

Searcy

ESTATE AND GIFT TAX

Fall 1991

NEW FACTS

Prior to the facts below, D never made any gifts. In November 1987 Donor D created a new inter vivos irrevocable and nonamendable trust obligating Trustee T to pay all net income to A for A's life, thereafter if D is living to pay all net income to Donor D for D's life, and upon the death of the latter to die of A or D to deliver all trust property outright to R and his heirs. In November 1987 D transferred to Trustee T some nondepreciable shares of Corporate Stock (CS). D died in 1991 survived by T, A, and R. A died in 1996 survived by T and R. T correctly paid \$7,000 of income to A in 1987 (the trust began in late November, so that was all the net income for 1987) and about \$75,000 per year net income in 1988 through 1996.

Assume that the actuarial values of the various interests in the trust at various dates were as follows:

	A's Interest	D's Interest	R's Interest
1987	50%	20%	30%
1991	40%	*15%	*45%
1996	*20%	-	*80%

*The asterisk percentages are computed based upon the life expectancy of the decedent without considering the fact of decedent's death. Of course the actuarial value of a life

income interest at the time of the life tenant's death would be zero if the fact of death were to be considered, and such zero value would cause all of the value of the entire property to be allocated to or among the other interest(s).

Assume that the Adjusted Basis (AB) and Fair Market Value (FMV) of the Corporate Stock CS were as follows:

\$ 700,000 D's 1983 cash cost and D's 1987 AB

1,000,000 FMV 1987 when D transferred to T

1,500,000 FMV 1991 when D died

At the time of D's death in 1991 the only asset that D owned was a \$1,000,000 cash Certificate of Deposit registered in D's name alone. D's will left his entire estate to his Sister S. D had no debts at the time of his death.

In 1990 Donor D made an outright gift of nondepreciable unimproved Land to C. The dollar factors are:

\$ 300,000 D's 1975 cash cost and D's 1990 AB

400,000 FMV 1990 date of gift

600,000 FMV 1991 date of D's death

1. With respect to D's 1987 irrevocable transfer to T, what is the dollar amount of sec. 2503(b) Gift Tax (GT) Per Donee Exclusions (PDE) available. Mark as many, if any, as are applicable:

A. \$10,000 by reason of the gift made to T

- B. \$ 7,000 by reason of the gift made to A
- C. \$10,000 by reason of the gift made to A
- D. \$10,000 by reason of the gift made to D
- E. \$10,000 by reason of the gift made to R

2. Throughout all remaining parts of the problems dealing with this Entire fact situation, disregard all PDE issues entirely. Compute D's 1987 GT due, i.e., the amount of tax which D is required to pay by reason of 1987 gifts.

3. Repeat 2, except for 1990. Throughout all remaining parts of this problem, you are to assume that D timely paid all correct GT before D died.

4. Assume that D's transfer of Corporate Stock to T was not to any extent a bone fide sale for adequate consideration and disregard sec. 2043. Analyze whether any amount of the trust will be included in D's Gross Estate (GE) by reason only of sec. 2036(a). Disregard the dollar amounts involved.

5. Assuming that sec. 2036(a) requires some inclusion, analyze the dollar amount includible.

6. Consistent with your answer in 5, analyze the dollar amount, if any, of sec. 2001(b)(1)(B) Adjusted Taxable Gifts (ATG) with respect only to D's trust which must be included in D's Estate Tax (ET) computation.

7. The dollar amount of corpus only includible in D's GE by reason of sec. 2035(a) with respect to D's transfer of Land to C is:

- A. Zero, because D died after 1981.

B. Zero, provided D's Executor E can establish that D's gift of Land was not made with contemplation of death thoughts or motives.

C. The amount of the GT due as determined in #3.

D. \$400,000.

E. \$600,000.

8. Compute the GE for D's ET computation. (Remember to consult your conclusions to #5, #6, and #7, but of course you need not limit your answer to those amounts.)

9. Compute the ATG for D's ET computation. (Remember to consult your answer to #6, but of course you need not limit your answer to that amount).

10. Using your answers to #8 and #9 without repeating any of them except the total amount in the GE and in ATG, compute the ET which Executor E is required to pay with D's ET return.

