating their dispositive objectives.

Three of the most popular tools are trusts:

* Credit shelter trusts
* QTIP trusts
* ILITs

Credit shelter trusts protect the estate of the first decedent from losing the estate tax unified credit because of bequeathing his or her entire estate to a surviving spouse under the unlimited marital deduction. QTIP trusts permit a decedent to direct the income from his or her assets to a surviving spouse and provide for their ultimate distribution according to the terms of the trust, thereby protecting the first decedent’s heirs.

Irrevocable life insurance trusts allow an estate owner to arrange for the purchase of life insurance on his or her life to provide for estate liquidity without increasing the value of the estate for tax purposes.

|  |  |
| --- | --- |
| Chapter 3 Thumbnail Summary | |
| Credit shelter trust | A trust established to be funded by a decedent’s assets up to the exemption equivalent of the estate tax unified credit. The exemption equivalent of the estate tax unified credit in 2015 is $5.43 million. |
| Testamentary trust | A trust established by a decedent’s last will and testament. |
| Inter vivos trust | A trust established during the lifetime of the trust creator. |
| Qualified terminable interest property (QTIP) trust | A trust designed to enable a decedent to:   * Determine the ultimate beneficiary of his or her assets but who wants to provide a lifetime income to the surviving spouse; * Protect the inheritance of children from a previous marriage; or * Ensure that his or her estate does not pass to a subsequent marriage partner. |
| Revocable trust | A trust whose terms may be changed and that may be revoked entirely; revocable trusts offer no estate tax protection. |
| Irrevocable trust | A trust that cannot be revoked and whose terms cannot be changed; irrevocable trusts offer estate tax protection. |
| Irrevocable life insurance trust (ILIT) | An irrevocable trust established during the grantor’s lifetime that is used to own life insurance usually on the life of the grantor. An ILIT may keep life insurance death benefit proceeds payable on the decedent’s death out of his or her federal gross estate. |
| Crummey powers | Powers that are generally included in an unfunded irrevocable life insurance trust giving trust beneficiaries a limited period—usually 30 days—during which they may withdraw funds transferred to the trust. The limited right of withdrawal, known as Crummey powers, causes the noncharitable gift to be eligible for the gift tax annual exclusion by changing the beneficiaries’ future interest in the transferred funds into a present interest. |

## Chapter Review

1. Which of the following could be an appropriate reason for designating the decedent’s estate as a life insurance beneficiary?
2. To ensure that specific individuals receive the proceeds
3. To fund a testamentary credit shelter trust
4. To provide funds for payment of estate taxes
5. To equalize inheritance
6. What is the maximum amount of assets that may be transferred to a credit shelter trust without incurring federal estate tax if a decedent died in 2015?
   1. $2,117,800
   2. $28,000
   3. $2,000,000
   4. $5,430,000

# Chapter 4 Calculating Federal Estate Taxes

## Introduction

Thus far, this course has focused on three areas:

1. The property that comprises the federal gross estate
2. The deductions from the gross estate
3. The unified tax credit

We are now going to change that focus somewhat, from a more academic approach to one that is practical and hands-on. You are going to have the opportunity to calculate the estate tax liability for several hypothetical clients.

We have included an estate tax calculation worksheet to assist you in making calculations. It will help you in two important ways:

1. It will enable you to see that the calculation of estate taxes in the majority of cases— despite some of the Internal Revenue Code’s arcane provisions—is relatively simple; and
2. It will help you organize the process of estate tax calculation.

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Identify the components of the federal gross estate;
* List the deductions that may be taken from the federal gross estate to arrive at the tentative taxable estate;
* Explain how state estate taxes are accounted for in calculating the federal estate tax liability;
* Calculate the value of adjusted taxable gifts that must be added to a decedent’s taxable estate;
* Describe the use of the estate tax unified credit, the credit on prior transfers and the foreign death tax credit in determining federal estate tax liability; and
* Calculate the federal estate tax liability under various estate tax fact patterns.

## Estate Tax Calculation

Calculating the federal estate tax liability is made somewhat simpler by using an estate tax calculation worksheet. A sample estate tax calculation worksheet is shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Estate Tax Calculation Worksheet** | | | |
| **Step** | **Category** | **Sub-Total** | **Total** |
| 1 | Property owned at death: |  |  |
|  | Real estate | \_\_\_\_\_\_\_\_\_ |  |
|  | Stocks & bonds | \_\_\_\_\_\_\_\_\_ |  |
|  | Mortgages, notes & cash | \_\_\_\_\_\_\_\_\_ |  |
|  | Insurance on decedent’s life | \_\_\_\_\_\_\_\_\_ |  |
|  | Jointly-owned property | \_\_\_\_\_\_\_\_\_ |  |
|  | Other miscellaneous property | \_\_\_\_\_\_\_\_\_ |  |
|  | Transfers during decedent’s life | \_\_\_\_\_\_\_\_\_ |  |
|  | Powers of appointment | \_\_\_\_\_\_\_\_\_ |  |
|  | Annuities | \_\_\_\_\_\_\_\_\_ |  |
|  | Total gross estate |  | \_\_\_\_\_ |
| 2 | Deductions: |  |  |
|  | Funeral expenses & expenses incurred in administering property subject to claims | \_\_\_\_\_\_\_\_\_ |  |
|  | Decedent’s debts | \_\_\_\_\_\_\_\_\_ |  |
|  | Mortgages & liens | \_\_\_\_\_\_\_\_\_ |  |
|  | Net losses during administration | \_\_\_\_\_\_\_\_\_ |  |
|  | Expenses incurred in administering property not subject to claims | \_\_\_\_\_\_\_\_\_ |  |
|  | Bequests, etc., to surviving spouse | \_\_\_\_\_\_\_\_\_ |  |
|  | Charitable, public, and similar gifts and bequests | \_\_\_\_\_\_\_\_\_ |  |
|  | Total deductions |  | -\_\_\_\_ |
| 3 | Tentative taxable estate (total gross estate *minus* deductions) |  | \_\_\_\_\_ |
| 4 | State death taxes |  | - \_\_\_\_ |
| 5 | Taxable estate (tentative taxable estate *minus* state death taxes) |  | \_\_\_\_\_ |
| 6 | Adjusted taxable gifts, other than taxable gifts included in gross estate |  | +\_\_\_\_ |
| 7 | Total (Taxable estate *plus* adjusted taxable gifts) |  | \_\_\_\_\_ |
| 8 | Tentative estate tax (based on line 7 total) |  | \_\_\_\_\_ |
| 9 | Total gift taxes paid on gifts after 1976 |  | -\_\_\_\_ |
| 10 | Gross estate tax (Tentative estate tax *minus* gift taxes paid) |  | \_\_\_\_\_ |
| 11 | Estate tax credits: |  |  |
|  | Estate tax unified credit | \_\_\_\_\_\_\_\_\_ |  |
|  | Credit for foreign death taxes | \_\_\_\_\_\_\_\_\_ |  |
|  | Credit for tax on prior transfers | \_\_\_\_\_\_\_\_\_ |  |
|  | Total tax credits |  | -\_\_\_\_ |
| 12 | Net estate tax (gross estate tax *minus* tax credits) |  | \_\_\_\_\_ |

## The Gross Estate

When we began our discussion of federal estate taxation, we started with a consideration of the composition of the federal gross estate. We saw that all of the following comprises the total federal gross estate:

* Property owned at death
* Property in which decedent had any incidents of ownership
* Life insurance death benefits under policies owned by an insured decedent
* Certain gifts

It includes everything that the decedent owned or in which he possessed any incidents of ownership at his death, the death benefits of any personally-owned life insurance policies, and certain gifts. When you calculate the total value of each of these estate components and add them together, you arrive at the total gross estate. Remember, however, that this is just the starting point in the federal estate tax calculation.

To get from the total gross estate to the next step—the *tentative taxable estate—*you need to deduct certain expenses that are incurred by the estate and make other specified deductions.

Refer to the estate tax calculation worksheet on the previous page.

## The Tentative Taxable Estate

The deductions that we need to take from the total gross estate to arrive at the tentative taxable estate are for:

1. Funeral expenses
2. Administration expenses
3. Debts and taxes
4. Unreimbursed losses
5. Bequests to an eligible spouse
6. Charitable and public gifts and bequests

The deductions that constitute the step from the total gross estate to the tentative taxable estate are those deductions for:

1. Wrapping up the decedent’s affairs - paying outstanding debts, including final income taxes, credit card balances, outstanding loan balances, and funeral expenses
2. Cost of settling the estate, which often includes the fees for professional assistance from attorneys, accountants, and appraisers as well as commissions paid to real estate brokers for the sale of real property
3. Transfers of the decedent’s property to an eligible surviving spouse
4. Charitable and public gifts and bequests

The decedent’s debts do not die with the decedent. They need to be paid by the estate along with any unpaid income, gift, or property taxes that are outstanding.