11. Assume that in 1989 Trustee T properly determined that it was in the best interest of all parties for T to sell all of the Corporate Stock and reinvest the sale proceeds in other assets which would be more suitable trust investments. The stock was a CA to T, and T's sale proceeds were \$1,700,000 in a 1989 arms' length sale to Q. For purpose of computing T's Gain or Loss Realized, T, who paid nothing for the Stock, should use as her AB :

A. Zero

B. \$700,000

C. \$700,000 plus some increase by reason of D's 1987 GT

D. \$1,000,000

E. \$1,500,000

12. Assume that in 1989 T properly purchased nondepreciable Preferred Stock (PS) for \$1,400,000 cash using part of the proceeds of the 1989 sale of Corporate Stock, and that \$1,400,000 is T's proper sec. 1012 cost basis for PS and that T's AB for PS is at all times \$1,400,000. Upon A's death in 1996 the PS has a FMV of \$1,600,000. T properly delivers the PS outright in kind to R in 1996. The amount included in A's GE with respect to the PS by reason of sec. 2033 is:

A. Zero because a GT has already been paid upon D's 1987 transfer to R.

B. The actuarial value of a person A's age at the time of A's death (disregarding the fact of A's death) multiplied by the \$1,600,000 FMV at the date of A's death.

C. \$1,600,000.

D. Zero, because although A has a sec. 2033 "interest", the sec. 2031 value includible is zero, because a Life Estate has a zero FMV on the date of death of the measuring life.

E. Zero because A has no sec. 2033 "interest"

13. The amount includible in A's GE with respect to the PS by reason of sec. 2036(a) is:

A. \$1,600,000.

B. \$1,600,000 minus the proper actuarial value of A's interest

C. \$1,400,000.

D. \$1,400,000 minus the proper actuarial value of A's interest.

E. Zero because sec. 2036(a) does not require any inclusion of anything in A's GE with respect to the PS.

14. Assume that T's proper 1996 delivery of the PS in kind to R (at a time when T's AB was \$1,400,000 and the FMV was \$1,600,000) was not a sec. 663(a) [excepted] distribution and also was not a transfer in satisfaction of a pecuniary [dollar amount] gift. Very concisely analyze R's basis for the PS immediately after he received it, supplying any additional facts which you would need to know in order to reach a conclusion.

NEW FACTS

In 1986, Donor D, age 60 years, furnished all the \$400,000 consideration for the purchase of real estate and took title as common law Joint Tenants (JT) with Right of Survivorship (and not as Tenants in Common) with himself D and his Niece N, who was age 25 years. This JT entitled each to one half the income and one half of any sale proceeds; either could bring a court action to sever and receive half of the property or half of the net forced sale proceeds; and upon death while the JT is still in effect the survivor succeeds to sole ownership by operation of law. Assume that the age difference between D and N causes the actuarial value of the JT to be 20% to D and 80% to N. Disregard the Sec. 2503 PDE and assume neither party has severed or taken any steps to undo the JT relationship.

15. Analyze the dollar amount of D's 1986 TG to N.

16. In January, 1991, D died when the FMV of the realty was \$700,000. Analyze the dollar amount included in D's GE under Sec. 2040.

17. N has decided that she wishes to disclaim the maximum amount disclaimable under local law. You are unsure whether this is zero, half, all or some other amount, so you follow local law practice of having N notify the Executor of D's estate in writing in May, 1991 (four months after D's death) that N disclaims to the maximum extent permissible under local law her interest in the realty. In order to determine the validity and effect of N's disclaimer, you bring a quiet title action under local law, which is the correct procedure to follow. All interested parties are given notice of N's lawsuit: D's Executor; the beneficiaries of D's will; D's heirs; and the persons who would be N's heirs if she were to die. The beneficiaries of D's estate vigorously contend in your lawsuit that they are entitled to 100% of the realty; D's heirs vigorously contend that they should receive one-half the realty and N should receive the other half; one of N's would-be heirs vigorously contends that he should receive 100% of the realty, and another of N's would-be heirs vigorously argues that since the state statutes are silent regarding disclaimers of JT property, N's purported disclaimer is void altogether and N remains the sole owner of the realty by operation of law survivorship.

After a lengthy trial with extensive briefs submitted by all parties, the trial court decides that (1) the legislature intended to permit disclaimer of JT interests, but merely failed to expressly designate JT in the statute, (2) N's written disclaimer is adequate in all respects, (3) the disclaimed JT property was owned one-half by the survivor before the death of the other JT, and such one-half

ownership continues after death regardless of any disclaimer, and (4) the other half, which was effectively disclaimed, passes to the disclaimant's would-be heirs. None of the parties appealed the final judgment, which therefore became binding on all parties.