As we noted earlier, to qualify for the marital deduction, the spouse must be a U.S. citizen and still be married to the decedent at the time of death; the spouse must have survived the decedent; and the property being passed to the spouse must be includible in the decedent’s estate. There is no upper limit on the amount of the marital deduction.

In addition to any deduction for property passing to an eligible spouse, the gross estate is reduced by any charitable bequests. We need to spend just a moment, however, on clarifying those charitable bequests that qualify as deductions from the gross estate.

The first point that needs to be made is that a bequest to an individual—no matter how needy that individual might be—is *not* a charitable bequest that is deductible from the gross estate. Furthermore, unlike the income tax deduction for charitable gifts made during a donor’s lifetime that is subject to certain percentage limitations, there are no percentage or amount limitations on charitable bequests.

The Internal Revenue Code provides a charitable deduction from the gross estate for the following bequests:

* A bequest to or for the use of the United States, any state, territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes
* A bequest to or for the use of corporations organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to foster amateur sports competition, and the prevention of cruelty to children or animals
* A bequest to trustees, or fraternal societies, orders or associations operating under the lodge system, but only if the bequests are to be used exclusively for religious, charitable, scientific, literary or education purposes, or for the prevention of cruelty to children or animals
* A bequest to or for the use of any veterans’ organization incorporated by Act of Congress or to any of its components, so long as no part of the net earnings inures to the benefit of any private shareholder or individual

A simple way to remember the types of organizations eligible for charitable bequests is to recall that they include veterans’ organizations, political subdivisions, and the same types of 501(c)(3) organizations eligible to sponsor tax-sheltered annuities—also known as 403(b) plans.

## State Taxes Imposed at Death

Individual states generally impose taxes at a decedent’s death. These taxes may be estate or inheritance taxes, a distinction that we will examine shortly. The federal tax code formerly provided a credit against the federal estate tax liability for state death taxes. Under that former system, the state death tax credit was equal to the *lesser* of the actual state death taxes paid and a specific credit amount.

In 2001, the specific credit amount was the amount calculated from the Credit For State Death Taxes table. EGTRRA reduced the amount of the credit after 2001 as follows:

|  |  |
| --- | --- |
| **Year** | **Treatment** |
| 2002 | 75% of credit |
| 2003 | 50% of credit |
| 2004 | 25% of credit |
| 2005 & later | Deduction |

Since 2005, the credit for state death taxes has been replaced by a deduction for state taxes paid at death. To arrive at the next step in the federal estate tax calculation—the taxable estate—we need to deduct any state taxes paid at death from the tentative taxable estate.

## Adjusted Taxable Gifts Added to Taxable Estate

To arrive at the estate value on which estate taxes are based, you need to add to the taxable estate the value of any adjusted taxable gifts made by the decedent since 1976 that are not included in the total gross estate.

Adjusted taxable gifts are lifetime gifts to the extent that they are in excess of the annual gift tax exclusion. Not included in “adjusted taxable gifts” added to the taxable estate are any gifts that are included in the gross estate under the bring-back rule because they were made within three years prior to death.

The following are subject to the bring-back rule that brings the value of the gift back into the total gross estate for tax purposes:

* Gifts of life insurance made within three years of death
* Any gift tax paid on gifts made within three years of death even if the gift, itself, is not subject to the bring-back rule

The annual gift tax exclusion, as we discussed earlier, is $14,000 in 2015. It is adjusted, however, for inflation. When these adjusted taxable gifts have been added to the taxable estate, you have the estate value on which estate taxes are calculated. To this estate value, the federal estate tax rates are applied to calculate the tentative estate tax.

The purpose of adding back the adjusted taxable gifts is to give effect to the unified concept of the transfer tax structure by calculating the estate tax on the basis of cumulative transfers made during the decedent’s life and at his or her death. In other words, the tax is based on *all* of the transfers the decedent made, both during his or her life and at death.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Federal Estate Tax Rates – 2015 | | | | | |
| **Tentative Tax Base** | | **Tax** |  |  |  |
| **Over** | **But Not Over** | **$** | **Plus** | **%** | **Over** |
|  | $10,000 |  |  | 18% | $0 |
| $10,000 | $20,000 | $1,800 |  | 20% | $10,000 |
| $20,000 | $40,000 | $3,800 |  | 22% | $20,000 |
| $40,000 | $60,000 | $8,200 |  | 24% | $40,000 |
| $60,000 | $80,000 | $13,000 |  | 26% | $60,000 |
| $80,000 | $100,000 | $18,200 |  | 28% | $80,000 |
| $100,000 | $150,000 | $23,800 |  | 30% | $100,000 |
| $150,000 | $250,000 | $38,800 |  | 32% | $150,000 |
| $250,000 | $500,000 | $70,800 |  | 34% | $250,000 |
| $500,000 | $750,000 | $155,800 |  | 37% | $500,000 |
| $750,000 | $1,000,000 | $248,300 |  | 39% | $750,000 |
| $1,000,000 | …….. | $345,800 |  | 40% | $1,000,000 |

## The Tentative Estate Tax

Now that we have added the adjusted taxable gifts back into the estate and calculated the tentative tax, we need to subtract the gift taxes that the decedent paid on the gifts that we added back. The reason for deducting the gift taxes paid on these post-1976 gifts is to avoid double taxation of those transfers. Since they were already subject to tax at an earlier stage of the calculation, failing to subtract the gift taxes that the decedent already paid would result in taxing the transfers twice.

When that step is completed, we arrive at the gross estate tax payable before we apply certain credits.

## The Tax Credits

The most significant credit that the decedent’s estate can take is the estate tax unified credit. We noted earlier that the 2010 Tax Act increased the estate tax unified credit to $1,730,800 for deaths occurring in 2010 and 2011, and $1,772,800 for deaths occurring in 2012. For deaths occurring in 2015, the estate tax unified credit is $2,117,800.

See the table below for the estate tax unified credit in other years.

|  |
| --- |
| Estate Tax Unified Credit and Exemption Equivalent |
| The exemption equivalent of the unified tax credit is the value of the assets that pass tax-free because of the credit. The estate tax unified credit and its exemption equivalents are shown in the table below.   |  |  |  | | --- | --- | --- | | **Year Of Death** | **Estate Tax Unified Credit** | **Exemption Equivalent** | | 2002 – 2003 | $345,800 | $1,000,000 | | 2004 – 2005 | $555,800 | $1,500,000 | | 2006 – 2008 | $780,800 | $2,000,000 | | 2009 | $1,455,800 | $3,500,000 | | 2010 | $1,730,800\* | $5,000,000\* | | 2011 | $1,730,800 | $5,000,000 | | 2012 | $1,772,800 | $5,120,000 | | 2013 | $2,045,800 | $5,250,000 | | 2014 | $2,081,800 | $5,340,000 | | 2015 | $2,117,800 | $5,430,000 |   **\***The estate tax unified credit and its exemption equivalent applicable to estates of decedents dying in 2010 are those applicable to the estates of decedents dying in 2011. However, estates of decedents dying in 2010 may elect not to be subject to any federal estate tax but to be subject to a modified tax cost basis regime instead. |

When you have subtracted the estate tax unified credit, the next credit that needs to be deducted from the gross estate tax is the foreign death tax credit. This provides an offset for foreign death taxes. The credit is equal to the death tax that is paid to a foreign country on property that is situated in that country but included in the decedent’s federal gross estate.

The final credit that is normally applied to the gross estate tax is the credit for estate taxes paid on prior transfers. The credit for tax on prior transfers is a diminishing credit and is designed to minimize the estate taxation on property includible in the estates of two or more persons who die within a short time of each other. If the transferor died within two years before or after the decedent, the credit is equal to the full amount of estate tax paid by the transferor’s estate *with respect to the property transferred to the decedent*.

If the transferor died more than two years before the decedent, the credit for tax on prior transfers is as follows:

|  |  |
| --- | --- |
| If transferor died within... | Percentage of prior tax credited... |
| 3rd or 4th year before decedent | 80% |
| 5th or 6th year before decedent | 60% |
| 7th or 8th year before decedent | 40% |
| 9th or 10th year before decedent | 20% |
| 11th or later | 0% |

If the decedent predeceased the transferor by more than two years, no credit is allowed.

These credits—the estate tax unified credit, the credit for foreign death taxes, and the credit for tax on prior transfers—are totaled and subtracted from the gross estate tax. The result is the net federal estate tax payable within nine months following the decedent’s death.

|  |  |
| --- | --- |
| Gross estate tax | |
| – | Estate tax unified credit |
| – | Credit for foreign death taxes |
| – | Credit for tax on prior transfers |
|  | Net federal estate tax due |

## Hypothetical Clients - Calculating the Estate Tax Liability

Now that we have looked at the rules concerning calculation of the federal estate tax, you will have the opportunity to do the estate tax calculation for two hypothetical clients. When you have completed the calculations, turn to the *Answers to Chapter Quizzes* section to review your results.

### Client #1 - George and Sheila Edwards

George and Sheila have been focused on accumulating a retirement nest egg much of their married life. As a result, they have a substantial amount of assets in their IRAs and qualified plans. Their assets are as follows:

|  |  |  |
| --- | --- | --- |
| Asset | Value | Ownership Arrangement |
| Principal residence | $ 675,000 | Owned as joint tenants with right of survivorship – no mortgage |
| Vacation home | $390,000 | Owned by George - $100,000 mtge. |
| Furnishings | $80,000 | Owned jointly |
| George’s vehicle | $60,000 | Owned by George |
| Sheila’s vehicle | $70,000 | Owned by Sheila |
| Savings | $35,000 | Owned jointly |
| IRA (George) | $590,000 | Owned by George |
| IRA (Sheila) | $350,000 | Owned by Sheila |
| 401(k) plan (George) | $2,700,000 | Owned by George |
| Teacher’s retirement plan (Sheila) | $650,000 | Owned by Sheila |
| Tax sheltered annuity (Sheila) | $350,000 | Owned by Sheila |
| Stock portfolio #1 | $1,000,000 | Owned jointly |
| Stock portfolio #2 | $3,000,000 | Owned by George |
| George’s life insurance policy #1 | $500,000 | Owned by George |
| George’s life insurance policy #2 | $800,000 | Owned by an ILIT |
| Sheila’s life insurance policy | $150,000 | Owned by Sheila |

George and Sheila’s debts are modest and amount to a $100,000 mortgage on George’s vacation home. Administration expense is estimated at $35,000, and funerals are expected to cost $20,000 each. Both George and Sheila have designated their favorite charity in their wills to receive $250,000. George’s will contains a provision for a credit shelter trust funded with an amount equal to the exemption equivalent of the estate tax unified credit in effect at the time of death. The balance of any assets at death will be transferred to the surviving spouse. (When calculating George’s federal estate tax, bear in mind that substantial assets are owned jointly. One-half of those jointly-owned assets are included in George’s federal gross estate.)

Assuming that George and Sheila were married in 1980, have never made any taxable gifts, live in a state having no state death tax and own no foreign property:

1. What would be the federal estate tax payable upon George’s death in 2015?
2. How much of George’s estate would be used to fund the credit shelter trust?
3. How much would be deductible from George’s estate as a marital deduction?

### Client #2 – Bill and Lori Bell

This is the second marriage for 65 year-old Bill, a widower with two grown children, and the fourth for Lori, a 40 year-old dancer. While Lori’s assets are quite modest, Bill’s are substantial and include a family-owned business. An examination of his estate produces the following asset inventory:

|  |  |  |
| --- | --- | --- |
| Asset | Value | Ownership Arrangement |
| Principal residence | $ 680,000 | All assets are owned by Bill |
| Vacation home | $250,000 |  |
| Furnishings | $100,000 |  |
| Two vehicles | $70,000 |  |
| Savings | $25,000 |  |
| IRA | $200,000 |  |
| Pension plan | $2,500,000 |  |
| Public company stock portfolio | $1,000,000 |  |
| Bill’s life insurance policy | $2,500,000 |  |
| Business value | $4,000,000 |  |

Bill is happy in his recent marriage to Lori but wants to be sure that his children receive his accumulated assets upon Lori’s death. He has agreed to leave Lori $2 million in assets outright upon his death and provide annual income to her under QTIP and credit shelter trusts. Bill’s ownership interest in the family business will be bought out by his co-stockholders under a buy-sell agreement. His funeral costs are estimated to be $25,000, and he has no debts. His administration expense is expected to be $100,000. He has made provision in his will to leave $1 million to the Salvation Army.

Bill’s will contains a provision for a credit shelter trust funded with an amount equal to the exemption equivalent of the estate tax unified credit in effect at the time of death. It also provides for the creation of a QTIP trust funded with assets equal to $2,770,000.

Assuming that Bill had never made any taxable gifts, lives in a state having no state death tax and owns no foreign property:

1. What would be the federal estate tax payable upon Bill’s death in 2015?
2. How much of Bill’s estate would be used to fund the credit shelter trust?
3. How much would be deductible from Bill’s estate as a marital deduction?

## Summary

Calculation of the federal estate tax payable is done in a process that begins with the calculation of the total gross estate, which is comprised of all of the property owned by the decedent, either totally or in part, life insurance death benefits and certain gifts. The decedent’s debts and taxes, the costs of estate administration, bequests to a surviving spouse, and charitable bequests are deducted from the total gross estate to determine the tentative taxable estate.

The taxable estate is determined by reducing the tentative taxable estate by any state death taxes paid. To the taxable estate any adjusted taxable gifts made by the decedent since 1976 must be added. The federal estate tax rates are then applied to the total to determine the gross estate tax due before credits. To this amount, the various tax credits are applied to determine the net federal estate tax due.

|  |  |
| --- | --- |
| Chapter 4 Thumbnail Summary | |
| Federal gross estate | The first step in calculating any federal estate tax. Equal to the sum of (a) the total value of the property owned by the decedent, (b) the value of property in which the decedent had an incident of ownership at death, (c) life insurance death benefits under policies owned by the decedent, and (d) certain gifts. |
| Tentative taxable estate | The second step in calculating any federal estate tax. Equal to the federal gross estate *minus* various deductions. |
| Taxable estate | The third step in calculating any federal estate tax. Equal to the tentative taxable estate *minus* any state taxes paid at death. |
| Adjusted taxable gifts | The fourth step in calculating any federal estate tax requires adding the value of any adjusted taxable gifts to the taxable estate. “Adjusted taxable gifts” are gifts made by the decedent during life to the extent they exceed the annual gift tax exclusion. |
| Estate value for calculation of tax | The amount calculated by adding the adjusted taxable gifts to the taxable estate. It is the value of the estate for the purpose of applying the tax rate in the Gift and Estate Tax Table. |
| Tentative estate tax | The federal estate tax calculated before subtracting the total gift taxes paid on taxable gifts made after 1976. Subtracting the gift taxes paid eliminates double taxation of taxable gifts because the taxable part of those gifts has already been added to the taxable estate in the fourth step of the estate tax calculation. |
| Gross estate tax | The federal estate tax payable after subtracting the total gift taxes paid but before subtracting the various estate tax credits (unified credit, foreign death tax credit, and credit on prior transfers). |
| Net estate tax | The federal estate tax payable after subtracting all allowable tax credits. |

## Chapter Review

What transfer is NOT considered when calculating the tentative taxable estate?

* + 1. A specific bequest to the American Red Cross
    2. A specific bequest to the decedent’s son
    3. A transfer of assets to an eligible spouse
    4. A specific bequest to a religious organization

1. Which of the following correctly identifies the treatment of state death taxes in calculating federal estate taxes?
   * 1. State death taxes are deducted from the tentative taxable estate to determine the federal taxable estate.
     2. The amount of state death taxes paid is deducted from the gross federal estate tax payable as a credit.
     3. The amount of state death taxes paid may be taken as a credit towards federal estate taxes payable if it exceeds the estate tax unified credit.
     4. Seventy-five percent of the amount of state death taxes paid may be deducted from the tentative taxable estate.

# Chapter 5 State Death Taxes

## Introduction

It isn’t only the federal government that levies taxes at death. The states also impose taxes. In the last section we noted that estates were formerly given a credit for their payment of state death taxes and that the credit declined for deaths occurring through 2004. That credit has been replaced by a deduction.

All states collect taxes at death that are at least equal to the state death tax credit formerly allowed under federal estate tax laws. More than one-half of the states formerly determined the amount of state death taxes by the amount of that credit.