The IRS auditor is attempting to assert a GT deficiency against N based upon invalidity under local law of N's disclaimer. Assume that the validity under local law of N's disclaimer is necessary as a first element of N avoiding GT under Sec. 2518. The IRS agent claims that the state trial court decision is entitled to no weight in a federal court hearing N's GT litigation, and N contends that the state trial court's final judgement on the issues there decided is binding on the government in tax litigation. Where the federal government was not a party to the state court proceeding, the best statement would be:

A. The principal U.S. Supreme Court opinion on point deals with the ET, and that opinion is therefore not relevant to a GT controversy.

B. If there was no fraud or collusion in the state court proceeding, all proper parties were present and participated, and all are fully bound by the final state trial court judgment, then the federal government is also bound in tax litigation as to issues so decided by the state trial court.

C. The state courts are more likely to be familiar with local law than are federal courts in tax litigation, and such federal courts are to accept the correctness of state court proceedings which are final and binding upon the parties where it is shown that the state court judgment proceeded from a genuinely adversary proceeding in which all proper parties had notice, appeared, and made bona fide efforts to prevail.

D. The federal court in tax litigation will decide on its own investigation what the state law is and will be bound only by the highest state appellate court in interpreting state law; all other court decisions, including those which are final and binding on the taxpayer, will receive only proper regard by the federal court in reaching its conclusions as to state law.

E. In the absence of fraud or collusion, if all proper parties are bound by a final judgment of a state trial court, then the federal courts will accept such state trial court's decisions.

18. Assume that the only issue remaining for N to achieve a valid Sec. 2518 "qualified disclaimer" of the one-half which the state court correctly held N effectively disclaimed and which passed to N's heirs is to show that N's disclaimer was made within Sec. 2518(b)(2) "...9 months after...the transfer creating the interest..." An IRS auditor contends that the 9 month period began to run in 1986 and that N's 1991 written disclaimer therefore fails to be a Sec. 2518 qualified disclaimer. Concisely explain the correct law on this point, including your rationale but without citing any authority.

NEW FACTS

Grantor G created a new irrevocable inter vivos trust in 1987, in which Trustee T is required to pay all net income to L for L's life, remainder to be distributed among the descendants of L as L may by will designate, and in the event L for any other reason fails effectively to so designate then the remainder is to be distributed outright among L's descendants per stirpes. In addition T may distribute corpus to or for the benefit of any of L's living descendants at any time and from time to time to provide for such distributee's medical needs or education as T may in

T's absolute discretion decide; no apportionment or reduction in any descendant's future share is required by reason of any distribution of corpus by T prior to L's death. T is the next door neighbor of L. Grantor G had no right to revoke, but G retained the power to eliminate any of the living descendants of L from being treated as a beneficiary at L's death or permissible designee of corpus distributions upon L's death, and to reinstate any beneficiary so deleted. In addition, G reserved the right to at any time during G's life and without cause remove T as trustee and substitute himself G as trustee. Assume that in 1987 the actuarial value of L's life estate was 70% of the aggregate value of all trust corpus. In 1987, G transferred irrevocably \$1,000,000 cash to T, which T promptly invested in income producing property. Grantor G died in 1991 when the FMV of all trust property was still \$1,000,000 and the actuarial value of L's life estate was 60%. G was survived by T, L, and several descendants of L; T never made any distributions of corpus to anyone, and G never exercised his power to eliminate any descendant of L from beneficiary status. The trust instrument grants T the discretion to select investments of his choice and to allocate trust receipts between principal (thus to be accumulated and held for ultimate distribution after L's death) or income (thus to be distributed currently to L).

19. Disregarding G's reserved power to remove the Trustee and substitute himself as Trustee, Sec. 2038(a)(1) will require the following in G's GE:

A. No inclusion because the powers which C retained are nonbeneficial to G.

B. No inclusion because G's power is not a general power of appointment.

C. No inclusion because the power to distribute is

limited by an ascertainable standard which a court of equity will enforce and which is therefore not a sufficiently extensive power to require inclusion.