Certain states had neither a separate state inheritance tax nor a separate state estate tax. Instead, they simply levied a tax equal to the maximum federal credit. Those states were:

|  |  |  |  |
| --- | --- | --- | --- |
| Federal Credit States | | | |
| Alabama | Georgia | Minnesota | Texas |
| Alaska | Hawaii | Missouri | Utah |
| Arizona | Idaho | Nevada | Vermont |
| Arkansas | Illinois | New Mexico | Virginia |
| California | Kansas | North Dakota | Washington |
| Colorado | Maine | Oregon | West Virginia |
| District of Columbia | Massachusetts | Rhode Island | Wisconsin |
| Florida | Michigan | South Carolina | Wyoming |

It is not surprising that those states formerly levying a state death tax equal to the maximum federal credit for state death taxes have made changes in their laws to accommodate the federal changes without reducing their tax revenue. Agents and other advisers doing estate tax planning work should carefully research the applicable state laws in the states in which they are practicing to ensure those death taxes are properly planned for.

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Describe the principal differences between state estate taxes and inheritance taxes;
* Identify the factors that affect the amount of state inheritance tax liability; and
* Explain how the familial relationship of a beneficiary to a decedent determines the applicable inheritance tax class.

## Estate Taxation

State death taxes are of two basic types:

1. Estate taxes
2. Inheritance taxes

The principal difference between estate taxes and inheritance taxes relates to the entity that is liable for their payment.

When an estate tax is levied by a state (in contrast to an *inheritance* tax), its payment is the responsibility of the decedent’s estate. The approach is similar to federal estate taxes that are payable by the decedent’s estate. Inheritance taxes, however, are the liability of the beneficiary of the property that is inherited.

These estate taxes, whether levied by the state or federal government, are based on the fair market value of the property transferred.

## Inheritance Taxation

Inheritance taxes are different from estate taxes not only with respect to the party that is liable for them, but also in what they are based on. Inheritance taxes levied by a state may be based on:

* The beneficiary’s relationship to the decedent, which may establish the tax rate
* The beneficiary’s exemption based on his or her blood or marital relationship to the decedent
* The fair market value of the property being transferred

In those states that impose an inheritance tax, beneficiaries are customarily assigned to classes based on their relationship to the decedent. Under this system, beneficiaries in higher classes generally enjoy higher exemptions and lower tax rates than beneficiaries in lower classes. A decedent’s spouse, for example, would normally be in a higher class than a decedent’s children; similarly, the decedent’s children would be in a higher class than the decedent’s aunts and uncles.

Inheritance tax classes, from highest to lowest, generally fall into the following categories:

1. Decedent’s spouse
2. Decedent’s children and grandchildren
3. Decedent’s parents and grandparents
4. Decedent’s brothers and sisters and their children
5. Decedent’s parents’ siblings and their descendants
6. Other relatives of the decedent

Regardless of the inheritance tax class, certain states exempt life insurance proceeds payable to a named beneficiary from any state death taxes.

## Summary

All states impose a tax at death. The tax levied, however, may be either an estate tax—one imposed on the decedent’s estate—or an inheritance tax under which the beneficiary, rather than the estate, is liable for any tax.

Although state estate taxes are calculated solely on the fair market value of the property passed, inheritance taxes are generally more complicated and are based on both the value of the transferred property and the beneficiary’s relationship to the decedent. With the removal of the state death tax credit brought about by EGTRRA, corresponding changes in the state death tax laws have occurred.

## Chapter Review

Who is responsible for payment of state inheritance taxes?

* + 1. All beneficiaries of the inherited property
    2. The estate
    3. The decedent’s immediate family members, equally
    4. Non-related beneficiaries of inherited property only

What affects the amount of state estate taxes payable?

* 1. The beneficiary’s relationship to the decedent
  2. The fair market value of the property
  3. The beneficiary’s tax rate
  4. The beneficiary’s exemption

Which of the following does NOT affect inheritance taxes?

* 1. The fair market value of the property
  2. The beneficiary’s tax rate
  3. The beneficiary’s exemption
  4. The federal estate tax rate

# Chapter 6 Estate Tax Payment

## Introduction

One of the important functions of estate planning is to reduce the size of the estate tax liability through the use of trusts, titling changes, and so forth. However, after all of the tools and techniques have been used to limit a decedent’s estate taxes and other transfer costs, owners of larger estates must usually come to grips with the reality of the estate tax liability.

Despite the changes that have occurred in recent years—changes that resulted in a reduction of the tax rates and an increase in the estate tax unified credit—federal estate taxes continue to be a concern for certain wealthy individuals and their families. It is this concern with federal estate taxes and their payment that brings us to the subject of this chapter: a consideration of the options available to the estate for the payment of federal estate taxes, state death taxes, and the costs of estate administration.

## Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

* Describe the four methods generally available for payment of estate settlement costs;
* Identify the factors that need to be considered when evaluating the relative effectiveness of the various methods of paying estate settlement costs;
* Determine the parties that should normally own life insurance when designed to be used solely to pay estate settlement costs; and
* Explain how life insurance death benefit proceeds payable to an irrevocable life insurance trust are used by a decedent’s estate to pay estate taxes and settlement costs.

## Paying Estate Taxes and Settlement Costs

There are four methods generally available for payment of estate settlement costs including federal and state taxes:

1. Use liquid assets held in the estate
2. Sell assets to produce cash
3. Borrow funds to pay costs
4. Use life insurance

Let’s examine the economic viability of each of these four ways of funding the payment of estate settlement costs, beginning with the use of liquid estate assets.

## Use of Liquid Estate Assets

When we talk about liquidity, we mean an investment’s ability to be converted to cash quickly at little or no loss of value. The kinds of investment vehicles that offer the greatest liquidity are:

* Passbook savings accounts
* Money market accounts

While these savings and investment vehicles may have a place in an individual’s financial planning, unfortunately, they are not places in which an investor is likely to maximize his or her investment return. This is simply another way of saying that there is a cost for the high liquidity and safety features that are characteristic of passbook savings and money market accounts. This is generally known as an opportunity cost and is reflective of the lost earnings resulting from investment in these vehicles.

In simpler terms, an individual needing a high level of liquidity—the kind of liquidity required to ensure estate tax payment—must generally be prepared to forgo higher earnings.

To gain an appreciation of the opportunity cost of maintaining the significant liquidity needed to pay estate costs, we need only compare the average returns obtained by investors. Common stock investors have enjoyed average annual returns in excess of 10 percent over the last 60 or so years. During this same period, passbook savings accounts have provided a return of about 4 percent on average. In recent years, passbook savings account returns have plummeted to less than 1 percent on average. By just looking at the percentage differences, we can see that the cost of liquidity may be fairly substantial.

However, let’s go a step further and consider what the cost might be, assuming a hypothetical estate tax and settlement cost liability of $500,000.

An estate owner’s need to maintain a $500,000 liquid position in order to ensure sufficient funds to pay estate liabilities would mean that those funds would probably be invested at an average annual rate of about 4 percent. Based on that assumption, the annual return on that $500,000 would then be $20,000. ($500,000 x .04 = $20,000)

However, if the same $500,000 were invested in a hypothetical common stock portfolio producing the historical 10 percent rate of return, the annual return would be increased to $50,000! Allowed to accumulate over a 10-year period, the 4 percent investment of $500,000 would have grown to $740,100, while the 10 percent investment of the same amount would have increased to $1,296,850. The difference represents a 10-year opportunity cost of $556,750 simply resulting from the decision to pay estate liabilities with liquid estate assets.

Even if we do not consider the lost earnings resulting from maintaining the large liquid position, the estate owner has, nonetheless, paid his or her estate taxes with dollars that cost 100 cents. In other words, the estate is reduced dollar-for-dollar by the amount needed to meet its liabilities. The heirs are also deprived of the assets used and any income that those assets might have subsequently produced for them.

If we do not consider the enormous opportunity cost of using liquid estate assets to pay estate liabilities, we can assign a simple cost of $1 to paying each dollar of estate liabilities using liquid assets. We can use that as a standard against which to evaluate the other three sources of cash to pay estate liabilities.

## Selling Illiquid Estate Assets

We noted that our second possible source of funds to pay estate liabilities is from the sale of estate assets. To fully appreciate the cost of selling illiquid estate assets, you need to have attended at least one estate sale.

There are two faces to an estate sale: the face with which the buyer is familiar and the other face more familiar to the seller. For the buyer, an estate sale is a place to get exceptional bargains. For the heirs, an estate sale is a sad event, similar to the liquidation of a company. Family heirlooms are on display for others to pick through, and they are likely to produce less than 50 cents for every dollar of actual value.

Estate sales that result in prices far below fair market value are commonplace because the estate is under pressure to sell. The estate is generally required to pay the federal estate taxes due within nine months following the decedent’s death, so it is compelled to sell the assets as quickly as possible.

Since the executor may well feel the hand of the federal government’s tax collector on his or her shoulder, an estate sale cannot be considered an arms-length arrangement under any circumstances. Instead, the executor must sell the assets for whatever they will bring. For the buyer, that may represent a once-in-a-lifetime opportunity. For the seller, it may be nothing short of a tragedy.

For purposes of our comparison, we will assume that the executor is able to obtain far more than is customary for the estate’s illiquid assets. Instead of only 40 cents or 50 cents for each dollar of assets sold in an estate sale, we will assume that the executor is able to get 75 cents. Therefore, to produce one dollar of cash for the estate by way of an estate sale, the executor must sell illiquid assets worth at least $1.33. ($1.33 x .75 = $1.00)

Let’s add the cost of that source to our admittedly non-scientific comparison of the methods of obtaining cash for the estate. The cost of the sources of funds for estate liquidity may be compared as follows:

|  |  |
| --- | --- |
| Obtaining Cash for Estate Liquidity Comparison of Methods | |
| Source of Funds | Comparative “Cost” |
| Use liquid estate assets | $1.00 |
| Sell illiquid estate assets | $1.33 |

## Borrowing to Pay Taxes

It should be clear that selling the estate’s non-liquid assets in an estate sale is normally a more costly alternative than using liquid estate funds to pay the estate liabilities. However, there are two other options that we need to examine. Let’s consider our third source of estate settlement funds—borrowing them.

When we look at the option of borrowing, we need to take into account another factor. Specifically, banks and other lenders normally loan money in order to obtain loan interest. To the banker, the loan interest is income; to the estate or any other borrower, it is an additional cost. Furthermore, in addition to paying loan interest, the estate must also repay the loan principal at some time.

Let’s return to our earlier estate that used its liquid estate assets of $500,000 to pay the estate’s liabilities. Suppose, instead, that the executor of the estate decided to borrow the $500,000 and located a lender willing to loan the money at 7 percent. Assuming the executor negotiated a 10‑year term, the interest alone on the borrowed money is almost $200,000. The total cost of paying the $500,000 in estate liabilities by borrowing is $700,000: $500,000 for the taxes and $200,000 in total interest payments.

In other words, every dollar that is used to pay estate settlement costs really costs the estate $1.40. Let’s add the cost of that source to our comparison of the methods of obtaining cash for the estate.

The cost of the sources of funds for estate liquidity may be compared as follows:

|  |  |
| --- | --- |
| Obtaining Cash for Estate Liquidity Comparison of Methods | |
| Source of Funds | Comparative “Cost” |
| Use liquid estate assets | $1.00 |
| Sell illiquid estate assets | $1.33 |
| Borrow funds | $1.40 |

## Using Life Insurance to Pay Taxes

Up to this point in our comparison, the least costly method of funding estate liabilities, if we ignore the lost investment opportunities that it involves, is having the estate hold liquid assets for that purpose. Not unexpectedly, the last fund source that we will examine—specifically, life insurance—will generally prove to be least costly by a substantial margin.

Because of its lower cost, life insurance is the right choice for most people as a method of funding estate liabilities. The only time that the use of life insurance is inappropriate as a means of paying estate liabilities is when the individual is uninsurable or so highly rated that the life insurance is unaffordable.

However, before we examine the comparative cost of using life insurance to pay estate liabilities, let’s consider another characteristic of life insurance. One of the important benefits of life insurance as a vehicle with which to pay estate liabilities is that it can be kept out of the decedent’s estate.

Even before we consider whether buying life insurance is a good economic alternative based on the comparative costs, the simple fact that life insurance proceeds can be kept out of the decedent’s estate makes it a big money saver. As we discussed earlier, an individual can keep death benefit proceeds out of his or her estate by vesting ownership in a third party.

For the estate owner interested in using the death benefit proceeds of a life insurance policy solely to pay estate liabilities, the most suitable third parties are normally either of the following:

* An irrevocable life insurance trust (ILIT)
* The estate owner’s children

The relatively simple step of arranging for life insurance policy ownership by an ILIT or the estate owner’s adult children can enable the policy’s death benefit proceeds to completely avoid inclusion in the estate. Since they are not a part of the estate, they are not subject to federal estate taxes. In a sense, the estate liabilities are paid *for* the estate but not *from* the estate.

Even though the death benefit proceeds avoid inclusion in the decedent’s estate, they can be made available to the estate to pay estate liabilities in either of the following ways:

* The trust or other third-party owner may loan the funds to the estate
* The death benefit proceeds may be used to purchase non-liquid assets from the estate

In most cases of third-party life insurance ownership of a policy purchased to provide estate liquidity, the owner-beneficiary routinely makes the funds available to the estate by loaning them to it or by purchasing the estate’s assets. As a result, the estate receives the funds it requires to meet its liabilities, and the estate beneficiaries receive their full inheritance, undiminished in any way.

Although the ability to exclude death benefit proceeds from the estate while using them to provide estate liquidity is an important benefit of the use of life insurance for meeting estate liability needs, it is often the comparative cost that tips the scales in favor of life insurance. Specifically, the total premium paid will not normally exceed 50 cents for every dollar of death benefit proceeds that are paid. So, using life insurance to provide estate liquidity offers two important benefits:

1. The needed funds may be shielded from additional estate taxes
2. The funds can be purchased usually for about half their value

Having identified the important benefits of life insurance for estate liquidity, let’s add this final “cost” to those that we have already identified.

The cost of the sources of funds for estate liquidity may be compared as follows:

|  |  |
| --- | --- |
| Obtaining Cash for Estate Liquidity Comparison of Methods | |
| Source of Funds | Comparative “Cost” |
| Use liquid estate assets | $1.00 |
| Sell illiquid estate assets | $1.33 |
| Borrow funds | $1.40 |
| Use life insurance | $0.50 |

There are clear advantages of purchasing life insurance for the purpose of paying estate liabilities. In addition to the other benefits of life insurance, the total cost of providing the needed funds is likely to be no more than one-half the cost of the next best alternative. In view of these advantages, any estate owner that can qualify for life insurance is likely to find it to be the most advantageous approach to funding estate liabilities.

## Summary

There are generally four sources available to estate owners to provide funds for estate liquidity:

* Liquid estate assets
* Non-liquid estate assets
* Borrowed funds
* Life insurance

Of the four alternatives, life insurance is usually the least expensive and should be implemented, provided the estate owner can qualify for the life insurance. Borrowing funds to pay estate taxes is often the most expensive alternative.

In addition to offering the least costly method of arranging for estate liquidity, life insurance enables the estate owner to meet his or her estate’s liquidity needs without causing the estate—and its tax liability—to increase.

## Chapter Review

1. An executor is often under considerable pressure to liquidate assets because federal estate taxes are generally due no later than \_\_\_\_\_\_ following the decedent’s death.
   * 1. 9 months
     2. 1 year
     3. 18 months
     4. 2 years
2. What method can be used to keep life insurance policy death benefit proceeds out of the insured’s federal gross estate?
   * 1. Making a revocable trust the policy beneficiary
     2. Third-party ownership
     3. Using a split-dollar plan
     4. Use a qualified plan

# Glossary

**Adjusted taxable gifts:** Adjusted taxable gifts are lifetime gifts to the extent that they are in excess of the annual gift tax exclusion.

**Administrator:** An administrator is appointed by the court to settle the estate of an intestate decedent. An administrator serves the same function as an executor.

**Administratrix:** An administratrix is a female administrator.

**Alternate valuation date:** The alternate valuation date generally is the date six months after the decedent’s death. If the executor chooses to use the alternate valuation date, all of the assets - not just the asset whose value has declined - must be valued as of that date.

**Annual gift tax exclusion:** Under existing tax law, an individual may make a non-charitable gift each year up to the annual gift tax exclusion amount and be liable for no gift tax. The amount of this annual gift tax exclusion in 2015 is $14,000 and is indexed for inflation.

**Bequest:** A bequest is a gratuitous transfer made at death by a decedent.

**Bring-back rule:** The bring-back rule is a federal estate tax rule under which gifts of life insurance made within three years of the insured’s death and gift taxes paid on post-1976 gifts made by the decedent within three years of death are includable in the decedent’s federal gross estate.

**Charitable gift:** Charitable gifts are those gifts made to charitable organizations and for which the donor receives an income tax deduction.

**Common law:** The common law is the body of law that was developed in England over the centuries and constitutes the foundation of the English and United States legal systems. It was developed based on custom and usage and the decisions of the law courts - as distinguished from statute law.