D. Inclusion of only \$400,000.

E. Inclusion of \$1,000,000.

20. G's reserved power to remove the Trustee and substitute himself has the following GE consequences by reason of Sec. 2038(a)(1) (check as many as are applicable):

A. G's ability to substitute himself as Trustee will cause G to be considered to hold at the time of G's death all of the powers of the Trustee even though G never exercised his ability to substitute anyone as Trustee.

B. No inclusion by reason of the power to distribute corpus to L's descendants during L's life because that power is limited by an ascertainable standard.

C. No inclusion by reason of the investment decision making discretion, which may favor income beneficiaries over remaindermen to a considerable extent and vice versa, because this is an administrative power which does not amount to a Sec. 2038(a)(1) power.

D. No inclusion by reason of broad general powers to allocate receipts between principal and income because such powers are generally interpreted to require fair treatment of all beneficiaries and therefore does not amount to a sec. 2038(a)(1) power.

E. No inclusion by reason of any other facts.

21. In 1993 L dies survived by T and six of L's descendants. Analyze in not more than two sentences why some

amount will or will not be included in L's GE by reason of L's ability to designate which of his descendants shall take the remainder (which power L intentionally did not exercise). Cite precise authority.

NEW FACTS

22. Wife W purchased life insurance on W's life using her own funds; she named her Husband H as beneficiary. Because she owned all incidents of ownership, Sec. 2042(2) requires inclusion of the face amount (the full death benefit) in W's GE. Disregarding the ET Marital Deduction (MD) Sec. 2056(b) Nondeductible Terminable Interest (NTI) rule, in 2 sentences or less and citing precise authority, explain whether and why the death benefit is or is not a Sec. 2056(a) "...interest in property which passes...from the decedent to [her] surviving spouse..."

NEW FACTS

Wife W owned outright a 1,000 acre tract of unimproved Vacation Land (VL) which produced no income and was used by her family members for vacation purposes off and on throughout the year, such as hunting, tent camping, hiking and fishing. Sometimes family members rented a nearby independently owned motel room for sleeping and spent daytime hours at VL, which land W has owned for 40 years. W also owned a minority interest (not a controlling interest) in closely held X corporation stock which had not paid any dividends in more than 20 years. Neither W nor any of her family ever worked for the corporation.

W died in 1991, leaving a valid will which gave VL and X stock to Testamentary Trustee T, pay all net income quarterly to W's Surviving Spouse H for his life, at his death pay all net income derived between the date of the preceding income distribution up through H's date of death

to H's probate estate, and distribute all remaining trust property to R and his heirs. The Testamentary Trust also specified that H could, by delivering to H's written inter vivos designation, provided H was not judicially declared mentally incompetent at any time before his death, direct T to immediately pay any or all trust property to H outright or to any of H's living descendants, and the Trust stated that any such direction by H shall supersede the remainder gift to R.

23. Disregarding Secs. 2056(b)(2) through (b)(9), which of the following are correct elements of the NTI rule which the H trust violates (Mark as many as apply):

A. On the lapse of time or on the occurrence of an event H's interest in this trust will terminate or fail.

B. H's income interest is illusory because the VL produces no income and the X stock currently pays no dividends.

C. An interest in the Testamentary Trust passed from W to R.

D. R's interest may be enjoyed by R after H's interest fails.

24. Assume that the Trust violates the NTI rule, and that W's Executor E wishes to qualify the trust for the MD by the LE/GPOA exception to the NTI rule. Which of the following are correct statements (Mark as many as apply):

A. Assuming H has the power under local law to compel T to sell unproductive and underproductive assets and invest in assets which produce an appropriate periodic flow of income, H's income interest satisfies the LE portion of the LE/GPOA exception provided H promptly demands that T do so.

B. Same as A except whether or not H at any time in fact makes any demand upon T to sell and reinvest.

C. H's right to direct T to deliver trust corpus immediately to H or his descendants meets the GPOA requirement of the LE/GPOA exception.

D. Same as C except H's right does not meet the GPOA requirement by reason of the fact that H may appoint not only to himself but also to his descendants.

25. Assume that the trust violates the NTI rule and that W's Executor E wishes to elect QTIP treatment for the entire testamentary Trust. Analyze whether H has a Sec. 2056(b)(7) Qualifying Income Interest QII in the entire trust, assuming that all trust assets at all times produce sufficient current income to satisfy that aspect of the QII requirements.