**Costs of administration:** The costs of administration include attorney’s fees, appraiser’s fees, accountant’s fees, commissions, executor’s fees, and probate court costs.

**Credit for tax on prior transfers:** The credit for tax on prior transfers is a diminishing credit and is designed to minimize the estate taxation on property includible in the estates of two or more persons who die within a short time of each other.

**Credit shelter trust:** A credit shelter trust (CST) is a trust that enables a decedent to use the unified tax credit to pass assets to children while still giving the surviving spouse all of the income from the property placed in the trust. The trust is also referred to by other names, such as “by-pass” or “exemption” trust.

**Crummey powers:** Crummey powers are limited rights given to trust beneficiaries to withdraw certain sums from the trust for a short time after the trust grantor makes the contribution. The intention is to change a gift of a future interest, which does not qualify for the annual gift tax exclusion, to a gift of a present interest, which does qualify.

**Executor:** An executor is the person named in the decedent’s will as the one designated to settle the estate of a decedent. An executor serves the same function as an administrator.

**Executrix:** An executrix is a female executor.

**Exemption equivalent of the estate tax unified credit:** The exemption equivalent of the estate tax unified credit is that amount that may be transferred at death by a decedent without the imposition of estate transfer taxes.

**Federal gross estate:** The federal gross estate is the total of all the decedent’s property that is subject to federal estate taxation. It includes the property owned by the decedent, or in which the decedent had any incidents of ownership, at death, plus certain additions.

**Foreign death tax credit:** The foreign death tax credit is equal to the death tax that is paid to a foreign country on property that is situated in that country but included in the decedent’s federal gross estate.

**Funded ILIT:** A funded ILIT is an irrevocable life insurance trust into which the insured-grantor transfers sufficient income-producing assets, the income from which will pay all future life insurance policy premiums.

**Gift tax:** A gift tax is a federal tax on an individual’s right to gratuitously transfer property to another person during the givers lifetime. The tax is a liability of the person making the gift, known as the donor.

**“I love you” will:** A will that leaves all of an individual’s property to a surviving spouse is commonly referred to as an “I love you” will.

**Incidents of ownership:** An incident of ownership can be broadly defined as a right in and to property. It refers to a right that is less than complete ownership.

**Inheritance tax class:** In those states that impose an inheritance tax, beneficiaries are customarily assigned classes based on their relationship to the decedent. Under this system, beneficiaries in higher classes generally enjoy higher exemptions and lower tax rates than beneficiaries in lower classes.

**Inter vivos trust:** An inter vivos trust is a trust that is created during the trust grantor’s lifetime.

**Intestacy laws:** The intestacy laws are those state laws that govern the distribution of the property of a decedent who dies without a will.

**Intestate:** The status of one dying without a will.

**Irrevocable life insurance trust (ILIT):** An irrevocable life insurance trust is an irrevocable inter vivos trust designed to own life insurance on the grantor’s life in order to avoid inclusion of its death benefit proceeds in his or her estate at death. It is normally used to provide estate liquidity.

**Irrevocable trust:** An irrevocable trust is a trust that cannot be changed or revoked. An irrevocable trust may provide estate tax savings.

**IRS Form 706:** IRS Form 706 is titled “United States Estate (and Generation-Skipping Transfer) Tax Return.” Generally, the executor or administrator must file the form no later than nine months following the date of the decedent’s death if the total value of the estate exceeds the amount that may be transferred tax-free by virtue of the unified credit.

**Joint tenants with right of survivorship:** Property that is held as a joint tenant with right of survivorship passes to the surviving joint tenant immediately upon the decedent’s death.

**Liquid assets:** Liquid assets are cash and other assets that can be converted into cash easily with little or no loss of value.

**Marital deduction:** The marital deduction is an unlimited deduction for inter-spousal transfers. It effectively permits married couples to avoid estate taxation upon the death of the first spouse.

**Personal property:** Personal property is all property that is not real property.

**Personal representative:** Personal representative is another term for an executor or administrator.

**Portability provision**–A provision of the estate tax law that allows a surviving spouse to use the unused part of his or her deceased spouse’s estate tax exemption for both gift tax and estate tax purposes, provided:

* The surviving spouse has not remarried; and
* The executor of the estate of the first spouse to die timely elected portability on the federal estate tax return.

**Primogeniture:** Primogeniture was a custom under English law that provided an exclusive right of inheritance to the decedent’s eldest son.

**Probate:** Probate is the process of administering the decedent’s estate under the supervision of a probate court or surrogate’s court.

**Probate estate:** The probate estate is comprised of all of the decedent’s property that passes, at his or her death, either by will or by the applicable state intestacy laws.

**QTIP trust:** A QTIP trust is a testamentary trust that permits a decedent to control the eventual disposition of the asset while still allowing the estate to take the marital deduction for the assets placed in the trust. It can be useful to protect the inheritance of the decedent’s children from a prior marriage.

**Qualified terminable interest property:** Qualified terminable interest property is property that passes from the decedent grantor of the trust, in which the surviving spouse has a qualifying income interest for life, and with respect to which the executor makes an irrevocable election on the federal estate tax return to have the marital deduction apply.

**Real property:** Real property consists of land and anything permanently attached to it - such as a building. This property is commonly known as real estate.

**Revocable trust:** A revocable trust is a trust that may be changed or revoked by the grantor. It generally provides no estate tax savings.

**Split gift:** A noncharitable gift in which the donor’s spouse joins. Split gifts double the amount of annual gift tax exclusion.

**State death tax credit:** The state death tax credit was equal to the lesser of the actual state death taxes paid and a specific credit amount. The specific credit amount was a percentage of the maximum tax credit that reduced each year through 2004 and was replaced by a deduction for state death taxes paid beginning in 2005.

**State estate taxes:** State estate taxes are based on the fair market value of the property transferred and are the liability of the decedent’s estate.

**State inheritance taxes:** State inheritance taxes are generally based on the fair market value of the property passed and the relationship of the beneficiary to the decedent and are the liability of the beneficiary.

**Surrogate court:** The surrogate’s court or probate court is the court that supervises the administration of the decedent’s estate.

**Tenancy in common:** Tenancy in common is a method of joint property ownership under which the decedent’s property rights pass to his or her heirs just as any other property would - by will or intestacy, rather than through survivorship.

**Tenants by the entirety:** Property that is held as tenants by the entirety passes to the surviving joint tenant immediately upon the decedent’s death. Tenants by the entirety must be spouses.

**Tentative taxable estate:** The tentative taxable estate is equal to the total gross estate less deductions for:

1. Estate administration costs
2. Decedent’s debts
3. Funeral expenses
4. Un-reimbursed property and casualty losses
5. Bequests to a surviving spouse
6. Charitable bequests

**Terminable interest:** A terminable interest is an ownership interest in property that is less than complete and which may terminate at some point.

**Testamentary trust:** A testamentary trust is a trust that is created and funded through the decedent’s last will and testament.

**Trust corpus:** The corpus of a trust is the amount of principal in the trust.

**Trustee:** A trustee is a person who holds legal - but not beneficial - title to trust assets and who administers a trust in accordance with a trust document. The trust grantor normally appoints the trustee.

**Trust grantor:** A trust grantor is the creator of a trust and is sometimes called a trustor.

**Unfunded ILIT:** An unfunded ILIT is an irrevocable life insurance trust to which annual cash transfers are made to pay premiums on the life insurance policies owned by the trust.

**Unified tax credit:** The unified tax credit is a dollar amount that each taxpayer can apply against any gift tax and estate tax owed.

**Usufruct interest:** A usufruct interest in property refers to the right to use property—or income from property—that is owned by another.

# Answers to Chapter Quizzes

### Chapter 1

Question 1 Feedback

1. Your answer is correct. The federal gross estate includes *all* property owned by the decedent, whether it was owned individually or jointly with someone else. Thus, while any property owned as a joint tent with the right of survivorship would avoid inclusion in the *probate* estate, it would be included in the *federal gross* estate.
2. Your answer is incorrect. Property owned as joint tenants with right of survivorship does avoid inclusion in the probate estate. Please try again.
3. Your answer is incorrect. Property owned in joint tenancy becomes the property of the surviving joint tenant immediately upon the death of the decedent and is free of the claims of the decedent’s creditors. Please try again.
4. Your answer is incorrect. That *is* the principal difference between joint tenancy with right of survivorship and a tenancy by the entirety. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Life insurance death benefit proceeds payable according to a beneficiary designation to other than the insured’s estate avoids inclusion in the probate estate. Thus, life insurance death benefit proceeds payable to the insured’s wife would not be part of the probate estate. Please try again.
2. Your answer correct. Life insurance proceeds designed for use in funding a testamentary trust are payable to the probate estate and distributed to the trust by the decedent’s will. Thus, in such a case, the proceeds would become part of the probate estate
3. Your answer is incorrect. Since the life insurance death benefits are payable directly to a named beneficiary they do not become part of the probate estate. Please try again.
4. Your answer is incorrect. While life insurance proceeds may become part of the federal gross estate, they would not be part of the probate estate when payable to a named beneficiary other than the estate. Please try again.

Question 3 Feedback

1. Your answer is correct. A tenancy in common does not involve survivorship rights. Thus, upon the death of the tenant in common, his or her share in the commonly-owned property becomes part of the probate estate for distribution according to the decedent’s will or the applicable intestacy laws.
2. Your answer is incorrect. Property owned as joint tenants with the right of survivorship passes immediately upon death to the surviving joint tenant. It does not become a part of the probate estate. Please try again.
3. Your answer is incorrect. Life insurance proceeds payable to a named beneficiary—in this case to the insured’s son—do not become part of the probate estate. Please try again.
4. Your answer is incorrect. In the case of property owned as tenants by the entirety—a type of property ownership available only to spouses—the property passes immediately upon death to the surviving spouse. It does not become a part of the probate estate. Please try again.

### Chapter 2

Question 1 Feedback

1. Your answer is incorrect. Although Arthur’s gift to his son is a non-charitable gift, only the value of the gift in excess of the annual gift tax exclusion amount would be taxable. Please try again.
2. Your answer is incorrect. The value of a gift made in 2015 that is tax-free is $14,000. Any gift in excess of that amount is taxable. Please try again.
3. Your answer is correct. The gift tax annual exclusion available in 2015 is $14,000. This is the maximum amount of non-charitable gift that an individual donor may make to a donee gift tax-free. Since Arthur made a gift valued at $16,000 in 2015, $2,000 of the gift is taxable.
4. Your answer is incorrect. Although gifts between spouses are not subject to gift taxation, gifts to others—including other members of the donor’s immediate family—are taxable to the extent their value exceeds the applicable gift tax exclusion amount. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Gifts given to multiple donees are simply individual gifts. Please try again.
2. Your answer is correct. A split gift is simply a gift in which the donor’s spouse joins. The net result of that split gift is to increase the annual gift tax exclusion amount by the additional amount that may be gifted by the spouse.
3. Your answer is incorrect. Split gifts are non-charitable gifts; no part of the gift qualifies for a charitable deduction. Please try again.
4. Your answer is incorrect. A completed gift of a present interest to a non-charitable donee always qualifies for the entire amount of the annual gift tax exclusion. Please try again.

Question 3 Feedback

1. Your answer is incorrect. Jim could make a $98,000 tax-free gift in 2015 to the 7 donees without his spouse. However, with his spouse participating in the gift, the maximum tax-free gift increases. Please try again.
2. Your answer is incorrect. Jim could make a $14,000 tax-free gift in 2015 to each donee. Since there are multiple donees and a split gift, the maximum possible gift increases. Please try again.
3. Your answer is correct. By making a split gift to 7 donees, the donor and spouse could make tax-free gifts in 2015 of $28,000 to each donee for a total of $196,000.
4. Your answer is incorrect. The maximum split gift in 2015 to each donee is $28,000. However, multiple donees are involved which increases the total. Please try again.

### Chapter 3

Question 1 Feedback

1. Your answer is incorrect. Although an insured’s naming his or her estate as the death benefit beneficiary would cause the funds to be payable as directed by the decedent’s will, it is generally inappropriate to make such a beneficiary designation when the insured wants to pay the funds to a specific individual. By doing so, the funds become subject to the claims of creditors and probate costs. Please try again.
2. Your answer is correct. A credit shelter trust may be a testamentary or *inter vivos* trust. If it is a testamentary trust, it is funded by the decedent’s assets that are distributed by way of his or her will. Thus, an insured may want to designate his or her estate as the beneficiary of a life insurance policy used to fund the credit shelter trust.
3. Your answer is incorrect. Paying death benefit proceeds into the probate estate for purposes of using them to pay federal estate taxes involves two bad results: funds are subject to probate costs, and the death benefit funds increase the federal gross estate. It is generally better, when life insurance is owned to pay estate taxes, for the life insurance to be owned by adult children or an irrevocable trust. In such a case, no probate costs are levied against the proceeds, and the death benefits may avoid inclusion in the gross estate for tax purposes. Please try again.
4. Your answer is incorrect. Equalizing inheritances may be more effectively accomplished by making death benefit proceeds payable directly to a named beneficiary. In such a case, the funds will avoid probate costs and possible depletion to meet creditor claims. Please try again.

Question 2 Feedback

1. Your answer is incorrect. That is the estate tax unified credit. The amount that may be transferred to a credit shelter trust without incurring federal estate tax is the exemption equivalent of the unified credit. Please try again.
2. Your answer is incorrect. $28,000 is the tax-free amount that may be gifted under a split gift in 2015; it has no direct relationship to federal estate taxes. Please try again.
3. Your answer is incorrect. The amount that may be transferred to a credit shelter trust without incurring federal estate tax is equal to the exemption equivalent amount. Please try again.
4. Your answer is correct. The maximum amount that may be transferred to a credit shelter trust without exposing the decedent’s estate to federal estate taxes is an amount equal to the equivalent exemption amount of the estate tax unified credit. In 2015 that amount is $5.43 million.

### Chapter 4

Hypothetical Clients – Estate Tax Calculation

Client #1 – George and Sheila

**a.** - What would be the federal estate tax payable upon George’s death in 2015?

No federal estate tax would be payable upon George’s death, assuming that he was still married at the time of his death. The assets that were not used to pay the costs of administration or donated to charity were placed in the credit shelter trust or transferred to Sheila. The amount placed in the credit shelter trust would pass estate tax-free under the estate tax unified credit provision; the amount transferred to Sheila would qualify for the marital deduction and would, similarly, escape estate taxation.

**b.** - How much of George’s estate would be used to fund the credit shelter trust?

George and Sheila’s estate plan called for the maximum amount to be placed in the credit shelter trust. Since the maximum amount is equal to the exemption equivalent of the estate tax unified credit, the amount placed in the trust when George dies in 2015 is $5,430,000.

**c.** - How much would be deductible from George’s estate as a marital deduction?

The amount that would qualify for the marital deduction is $2,300,000.

Client #2 – Bill and Lori

**a.** - What would be the federal estate tax payable upon Bill’s death in 2015?

No federal estate tax would be payable upon Bill’s death.

**b.** - How much of Bill’s estate would be used to fund the credit shelter trust?

Bill’s estate plan called for the maximum amount to be placed in the credit shelter trust. Since the maximum amount is equal to the exemption equivalent of the estate tax unified credit, the amount placed in the trust when he dies in 2015 is $5,430,000.

**c.** - How much would be deductible from Bill’s estate as a marital deduction?

The marital deduction from Bill’s estate is $4,770,000. That amount is comprised of the $2 million in assets given outright to Lori plus $2,770,000 placed in the qualified terminable interest property (QTIP) trust. The completed estate tax calculation worksheets for these two clients are shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Estate Tax Calculation Worksheet—George and Sheila** | | | |
| **Step** | **Category** | **Sub-Total** | **Total** |
| 1 | Property owned at death: |  |  |
|  | Real estate | \_\_\_\_\_\_\_ |  |
|  | Stocks & bonds | \_\_\_\_\_\_\_ |  |
|  | Mortgages, notes & cash | \_\_\_\_\_\_\_ |  |
|  | Insurance on decedent’s life | \_\_\_\_\_\_\_ |  |
|  | Jointly-owned property | \_\_\_\_\_\_\_ |  |
|  | Other miscellaneous property | \_\_\_\_\_\_\_ |  |
|  | Transfers during decedent’s life | \_\_\_\_\_\_\_ |  |
|  | Powers of appointment | \_\_\_\_\_\_\_ |  |
|  | Annuities | \_\_\_\_\_\_\_ |  |
|  | Total gross estate |  | $8,135,000 |
| 2 | Deductions: |  |  |
|  | Funeral expenses & expenses incurred in administering property subject to claims | $20,000 |  |
|  | Decedent’s debts | \_\_\_\_\_\_\_ |  |
|  | Mortgages & liens | $100,000 |  |
|  | Net losses during administration | \_\_\_\_\_\_\_ |  |
|  | Expenses incurred in administering property not subject to claims | $35,000 |  |
|  | Bequests, etc., to surviving spouse | $2,300,000 |  |
|  | Charitable, public, and similar gifts and bequests | $250,000 |  |
|  | Total deductions |  | $2,705,000 |
| 3 | Tentative taxable estate (total gross estate *minus* deductions) |  | $5,430,000 |
| 4 | State death taxes |  | $0 |
| 5 | Taxable estate (tentative taxable estate *minus* state death taxes) |  | $5,430,000 |
| 6 | Adjusted taxable gifts, other than taxable gifts included in gross estate |  | $0 |
| 7 | Total (Taxable estate *plus* adjusted taxable gifts) |  | $5,430,000 |
| 8 | Tentative estate tax (based on line 7 total) |  | $2,117,800 |
| 9 | Total gift taxes paid on gifts after 1976 |  | $0 |
| 10 | Gross estate tax (Tentative estate tax *minus* gift taxes paid) |  | $2,117,800 |
| 11 | Estate tax credits: |  |  |
|  | Estate tax unified credit | $2,117,800 |  |
|  | Credit for foreign death taxes | \_\_\_\_\_\_\_ |  |
|  | Credit for tax on prior transfers | \_\_\_\_\_\_\_ |  |
|  | Total tax credits |  | $2,117,800 |
| 12 | Net estate tax (gross estate tax *minus* tax credits) |  | $0 |

|  |  |  |  |
| --- | --- | --- | --- |
| **Estate Tax Calculation Worksheet—Bill and Lori** | | | |
| **Step** | **Category** | **Sub-Total** | **Total** |
| 1 | Property owned at death: |  |  |
|  | Real estate | \_\_\_\_\_\_\_ |  |
|  | Stocks & bonds | \_\_\_\_\_\_\_ |  |
|  | Mortgages, notes & cash | \_\_\_\_\_\_\_ |  |
|  | Insurance on decedent’s life | \_\_\_\_\_\_\_ |  |
|  | Jointly-owned property | \_\_\_\_\_\_\_ |  |
|  | Other miscellaneous property | \_\_\_\_\_\_\_ |  |
|  | Transfers during decedent’s life | \_\_\_\_\_\_\_ |  |
|  | Powers of appointment | \_\_\_\_\_\_\_ |  |
|  | Annuities | \_\_\_\_\_\_\_ |  |
|  | Total gross estate |  | $11,325,000 |
| 2 | Deductions: |  |  |
|  | Funeral expenses & expenses incurred in administering property subject to claims | $125,000 |  |
|  | Decedent’s debts | \_\_\_\_\_\_\_ |  |
|  | Mortgages & liens | \_\_\_\_\_\_\_ |  |
|  | Net losses during administration | \_\_\_\_\_\_\_ |  |
|  | Expenses incurred in administering property not subject to claims | \_\_\_\_\_\_\_\_ |  |
|  | Bequests, etc., to surviving spouse | $4,770,000 |  |
|  | Charitable, public, and similar gifts and bequests | $1,000,000 |  |
|  | Total deductions |  | $5,895,000 |
| 3 | Tentative taxable estate (total gross estate *minus* deductions) |  | $5,430,000 |
| 4 | State death taxes |  | $0 |
| 5 | Taxable estate (tentative taxable estate *minus* state death taxes) |  | $5,430,000 |
| 6 | Adjusted taxable gifts, other than taxable gifts included in gross estate |  | $0 |
| 7 | Total (Taxable estate *plus* adjusted taxable gifts) |  | $5,430,000 |
| 8 | Tentative estate tax (based on line 7 total) |  | $2,117,800 |
| 9 | Total gift taxes paid on gifts after 1976 |  | $0 |
| 10 | Gross estate tax (Tentative estate tax *minus* gift taxes paid) |  | $2,117,800 |
| 11 | Estate tax credits: |  |  |
|  | Estate tax unified credit | $2,117,800 |  |
|  | Credit for foreign death taxes | \_\_\_\_\_\_\_\_\_ |  |
|  | Credit for tax on prior transfers | \_\_\_\_\_\_\_\_\_ |  |
|  | Total tax credits |  | $2,117,800 |
| 12 | Net estate tax (gross estate tax *minus* tax credits) |  | $0 |

Question 1 Feedback

1. Your answer is incorrect. A bequest to the American Red Cross would be deducted from the total gross estate. The deductions taken from the total gross estate to arrive at the tentative taxable estate are deductions for outstanding debts, fees for professional estate services, gifts to charity and spousal bequests. Please try again.
2. Your answer is correct. A specific bequest to a decedent’s son is not considered in arriving at the tentative taxable estate.
3. Your answer is incorrect. Spousal transfers are deducted to arrive at the tentative taxable estate. The deductions taken from the total gross estate to arrive at the tentative taxable estate are deductions for outstanding debts, fees for professional estate services, gifts to charity and spousal bequests. Please try again.
4. Your answer is incorrect. Bequests to religious organizations are charitable gifts which are deducted to determine the tentative taxable estate. The deductions taken from the total gross estate to arrive at the tentative taxable estate are deductions for outstanding debts, fees for professional estate services, gifts to charity and spousal bequests. Please try again.

Question 2 Feedback

1. Your answer is correct. State death taxes are deducted from the tentative taxable estate in their entirety in order to determine the federal taxable estate.
2. Your answer is incorrect. Estates were formerly given a credit for their payment of state death taxes. However, the credit declined for the deaths occurring through 2004 and has been replaced by a deduction. Please try again.
3. Your answer is incorrect. The estate tax unified credit plays no part in the federal estate tax treatment of state inheritance and estate taxes. Estates were formerly given a credit for their payment of state death taxes. However, the credit declined for the deaths occurring through 2004 and has been replaced by a deduction. Please try again.
4. Your answer is incorrect. State death taxes are deducted from the tentative taxable estate in their entirety in order to determine the federal taxable estate. Please try again.

### Chapter 5

Question 1 Feedback

1. Your answer is correct. Inheritance taxes, in contrast to estate taxes, are the liability of the individual beneficiary
2. Your answer is incorrect. A decedent’s estate has no liability for paying inheritance taxes. Please try again.
3. Your answer is incorrect. Although immediate family members may actually pay inheritance taxes because they inherit the decedent’s property, they are not taxed simply because of the familial relationship. Please try again.
4. Your answer is incorrect. Inheritance tax liability is not restricted to unrelated beneficiaries. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Although the beneficiary’s relationship to the decedent may establish the state inheritance tax rate; however, it plays no role in estate tax liability. Please try again.
2. Your answer is correct. The only determinant of the level of estate taxes payable is the fair market value of the property at the time of death.
3. Your answer is incorrect. Even though the beneficiary’s tax rate affects inheritance taxes, does not affect estate tax liability. Please try again.
4. Your answer is incorrect. The beneficiary’s blood or marital relationship with the decedent can affect his or her inheritance tax liability but not the estate tax liability. Please try again.

Question 3 Feedback

1. Your answer is incorrect. The fair market of the property passed to a beneficiary is an important component in state inheritance tax liability. Please try again.
2. Your answer is incorrect. Depending on the state inheritance tax statutes, the beneficiary’s relationship to the decedent may establish the state inheritance tax rate. Please try again.
3. Your answer is incorrect. The beneficiary may receive an exemption from state-levied inheritance taxes based on his or her blood or marital relationship with the decedent. Please try again.
4. Your answer is correct. The federal estate tax rate does not affect the inheritance tax liability

### Chapter 6

Question 1 Feedback

1. Your answer is correct. Federal estate taxes are generally due 9 months following the decedent’s death.
2. Your answer is incorrect. Although extensions for payment may be granted for various reasons, federal estate taxes are generally due nine months after the decedent’s death. Please try again.
3. Your answer is incorrect. Although extensions for payment may be granted for various reasons, federal estate taxes are generally due nine months after the decedent’s death. Please try again.
4. Your answer is incorrect. Although extensions for payment may be granted for various reasons, federal estate taxes are generally due nine months after the decedent’s death. Please try again.

Question 2 Feedback

1. Your answer is incorrect. Trusts are frequently and effectively employed to reduce estate tax liability. However, a revocable trust offers grantors no tax benefits. Please try again.
2. Your answer is correct. Third-party ownership of life insurance policies can keep life insurance policy death benefits out of the total gross estate.
3. Your answer is incorrect. A split dollar life insurance plan is simply a method of paying for life insurance and has no effect on whether or not death benefit proceeds avoid inclusion in a decedent’s federal gross estate. Please try again.
4. Your answer is incorrect. Qualified plans offer important retirement accumulation benefits but do not affect the inclusion of life insurance death benefits in the decedent’s federal gross estate. Please try again.

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